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Georg Kirchsteiger and Martin Larch

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Centre for Economic Policy Research
187 boulevard Saint-Germain, 75007 Paris, France
2 Coldbath Square, London EC1R 5HL
Tel: +44 (0)20 7183 8801
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Abstract

The EU's fiscal governance framework was built to contribute to overall macroeconomic stability through compliance with fiscal rules and the commitment not to bail-out countries in trouble. Yet successive crises have revealed vulnerabilities under systemic stress: countries with a propensity to run deficits push frugal ones into ex-post bail-out arrangements to avert collapse, thus undermining the ex-ante credibility of the framework. The absence of a permanent, preventive instrument forces the Union to oscillate between leniency and emergency intervention. A permanent RRF-like mechanism - linking EU funds to reform and investment projects - offers an incentive compatible solution and a possible bridge to a larger EU budget.

JEL Classification: D72, H62, H63, H77

Keywords: N/A

Georg Kirchsteiger - georg.kirchsteiger@ulb.be
ECARES Solvay Brussels School of Economics and Management Universite Libre de Bruxelles and CEPR

Martin Larch - martin.larch@ec.europa.eu
European Fiscal Board European Commission

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Key words: European Union, Stability and Growth Pact, EU budget, systemic crisis, conditional budgeting

JEL codes: D72, H62, H63, H77

Georg Kirchsteiger, European Center of Advanced Research in Economics and Statistics (ECARES), SBS-EM, Université libre de Bruxelles

Martin Larch, Head of Secretariat European Fiscal Board, European Commission, Brussels, martin.larch@ec.europa.eu

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1. Introduction

The Economic and Monetary Union (EMU) represents one of the most ambitious projects of modern economic integration: the creation of a single currency without a federal fiscal authority. This specific design choice rested on the conviction that numerical rules and the no-bail-out clause would ensure fiscal responsibility, a precondition for effective monetary policymaking in a single currency area.

The framework functioned reasonably well as long as shocks were moderate and idiosyncratic. However, the crises since 2008 revealed that in the face of systemic stress, the framework loses credibility: enforcement becomes politically too costly, and member states' vulnerabilities become mutually reinforcing. As a result, the original framework - to ensure fiscal discipline while preserving national sovereignty -has not played out as intended.

This paper argues that the main weakness lies in the absence of a mechanism that builds resilience before major shocks occur. As a matter of fact, the blueprint for the EMU architecture was drawn up at a time - the late 1980s and early 1990s - when mainstream macroeconomics was rather sanguine about overall macro financial stability. In particular, the idea prevailing at the time - often dubbed as Great Moderation - was that improved monetary policy run by independent experts with a clear mandate of achieving stable and low inflation coupled with sustainable public finances path, effectively avert major disruptions (see for instance Clarida et al., 2000 or Bernanke, 2004).

However, a series of large shocks starting with the global financial crisis in 2008 and 2009 exposed the prevailing macroeconomic ideas underpinning the EMU as excessive self-confidence. Repeated ex-post interventions at the EU level - financial assistance, ad-hoc instruments, emergency support - clearly showed that the existing fiscal governance framework, i.e. commonly agreed fiscal rules and the no-bail-out clause, did not deliver as intended. In particular, they painfully made clear that prevention via a consistent focus on structural reforms had been systematically underprovided.

The temporary Recovery and Resilience Facility (RRF), introduced in 2020 in response to the Covid pandemic, represents a structural departure: It involves a 'contract' between

individual member states and the EU where payments are made conditional on the delivery of reforms and investment projects. Its preventive, conditional design offers a possible template for rebalancing EU fiscal governance.

We develop the argument in five steps. First, we recall why the original governance model failed once systemic vulnerabilities became salient. We draw on a basic game-theoretical model developed earlier (Kirchsteiger and Larch, 2025) showing why enforcement and dissuasion collapse with the advent of systemic stress. Second, we extend the basic model to show how conditional, ex-ante transfers through a mechanism akin to the one of the Recovery and Resilience Facility (RRF) can help establish a better equilibrium that ideally averts ex-post damage limitation involving unidirectional transfers. Third, we discuss what we know about the effectiveness of conditional budgeting. Fourth, we argue that a permanent, conditional ex ante mechanism, modelled on the RRF, can be an incentive compatible and economically sound way to strengthen the EU's capacity to act. It can also provide a politically viable bridge toward a larger EU budget.

2. Tensions in the current EU fiscal framework

The EU fiscal framework was established in the early 1990s under macroeconomic conditions that assumed shocks would be largely idiosyncratic, and with the understanding that the right governance would contain fiscal excesses thereby ensuring an overall smooth functioning of the EMU. The foundational arrangements of EU fiscal governance were predicated on three interlinked pillars, all of which form part of the broader landscape of EU public finances: (i) national fiscal sovereignty without a significant central fiscal transfer mechanism, (ii) commonly agreed fiscal rules, and (iii) the commitment not to help countries in trouble.

Starting with fiscal sovereignty, in the EMU, member states retain full control over national taxation and spending decisions but are expected to coordinate their decisions at the EU level. Coordination is codified in the form of a set of commonly agreed fiscal rules, the Stability and Growth Pact (SGP). The SGP is a surveillance framework designed to prevent

'gross errors',[1] that is, excessive deficits and debt, to safeguard monetary dominance, as opposed to fiscal dominance where unsustainable fiscal positions may force the central bank to compromise on its inflation target. Finally, the 'no-bailout' clause as per Article 125 of the Treaty on the functioning of the European Union (TFEU) constitutes a legal commitment of the EU and its member states not to be liable for or assume the commitments of another Member State, preventing de facto debt mutualisation.

Although conceptually sound and coherent at the time, the framework underestimated the degree to which member states' fiscal positions were vulnerable to shocks and interconnected. Member states were expected to internalise fiscal risks through responsible national policies, while markets would price sovereign debt accordingly. In practice, however, the no-bail-out clause lost credibility under systemic stress. When the stability of the monetary union is at stake, no rational policymaker can commit to withholding support to vulnerable countries. The perceived and most likely effective cost of contagion is simply too high. As a result, fiscal risks have not been internalised ex ante but ex post, in the wake of crises, through significant ad hoc support packages.

One structural issue stands out. Persistent heterogeneity in the conduct of fiscal policy and debt levels made some member states disproportionately exposed and vulnerable to shocks when markets typically reassess sovereign risks. Without a larger EU budget, or a central fiscal stabilisation capacity, the governments of these member states were not in a position to bear the full burden of adjustment on their own.

