The enforcement dilemma of EU fiscal rules

Martin Larch
Head of Secretariat
European Fiscal Board, European Commission
(joint work with Georg Kirchsteiger,
ECARES, Université Libre de Bruxelles)

XXII Banca d'Italia Public Finance Workshop
5-6 September 2024

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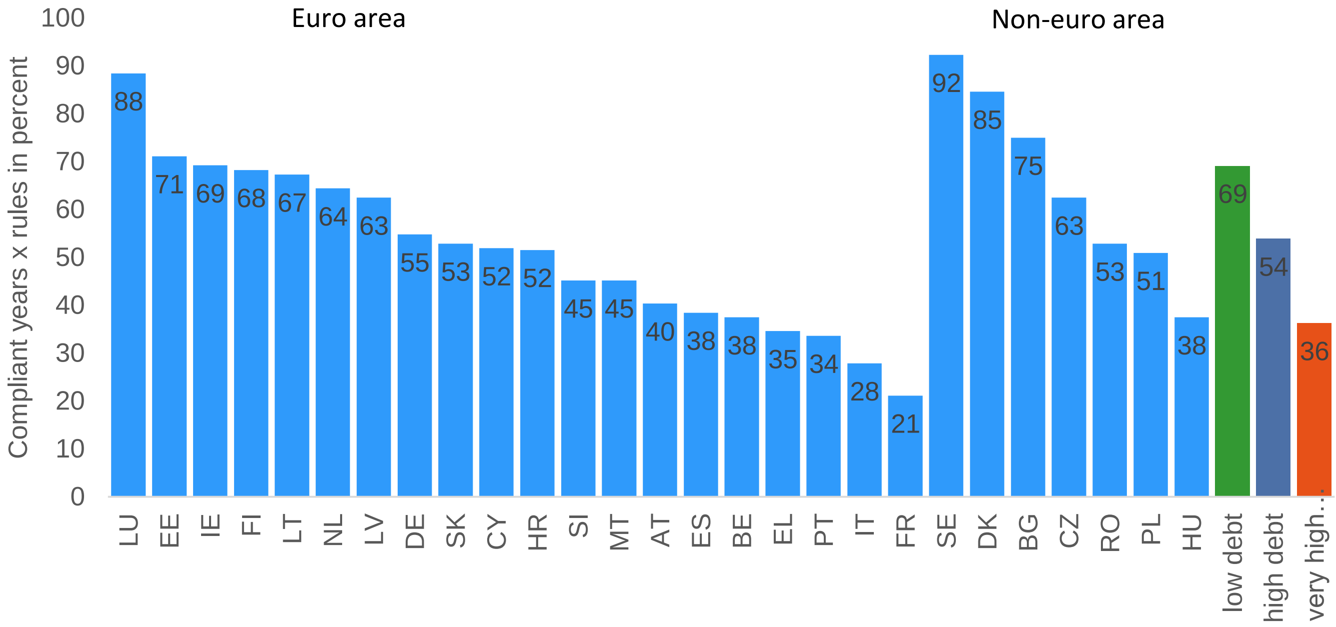
Outline

- SGP compliance and enforcement
- The enforcement dilemma
- Design flaws?
- Conclusions and policy considerations

SGP compliance and enforcement

Numerical compliance diverges strongly across countries ….

