The enforcement dilemma of EU fiscal rules
Why the EU never enforced sanctions under the Stability and Growth Pact

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Abstract: Effective enforcement is an essential element of any fiscal rule. The EU's Stability and Growth Pact has been struggling with this truism since inception. We show that its effectiveness goes beyond the threat of fines. The notion that deficit-prone member states adopt a more virtuous fiscal behaviour to avert sanctions is overshadowed by the realisation that in the event of a major shock virtuous countries will come to their rescue as the survival of the entire system is at stake. Unless the underlying issues are addressed, the effectiveness of any EU fiscal rule remains limited.

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1. Introduction

The effectiveness of fiscal rules crucially hinges on their enforceability. This notion looms large in the relevant literature starting with the seminal work by Kopits and Symansky (1998) who characterised the stylised profile of an 'ideal' fiscal rule. It also applies to the Stability and Growth Pact (SGP), a coordination devise of the European Union (EU) aimed to ensure the smooth functioning of the Economic and Monetary Union (EMU). In this paper we highlight and expound on the sharp dichotomy between the evident and declared need of enforceable fiscal rules in the EMU on the one hand and the apparent difficulty with enforcing those rules on the other. We draw on basic elements of game theory to show that while enforcement may have been a credible proposition when the EU's fiscal framework was designed and launched in the 1990s, formal instruments turned into implausible threats later on.

By enforcement we mean adequate leverage at the EU level, such as the threat of financial sanctions, that would effectively generate enough pressure on member states to implement the fiscal adjustment prescribed by the EU's fiscal framework. Hence, enforcement is different from compliance. Generally speaking, credible enforcement instruments will induce compliance. However, in any given year (non)-compliance may depend on a number of factors that are outside the control of national governments such as the economic cycle or other circumstances that affect the fiscal performance vis-a-vis given benchmarks or rules. They can be and are taken into account when considering procedural steps in the application of EU fiscal rules. There is a growing literature both in political science and economics looking into the determinants of compliance (see for instance Hansen, 2015, Reuter, 2019) where the focus is generally on numerical as opposed to legal adherence to the rules. The difference is crucial because under EU fiscal rules EU institutions enjoy a large degree of discretion in deciding whether a country's fiscal performance is in line with the legal requirements or not (see Larch et al. 2023). Concretely, a country may deviate from the main numerical constraints set out in the rules but still be found legally compliant.[1] More generally, the credibility of enforcement instruments depends on a number of elements – economic and political - which, as we will argue, go well beyond the letter and spirit of the EU fiscal rules.

When the blueprint of the EMU was designed at the end of the 1980s, its architects clearly understood that the combination of centralised monetary and decentralised fiscal policy making would only work smoothly if public finances of member states remained on a sustainable path. Building on this insight, the EU agreed on common fiscal rules in 1997. The rules define limits to the discretion of national budgetary authorities with the possibility to impose financial sanctions if a member state repeatedly flouts the recommendations of the Council of the European Union (henceforth Council)[2].

Looking back, the track record of the EU's fiscal framework has been mixed for a variety of apparent reasons (European Fiscal Board, 2019 and Larch et al. 2023). As a result, a number of important member states accumulated growing levels of government debt making them vulnerable to sudden shifts in financial market expectations. Despite the mixed track record of its fiscal rules, the EU never managed to deploy the financial sanctions set out in the SGP. On the contrary, once very large shocks exposed the vulnerabilities of deficit-prone countries, the EU agreed new instrument to rescue sovereigns that risked losing access to market financing at sustainable rates.

A first attempt to enforce the SGP was made in autumn 2003 after France and Germany had not complied with earlier Council recommendations under the SGP. Following the provisions of the SGP, the European Commission recommended taking the next step in the excessive

[1] For instance, after the global financial and economic crisis France stayed in the excessive deficit procedure for almost 10 years, well beyond the initial deadline for the correction of the fiscal imbalance, although it rarely complied with the quantitative recommendations of of the Council of the European Union. The latter agreed to successive extensions of the deadline and never escalated the procedures towards possible sanctions.

[2] The Council brings together all EU Member States and is the ultimate decision-making body under the Stability and Growth Pact. It takes decisions based on proposals from the European Commission. See Larch and Jonung (2014) for a succinct presentation of the SGP.

deficit procedure (EDP), the one preceding the imposition of sanctions. The attempt failed as the two large member states, with the help of a third (Italy), blocked the Commission's initiative in the Council. Since then, the EU fiscal framework has undergone three major legislative reforms, each time with the intent of improving enforcement, e.g., by an extension of its arsenal of financial sanctions in 2011 with the so-called six-pack reform.[3] None of the new enforcement instruments have been deployed.

In early 2024, the EU agreed a fourth legislative reform where the objective of strengthening enforcement features prominently once again. The official narrative underpinning the reform proposal underscores stronger enforcement via a more consistent recourse to financial sanctions as the necessary counterweight to more flexible and country-specific fiscal adjustment requirements.[4] However, the recognition of enforcement as a crucial element of any effective fiscal rule is not backed by any new procedural or institutional arrangements. It relies (i) on the expectation that a more direct involvement of members states in defining their own fiscal adjustment paths would enhance compliance with the rules, and (ii) a promise on the part of the Commission to finally take off its gloves and to recommend consistently the imposition of sanctions under the EU fiscal rules.

We argue that all valiant attempts to strengthen the SGP's enforcement will not bear fruit unless a number of politically charged but fundamental issues are addressed. In particular, the EU needs to find credible ways to (i) consistently impose meaningful sanctions in the event of non-compliance; (ii) link financial support in the wake of major shocks to a meaningful degree of macro-conditionality; and (iii) strengthen the resilience of member states to major economic shocks.

