

DISCUSSION PAPER SERIES

DP18304

THE ENFORCEMENT DILEMMA OF EU FISCAL RULES

Georg Kirchsteiger and Martin Larch

PUBLIC ECONOMICS

CEPR

THE ENFORCEMENT DILEMMA OF EU FISCAL RULES

Georg Kirchsteiger and Martin Larch

Discussion Paper DP18304

Published 18 July 2023

Submitted 14 July 2023

Centre for Economic Policy Research
33 Great Sutton Street, London EC1V 0DX, UK
Tel: +44 (0)20 7183 8801
www.cepr.org

This Discussion Paper is issued under the auspices of the Centre's research programmes:

- Public Economics

Any opinions expressed here are those of the author(s) and not those of the Centre for Economic Policy Research. Research disseminated by CEPR may include views on policy, but the Centre itself takes no institutional policy positions.

The Centre for Economic Policy Research was established in 1983 as an educational charity, to promote independent analysis and public discussion of open economies and the relations among them. It is pluralist and non-partisan, bringing economic research to bear on the analysis of medium- and long-run policy questions.

These Discussion Papers often represent preliminary or incomplete work, circulated to encourage discussion and comment. Citation and use of such a paper should take account of its provisional character.

Copyright: Georg Kirchsteiger and Martin Larch

THE ENFORCEMENT DILEMMA OF EU FISCAL RULES

Abstract

Effective enforcement is an essential element of any fiscal rule. The EU's Stability and Growth Pact (SGP) has been struggling with this truism since inception. In this paper we show that its effectiveness goes beyond the threat of fines. The notion that deficit-prone member states would adopt a more virtuous fiscal behaviour to avert sanctions under the SGP is overshadowed by the understanding that in the event of a major shock the virtuous countries will come to their rescue as the survival of the entire system is at stake. Unless the underlying risks of running afoul of the SGP are addressed, the effectiveness of fines is limited. Beyond majorities in the decision-making bodies, SGP enforcement crucially depends on the resilience of member states' economies and the macro-conditionality deficit-prone countries face in the wake of major shocks in return for financial support.

JEL Classification: D72, H62, H63, H77

Keywords: Fiscal rules, Stability and growth pact, European union, Rule enforcement

Georg Kirchsteiger - georg.kirchsteiger@ulb.be
ECARES, SBSEM, Université libre de Bruxelles and CEPR

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

Acknowledgements

We would like to thank Vitor Gaspar and his colleagues at the IMF Fiscal Affairs Department, Friedrich Heinemann and Charles Wyplosz for helpful comments. Disclaimer: The views expressed in this article do not necessarily reflect those of the European Commission or of the European Fiscal Board.

The enforcement dilemma of EU fiscal rules

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

Martin Larch, Head of Secretariat of the European Fiscal Board, European Commission

Abstract

Effective enforcement is an essential element of any fiscal rule. The EU's Stability and Growth Pact (SGP) has been struggling with this truism since inception. In this paper we show that its effectiveness goes beyond the threat of fines. The notion that deficit-prone member states would adopt a more virtuous fiscal behaviour to avert sanctions under the SGP is overshadowed by the understanding 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 risks of running afoul of the SGP are addressed, the effectiveness of fines is limited. Beyond majorities in the decision-making bodies, SGP enforcement crucially depends on the resilience of member states' economies and the macro-conditionality deficit-prone countries face in the wake of major shocks in return for financial support.

JEL codes: D72, H62, H63, H77

Keywords: Fiscal rules, European Union, Stability and Growth Pact, enforcement, sanctions

Acknowledgements: We would like to thank Vitor Gaspar and his colleagues at the IMF Fiscal Affairs Department, Friedrich Heinemann and Charles Wyplosz for helpful comments.

Disclaimer: The views expressed in this article do not necessarily reflect those of the European Commission or of the European Fiscal Board.

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 device 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 the commitment and enforcement device under the SGP are ineffective and/or imply an implausible threat.

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 limit the discretion of national budgetary authorities with the possibility to impose financial sanctions if a member state does not follow the recommendations of the Council of the European Union (henceforth Council).¹

From today’s perspective, the track record of the SGP has been mixed for a variety of apparent reasons (European Fiscal Board, 2019). The common thread connecting the multitude of issues is a lack of compliance and enforcement. Since inception, some member states regularly and significantly deviated from the course of action implied by the EU fiscal rules (Larch et al. 2023). As a result, they accumulated growing levels of government debt making them vulnerable to sudden shifts in market expectations in the wake of major negative shocks to their economies. Despite a dismal compliance record, the EU never managed to deploy the financial sanctions set out in the SGP.