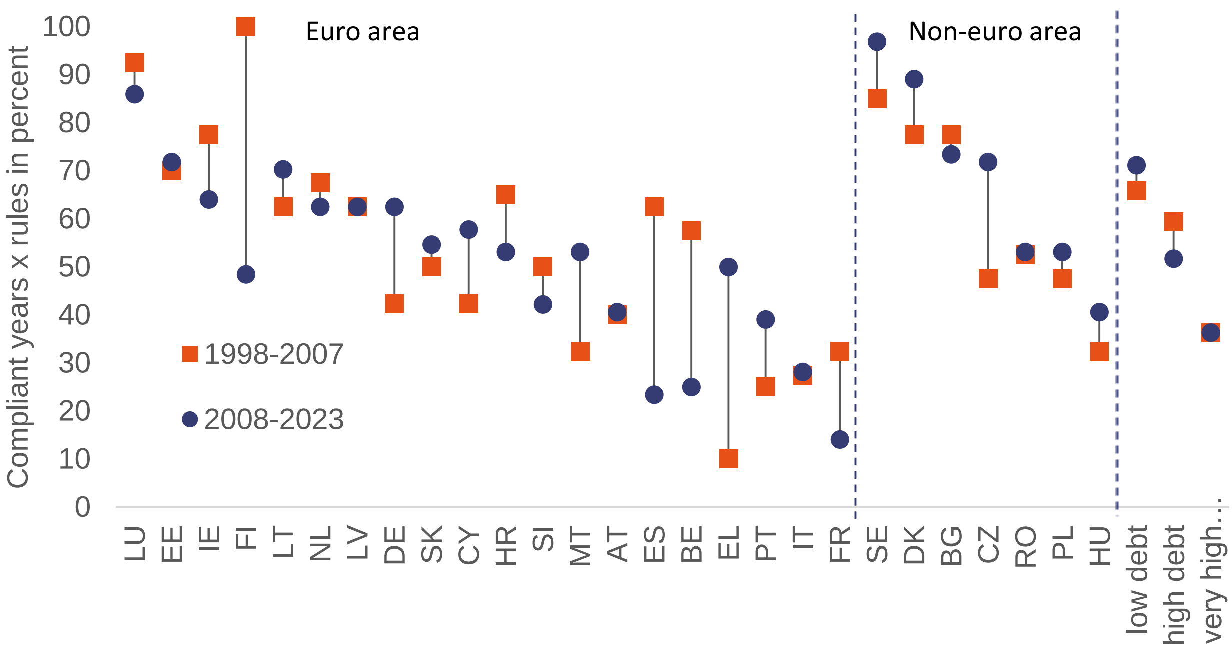


Note: Countries grouped based on their average debt levels in 2011-2019. Low debt = Countries with av. government debt <= 60% of GDP . High debt: Countries with 60% of GDP > av. government debt >= 90% of GDP. Very high debt: Countries with av. government debt > 90% of GDP.

Source: Compliance tracker of EFB secretariat

SGP compliance and enforcement

… but is broadly stable over time



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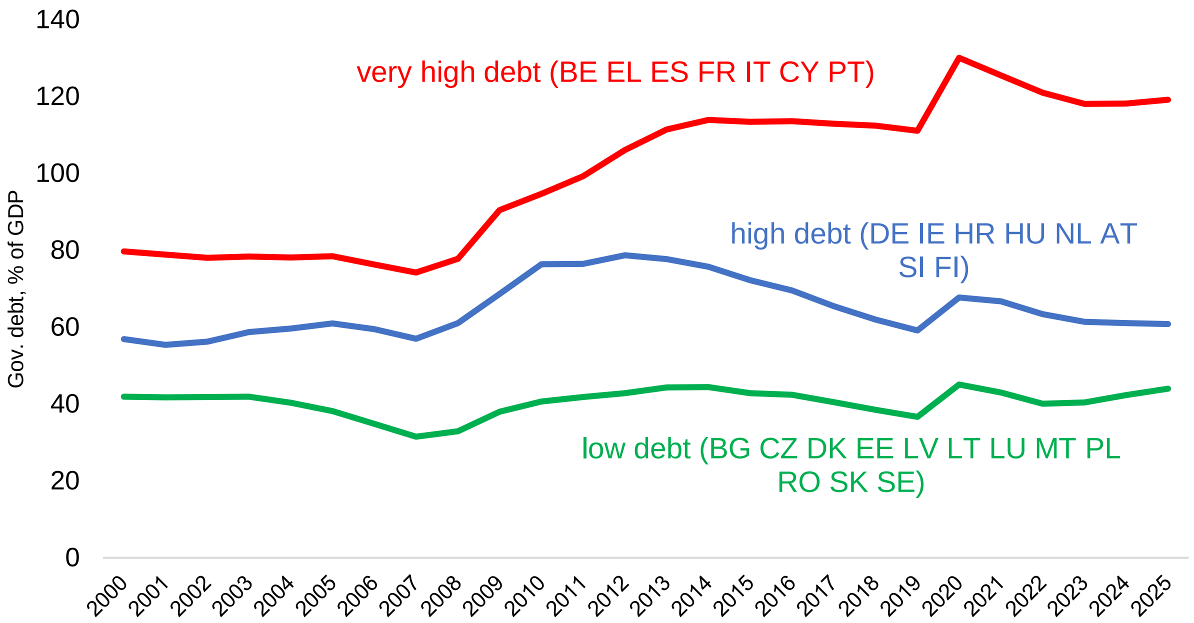
Source: Compliance tracker of EFB secretariat