[3] Until 2011, sanctions under SGP were designed to be applied at the end of the excessive deficit procedure, a process set out in the EU Treaty aimed to correct gross policy errors. The six-pack reform of 2011 introduced a whole sequence of financial disincentives that were meant to be deployed in an escalating manner ahead of the ultimate, Treaty-based sanction (see Regulation (EU) No 1173/2011).
[4] Commission welcomes political agreement on a new EGR (europa.eu)

The underlying problem - corroborated by the history of the EMU - is that countries with a time-tested preference for looser fiscal policy know that in the event of non-compliance there has always been a blocking minority preventing the imposition of sanctions. They also understand that in the event of a very large negative shock their own fiscal vulnerability can produce collateral damage for the fiscally prudent countries. Hence, when standing on the brink of a much bigger adversity, the prudent countries will accept to pay for the survival of the EMU even if ex-ante they formally committed not to do so. In hindsight, the EU fiscal framework may therefore look like a bad deal for the group of countries that overall decided to honour the original agreement by running responsible fiscal policies. However, in the 1990 when the foundations of the Economic and Monetary Union were built a majority of member states was of the view that the agreed governance framework would work.

2. A brief flashback

The dilemma of SGP enforcement has deep roots. It originates in the diverging motivations of the 12 Member States who in the early 1990s decided to progress towards an EMU by establishing a single currency. Abstracting from the official declarations issued at the time, southern countries with a propensity to run government deficits supported the introduction of the single currency area because, weary of trailing the low inflation policy of the Bundesbank within the European Exchange Rate Mechanism (EMS), they wanted to have a say in the prospective joint institution to be tasked with monetary policy making. In contrast, the Deutschmark block, who had enjoyed relative macroeconomic stability for some time already, wanted to extend their model to the EU as a whole. In essence, two fairly distinct groups of countries sought to export their respective approach of macroeconomic policy making to the other (see for instance Lucarelli, 2013 or Buti and Larch, 2019).

At first sight, the governance framework emerging from this collision of diverging motivations seemed to tick all 'German boxes'. The Maastricht Treaty, which formalised the roadmap towards the adoption of a single currency, defined a strict mandate for the European Central Bank (ECB) with a clear and sole focus on inflation, outlined a procedure for correcting excessive government deficits in the member states, including sanctions for non-effective action, and banned any form of monetary financing or bail-outs of governments. In addition, to assuage remaining concerns, the then German Finance Minister Theo Waigel convinced his peers and EU leaders to adopt the SGP, supplementary legislative provisions aimed to ensure budgetary discipline beyond the broad perimeters set out in the Treaty articles 121 and 126.

For completeness, it is worth noting that the Maastricht Treaty and later the SGP also embodied the views and concerns of experts. In 1989, following a mandate by the European Council, the European Commission issued a report examining and proposing concrete steps towards the establishment of the EMU. The report reflected the work of a dedicated committee chaired by then Commission President Jacques Delors and consisted of the Governors of the European Economic Community Member States' central banks and some other members, in particular Alexandre Lamfalussy, then General Manager of the Bank for International Settlements in Basel and later the first President of the European Monetary Institute (EMI), the precursor of the ECB. In a paper drafted at the early stages of the committee's work, Lamfalussy underscored a point that would feature prominently in the final report and later on in the Maastricht Treaty. Acknowledging "*widely diverging 'propensities to run deficits' prevailing in the various European countries*" he anticipated the need for arrangements constraining fiscal policy lest the EMU encountered political tensions and/or pressure on the ECB to relax monetary policy.[5]

[5] The need for co-ordination of fiscal policies in a European Economic and Monetary Union (europa.eu).

Prominent observers expressed reservations about the stability of the EMU early on (e.g. Eichengreen, 1991 and Feldstein, 1997). To them it was clear that the introduction of the euro and, with it common fiscal rules, were less motivated by economic but rather political arguments. At the same time, while many concurred that the then 12 member states of the EU did not form an optimal currency area there was also the expectation that a single currency may eventually help participating economies become optimal (Frankel and Rosen, 1998). Moreover, with the loss of national monetary policy, euro area countries was expected to strengthen market-based adjustment mechanisms in order to cope with adverse shocks (Bean, 1998).

The compromise that made the Maastricht Treaty first and the SGP after acceptable to the other group of countries may have been less conspicuous but turned out to be crucial for how the fiscal framework worked. Most importantly, the SGP largely relies on Council recommendations, a legal instrument that does not produce obligations on the part of member states. Linked to this, the Treaty also excludes recourse to the main enforcement instrument under EU law - the infringement procedure - for the largest part of the excessive deficit procedure.[6] Finally, all material deliberations under the SGP are taken by the member states in the Council with a qualified majority. Hence, the actual implementation of the rules depends on how the risks of non-compliance are distributed across the decision-making body or, to be more concrete, whether deficit-prone countries manage to form a blocking minority in the Council or not.

These legal and procedural arrangements clash with the conclusions of the Delors committee and underscore the political nature of the compromise underpinning the SGP. The group of central bank governors led by Jacques Delors unambiguously envisaged binding and

[6] See Article 126(10) of the Treaty.

enforceable decisions. Cognisant of the diverging propensities to run deficits, the committee explicitly refers to the European Commission or "*another appropriately delegated authority*" that "*would be responsible for taking effective action to ensure compliance*".[7]

What the Delors committee and other observers at the time did not anticipate were the systemic risks of the type that would afflict the EMU during the global financial crisis and after. The Treaty-based commitment to non-monetary financing and the no-bail-out clause were meant as a dissuasive device. Furthermore, the SGP can be and has been interpreted as an additional insurance mechanism to mitigate the risk of monetising debt of a single country or of a bail-out, a risk that at inception was considered to be remote (Wyplosz, 1997). However, as some member states did not compensate the loss of monetary policy with more active structural policies and once systemic risks materialised, the commitment devices established ex ante lost their credibility because, if strictly implemented, would have implied the demise of the EMU as a whole. In other words, the advent of systemic risks completely changed 'the game' around the enforceability of the EU fiscal rules. Following Fearon (1998) and (Franchino and Mariotto (2021), parts of the final deal – notably the way decisions are taken in the Council – most likely ensued from 'harder negotiations' on the part of those who anticipated a greater risk of non-compliance. However, exogenous factors that had not been anticipated at the time of the negotiations or excessive optimism about the capacity of member states to adapt to the constraints of a single currency area, eventually invalidated initial expectation of enforceability.