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 deficit procedure (EDP), the one preceding the imposition of sanctions. The attempt failed as

¹ 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.

the two large member states, with the help of a third (Italy), blocked the Commission's initiative in the Council. Since then, the SGP 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.

At the time of writing, the SGP is at the cusp of 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. 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 member 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 SGP.

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 substantial 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. 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 know 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.

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 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.³ 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 Jaques Delors unambiguously envisaged binding and 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*”.⁴

What the Delors committee and other observers at the time did not anticipate are 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, 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 changed ‘the game’ around the credibility of fiscal rules.

³ See Article 126(10) of the Treaty.

⁴ Section II.4 and III.5 of the [Delors report](#).

3. The dilemma of SGP enforcement dissected

If one accepts the narrative outlined in the previous section, the lack of SGP enforcement should be less of a surprise than many stakeholders and commentators are ready to admit. This interpretation not only helps understand the past, it is also relevant in light of the ongoing legislative reform of the SGP, the fourth since inception back in 1997.

The 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 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 chooses 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.⁵ 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

⁵ 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.

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 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 $x_D \varepsilon (0,1)$ for Group D and $x_S \varepsilon (0,1)$ for Group S expressed as a share of their respective GDPs.⁶ Hence, without help the GDP of Group S is given by $(1-x_S)Y_S$, while Group D's GDP is $(1-x_D)Y_D$. 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 country 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 shock⁷, EMU meltdown is avoided. Group S bears the costs of the transfer t but it attaches certain conditions,

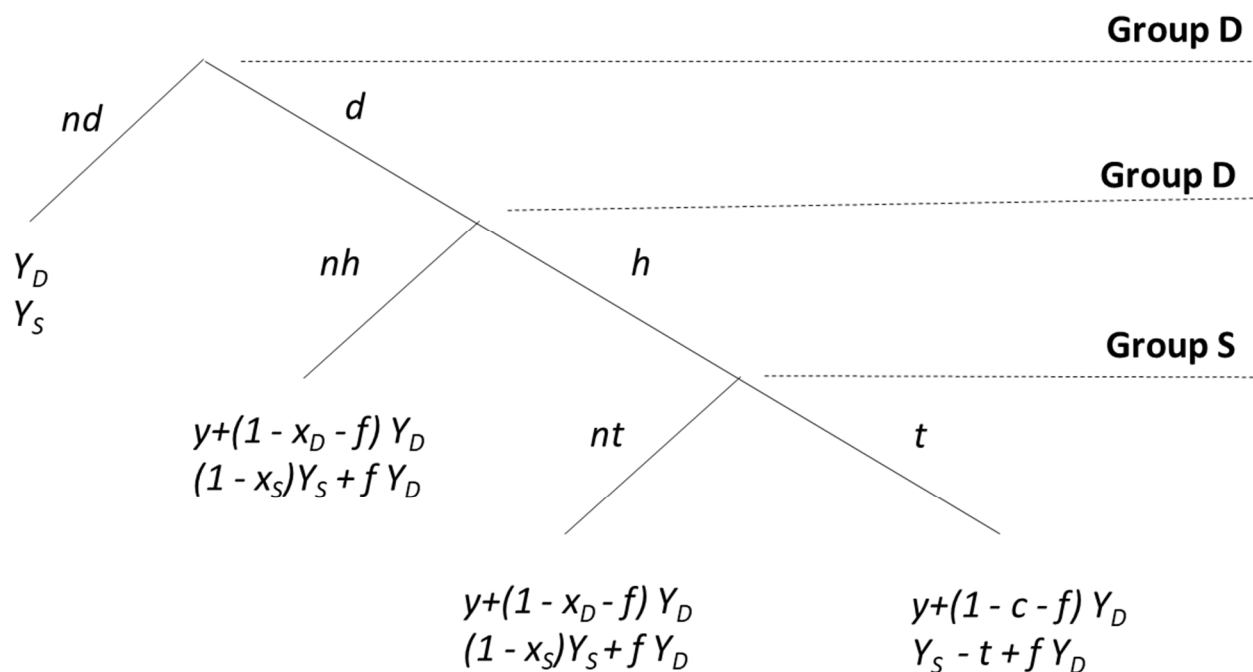
⁶ We model crisis costs x_S and x_D , the fine f , and the costs of the conditions to help c (see below) as shares of the GDPs Y_D and Y_S . The other variables (y and t) are modelled in absolute terms. Since Y_D and Y_S are fixed, modelling these variables in relative or absolute terms is just a matter of notation that has no impact on our results.

⁷ 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 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.

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 $c \in (0,1)$.^{8 9}

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 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.

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



⁸ 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.

⁹ 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.