These vulnerabilities undermined the credibility of both the no-bail-out clause and the fiscal rules. Low-debt countries repeatedly faced pressure to endorse emergency support measures to help high-debt countries lest the entire monetary union collapse. The result was a governance system that functioned only under fair-weather conditions but lost traction precisely when it was needed most, further cementing divisions across member states that have marred EU economic integration for decades.

Kirchsteiger and Larch (2025) developed a simple game-theoretical model outlining the underlying enforcement dilemma of the EU fiscal framework. The model considers two

[1] This is the terminology used in Article 126 of the Treaty on the Functioning of the European union (TFEU).

groups of EU countries, which together decide about the implementation of the EU fiscal rules in the Council of the European Union: (i) a group of fiscally stronger member states (Group *S*), which over time manages to preserve sufficient fiscal space to cope with shocks; and (ii) a group of fiscally weaker countries (Group *D*), prone to run deficits and to accumulate debt, which makes them vulnerable to shocks . Of note, this grouping, although stylised, draws on a reality which, at the end of the 1980s, informed and very much influenced the work that eventually shaped the architecture of the EMU, and is still relevant today. [2]

The key insights from the basic model are clear cut: Fiscal rules will not be enforced because (i) the group of deficit-prone countries manage to maintain a blocking minority in the Council and, as a result, effectively blocks the implementation of the SGP; and (ii) when shocks are large, the vulnerability of the deficit-prone countries threatens the stability of the EMU as a whole, pushing fiscally stronger member states to extend financial help subject to some conditions. However, the strings attached to the deal cannot be too tight as the group of deficit-prone countries will weigh the costs of macro conditionality against the costs of going through the crisis without help, which in turn comes with major spillovers for the other group. In sum, the EU fiscal framework is largely toothless: it does not involve credible incentives for countries with a propensity to run deficits to adopt more responsible fiscal policies, because, in the event of a systemic shock, the group of deficit-prone countries can bank on the self-preservation of the EU.

The effective inability to enforce the EU's fiscal framework has obviously important implications for the prospect of moving ahead with economic or fiscal integration in the EU. Redistribution and risk sharing have always been politically sensitive within the EU, as they clash with the specular concept of risk reduction.

The current landscape of EU public finances encompasses two forms of redistribution. The first one takes place through the EU budget; the second is agreed on the back of major crisis. The EU budget is agreed within a well-codified, treaty-based legal framework with

[2] When discussing the need for fiscal policy coordination in a European Monetary Union (EMU), members of the Delors group, the architects of EMU, explicitly referred to "widely diverging 'propensities to run deficits in the various European Countries (The need for co-ordination of fiscal policies in a European Economic and Monetary Union). The final Delors report echoes this insight when it says that "uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community" (monetary_delors.pdf)

predictable rules and predictable outcomes in terms of net transfers. However, with an overall size of around 1% of GDP of all EU member states taken together, the EU budget and the ensuing cross-country transfers remain rather modest. Moreover, the bulk of the expenditure programmes disburse funds on the basis of sound accounting principles within pre-agreed priority areas rather than subject to concrete deliverables.

By contrast, fiscal support agreed in the wake of crises - such as financial assistance programmes or emergency stabilisation tools – typically turn out to be quite sizeable and, more importantly, unidirectional confirming early fears.[3] To use the grouping of the basic model of Kirchsteiger and Larch (2025), fiscal support agreed on the back of crises tends to flow from the group of fiscally stronger to the group of deficit-prone countries.

From a normative perspective, there is no doubt that a central fiscal transfer mechanism should be part and parcel of any currency area that seeks to ensure a sufficient degree of stability. This fundamental insight was developed way back by Mundel (1961) and is generally accepted in the macroeconomic mainstream. All programmatic documents aimed at strengthening economic integration in Europe - the Werner Report in 1970[4], the MacDougall Report in 1977[5] , the Delors report in 1989 [6], the Five President's report in 2015[7] and more recently the Draghi report[8] - have argued in favour of establishing some kind of more meaningful central fiscal capacity. However, with little success. Deep and longstanding divisions across member states remain. The common understanding of the normative perspective is overshadowed by political economy issues where persistent heterogeneity in national fiscal policies averts progress towards a fiscal union.

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[3] Discussions within the Delors committee, the group of experts who under the leadership of then Commission President Delors prepared the blueprint of the Economic and Monetary Union, clearly document awareness of the risks of diverging fiscal policies including the risk of political pressure to agree to bail-out arrangements ex post: 1989-07-06 - Macro-fiscal policy co-ordination in an EMU by C. Borio

[4] Council and Commission of the European Communities (1970) Report to the Council and the Commission on the realisation by stages of Economic and Monetary Union in the Community https://www.eui.eu/Documents/Projects/PWC/Pierre-Werner-Report.pdf

[5] Commission of the European Communities (1977) Report of the study group on the role of public finances in European Integration, Volume I The MacDougall Report — Volume I (Brussels, April 1977) and Volume II The MacDougall Report — Volume II (Brussels, April 1977)

[6] Committee for the study of Monetary and Economic Union (1989) Report on Monetary and Economic Union in the Community Report on economic and monetary union in the European Community - Publications Office of the EU

[7] Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz (2015) Completing Europe's Economic and Monetary Union The Five Presidents' Report: Completing Europe's Economic and Monetary Union - European Commission

[8] The future of European competitiveness: Report by Mario Draghi: https://commission.europa.eu/topics/competitiveness/draghi-report_en

Put differently, the fiscally stronger countries, which largely overlap with the main net contributors to the EU budget/multi-annual financial framework (MFF), find themselves in a system of EU public finances that forces them to accept additional and not previously agreed transfers because a fairly stable group of member states continues to run diverging fiscal policies. As a result, the fiscally stronger countries remain highly sensitive to any proposal to increase the size of the EU budget/MFF without strengthening fiscal responsibility in other member states.

Figure 1 illustrates the underlying issue. Based on the original Maastricht architecture, only one form of redistribution should have taken place, the one agreed ex ante via the EU budget. After 2008, with the advent of systemic stress, an additional form of redistribution surfaced - in the policy debate often characterised as risk sharing. It is agreed ex post in the wake of large unexpected negative shocks, where a broadly stable set of countries benefits from crisis management arrangements established on ad hoc basis to address their vulnerabilities which threaten the stability of the EMU as a whole.