SGP compliance and enforcement

Diverging compliance translates into diverging fiscal performance, notably gov. debt



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Source: European Commission

SGP compliance and enforcement

In spite of dismal compliance record **sanctions under the SGP** have never been imposed:

First attempt: 2003 (FR and DE) – Council blocked

Second attempt: 2016 (ES and PT) – Council adopts SGP fine of € 0

Conditionality under structural funds linked to EDP applied but to small countries only:

HU 2012: suspension of funds was applied for first and only time

ES+PT 2016: Commission had to propose suspension of funds but Parliament dragged its feet

In the event of large shocks **EU agreed new support instruments** to 'bail out' high-debt countries under pressure in financial markets

The enforcement dilemma

Dismal compliance with rules by some countries

No enforcement with sanctions

Diverging national preferences

"Divergent propensities to run deficits" lead to growing debt levels in one group of EU countries with sufficient weight.

Systemic risks

In the event of large shocks countries with high debt levels come under pressure with risk of collateral damage for the fiscally prudent countries and EMU as a whole.

Deficit-prone countries can block enforcement of rules

Fiscally prudent countries have incentive to bail out deficit-prone countries and conditionality for support cannot be too harsh

The enforcement dilemma

Simple model

2 groups of countries

- Group D: enjoys political + economic benefits from running deficits
- Group S: runs sustainable fiscal policies

SGP implementation takes place in three stages

- Stage 1: Group D decides its fiscal policy course
- Stage 2: An economic shock hits and Group D decides whether to ask for help or not
- Stage 3: Group S decides whether to offer help and under which conditions

The enforcement dilemma: systemic risks

Think forward

Stage (1)

D sets its fiscal policy

- D decide *d* or *nd*
- D enjoy a short-term (economic and political) benefit *y* from running deficits.
- Council can decide to impose financial sanction in case D do not correct excessive deficits; fine amounts to f^*Y_D. Outcome of vote in Council is determined by the distribution of risks of non-compliance across countries.

Stage (2)

A major negative economic shock hits euro area

- D decide whether to ask S for financial support *t*.
- If D chose *nd* in stage (1) it weathers the shock on its own.
- If D chose *d* stage (1) reassessment of sovereign risks by markets makes the fiscal position of D unsustainable. Costs for D are xd^*Y_D, spillovers on Group S are xs^*Y_S threatening the stability of the EMU as a whole.
- Help *t* comes with policy conditions, which produce (economic and political) costs of; c^*Y_D (see stage (3)).

Stage (3)

S decides whether to support D

- If S offers financial support *t*, meltdown is averted.
- Meltdown is the worst possible outcome for S.
- S bears the costs of the financial support *t* but attaches policy conditions, which produce social and political costs for D equal to c^*Y_D

Reason backward

If D has a blocking minority in Council, sanctions will not be applied: $f=0$. Hence, the decision of D mainly depends on the policy conditions in the event of a major shock: $y < c^*Y_D$

D will ask for financial support if $c < xd$. Policy conditions cannot be too strict (or a non-EU power may offer help which reduces *xd*):

S will provide financial support if asked by D if $t < xs^*Y_S$

Design flaws?