3. The dilemma of SGP enforcement dissected

This section illustrates the fundamental change in the enforceability of EU fiscal rules. We first start with a simple game-theoretical model highlighting the current dilemma and then pinpoint

[7] Section II.4 and III.5 of the Delors report.

the main elements that made the original design of the EU fiscal framework look like an effective system.

If one accepts the narrative outlined in the previous section, the lack of enforcement of EU fiscal rules should be less of a surprise than many stakeholders and commentators are ready to admit. The current dilemma of SGP enforcement is best illustrated by a simple stylised model. For that purpose, let us think of the EU as consisting of two groups of member states: Group D tends to run deficits and accumulates growing levels of debt, while Group S runs sustainable fiscal policies. The exact composition of these two groups may change over time as individual countries can and have switched side, but each group usually safeguards a blocking minority in the Council, the EU institution were the ultimate power regarding the implementation of the EU fiscal rules resides.[8]

Although a simplification, dividing EU member states in the Council into two groups is less arbitrary than one may think at first. As mentioned in the previous section, the architects of the EMU drew up their blueprint on the already then prevailing understanding that different member states had different propensities to run deficits. These differences did not disappear with the implementation of the EU fiscal framework since 1998. In a comprehensive assessment of the EU fiscal framework, the European Fiscal Board (2019) showed how one fairly stable and large group of member states managed to use government debt more or less symmetrically over the cycle, while another group accumulated growing levels of debt. Using a more sophisticated inferential method, Koehler und König (2015) reach similar conclusions as regards debt developments. They identify the first group of countries as ‘donors’ and the

[8] Germany is probably the most prominent case of changing sides. The most vocal supporter of EU fiscal rules ahead of their introduction, in 2003 the country teamed up with France and Italy in the Council to avert the risk of sanctions under the EU’ Stability and Growth Pact. Later on, since the onset of the global financial crisis, Germany has again become a fervent supporter of prudent fiscal policy making and a supporter of an effective implementation of EU fiscal rules.

second group as 'recipients' depending on whether they mostly contribute to or benefit from EU structural funds.

Against this backdrop, the implementation of the SGP can be characterised as taking place in three stages:

- In stage (1), which can encompass several annual budget cycles, Group D decides about the budget deficit, which can either be *nd* or *d*. The choice *nd* leads to a fiscal position that is considered sustainable under all economic circumstances. Based on experience, Group D has an incentive to run deficits. To model this, we assume that the governments of Group D enjoy an immediate payoff y from choosing *d*, with $y > 0$. Hence, y measures the temptation to consistently run deficits, which over time turn out to be unsustainable.

  If Group D choses *d*, the Council has the possibility to impose a fine. We do not explicitly model this choice. Rather, we use the variable $f \in [0,1)$ to denote the fine expressed as a share of GDP. If $f = 0$, either the Commission does not propose a sanction to the Council or Group D, as indicated above, keeps a blocking minority in the Council, while if $f > 0$, the Council decides to impose a fine. The absolute amount of the fine is given by fY_D, with Y_D denoting the GDP of Group D (see below).

- In stage (2), a negative shock hits.[9] We consider two stylised types of shocks: (i) a normal shock, which leads to a recession; and (ii) a major shock, which on top of a recession leads to a reassessment of sovereign risks by financial markets. If Group D has chosen *nd* in stage (1), it will weather the impact of both shocks on its own. There are no negative externalities to Group S, and even in case of a major shock there is no

[9] In our model the shock hits with certainty and is foreseen. In reality, shocks occur only with certain probabilities. As long as these probabilities are known to the players and taken into account appropriately, our model takes random shocks implicitly into account when one interprets Y_D and Y_S as expected GDPs, f as expected fine, etc. Hence, none of our conclusions depend on the simplifying assumption that the shock is not random.

danger of EMU meltdown. In that case, Y_D and Y_S are the GDP of Group D and Group S respectively.

However, if Group D has chosen *d* in stage (1), it is in trouble. It can ask for financial help (action *h*), for instance because it has no fiscal space to lean against the wind or refrain from asking for help (action *nh*). In case Group S does not help, the negative impact of the crisis amounts to x_D ε $(0,1)$ for Group D and x_S ε $(0,1)$ for Group S expressed as a share of their respective GDPs.[10] Hence, without help the GDP of Group S is given by $(1\text{-}x_S)Y_S$, while Group D's GDP is $(1\text{-}x_D)Y_D$. Obviously, the repercussions of a major negative shock are much more severe than those of a normal shock. The reassessment of sovereign risks by financial markets makes the fiscal position of Group D unsustainable and contagion threatens the stability of the EMU as a whole. A priori, the severity of this threat should depend on the size of the Group D countries running unsustainable deficits, that is, spill-over effects to the rest of the currency area should be less important if they originate in a small as opposed to a 'too-big-to-fail' economy. However, developments ensuing from the onset of the sovereign debt crisis in Greece at the end of 2009 suggest that issues in fairly small countries can trigger much wider disruptions with serious repercussions for the monetary union as a whole.