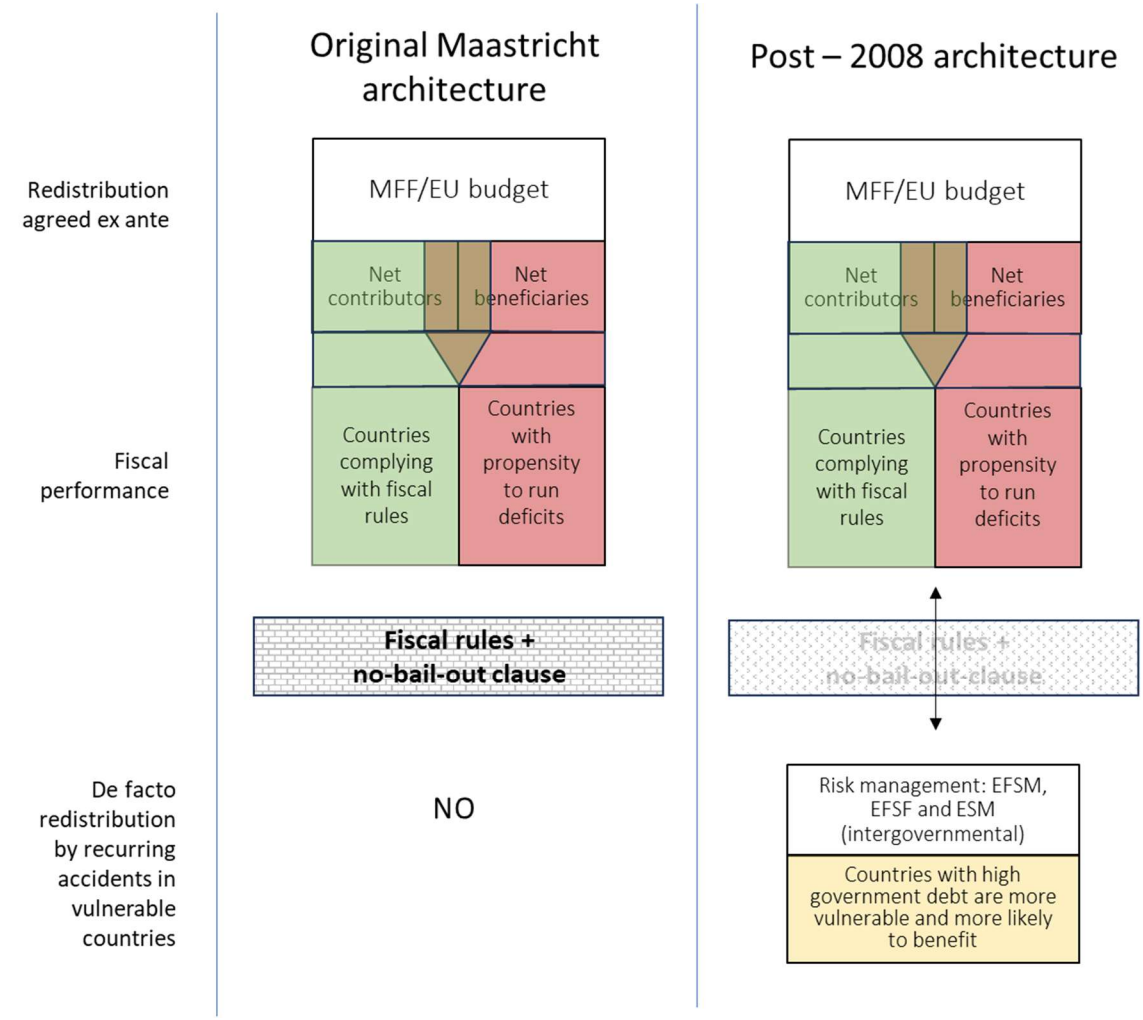
Naturally, past risk patterns may change in the future, but right now one important part of the EU takes the view, grounded in experience, that it is asked to pay twice, first in the context of the EU budget and second because some countries do not succeed in addressing a propensity to run deficits exposing themselves and others to major risks in the event of shocks. In more technical terms, the fiscally stronger countries are hesitant to sustain or expand a system that resembles an insurance arrangement without a premium.

The key insight from this discussion is that fiscal rules combined with a no-bail-out clause cannot redress diverging trends in national fiscal policies and reduce ensuing vulnerabilities when systemic stress is a real risk. Until now economic vulnerabilities across EU member states have been confronted at two extreme ends of a spectrum of policy options.

At the one end, there are policy recommendations issued in the context of the European Semester, which a former senior EU official characterised as ‘life-style advice’. This catchy expression is meant to underscore the fact that in practice recommendations cannot be enforced. It is entirely up to the member states’ inclination to heed the recommendations or to ignore them. At the other end of the spectrum, vulnerabilities have been addressed in

the wake of a crisis when the stability of the EMU construction was at risk by reluctantly agreeing to transfer mechanisms.

Figure 1: Types of redistribution in EU public finances - original design and status quo



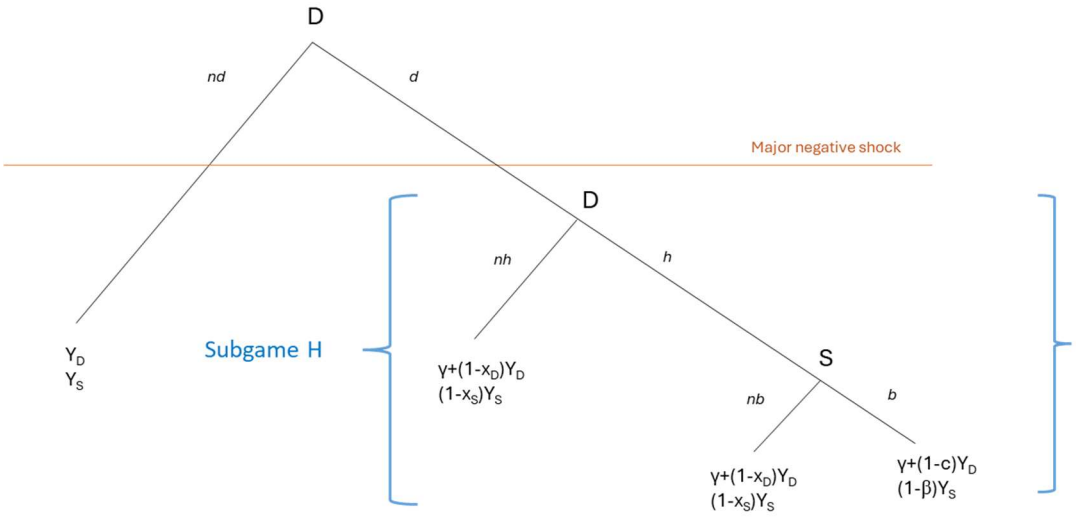
The discussion also shows how the current system and experience weigh on the mutual trust necessary to make progress towards stronger EU public finances. Ex-post interventions are costly and politically toxic. What is missing is a middle way, a preventive incentive compatible risk reduction mechanism that strengthens resilience, supports reforms, and reduces as much as possible the need for emergency support.