Blueprint for non-systemic risks was fine

Delors committee: Lamfalussy, internal paper January 1989

With **widely divergent "propensities to run deficits" prevailing in the various European countries**, I doubt whether we could count in the foreseeable future on a convergence within a European EMU similar to that observed in most contemporary federal systems. [....] This could lead not only to an **emergence of intra EMU political tensions, but also to pressure on the federal monetary authority to relax monetary policy.**

Delors report, April 1989

[...] an economic and monetary union could only operate on the basis of mutually consistent and **sound behaviour by governments** and other economic agents in all member countries. In particular, **uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community.**

[....] **in the event of non-compliance** by Member States, the Commission, or another appropriately delegated authority as envisaged in paragraph 31, would be **responsible for taking effective action to ensure compliance**;

Design flaws?

Actual SGP deviated from blueprint

- EU fiscal policy guidance largely issued as recommendations, i.e. legally non-binding acts
- Treaty excludes recourse to the main enforcement instrument under EU law - the infringement procedure - for the largest part of the EDP.
- All material deliberations under the SGP are taken by the member states in the Council with a qualified majority. Hence, enforcement depends on distribution of risk of non-compliance i.e. relative size of Group D

Shadow of future enforcement of international agreement gives states an incentive to bargain harder.

Fearon (1998). Bargaining, Enforcement, and International Cooperation. *International Organization*

Franchino and Mariotto (2021) Non-compliance risk, asymmetric power and the design of enforcement of the European Economic governance, *European Union Politics*

Design flaws?

Systemic risks not on the radar + expectation of convergence

- At the end of the 1980s the EU had gone through a relatively 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

- While many concurred that EU did not form an optimal currency area there was expectation that a single currency may eventually help participating economies become optimal (Frankel and Rosen, 1998; Bean, 1998).

- Global financial and economic crisis and Covid pandemic invalidated ‘great moderation’ paradigm

- Hopes linked to dynamic OCA did not materialise

Enforcement dilemma: non-systemic risk

Think forward

Stage (1)

D sets its fiscal policy

- D decide *d* or *nd*
- D enjoy a short-term (economic and political) benefit *y* from running deficits.
- Delegated entity effectively imposes financial sanction in case D do not correct excessive deficits; fine amounts to $f*Y_D$.

Stage (2)

A normal negative economic shock hits euro area

- D can whether all shocks on its own but can still decide to ask S for help *t*.
- Help *t* comes with policy conditions, which produce (economic and political) costs of; $c*Y_D$ (see stage (3)).

Stage (3)

S decides whether to support D

- For S offering support *t* is more costly than bearing the cost of the shock $xs*Y_S$: $t > xs*Y_S$
- If D where to ask for *t* is would face conditionality of $c*Y_D$

Reason backward

Sanctions are effectively enforced : $f>0$. Hence, the decision of D also depend on the size of fines:
If $y < (c+f)*Y_D$ then D choses *nd*
if $y > (c+f)*Y_D$ then D choses *d*

D does not ask for help in case it goes for *d* because S has no incentive to offer *t*. Hence, it needs to cover costs *xd* on its own.

S will not offer support *t* because $t > xs*Y_S$. No-bail-out is implement.

Conclusions and policy considerations

Conclusions

- Outcome of fiscal surveillance framework invariant to design of rules especially fiscal sanctions as long as divergent fiscal preferences persist.
- No-bail-out provisions are not effective as long as risk of collateral damage from deficit-prone countries endangers EMU as a whole. More prudent countries will not seal their own demise, but financial help does not come for free yet cannot be too high.

Policy considerations

- More transparency and advocacy: stronger IFIs
- Less discretion in setting macro conditionality
- Stronger economic resilience to major shocks (supervision, sovereign-bank nexus, central fiscal capacity (?)

Thanks for your attention!

Extensive form of our stylised model of SGP implementation