- Stage (3) models the choice of Group S. Specifically, if Group D goes for *d* in stage (1), and if it asks for help in stage (2), Group S faces two options. It can either agree to help Group D (action *t*) or not (action *nt*). If a transfer *t* is granted, the impact of a normal shock on Group D is milder. In the event of a major shock[11], EMU meltdown is

[10] We model crisis costs x_S and x_D, the fine *f*, and the costs of the conditions to help *c* (see below) as shares of the GDPs Y_D and Y_S. The other variables (*y* and *t*) are modelled in absolute terms. Since Y_D and Y_S are fixed, modelling these variables in relative or absolute terms is just a matter of notation that has no impact on our results.

[11] In reality the size of the necessary transfer depends on the size of the shock. To keep our notation simple, we abstract from this. None of our results would change qualitatively if we made the size of the transfer dependent

avoided. Group S bears the costs of the transfer t but it attaches certain conditions, which produce social and political costs for Group D. For simplicity we model these costs as a share c of Group D's GDP, with $c \in (0,1)$.[12] [13]

The extensive form of the game is depicted in Figure 1. In the event of a major negative shock, the EMU might collapse for two reasons: either because Group S refuses to step in or because Group D does not ask for help. It is plausible to assume that the collapse of the EMU, and with it the possible disintegration of the single market, is the worst outcome for Group S. This implies that $Y_S - t + fY_D > (1-x_S)Y_S + fY_D$, a condition that boils down to $t < x_S Y_S$. Its interpretation is straightforward: If the transfer necessary to prevent the collapse of the EMU is lower than the damage caused by the collapse, the collapse is the worst possible outcome for Group S.

The payoffs in our model should be understood as the payoffs of the decision makers within the different countries (or groups of countries). For instance, x_S - the assumed impact of a shock on Group S - can also encompass the costs of political repercussions at the EU level.[14] While one could plausibly argue that in the long run the populations of all countries would benefit economically from prudent budgetary policies, this is not necessarily true for the payoffs of the politicians deciding about the budgets. Typically, politicians' time horizons are comparatively short, determined by the electoral cycle. At the same time, countries can differ substantially by the extent long-term budgetary considerations or political costs related to cross-border

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on the size of the shock, provided the size of the necessary transfer and of the damage of not providing it fulfill the assumptions explained below.

[12] The harshness of the conditions - the size of c - depends in general on the size of the transfer, which in turn depends on the size of the shock. To keep our notation simple, we abstract from this. None of our results would change qualitatively if we took this relation between the size of the shock and the harshness of the conditions into account, provided the size of the necessary transfer and of the damage of not providing it fulfill the assumptions explained below.

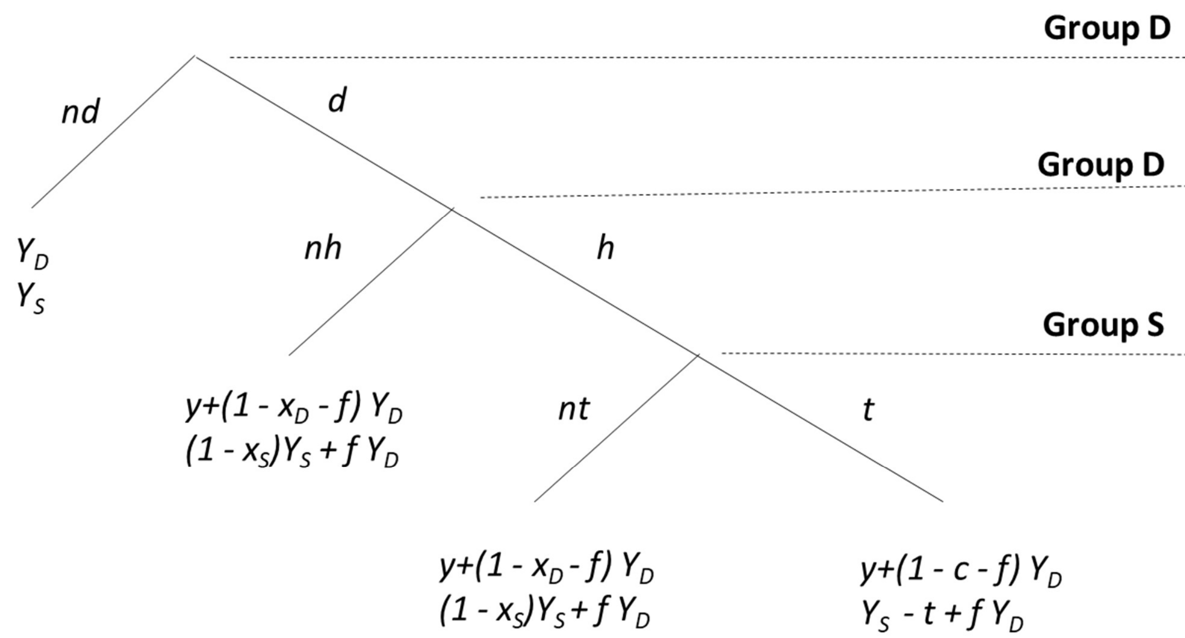
[13] In principle, one could introduce a final stage (4) where Group D has the possibility to reject any help proposed in stage (3). The resulting equilibrium outcomes of this extended game would not differ from those of the simpler 3-stage game depicted here, and hence we refrain from this extension of the model.