3. The problem and a possible solution: Conditional budgeting as a preventive mechanism

3.1. The problem

To outline the underlying enforcement dilemma of the EU fiscal framework, take the model as depicted in Figure 2.[9]

Figure 2: The problem



At the first stage, the deficit-prone Group *D* decides whether to choose a deficit level that is sustainable even in case of a major shock (choice *nd*), or an unsustainable deficit level (choice *d*). Choosing a high deficit level, Group *D* (or the governments of the countries belonging to Group *D*) enjoy(s) a benefit of *y*.

Then a major shock hits the whole euro area. If Group *D* choses *nd*, it could ride out the shock without any help and gets a payoff of Y_D, while Group *S* gets a payoff of Y_S. By contrast, if Group *D* choses *d*, it cannot overcome the recession without a bail-out from Group *S*. Without bail-out, the monetary union collapses. The additional negative impact

[9] This model is a simplified version of the game analyzed in Kirchsteiger and Larch (2025). This paper abstracts from the possibility of sanctions in the context of the excessive deficit procedure (EDP). Kirchsteiger and Larch (2025) show that the possibility of such sanctions does not solve the basic problem.

of such an outcome is given by $x_D \varepsilon (0,1)$ for Group *D* and $x_S \varepsilon (0,1)$ for Group *S, both* expressed as a share of their respective GDP.

To avoid the collapse, Group *D* can decide to ask Group *S* for help (choice *h*). If Group *D* asks for help, Group *S* decides whether to bail-out at a cost of β (choice *b*) or not (choice *nb*), with $\beta \varepsilon (0,1)$ being expressed as a share of the GDP of *S*. If *D* asks for help, and *S* agrees, the meltdown of the monetary union is averted. But *S* has to pay the bail-out costs β, and *D* has to accept conditions which, depending on their harshness, lead to costs of *c* for the Group *D*. Again, $c \varepsilon (0,1)$ is expressed as a share of *D's* GDP.

The collapse of the monetary union is plausibly the worst outcome for *S*. Hence, it is less costly for *S* to save the monetary union than to allow it to collapse, i.e. $x_S > \beta$. We assume from now on:

Assumption A1: $x_S > \beta$ - For group *S* the worst outcome is a collapse of the monetary union.

We first analyse the subgame after Group *D* choses *d* and a shock occurred, i.e. subgame *H* (see Figure 2).

Proposition 1: For generic parameter values, the subgame perfect equilibrium of subgame *H* is characterized by:

i) If $c < x_D$, Group *D* chooses *h* and Group *S* chooses *b*.

ii) If $c > x_D$, Group *D* chooses *nh* and Group *S* chooses *nb*.

Since the harshness of the conditions is at least partly determined by *S*, and since a collapse of the monetary union is the worst outcome for *S*, it is plausible to assume that *S* will avoid too harsh conditions (for a detailed discussion of the matter see Kirchsteiger and Larch, 2025).

Assumption A2: $c < x_D$ - the conditions for a bail-out will not be so harsh that *D* prefers a collapse of the monetary union.

A2 is necessary and sufficient that the monetary union does not collapse, i.e. that part i) of Proposition 1 is realised. But because of A2, it is impossible to persuade *D* to choose a sustainable deficit level in the first stage if the benefit of a high deficit for (the government

of) Group *D* is large enough, which can happen e.g. because governments are typically in power only a very limited number of years (for a detailed discussion of the issue see Kirchsteiger and Larch, 2025).

Proposition 2: Assume that A1 and A2 hold and that $y > cY_D$. For generic parameter values, the subgame perfect equilibrium is given by:

i) Group *D* chooses *d* in the first stage and *h* after the shock.

ii) Group *S* chooses *b*.

iii) The equilibrium payoffs are given by $u_D=\gamma+(1-c)Y_D$ and $u_S=(1-\beta)Y_S$.

To deal with the worst-case scenario, we assume from now on that Group *D* has a strong incentive to run unsustainable deficits.

Assumption A3: $\gamma > cY_D$.

Propositions 1 and 2 show the basic dilemma if Group D's political and social payoff of running a high deficit is large enough. Group *S* cannot impose too harsh conditions for a bail-out, since in that case Group *D* would prefer not to get bailed-out, leading to a collapse of the monetary union as a consequence. But with relatively soft bail-out conditions, Group *D* has no incentive to run sustainable deficit levels in the first place.

3.2 A possible solution: Conditional budgeting as a preventive mechanism

In our view, the dilemma described in the previous section can be addressed with what we call conditional budgeting. The idea of conditional budgeting can be summarised as follows. Before a shock occurs, the fiscally stronger member states support a new spending programme or adapt existing spending programmes within the EU budget to the benefit of Group *D* if and only if Group *D* introduces reforms that increase its resilience to the shock. These additional transfers are made only (i) after the deficit-prone countries have delivered on the agreed reform and investment projects; and (ii) the reform and investment projects can on average be expected to be effective.