What happens in the event of a major negative shock? To see this and to characterise the subgame perfect equilibrium, we use backward induction. Since the meltdown of the system is the worst outcome for Group S, it will choose t in its decision node. 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 .¹⁰ Hence, it is reasonable to assume that $c < x_D$.¹¹

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 $y < cY_D$.¹² 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 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 $f = 0$.

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

¹⁰ 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.

¹¹ 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.

¹² 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](#)

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., $f > 0$.

Solving the game with this parameter constellation 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.¹³ 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 could be explained or rationalised 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

¹³ To be more precise, the game exhibits are two subgame perfect equilibria in pure strategies for this parameter constellation, one where Group D asks for help, and one where it does not. Since Group S will not transfer resources, anyhow, 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.

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. This idea is very difficult to rationalise even in hindsight. The members of the Delors committee, and especially its chair, 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 SGP rules is the prospect of conditionality to access support instruments the EU typically deploys in the wake of major economic shocks. In particular, the conditionality needs to be sufficiently strong. 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.¹⁴ Furthermore, the effectiveness of conditionality in preventing deficits d depends crucially 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.¹⁵

¹⁴ 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](#))

¹⁵ 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 implausible to assume that governments are very patient and have infinite time horizons. Hence, we do not analyse such an infinitely repeated game.

4. Policy implications

The stylised model of SGP implementation 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 within the Council, 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 whether to impose 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. Prominent examples are Jean-Claude Juncker's famous quote of 2016 "*because it is France*" or Pierre Moscovici's comments in the same year after effectively waving sanctions for Spain and Portugal.¹⁶ 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.¹⁷

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

¹⁶ [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 \(ft.com\)](#)

¹⁷ 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).

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, 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.¹⁸ 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.¹⁹ 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, 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. 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

¹⁸ [EU's wilful blindness to sovereign risk adds to eurozone danger | Financial Times \(ft.com\)](https://www.ft.com/content/2021/06/01/eu-wilful-blindness-to-sovereign-risk-adds-to-eurozone-danger)

¹⁹ 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.

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.²⁰

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 may 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 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

²⁰ New York City in the 1970s, California after 2008, Detroit in 2013 and Puerto Rico in 2016.

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 construction as a whole, financial help will not come for free.

References

Bénassy-Quéré, A., M. Brunnermeier, H. Enderlein, E. Farhi, M. Fratscher, C. Fuest, P.-O. Gourinchas, Ph. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel, N. Veron, B. Weder di Mauro, J. Zettelmeyer (2018), *Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Area Reform*, CEPR Policy Insight No. 91.

Buti, M. and M. Larch (2019) *The Economic Governance of the Euro Area*, in: *The History of the European Union*, G. Amato, E. Mavero-Milanesi, G. Pasquino, L. Reichlin (eds), Bloomsbury Publishing, London.

Debrun, Xavier, David Hauner and Manmohan S. Kumar (2009) *Independent Fiscal Agencies*, *Journal of Economic Surveys*, 23: 44-81

Dermine, P. and M. Larch (2023) *Solving the enforcement dilemma of the EU fiscal rules*, *EconPol Forum* 3/2023.

Beetsma, R.W.M.J. and X. Debrun (2016) *Fiscal Councils: Rationale and Effectiveness*, IMF Working Paper WP/16/86.

European Fiscal Board (2019) *Assessment of EU fiscal rules with a focus on the six and two-pack legislation*, Brussels.

European Fiscal Board (2022) *Annual Report 2022*, Brussels.

Fahri, E., and J. Tirole (2018) *Deadly embrace: Sovereign and financial balance sheets doom loops*, *Review of Economic Studies*, 85(3): 1781–1823

Fuest, C., F. Heinemann and Ch. Schröder (2016) *A Viable Insolvency Procedure for Sovereigns in the Euro Area*, *Journal of Common Market Studies*, 54(2): 301-317.

Kopits, G and S. A.Symansky (1998) *Fiscal Rules*, IMF Occasional Paper No. 162.

Larch, M., Jonung, L. (2014). *Stability and Growth Pact of the European Union*, the. In: *The New Palgrave Dictionary of Economics*. Palgrave Macmillan, London. https://doi.org/10.1057/978-1-349-95121-5_2877-1

Lucarelli, B. (2013) *The endgame for the euro: a critical history*, Palgrave MacMillan, New York.

Larch, M., J. Malzubris and S. Santacroce (2023) *Numerical compliance with the EU fiscal rules: Facts and figures from a new database*, *Intereconomics*, 58(1): 32-42.

Wyplosz, Ch. (1997) EMU: Why and How It Might Happen, *Journal of Economic Perspectives*, 11(4): 3–22