[14] Similarly, x_S could include a measure of the degree of solidarity among Group S. In that case, a very low or negative degree of solidarity could reduce the perceived costs x_S which in turn translate into lower transfers t.

considerations in the EMU impact the voting behaviour.[15] Hence, the parameter y – the assumed benefit of Group D of running a deficit – can also be interpreted as measuring the extent to which future budgetary problems are disregarded by the voters, and in turn, decision makers in Group D. In the extreme case y=0, when policy makers in Group D take the future fully into account, the enforcement dilemma disappears in our model.

[15] For instance, Negri et al. (2021) suggest that supra national institutions - including the EMU - produce feedback effects on the sense of belonging to a polity which, in turn, could influence the payoff in our model.

Figure 1: Extensive form of a stylised model of SGP implementation



What happens in the event of a major negative shock, i.e. when the existence of the EMU is under threat? Disregarding non-generic parameter constellations, the answer is given by the following proposition:

Proposition 1 (Major shock): In case of a shock threatening the existence of the EMU, i.e. if $t < x_S Y_S$, the subgame perfect equilibrium is given by:

i) If $y > (c+f)Y_D$ and if $c < x_D$, the D-group chooses *d* in stage (1) and *h* in stage (2). The S-Group chooses *t* in stage (3).

ii) If $y > (c+f)Y_D$ and if $c > x_D$, the D-group chooses *d* in stage (1) and *nh* in stage (2). The S-Group chooses *t* in stage (3).

iii) If $y < (c+f)Y_D$ and if $c > x_D$, the D-group chooses *nd* in stage (1). It would choose *nh* in stage (2) if reached, and the S-Group would choose *t* in stage (3) reached.

iv) If $y < (c+f)Y_D$ and if $c < x_D$, the D-group chooses *nd* in stage (1). It would choose *h* in stage (2) if reached, and the S-Group would choose *t* in stage (3) if reached.

To proof the proposition, we use backward induction. Since by definition a major shock threatens the very existence of the system, and since its meltdown is the worst outcome for Group S, it will choose *t* in stage (3). If Group D goes for *d* in stage (1), it will ask for help in stage (2), i.e., it will choose *h*, if and only if $y+(1-c-f)Y_D > y+(1-x_D-f)Y_D$. This condition boils down to $c < x_D$. It shows that Group S has an incentive not to make the transfer conditions too harsh, because otherwise Group D will refuse any help and the whole system collapses. To put it differently: There is an upper bound on *c*, the harshness of the conditions Group S can attach to the transfer *t*.[16] Hence, it is reasonable to assume that $c < x_D$. [17] This implies that cases ii) and iii) of the proposition can be disregarded.

In stage (1), Group D will choose a deficit *nd* if $Y_D > y+(1-c-f)Y_D$, which boils down to $y < (c+f)Y_D$. Whether this condition is fulfilled also depends on the SGP fine *f*. Experience shows that Group D is likely to form a blocking minority in the Council (i.e., $f = 0$), implying that the condition for choosing *nd* reduces to $y < cY_D$.[18] But even if $f > 0$, there is always a high enough *y* such that the condition $y < (c+f)Y_D$ is not fulfilled. As indicated above, there is an upper bound on *c* beyond which Group D will refuse to accept financial support because conditionality attached to financial help is considered too harsh. Hence, when the short-term temptation *y* is large enough, the fiscal framework cannot prevent Group D from running a

[16] In this context, the other crucial variable is x_D, the impact of the negative shock on Group D in case it chooses *d* in stage (1) and receives no help. These costs could depend on whether powers outside the EU are willing to help Group D possibly with the intent of weakening the EU. Such external help could decrease x_D, which in turn would lower the highest possible *c*, i.e., the conditionality attached to the transfer from Group S. For instance, during the financial crisis, several Greek politicians mentioned the possibility to ask Russia for help.

[17] This conclusion is supported by Spain's decision not to agree to a full macroeconomic adjustment programme in the wake of the euro area sovereign debt crisis in 2011. Instead, the Spanish government negotiated a more targeted and circumscribed programme with policy conditions limited to the financial sector.

[18] The link between fiscal rules enforcement and policy conditions attached to financial support in the event of macro-financial difficulties is corroborated by recent developments: Italy says it can't approve ESM treaty without deal on new EU budget rules | Reuters

deficit d, since it knows it will be bailed out in case of a major negative shock. Furthermore, for a given y the condition is less likely to be fulfilled if Group D has a blocking minority in the Council, i.e., when $f = 0$. Therefore, case i) of the proposition above, i.e. extensive deficit of the D-group followed by a bail-out of the S-group, is the most plausible outcome when a major shock occurs.

These results are not surprising and reproduce nicely the main outcomes of SGP implementation since 1997. They highlight the impact of both the political economy in the Council and of systemic risks on the credibility of financial sanctions for flouting EU fiscal rules. They also raise the question of whether the SGP was not bound to fail from the start. As indicated at the end of the previous section, the group of experts who prepared the blueprint of the EMU - the Delors committee - had in mind normal shocks and limited cross-border spill overs from national fiscal policies. It did not anticipate the type and the magnitude of shocks, which actually hit the euro area and the EU from the global financial crisis onwards. The Delors committee also envisaged a completely different implementation of the excessive deficit procedure, namely one that would circumvent the political economy in the Council and rely on "*binding*" and "*enforceable*" instruments.

Within our framework, the scenario of the Delors committee can be modelled as follows. First, the Delors scenario envisaged shocks that do not threaten the very existence of the EMU. Hence, not offering help would not lead to the worst possible outcome for Group S. In terms of our model, this means that the payoffs are such that $Y_S-t+fY_D < (1-x_S)Y_S+fY_D$, which boils down to $t > x_S Y_S$. Furthermore, in the Delors scenario Group D cannot block fines, i.e., $f > 0$. For this scenario the subgame perfect equilibrium is given by:

Proposition 2 (Delors Scenario): If the shock does not threaten the existence of the EMU, i.e. if $t > x_S Y_S$, and if the D-group has no blocking minority in the council, the subgame perfect equilibrium is given by:

i) If $y > (c+f)Y_D$, the D-group chooses *d* in stage (1) and *nh* in stage (2). The S-Group chooses *nt* in stage (3).

ii) If $y < (c+f)Y_D$, the D-group chooses *nd* in stage (1). It would choose *nh* in stage (2) if it were reached, and the S-Group would choose *nt* in stage (3) it it was reached.