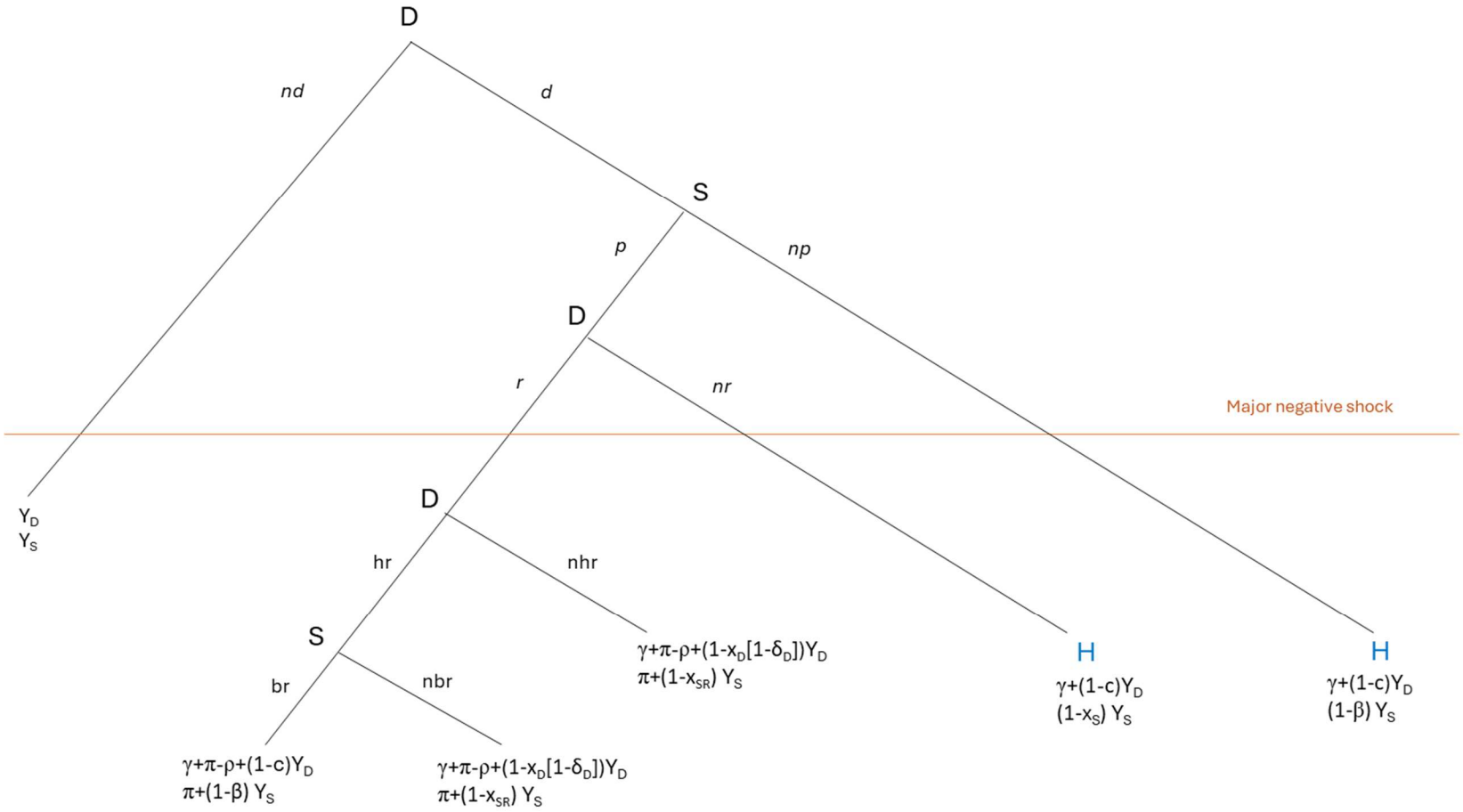
To outline the idea, consider the extensive form game depicted in Figure 3. First, Group *D* decides about its deficit level. Then *S* decides whether to offer Group *D* an additional payment of π in exchange for reforms that increase the resilience of Group *D* (choice *p*) or

not (choice *np*). If Group *S* decides not to propose such a deal, a major shock hits and the play enters subgame H (see Figure 2), resulting in payoffs of $u_D=\gamma+(1-c)Y_D$ and $u_S=(1-\beta)Y_S$.

If Group *S* decides to promise π in exchange for reforms, *D* has to decide whether to accept the proposal and implement the reforms (choice *r*) or not (choice *nr*). Then a major shock hits. In case Group *D* does not implement the reforms, it does not receive the promised payment π. The play enters subgame H (see Figure 2), resulting in payoffs of $u_D=\gamma+(1-c)Y_D$ and $u_S=(1-\beta)Y_S$.

If Group *D* decides to accept the proposal, it receives the payment π. But it has to bear the political and social costs of the reforms, which are denoted by ρ. Then the shock hits, but now Group *D* is more resilient to the shock. Group *D's* costs of the shock combined with the unsustainable deficit is no longer x_D, but $x_D(1-\delta_D)$, measured again as fraction of Group *D's* GDP, with $\delta_D \varepsilon [0,1]$. δ_D measures how effective the reforms are in reducing the costs of a shock for Group *D* and, hence, in preventing the melt-down of the monetary union. When δ_D is sufficiently large, reforms are effective. Specifically, effective reforms make Group *D* resilient to large shocks and a melt-down of the monetary union can be prevented without a bail-out from Group *S*. The threshold between successful and unsuccessful reforms is denoted by $\tau \varepsilon (0,x_D)$: If $\delta_D > \tau$, Group *D* is resilient to large shocks, while for $\delta_D < \tau$ it is not.

Figure 3: A possible solution – conditional budgeting



Proposition 3: Assume A1-A3. Furthermore, assume further that reforms make Group *D* resilient to large shocks ($\delta_D \geq \tau \leftrightarrow x_{Sr} = 0$) and that the costs of the reform and the connected payment fulfil $\rho - cY_D + x_D(1-\delta_D)Y_D < \pi < \beta Y_S$. Under these assumptions the subgame perfect equilibrium is given by:

i) Group *D* choses *d, r,* nh_r.

ii) Group *S* chooses *p,* nb_r.

Proof: Straightforward application of backward induction.

In the equilibrium described by Proposition 3, Group *D* chooses unsustainable high deficits in the first place, similar to the result without the conditional budgeting mechanism. But Group *S* does not bail-out Group *D*, since the reforms are successful enough to prevent a melt-down of the monetary union without bail-out in the event of a large shock.[10] For Group *S,* this outcome is better than a bail-out whenever the "reform transfers" are below the bailout costs (i.e. $\pi < \beta Y_S$). On the other hand, Group *D* will undertake the reforms whenever the transfers are larger than costs of the reform minus the costs of the bail-out conditionalities plus the remaining costs of the shock ($\pi > \rho - cY_D + x_D(1-\delta_D)Y_D$). Note that the payoffs of the equilibrium described in Proposition 3 are given by $u_D=\gamma+\pi-\rho+(1-x_D(1-\delta_D))Y_D$ and $u_S=Y_S-\pi$. Under our assumptions, these payoffs are better for both players than the equilibrium payoff without the conditional budgeting mechanism.

If any of the conditions of Proposition 3 does not hold, we are back to the bail-out result (under A1-A3), i.e. to the basic problem explained in the previous subsection. In particular, if successful reforms are not available or only available at very high costs (i.e. ρ very high), the mechanism cannot work. Obviously, it is an empirical question whether the necessary reforms are available at sufficiently low political costs.

4. The effectiveness of preventive transfers: the role of δ_D

The model presented above shows that conditional budgeting can, in principle, generate a better and incentive compatible equilibrium outcome than the status quo of the basic model.

