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Rewarding Compliance with Fiscal Rules — A Proposal for Reform of the Stability and Growth Pact*

KEY MESSAGES

- **The European Commission has recently published legislative proposals for a reform of the Stability and Growth Pact (SGP). The declared object is to make the economic governance of the EU simpler, improve national ownership, place a greater emphasis on the medium term and strengthen enforcement**
- **However, critics doubt that the proposals are suited to enforce member-state fiscal discipline in the original sense of the SGP**
- **This paper argues in favor of shifting the competence to impose sanctions in the event of non-compliant behavior of member states from the Community to the intergovernmental level. Rewarding compliance rather than penalizing non-compliance makes the shift possible**
- **Such a reform should help to strengthen the accountability for enforcing fiscal discipline, as well as the credibility of sanction threats**
- **The reform would bring the governance framework of the SGP closer to that of the European Stability Mechanism (ESM)**

Public debt is like a contract at the expense of third parties. In this case, to the disadvantage of future generations. As Liz Truss experienced in autumn 2022, such a contract is not only morally questionable, but also risky in terms of financial stability. When the then-newly elected British Prime Minister tried to finance generous tax rebates with debt, the financial markets panicked. The British pound fell to a historic low, forcing her to resign after only 45 days in office.

If the British had adopted the euro, it would not have come to this. Interest rates on British government bonds might have risen slightly and the Euro might have lost some value against the dollar, but otherwise Liz Truss could have carried on unhindered. After all, at the time the UK's sovereign debt amounted to only 98 percent of GDP. While this was higher than in the previous sixty years, it was still quite average by Eurozone standards. In 2021, Italy had a debt-to-GDP ratio of roughly 150 percent, while that of Greece was not far from 200 percent.

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The euro makes such ratios viable by spreading the effects of individual member states' debt across the entire Eurozone. If Italy's debt ratio increases by 15 percentage points, the ratio in the whole Euro area increases by less than a single percentage point. However, this cushioning effect of a common currency creates a problem for fiscal discipline, as it weakens member states' incentives to exercise fiscal restraint. This is likely to have fueled the increase in the zone's common debt-to-GDP ratio from 67 percent at the introduction of the euro to 95 percent most recently.

THE STABILITY AND GROWTH PACT

In fact, a rise in public debt was anticipated as a potential risk and was the reason for signing the European Stability and Growth Pact (SGP) before introducing the euro. The Pact aimed to ensure that the level of public debt remained below 60 percent and that new borrowing did not exceed three percent of GDP in normal times. Sanctions were to apply in the event of non-compliance, but these were never consistently imposed. As a result, over the years the monetary union was allowed to take on the character of a debt union. Revisions to the Pact's rules introduced between 2011 and 2013 in response to the Greek sovereign debt crisis could do little to change this (for a guide to European economic governance, see Suttor-Sorel 2021). Whether the European Commission's (2022 and 2023) proposals for a comprehensive reform of the EU economic governance framework will make fiscal rules more binding is strongly doubted (Wyplosz 2022).

The Covid-19 pandemic even raised the European debt problem to a new level by deciding to finance the Next Generation EU recovery fund with common debt. The fund was established in support of countries particularly affected by the pandemic, such as Italy. The legal objection that the EU treaty does not provide for common debt was countered by referring to the extraordinary threat posed by Covid-19. Fiscal disciplinarians are now pinning all their hopes on this rule-breaking being a one-off exception. However, current discussion of how the rebuilding of war-ravaged Ukraine and the upcoming digitalization and decarbonization of the economy are to be financed

gives reason to suspect that the breach has merely set a precedent.[1] Why the European capital markets have not yet shown any signs of growing unrest, as they did in the case of the UK, is not entirely clear and must remain unanswered here. Whatever the reasons, it would certainly be irresponsible to test the limits of public debt in the EU. What is needed instead are ideas on how to enforce fiscal discipline in the Eurozone.

However, this search for ideas must be preceded by a clarification of the causes for insufficient fiscal discipline. Two are worthy of consideration. First, as already mentioned, there is a tendency for countries to exploit the monetary union to communitize the adverse effects of excessive debt and to externalize currency and interest rate effects. Yet such behavior can only spread, because the sanctions provided for in the SGP are not imposed in practice. And this points to the second cause of the problem: The Pact communitizes the competence for imposing sanctions, too. As can be seen in many areas of life, however, collective competence means diluted accountability. As a result, threats of sanctions lose their credibility. Their enforcement suffers from relying on collective action, which often requires political compromises. There are thus two obvious strategies for remedying this flaw in the SGP governance. Either accountability is strengthened at the Community level, which, however, would most probably require the EU to be developed into a federal state or, alternatively, the competence and accountability for the imposition of sanctions is returned to the member states. In other words, Europe must choose between deeper political integration and some partial but targeted disintegration. Since the latter is the more realistic option, it is this that is considered below in more detail.