Proofing this proposition by backward induction, we see first that Group S can credibly commit to choose action *nt*, since in the event of a normal shock it has no incentive to provide a transfer. Therefore, Group D has no incentive to ask for help in stage (2), i.e., it will choose *nh*, and the no-bail-out clause is implemented.[19] In stage (1), Group D will refrain from running a deficit if $Y_D > y+(1- x_D -f)Y_D$, which boils down to $y < (x_D+f)Y_D$ with $f > 0$. Comparing this condition with the one derived for the case of a major negative shock with Group D blocking fines in the Council (i.e., $f = 0$), one sees that the condition to prevent deficits *d* is more likely to be fulfilled in the Delors scenario. The reasons for this are twofold. On the one hand, the fine would be imposed. On the other hand, Group D does not get help from Group S and must cover the costs of its deficits in the event of a negative shock, measured by x_D, alone. Hence, Group D's propensity towards deficits *d* can effectively be curbed by a sufficiently high sanction.

In hindsight, the Delors scenario looks excessively optimistic and ambitious. The optimism relates to the actual size of economic shocks and the resilience of our economies. It can be

[19] To be more precise, the game exhibits two subgame perfect equilibria in pure strategies for $t > x_S Y_S$: The one explained in Proposition 2 where Group D does not ask for help in stage (2), and another one where it does ask for help. Since Group S will not transfer resources when asked for help, both equilibria lead to the same outcomes for both players. For simplicity, we only describe the equilibrium where Group D does not ask for help.

explained by the fact that at the end of the 1980s the EU had gone through a fairly long period of relative stability and was putting in place a system of macroeconomic governance that later on would be associated with the great moderation: independent monetary policy with a clear focus on price stability combined with the insight that discretionary fiscal policy should be restrained (see e.g. Cabanillas and Ruescher, 2008).

The ambition relates to the enforcement of fiscal rules at the EU level, in particular the assumption that the Council would be impervious to the actual distribution of interests across member states and/or the Commission would effectively play the Guardian of the Treaty. The members of the Delors committee were all seasoned decision-makers with plenty of direct policy experience. Most likely, the ambition sprang from a programmatic eagerness to inspire politicians to temporarily exchange short-term considerations for the bigger long-term picture.

In any case, our simple model leads to the conclusion that unless the distribution of deficit-prone countries changes in the Council, an unlikely prospect in the short run, the only consideration that prevents them from deviating from the EU fiscal rules is the prospect of conditionality to access support instruments the EU deploys in the wake of major economic shocks. In particular, the conditionality needs to be sufficiently strong (or the benefit of Group D of running a deficit sufficiently low). However, there is an upper bound on the harshness of the policy conditions attached to a transfer, since too harsh conditions would prevent Group D from asking for help when needed.

An interesting corollary of this is that such an upper bound might even be decreased by the possible intent of an external powers to weaken the EU, disguised as a promise to help Group D.[20] Furthermore, the effectiveness of conditionality in preventing deficits *d* depends crucially

[20] Remember the rumours that at some point in the financial assistant programme for Greece the government signalled its willingness to discuss alternative help from Russia (see for instance Tsipras to meet Putin over bailout loan as fears of Greek exit from EU mount | Eurozone crisis | The Guardian)

on whether governments are sufficiently forward-looking or long-lived. Very myopic governments, who attach a large enough weight to the short-term benefits of a fiscal deficit *y* or do not expect to be around when access to EU support programs is decided, will obviously not be deterred by the prospect of conditionality.[21]

4. Policy implications

The stylised model of SGP enforcement outlined in the previous section gives rise to a number of important policy implications. Starting with the most obvious but still important one, enforcement of the EU fiscal rules crucially depends on the decision making in the Council. As long as the implementation of the SGP does not find the necessary majority among EU member states, which in turn depends on the number of countries with a propensity to run excessive deficits, sanctions will produce limited effects.

However, the European Commission can also play an important role. It prepares all the assessments under the excessive deficit procedure of the SGP and determines whether to confront the Council with the successive decisions that eventually lead to the ultimate question of imposing sanctions or not. Past experience on this front is mixed. As indicated in the introduction, the first attempt was made 2003 when Germany and France had not taken effective action to correct their excessive deficit. The Commission referred the case to the European Court of Justice (ECJ), but the ruling only clarified some procedural subtleties.

In the subsequent years, the Commission chose to become a more political actor anticipating the positions/majorities in the Council (see for instance van der Veer, 2021). Prominent examples are Jean-Claude Juncker's famous quote of 2016 "*because it is France*" or Pierre

[21] One could also consider a model where Group D and S interact more than once, i.e., play the game repeatedly. As long as the number of repetitions is finite, none of the results would change, since the stage game has a unique equilibrium outcome. If Groups D and S are very patient and interact infinitely often, the folk theorem would apply: "nearly anything" would be a subgame perfect outcome and the model would no longer make clear-cut predictions. Even more important, it is unplausible to assume that governments are very patient and have infinite time horizons. Hence, we do not analyse such an infinitely repeated game.