[10] There is another subgame perfect equilibrium where *D* chooses h_r instead of nh_r. This second equilibrium leads to the exact same economic outcome. We do not discuss this equilibrium explicitly.

Fiscal rules and the no-bail-out clause can mandate consolidation, but they cannot generate credible incentives for reforms or create fiscal space in economic good times. For countries with a time-honoured propensity to run deficits incentives for resilience are weak compared to the perceived benefits of running deficits γ because payoff horizons are long, political cycles short, and costs ρ are immediate. Conditional budgeting can address this problem by providing benefits for both groups (δ_D and $x_{Sr} = 0$) in exchange for reforms whose gains materialise over time.

However, this conclusion stands or falls with the parameter δ_D, the measure of the effectiveness of reforms in reducing the vulnerability of Group D to shocks. Recall the conditions that must simultaneously hold for conditional budgeting to constitute an equilibrium:

$$\delta_D \geq \tau \leftrightarrow x_{Sr} = 0 \text{ and } \rho - cY_D + x_D(1-\delta_D)Y_D < \pi < \beta Y_S.$$

From Group D's perspective, this means that the net costs of the reform (ρ-π) must be lower than the costs of a bailout arrangement (cY_D) minus the remaining costs of the shock ($x_D(1-\delta_D)Y_D$). These remaining costs are decreasing with the effectiveness of the reforms, i.e. in δ_D. Hence, the more effective the reforms, the more likely Group D will accept it (for a given transfers and given reform costs of undertaking reforms). From Group S's perspective, the price tag of the conditional, preventive transfer to Group D π must be lower than the cost of an ex-post bailout.

For both perspectives to support an equilibrium, i.e. support an incentive compatible preventive arrangement different from ex-post bailouts, the effectiveness of reforms δ_D needs to exceed a critical threshold τ. If δ_D is (too) small the system reverts to the equilibrium of the basic model of Kirchsteiger and Larch (2025): Group D runs deficits, vulnerability accumulates, and crises are resolved through costly and politically contentious ex-post bailouts. Therefore, understanding what determines δ_D, and under what conditions it can be expected to be sufficiently large, is therefore central to the case for conditional budgeting.

The effectiveness parameter δ_D is not directly observable but can be conceptualised as a function of four interrelated factors: (i) the quality of the reforms; (ii) the institutional

capacity of recipient countries to implement agreed measures; (iii) the impartiality and rigour of the central level in assessing the implementation of reforms; and (iv) the time horizon over which reforms generate macroeconomic benefits.

The empirical literature on structural reforms provides relevant, if mixed, evidence. A well-documented finding is that structural reforms, particularly in product and labour markets, tend to raise potential output and improve fiscal positions over the medium to long run (Égert and Gal, 2017; Bouis and Duval, 2011). However, the short-run effects can be negative, particularly in periods of economic weakness, as transitional adjustment costs temporarily depress output (Eggertsson et al., 2014; Cacciatore et al., 2016). This short-run cost is captured in the model by the implementation cost ρ, which Group D must be willing to bear in exchange for the conditional transfer π.

The experience of the Recovery and Resilience Facility (RRF), the closest real-world analogue to conditional budgeting, provides early but instructive evidence on the feasibility of achieving high δ_D. The RRF's design - large-scale transfers subject to the verified delivery of reform and investment projects - was explicitly intended to generate measurable improvements in resilience. European Commission assessments have identified potential gains in areas such as energy transition, digital transformation, and public administration quality (European Commission, 2022, 2023). At the same time, implementation has been uneven across member states, reflecting heterogeneity in institutional capacity, administrative quality, and political will, all factors that bear directly on the achievable level of δ_D.

Crucially, the RRF experience underscores that δ_D is not an exogenous constant but an endogenous outcome of the design and monitoring of the preventive mechanism. A well-designed mechanism with credible milestones, robust ex-post verification, and technical assistance to lower-capacity member states can raise the expected value of δ_D significantly. Conversely, a mechanism that disburses funds against easily met formal criteria - resembling the bulk of existing EU spending programmes more than the RRF - risks generating a low δ_D, undermining the incentive compatibility conditions of the model.

The dependence of the entire conditional budgeting framework on δ_D has direct and concrete implications for how a permanent RRF-like mechanism should be designed. Three design principles follow directly from our model.

First, the conditionality must be outcome-oriented rather than input-oriented. The distinctive feature of the RRF relative to earlier EU expenditure programmes was precisely that disbursements were tied to measurable reform outcomes, legislative changes, structural benchmarks, quantitative targets - rather than to spending plans. This is the institutional analogue of a high δ_D: it would ensure that transferred funds are linked to actual reductions in vulnerability rather than to compliance with procedural requirements.

Second, the preventive mechanism must invest in the administrative capacity of recipient countries. A systematic finding in the structural reform literature that institutional quality - the efficiency of public administration, the rule of law, regulatory quality - is a strong predictor of reform success (Acemoglu et al., 2005; Rodrik et al., 2004). Hence, countries with weak institutional capacity systematically can be expected to achieve lower δ_D for any given reform design. A permanent conditional budgeting mechanism should therefore include a dedicated component for capacity building and technical assistance, with access to preventive transfers conditional not only on reform delivery but on demonstrated progress in implementation capacity.

Third, the identification of eligible reform projects and the assessment of their implementation must be strictly evidence based. It must be built on technically credible analyses and insulated from political pressure of the countries being assessed.

Fourth, the mechanism must operate over a sufficiently long-time horizon to allow δ_D to materialise. The mismatch between the short-run costs and long-run benefits of structural reforms creates a time-inconsistency problem: reforms may be politically unpopular in the short run, when costs are concentrated, even if they are welfare-enhancing over the medium term, when benefits diffuse broadly. A permanent mechanism, as opposed to a temporary crisis response like the RRF, is better positioned to smooth this intertemporal trade-off by providing sustained incentives over multiple budget cycles, building credibility and political sustainability that a one-off instrument cannot offer.

Taken together, these design implications point in a consistent direction: a permanent conditional budgeting mechanism can generate a high enough δ_D to satisfy the incentive conditions of the extended model, but only if its architecture is fundamentally different from traditional EU expenditure programmes. The RRF demonstrated that such an architecture is potentially feasible. The challenge for the post-RRF period is to institutionalise and strengthen this approach in a permanent framework that outlasts the current MFF and provides a stable foundation for the EU's fiscal governance going forward.