THE EUROPEAN STABILITY MECHANISM (ESM) AS A GOVERNANCE MODEL

The ESM is an intergovernmental organization, established in 2012 as a permanent firewall for the Eurozone. Indispensable to safeguard the financial stability of the Eurozone as a whole and of its member states individually, the ESM may provide stability support subject to strict conditionality. Such conditionality may range from a macro-economic adjustment program to continuous adherence to pre-established eligibility conditions. Importantly, decisions on the choice of instruments and the financial terms and conditions must be adopted by mutual agreement of the ESM member states. This means that each member state has a veto power, and that accountability is not diluted despite joint decision-making. However, the treaty establishing the ESM does not specify any sanctions to be imposed in case of non-compliant behavior by beneficiary states. Potential sanctions are limited to refusing support to a non-compliant member state if it would ask for support at a later occasion.

The governance of the ESM cannot be directly transferred to the SGP. The functions of these two institutions are too different. The ESM is called upon in cases of emergency, while the SGP is supposed to restrict member states' leeway in ongoing debt policy. Therefore, the governance of the ESM can only serve as a rough model for the reform of the SGP.

RESTRUCTURING THE SANCTIONING COMPETENCE OF THE SGP

The strengthening of accountability and shift of sanctioning competence to the member states can be achieved through rewarding compliant behavior rather than penalizing non-compliance. Instead of threatening member states with fines for excessive indebtedness, it would be more expedient to help them reduce excessive debt. At first glance, this reversal of payment obligations may seem unreasonable in that it runs counter to the principle that the "polluter" must pay for damages. However, putting a premium on compliant behavior has two key advantages. Firstly, it makes it possible to share the benefits and costs of debt reduction more fairly among member states. After all, a state with low debt also benefits if a highly indebted state reduces its debt and thus strengthens the stability of the common currency. Secondly, if a beneficiary state is mulling non-compliant behavior, the threat of an obligated state to withhold its agreed premium payment is more credible than the threat of the EU imposing a fine. After all, the European level lacks the sovereign power to collect a fine it has imposed. At best, it can reduce payments from the EU budget, but this requires a politically negotiated agreement. Such an intergovernmental agreement is not necessary if an obligated state refuses to pay a premium conditioned on compliant behavior because the beneficiaries in question did not behave compliantly. The withholding of the premium payment would merely mean acting in conformity with contracted rules. At most, it is conceivable that an obligated state might be willing to pay out the promised premium despite the beneficiaries' non-compliance. In this case, however, the government paying out must explain such generosity to its electorate. In other words, the government of an obligated state faces a credible threat of backlash if it fails to comply with its sanctioning obligation.

The proposed reform of the SGP could function as follows. First, the EU member states are divided into two groups. Countries with above-average public debt ratios are considered financially weak, while countries with below-average ratios are regarded as financially strong. The latter, which thus become "donor countries," are then obliged to make conditional transfer payments to the former, now "recipient coun-

[1] In an interview with the FAZ (2023), EU Economic Affairs Commissioner Paolo Gentiloni openly advocates new EU debt.

Table 1
Illustration of the Debt Reduction Plan, 2021

	GDP in €m, 2021	Public debt in €m, 2021	Public debt ratio as percent of GDP, 2021	Public debt at average EURO19-ratio	Over-hanging public debt 2021	Transfer in 2021	Debt Reduction/ Increase	Resulting public debt in 2021
AUT	406,148	334,260	82.3	387,465		1,380	1,380	640
BEL	502,312	548,524	109.2	479,205	69,319	-693	-2,080	546,445
DEU	3,601,750	2,470,801	68.6	3,436,070		12,238	12,238	2,483,038
ESP	1,206,842	1,427,694	118.3	1,151,327	276,367	-2,764	-8,291	1,419,403
EST	31,445	5,534	17.6	29,998		107	107	5,641
FIN	251,520	182,100	72.4	239,950		855	855	182,955
FRA	2,500,870	2,820,981	112.8	2,385,830	435,151	-4,352	-13,055	2,807,927
GRC	181,675	353,357	194.5	173,318	180,040	-1,800	-5,401	347,956
IRL	426,283	236,161	55.4	406,674		1,448	1,448	237,609
ITA	1,782,050	2,678,422	150.3	1,700,076	978,346	-9,783	-29,350	2,649,071
LTU	56,179	24,550	43.7	53,595		191	191	24,741
LUX	72,295	17,712	24.5	68,969		246	246	17,958
LVA	33,696	14,691	43.6	32,146		114	114	14,806
MLT	14,983	8,435	56.3	14,293		51	51	8,486
NLD	856,356	448,731	52.4	816,964		2,910	2,910	451,640
PRT	214,471	269,161	125.5	204,605	64,556	-646	-1,937	267,224
SVK	98,523	61,281	62.2	93,991		335	335	61,616
SVN	52,208	38,895	74.5	49,807		177	177	39,072
ZYP	24,019	24,259	101.0	22,914	1,345	-13	-40	24,219
Euro19	12,313,624	11,747,197	95.4		2,005,123	0	-40,102	11,707,095

Source: Author's calculations with data from Eurostat.

tries." As part of the plan to reduce public debt, donor and recipient countries conclude a contract at the intergovernmental level. Under this contract, donor countries are given the right to withhold their share of an agreed transfer payment if the beneficiary is non-compliant. The right to impose sanctions in the event of contract violation is thus reserved for the donor countries and not ceded to EU institutions.