Moscovici's comments in the same year after effectively waving sanctions for Spain and Portugal.[22] In the wake of the Covid pandemic, the Commission proposed the activation of the severe economic downturn clause of the SGP. Although the clause does not suspend the SGP - a point repeatedly stressed in official Commission documents - and while many member states continued running excessive deficits after their economies had recovered from the pandemic, the Commission decided not to suggest the opening of EDPs.[23]

With growing economic and political integration in the EU, and in the wake of major crises, it is inevitable and even welcome for the Commission to turn into a genuine and more political EU executive. However, as pointed out by Dermine and Larch (2023), this evolution comes with important costs. Because of the Commission's "mélange des genres" the EU is effectively left without a crucial element of transparency and advocacy: if the Guardian of the Treaties does not launch the steps necessary to ensure an effective enforcement, the rules-based nature of EU fiscal rules is at risk; the ECJ does not even get the chance to deliberate whether due process has been followed or not.

One way of addressing the issue of transparency and advocacy is to involve independent assessors such as national fiscal councils or the European Fiscal Board. Their views are not binding but aim to enhance accountability of the decision makers: they help the public to understand whether due process has been followed and, by extension, make a more informed decision when electing a new parliament (Debrun et al. 2008; Beetsma and Debrun, 2016).

Another way is to limit the discretion in the decision on sanctions. Macro-conditionality under the EU's cohesion policies is a good example. On top of the financial sanctions under the SGP,

[22] EU gives budget leeway to France 'because it is France' - Juncker | Reuters and The European Commission is political — it has no other choice | Financial Times (ft.com)

[23] The decision was motivated by high economic uncertainty. This uncertainty was not foreseen by the SGP, but, according to the Commission, excluded a meaningful formulation of an adjustment path. At the same time, the Commission launched an EDP for Romania in spring 2020 and continued to apply it thereafter because the excessive deficit pre-dated the pandemic (see European Fiscal Board, 2022).

at the end of the 1990s the EU introduced conditionality arrangements making access to EU funds conditional upon compliance with the excessive deficit procedure of the SGP.

These arrangements have been strengthened over time. At first, the Commission enjoyed discretion in deciding whether to propose the suspension of EU funds in the event of non-effective action by of a member state in EDP. Since 2007 this discretion is gone. Initially, the macro-conditionality was limited to the cohesion fund, with limited eligibility across EU member states, but was later expanded to include most EU structural funds. Finally, the role of the European Parliament has been clarified over the years. Until 2020, the Commission had to consult the Parliament, which in 2016, when Spain and Portugal had been found not to have taken effective action, led to an impasse as the Parliament dragged its feet in offering an opinion. With the latest financial framework covering the period 2021-2027, the Commission still needs to inform the Parliament, but also needs to carry the suspension procedure forward. While the ultimate responsibility of adopting the suspension lies with the Council, the strengthened process leaves little wiggle room to the Commission and forces the Council to take responsibility in a transparent manner. The strengthened provisions have not been tested yet, because they entered into force in 2021 after the de-facto suspension of the SGP. However, it stands to reason that the process underpinning this particular enforcement instrument will be launched more often.

An equally substantive implication of our small model goes beyond the SGP. The question of how to enforce EU fiscal rules depends crucially on whether major shocks can threaten the integrity of the EMU. As a result, the effectiveness of fiscal rules hinges on the policy makers' capacity to mitigate the impact of major shocks. While major shocks cannot be completely prevented, especially exogenous ones such as the Covid pandemic, there are ways to make economies more resilient, which in turn reduces the risk of a meltdown.

The global financial crisis highlighted the faithful interlinkages between banks and sovereigns where fragilities in one sector produced harmful spillovers to the others, threatening the stability of the macroeconomy as a whole and possibly that of other countries entertaining financial and trade links. Since then, the role and scope of financial supervision have been carefully examined and reviewed. In the EU, a Single Supervisory Mechanism (SSM) entered into force in 2014 with the mandate to directly supervise more than 100 banks across the EU, representing more than 80% of the banking assets of all member states. Fahri and Tirole (2018) clarify the economic rationale for delegating financial supervision to a supranational entity. They show that national or domestic supervision produces important externalities that can be internalised by delegating supervision to the supranational level.

However, Fahri and Tirole (2018) also show that the stability of the union can only be safeguarded if it agrees on a dedicated cross-border transfer mechanism for banks, ensuring the level of depositor confidence in a bank does not depend on the bank's location. Although discussions to establish such transfer commitments were launched at the EU level already in 2015, taking the form of a European Deposit Insurance Scheme (EDIS), progress has been very slow. Countries with a more stable banking sector and lower government debt are very hesitant to agree to an EDIS, because based on past experience they do not consider shocks or vulnerabilities to shocks to be random. They insist vulnerable countries should first reduce their vulnerabilities before new transfers are promised. Evidently, this attitude suffers from the same fallacy as the enforcement of SGP rules.

The sovereign-banks' nexus also involves eminent regulatory issues. First and foremost, under current rules sovereign debt is considered risk free. In practice this means that banks are not required to set aside capital to protect themselves from potential losses making them less costly than other assets held by banks. While banks may want to hold sovereign bonds for other reasons too - they are highly liquid and eligible collateral in operations with the central bank -

the zero-risk weight is one important reason why in Europe domestic banks hold between 20 and 30% of their sovereign's stock of debt. This concentration is a crucial factor in the sovereign-banks doom loop and should be addressed by either requiring non-zero risk weights on banks' sovereign debt holdings and/or imposing exposure limits on holdings of debt of individual sovereigns. Although the solution seems easy, the political economy is not. For some countries, especially those with a high government debt ratio and a stronger home bias of domestic banks, the regulatory change comes with higher costs for their sovereigns especially if other jurisdictions outside the EU do not implement the same regulatory change.[24] Several Commission proposals to tackle the zero-risk weight and the lack of exposure limits have not gone far in the Council.