5. Conditional budgeting as a bargain toward a larger EU budget

The game-theoretical model developed in the preceding sections offers a stylised but analytically tractable account of why conditional budgeting can improve upon the status quo. This section argues that it could also be used as part of a bargain in which the main net contributors to the EU budget - countries that largely overlap with Group *S* in our model - accept a larger EU budget in exchange for a credible, institutionalised reduction in the risk of ex-post redistribution.

To understand the conditions for a grand bargain, we briefly recall arguments discussed in Section 2. The current system of EU public finances involves two distinct types of redistribution: a comparatively modest, predictable, Treaty-based flow through the EU budget, and a potentially large, unpredictable, politically contentious flow through crisis management instruments agreed ex post. The main net contributors, which in practice are also fiscally stronger member states of Group *S*, participate in both flows, but the second flow is particularly costly from their perspective because it is involuntary, and opaque in terms of ultimate magnitude.

First, there is no ex-ante commitment from Group *D* to constrain its fiscal behaviour, and so Group *S* faces an ongoing contingent liability of uncertain magnitude. Second, any proposal to expand the EU budget, however justified on grounds of efficiency or scale economies in the provision of EU public goods, is perceived as potentially increasing rather than reducing this exposure. A larger EU budget without accompanying structural reforms

in high-debt member states could simply shift additional resources from Group *S* to Group *D* through the budgetary channel while leaving the contingent ex-post liability in place.

This logic explains the long-standing resistance of main net contributor countries to ambitious proposals for EU budget expansion. It is not simply parsimony or narrow national interest; it reflects a rational assessment of the incentive structure. In the absence of instruments that durably reduce Group *D*'s vulnerability, any increase in the EU budget is a partial substitute for, not a complement to, ex-post bailout instruments, with no guarantee that it reduces overall transfer flows from Group *S* to Group *D*.

Conditional budgeting can change this political calculus, because it simultaneously addresses both concerns of Group *S and* Group *D*, i.e. the potentially open-ended contingent liability from ex-post redistribution to avert the worst possible outcome, and a rules-based, contractual framework for solidarity.

The bargain can be understood as follows. Group *S* agrees to channel more resources in a preventive fashion through the EU budget specifically earmarked for reforms. In exchange, Group *D* commits to implementing agreed reforms aimed to reduce its vulnerability to shocks. The conditionality mechanism ensures that the additional resources are released only upon verified delivery, so Group *S* is not simply providing unconditional transfers but purchasing, at a known and capped price, a reduction in the systemic risk it would otherwise face in the event of a crisis. At the same time, preventive, conditional transfers (π in our setup) constitute an incentive for Group *D* that can outweigh the benefits of running unsustainable deficits and the short-term costs of structural reforms.

This possible bargain has several features that distinguish it from the status quo and from earlier, unsuccessful proposals for EU budget expansion. First, the additional transfers are contractual rather than discretionary: they are governed by rules agreed in advance, disbursed on the basis of verified performance, and predictable in their magnitude. This predictability is essential for Group *S*, which needs to be able to assess ex ante what it is committing to. Second, the transfers are conditional rather than automatic: Group *D* receives resources if and only if it effectively delivers on reforms, creating direct incentives for vulnerability reduction rather than simply increasing fiscal capacity without behavioural change. Third, the arrangement is symmetric in its benefits: Group *D* gains

access to EU resources that support costly reforms with limited immediate fiscal cost; Group *S* gains a reduction in the probability and magnitude of future ex-post bailouts.

Crucially, the bargain also addresses the political economy of the EU budget negotiations. The main net contributors have historically resisted increases in the EU budget partly on grounds of efficiency, questioning the value for money of EU expenditure, and partly on grounds of distributional fairness, fearing that an expansion of the EU budget would primarily benefit net recipient countries without corresponding changes in behaviour. Conditional budgeting can reframe the proposition: additional budget resources are precisely conditioned on behavioural change, and the value for money of expenditure is assessed not by compliance with procurement rules but by measurable reductions in macroeconomic vulnerability. This reframing can help construct a coalition among main net contributors in favour of budget expansion, but only if the conditionality is genuinely credible. Without such a reframing the system remains stuck with the confrontation between fiscally stronger countries on the one hand and deficit-prone countries on the other.

The RRF itself was agreed precisely in a political context in which the fiscally stronger member states were persuaded to accept a degree of joint borrowing and transfer spending that had previously seemed politically impossible. The key to that agreement was the combination of conditionality (milestone-based disbursements), limited duration (the RRF was designed as a temporary instrument).

A permanent conditional budgeting mechanism would need to replicate these political conditions in a more durable institutional framework. Several design features would be essential to maintain the political viability of the bargain. The governance of the mechanism must be transparent and credible, with independent and strict verification of milestone achievement by a dedicated independent body.

The size of the mechanism - π in the notation of our extended model - must be calibrated to the actual magnitude of the contingent ex-post liability that Group *S* currently faces and the short erm political costs of Group *D*, so that the trade-off - more ex-ante transfers in exchange for less ex-post exposure - is demonstrably favourable.