To be even more specific, let us define "overhanging" public debt as that part of member states' debt that exceeds the Eurozone's average debt ratio. The recipient countries are then required to reduce a given percentage of their overhanging debt each year. If this is done, they are reimbursed by the donor countries with a transfer payment for a specified proportion of the reduced debt. If, for example, the minimum percentage of reduction were set at 3 percent and the reimbursed proportion at one-third, the recipient countries would be obliged to reduce their overhanging public debt by at least 2 percent per year on a net basis. The amount donor countries are obliged to contribute would be based on their economic strength, because in the European context GDP is considered the measure of ability to pay. To make it easier for donor countries to finance their payment obligations, they would be allowed to borrow the relevant amounts without violating the SGP.

To what extent would the rewarding of compliant behavior outlined above be open to abuse? Could it be exploited by a country intent on a deliberate breach? In theory, yes, but in practice, unlikely. The direct cost that a non-compliant country would have to bear is the loss of the agreed premium payments. By design, this cost increases with the size of the overhanging debt and vanishes with a vanishing overhang. By contrast, the benefit of non-compliant behavior is independent of the overhang's size. Therefore, when the overhang vanishes, a costless advantage beckons. This consists of the deferred perpetuity of debt-reduction premium payments on the increase in non-contractual debt. Hence, the possibility of abuse cannot be dismissed out of hand. However, it can be qualified. Firstly, the benefits of abuse can be reduced by extending the phase during which previously non-compliant countries must demonstrate compliance before donor countries return to paying debt reduction premiums. Secondly, non-compliant countries will realize that they are curtailing their own budgetary flexibility to their own detriment as debt and interest payments increase.

AN ILLUSTRATION WITH DATA

How the proposal might function is briefly demonstrated with data from 2021 (see Table 1). For the sake of simplicity, it is assumed that a minimum percentage of debt reduction of three percent and a reimbursement rate of one-third have been agreed, and that the recipient countries manage to reduce their overhanging public debt by exactly 3 percent. The parameters

mentioned would of course have to be negotiated; those used here are merely for illustrative purposes. It is clear that the choice of the reimbursement rate determines not only the extent of the redistribution between donor and recipient countries but also the strength of the sanction threat and thus the incentive for compliance on the part of the recipient countries.

In 2021, GDP in the euro area was €12.3 trillion and the average public debt-to-GDP ratio was 95.4 percent. Countries with above-average ratios were Belgium (109 percent), Cyprus (101 percent), France (113 percent), Greece (195 percent), Italy (150 percent), Portugal (126 percent), and Spain (118 percent). All these would have been classified as recipient countries. Their combined debt overhang amounted to a total of €2.0 trillion. Under the outlined plan, the recipient countries would have to reduce their overhanging public debt by 3 times €20 billion. In return, they would receive €20 billion from the donor countries. Germany, Europe's most important donor country, would have to contribute €12.2 billion. Though this sum may appear high, it merely reflects the country's economic strength. The sum would be the price Germany would have to pay for improving financial stability in the Eurozone. The reduction and alignment of individual countries' public debt ratios would significantly ease the job of the European Central Bank.

POLICY CONCLUSION

The EU sees the need to reform its fiscal rules (European Commission 2022). The only question is how. In academia, various models are being discussed, including a communitized European servicing of interest for the public debt attributable to the Covid-19 pandemic (Giavazzi et al. 2021), a change of focus away from debt and deficit ratios toward expenditure ratios, and a differential treatment of consumption and investment spending (Gros and Jahn 2020, with references to the literature). In contrast, the Commission wishes to strengthen the fiscal surveillance process and negotiate a separate adjustment path with each member state. This policy approach is based on the view that "one-size-fits-all" fiscal rules have not proved politically and economically viable (Paolo Gentiloni in his interview with FAZ 2023).[2]

[2] The Commission's original 2022 proposal was to replace rigid limits on public debt and fiscal deficits with country-specific debt reduction plans. In contrast, the proposals published in April 2023 require countries with deficits exceeding 3 percent to reduce debt by at least 0.5 percent per year. Reichlin (2023) criticizes this tightening with the argument that "rigid rules that fail to adapt to changing circumstances either harm the countries attempting to follow them or are violated systematically, undermining the credibility of the rule-setting body."

In none of these reform models, however, is it clear how compliance with fiscal rules can effectively be enforced. To remedy this, this paper argues for shifting the sanctioning competence for rule-breaking behavior from the Community level to the intergovernmental level. Such a shift would strengthen the accountability for enforcing fiscal discipline and increase the credibility of the sanction threat. However, the shift would require a switch from penalizing non-compliance toward rewarding compliance. That would not mean, though, that all the fiscal rules already in place should be abandoned. After all, it would still be necessary to have rules for dealing with cyclical fluctuations and macroeconomic shocks. The Maastricht criteria would also continue to be needed as a threshold for joining the monetary union. After all, countries must be kept from first pursuing an excessive debt policy and then joining the Euro in the expectation that they will be helped to reduce their debt.

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