Even if EU economies became more resilient, very large shocks threatening the stability of a given country with possible spill-over effects on others cannot be fully excluded. That is why several commentators have touched upon the role of orderly sovereign debt restructuring; prominent examples are Fuest et al. (2016) and Bénassy-Quéré et al. (2018). In the logic of our model an orderly restructuring can be interpreted as reducing the costs incurred by Group D and S in the event of a major shock, i.e. x_D and x_S, which by extension means that transfers can be coupled with a lower degree of conditionality.

Finally, some observers believe that the effectiveness of the SGP would increase with a permanent central fiscal transfer mechanism to stabilise the EMU in the event of a major shock.[25] Arrangements in the US are often used as a reference where the federal level redistributes funds under an unemployment benefit scheme in function of market developments across the Union. However, our model underscores two important interconnected issues. First,

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[24] EU's wilful blindness to sovereign risk adds to eurozone danger | Financial Times (ft.com)

25 In June 2021, the Centre for Macroeconomics (CFM) carried out a dedicated survey on Fiscal Rules in the European Monetary Union (https://cfmsurvey.org/surveys/fiscal-rules-european-monetary-union). More than 20% of the surveyed prominent European economists (out of a total of close to 130) indicated a central fiscal capacity as the one reform that would improve fiscal rules.

it indicates how the prospect of transfers from one part of the union to another feeds back on the decision to comply or not with the EU rules. If Group D knows upfront that it will always be able to rely on fiscal support when faced with troubles its choice between running deficits or not will clearly tilt towards the former.

In our simple model, a permanent central fiscal capacity means there is no longer stage (3) as the transfer would conceivably be decided automatically based on a prior legal agreement. At the same time Group D's decision in stage (1) would still be determined by the level of conditionality c attached to any transfer ensuing from a prior legal agreement, which, as we show above, cannot be too demanding, and Group D would conceivably still have the choice of accepting conditions or not. As a result, the final outcome would not change in the event of a large shock, because Group S is willing to agree to transfers also without a permanent capacity to avert the risk/costs of a collapse of EMU. What may change with a permanent central fiscal capacity is the way policy conditions are set. In the discussion of Proposition 1 we investigated the upper bound of c such that Group D asks for help, and its impact on the willingness of Group D not to go for excessive debt levels. This discussion implicitly assumes that Group S decides about c, taking Group D's possibility to reject too harsh conditions into account. This reflects how help was actually granted to some countries during the financial crisis. In case of a permanent fiscal capacity based on a prior legal agreement, conditionality c needs to be agreed in the Council by both Group D and S. While we do not explicitly model such an agreement, if conditionality c were to be decided like the sanctions f, the outcome would most likely be no conditionality, hence, no incentive for Group D not to run a deficit.

Second, with the establishment of a central fiscal capacity aimed to offer stabilisation in the event of large negative shocks one would also have to re-discuss the scope of fiscal policy discretion across the different levels of governance in the EU. As fiscal authority increases at the centre, one would arguably have to limit it at the member states level to avoid accumulating debt both at the centre and the periphery. In the US, most states imposed a balanced-budget rule on themselves, not least because the federal government, while offering transfers to support unemployment benefits in states hit by a negative shock, proved to be rather strict about offering direct financial help to troubled state or local administrations more generally. In particular, there are several examples of US local governments that were not bailed out or received only partial help.[26]

5. Conclusions

Since pure commitment and reciprocity are of limited use in the context of EU fiscal policy making, the enforcement of the Stability and Growth Pact (SGP) depends largely on the dissuasive power of sanctions. When the SGP was designed, its architects assumed or suggested that sanctions on the deficit-prone countries would be effectively enforced by the European Commission or another appropriately delegated entity. In practice, enforcement has turned out to be very difficult because all relevant decisions are being taken by the Council where deficit-prone countries typically form at least a blocking minority against sanctions. In addition, with the advent of major economic shocks that threatened the sustainability of deficit-prone countries and in turn the integrity of the EMU, the credibility of sanctions has been further weakened. Deficit-prone countries can count on the fact that the EU will not seal its own demise by refusing financial support to troubled countries. Moreover, the macro-conditionality the EU may attach to financial support cannot be too strict because receiving countries my find them excessive or drive them into the hands of non-EU powers.

In the ongoing debate on how to reform the SGP enforcement plays once again a key role. However, apart from a solemn commitment by the Commission to propose SGP sanctions more consistently in the future, the reform proposal does not address the specific issues which

[26] New York City in the 1970s, California after 2008, Detroit in 2013 and Puerto Rico in 2016.

effectively weigh on the dissuasive power of sanctions. Most importantly, the governance framework around the implementation of the SGP remains unchanged and the initial size of potential sanctions, which deficit-prone countries would have to weigh against the benefit of running deficits, is reduced. At the same time, very little progress is being made towards strengthening the resilience of EU member states to major economic shocks especially as regards the capital markets union. Progress on that front would be an obvious alternative to financial support programs, which the EU typically launches in the wake of large shocks to make sure the vulnerabilities of high-debt countries do not jeopardize the EMU as a whole.

In the final analysis, the EU is facing a catch-22 situation: It cannot dissuade countries from running deficits because the distribution of risks of running deficits ensures a blocking minority in the Council. At the same time, it cannot agree on ways to strengthen the resilience of the economic governance framework because the risks of accumulating too much government debt are not perceived as random. The virtuous countries are expecting some upfront commitment of the deficit-prone countries which does not materialize.

As a result, the only dissuasive element left in this impasse is the understanding that whenever the vulnerabilities of high government debt countries entail major risks for the EMU as a whole, financial help will not come for free.

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