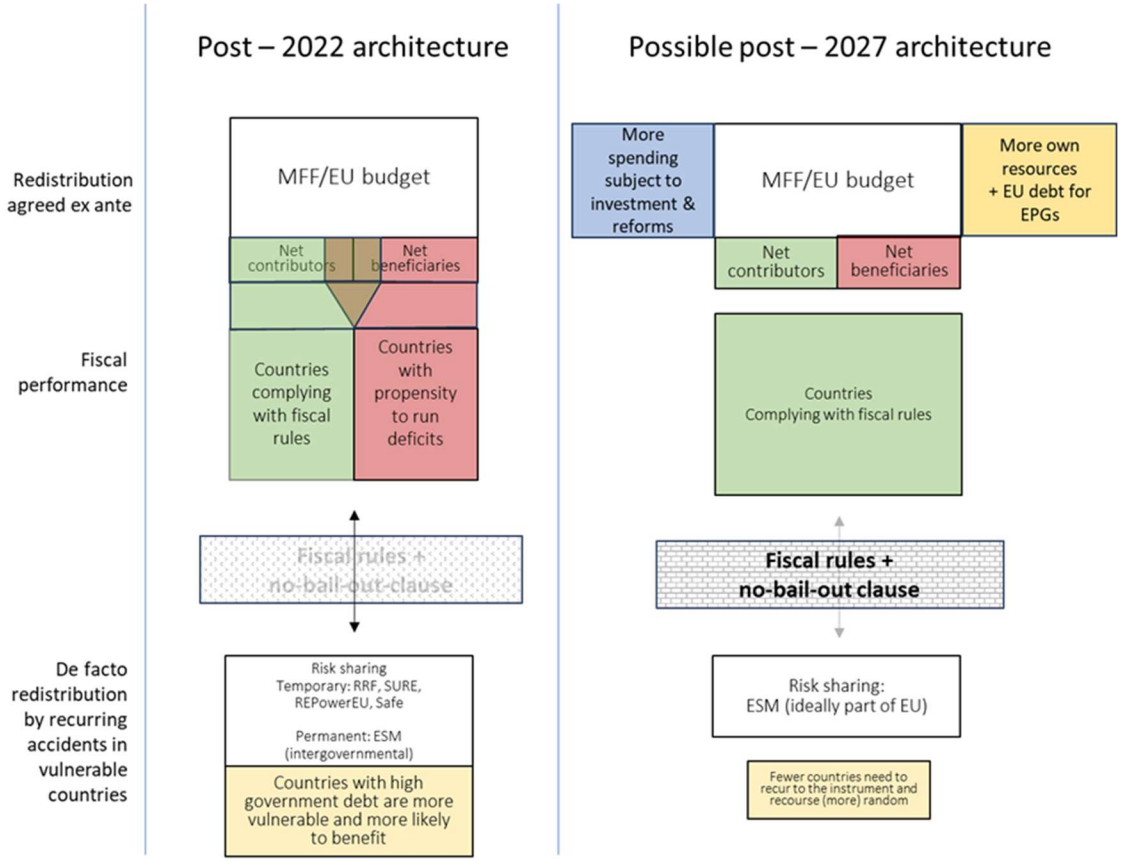
Finally, it is important to be precise about what conditional budgeting can and cannot achieve in the context of a possible expansion of the EU budget. The proposal is not that conditional budgeting replaces the existing EU budget or its established spending programmes in areas such as cohesion policy, the Common Agricultural Policy, or research and innovation. These programmes serve legitimate purposes rooted in Treaty obligations and long-standing political agreements. Rather, conditional budgeting should be understood as an alternative deliver mechanism that introduces the RRF-like milestone-based conditionality into the permanent architecture of the EU budget.

Nor is conditional budgeting a substitute for fiscal rules. The EU's fiscal framework continues to need robust rules, backed by credible enforcement mechanisms, to prevent the accumulation of vulnerabilities in the first place. Conditional budgeting complements fiscal rules by providing positive incentives for reform, a carrot alongside the stick of fiscal surveillance, and by building resilience ex ante that reduces the probability of the enforcement dilemma identified in our basic model.

What conditional budgeting can offer, however, is a politically viable bridge toward a larger EU budget: a framework in which main net contributors may accept a more ambitious EU fiscal perimeter because the additional resources are tied to genuine reduction of vulnerability rather than unconditional transfers. In this sense, conditional budgeting has the potential to addresses the fundamental political economy obstacle that has blocked EU budget expansion for decades: the perception among net contributors that more resources for the EU budget mean more risk, not less.

Figure 3 illustrates the strategic logic of the proposed bargain. In the status quo (left panel), redistribution through the EU budget is modest and agreed ex ante, while crisis-driven redistribution is large, discretionary, and agreed ex post. In the scenario with conditional budgeting (right panel), the ex-ante component of redistribution is larger and governed by performance-based conditionality, while the ex-post component shrinks as conditional, preventive transfers reduce Group *D*'s vulnerability.

Figure 4: Types of redistribution in EU public finances - status quo and possible improvements via conditional budgeting.



From Group *S*'s perspective, this is a better deal: the total expected transfer from Group *S* to Group *D* may be similar, but the ex-ante component is contractual, predictable, and tied to vulnerability reduction, while the ex-post component is reduced. The system as a whole becomes more stable and more credible, a genuine improvement over the status quo for both groups.

Mid-2025 the Commission has put forward a proposal for the next MFF 2028-2034. The proposal provides a natural focal point for launching innovations to the permanent architecture of EU public finances. It includes a novel, horizontal regulation, which would apply across many EU spending programmes and sets out the principles of linking payments the fulfilment of pre-defined results, primarily through the delivery model of National and Regional Partnership Plans and the Regulation on a budget expenditure and

performance framework.[11] The proposed system would shift the focus of checks and controls from underlying costs to the deliverables of projects. If agreed as proposed it would constitute a step in the direction outlined in this paper.

6. Conclusions

The EU's fiscal governance framework has repeatedly failed under systemic stress because enforcement mechanisms lose credibility. The model presented in this paper shows that enforcement and resilience are complementary: fiscal rules cannot function without instruments that reduce vulnerability ex ante.

The RRF introduced a new paradigm based on conditional, preventive transfers. This approach strengthens reform incentives, supports investment, reduces systemic risk, and helps restore the credibility of fiscal rules and the no-bailout clause. A permanent RRF-like mechanism would embed this logic into the fiscal framework, offering a politically viable way to enhance the EU's capacity to act while avoiding ex-post bailouts.

The viability of the approach, however, is not unconditional. As the model demonstrates, the entire incentive structure of conditional budgeting rests on the effectiveness of conditional, preventive transfers in reducing vulnerability, denoted as δ_D. A permanent mechanism that fails to achieve a sufficiently high δ_D will not satisfy the incentive conditions for either Group *S* or Group *D* and will collapse into the inefficient equilibrium of the basic model. This places a premium on outcome-oriented conditionality, investment in recipient country capacity, and long-term institutional commitment, all lessons that the RRF experience has reinforced.

Equally, the political sustainability of conditional budgeting depends on its framing as a bargain rather than a unilateral concession. Main net contributors to the EU budget/MFF are not simply being asked to provide more resources; they are being offered a reduction in the open-ended contingent liability they currently face from ex-post crisis management. The bargain is credible only if the conditionality is genuine, the governance is transparent,

[11] EU budget 2028-2034.

and the reduction in ex-post redistribution risk is demonstrable. If these conditions are met, conditional budgeting offers a politically viable bridge toward a larger EU budget, one that reconciles the ambitions of fiscal integration with the legitimate concerns of member states that have long resisted a transfer union.

The conclusion is clear: no help is the preferred outcome for fiscally strong countries, yet ex post help becomes inevitable when vulnerability of deficit-prone countries increases in the wake of large shocks. A permanent preventive mechanism resolves this dilemma by providing targeted, conditional support before shocks occur. By institutionalising resilience through a well-designed, outcome-oriented conditional budgeting mechanism, the EU could take a decisive step toward a more stable, cohesive, and geopolitically capable union, and toward a fiscal architecture worthy of the ambitions of European economic integration.

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