**Member State Sanctioning and Compliance under the European Union's Stability and Growth Pact**

by

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This paper examines the compliance of fifteen Member States under the European Union's Stability and Growth Pact (SGP) that entered force in 1999, or after the decision on which countries would join the common currency, the euro. The SGP requires every European Union Member State to submit annual macro-economic programmes to a supranational body, the European Commission, for evaluation. Those programmes include information on deficits, debts, and economic growth. The Commission, in turn, makes a recommendation to the intergovernmental Council of Economic and Finance Ministers (ECOFIN, or "Council."). While I will go into more detail about the provisions of the SGP below, the key figure is a budget deficit of 3%. The Council, based on an initial recommendation from the Commission, may find that a country with deficits above this figure has an "excessive deficit." The Commission may also recommend corrective measures. If a country ignores the Council's ruling, the Council, again with initial Commission recommendation, may ultimately decide to fine a non-complying country.

The Stability and Growth Pact has had a rocky history since 1999. While the goal was to prevent states from running "excessive deficits," by 2005 half of the twelve states in the eurozone representing over 80% of eurozone GDP were in excessive deficit. Moreover, a goal of the Pact was to get states out of excessive deficit soon after they were declared to have one. Two large founding members of the European Community, France and Germany, were especially visible in their violation of the Pact. They repeatedly ignored Commission advice to get their budget deficits below 3% of GDP, and in November 2003 the countries received what amounted to backing from the Council

agains the Commission's recommendations on sanctions. The following year, the Commission took the Council to the European Court of Justice but the outcome did not materially affect the overall setup, which still left the member states themselves voting through their seats on the Council whether to impose the Commission's recommendations. In March 2005, the member states revised the Stability and Growth Pact in ways thought to weaken the Pact still further. Finally, in 2011 the Union revised the procedures again.

These events led some to conclude that the Stability and Growth Pact had been a failure. While this conclusion was certainly too strong, the goal this paper is to evaluate three separate steps of the process. The first is the selection of countries the Commission makes each year to issue recommendations. The second is the frequency with which the Council weakens the Commission's reports; was the incident with France and Germany a notable exception, or was it the norm? The final question concerns compliance. Once again, the two large countries seemed to ignore Commission recommendations, but was this a broad pattern, or did other countries comply?

To answer these questions, the paper presents a dataset constructed from existing stability and convergence programmes, Commission reports on those programmes that are meant to be the text that the Council then gives to the member state in question, and the content of the Council recommendation. The findings are clear. If one looks at all programmes, the Council weakened the Commission text about one-third of the time between 1999 and 2008. If one looks just at concrete recommendations for change, the Commission made such recommendations 23 times, and the Council weakened the subsequent language that was passed along to the member state in over half of these

cases. Finally, even given the recommendations that the Council ultimately did make, member states failed to comply over half of the time.

These findings then beg explanation, which represents the bulk of the paper. The first part examines dynamics between the Commission and the Council. It begins with a Heckman selection model where the first stage is the Commission's decision on what to report on member states while the second stage is the Council's decision whether to weaken the report. The model examines whether countries then complied with the recommendation that the Council issued to it.

While the dataset comes from the European Union, the analysis has broader theoretical relevance. Work in international relations considers why do governments comply with some treaties that their governments sign while others do not.

**Stability and Growth Pact**

a. Background

The Maastricht Treaty provided the road map to create a common currency and an independent central bank to regulate it. While fiscal policies were to remain the domain of Member States, the Treaty anticipated the need for some sort of macro-economic policy coordination. As Article 99(1) of the Treaty stated, "Member states shall regard their economic policies as a matter of common concern and coordinate them in the Council." The initial institutional tool was the Broad Economic Policy Guidelines, which the Commission would draft and the Council would pass.

The European Monetary System crisis in 1992-3, however, combined with a general worsening of budget deficits across the Union, heightened concerns about how

countries would perform once Economic and Monetary Union began. Two of the so-called 'Maastricht criteria' focused on fiscal policy and set reference values of a general government deficit no larger than 3 per cent of GDP and general government debt burden no larger than 60 per cent of GDP. The Commission used these values, in turn, to judge whether countries met the requirements to join the Euro Area (Stage III). In practice, the emphasis in the run-up to the introduction of the euro was on the deficit figure, and Member States had to get their deficits at or below 3.0 per cent if they wanted to adopt the euro.[1] However, there were only vague provisions for what to do once the euro was created.

Article 103 of the Maastricht Treaty was judged as a 'no bailout clause' because it stated that neither the Community nor the other Member States were liable for the commitments of other governments. There was concern, however, that this was not a credible position, and indeed, the bailouts of Greece and Ireland confirmed this. A state with a fiscal crisis could hurt all members of the Euro Area, and the remaining countries could subsequently find it in their best interest to bail out this state. Consequently, there seemed little to prevent states from relaxing their fiscal stances once they joined.

These concerns led to the creation of the Stability and Growth Pact, which the Member States agreed at the Dublin Summit in December 1996.[2] The details of the Pact's operation are important in assessing whether the Pact has been successful in improving

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[1] The evaluation of the relative "fitness" of Member States for Stage III of EMU gave the Commission some agenda-setting power. The Treaty indicated that a "ratio [that] has declined substantially and continuously and reached a level that comes close to the reference value" (Article 104(2a)) would suffice. In 1994, the Commission judged that all countries but Luxembourg and Ireland had "excessive deficits." While Ireland had a debt level well above 60%, the Commission argued that the ratio was going in the proper direction. This meant in practice that countries such as Belgium and Italy with debt levels above 100% of GDP could get into Stage III of EMU so long as their deficit number was below 3%. For more details, see Hallerberg (2004), Chapter 2.

[2] See Heipertz and Verdun (2010) for more detail about the Pact's creation.

fiscal discipline and in coordinating the fiscal policies of the Member States. At its core, it has both preventive and corrective mechanisms. The preventive mechanism focuses on detailed monitoring of what Member States are doing. While states submitted some information to the Commission beginning in 1994, the contents of those reports were not well-specified. States would now have to write either convergence (non-euro members) or stability programs (euro members) and update those programs roughly at the end of each year. All states were expected to have budgets that were 'close to balance' or in surplus over the medium-term. The Commission then had the responsibility to review each programme, and to make recommendations to the ECOFIN Council on whether the programme met European goals and whether the goals set in the programmes were realistic, given domestic conditions. The Commission could also recommend that a state receive an 'early warning' that it would run an excessive deficit if immediate action were not taken, which the ECOFIN Council would subsequently have to approve in order for the warning to become official.

The corrective arm followed from the Commission's assessment of a given state's domestic policy. If it judged both that an 'excessive' deficit existed and that a state had not made any progress in eliminating it, the Commission could recommend to the Council that the state make a non-interest-bearing deposit with it of up to 0.5 per cent of GDP, depending on the size of the deficit. If the Member State continued to neglect necessary reforms, the deposit could become a fine. The Commission is further charged with considering 'exceptional' circumstances in its assessment, which would be automatic if there were an economic contraction of at least 2 per cent of GDP; if economic growth were to drop into the 'box' 0.75-2 per cent of GDP, the existence of

‘exceptional’ circumstances would be determined by Commission recommendation and subsequent ECOFIN vote. In practice, this meant that zero growth years were not ‘exceptional’.

The initial performance of the Stability and Growth Pact was mixed. France and Germany had problematic deficits beginning in 2002. The Commission recommended an ‘early warning’ to Germany in 2002, but the ECOFIN Council did not pass it, and an informal agreement reached with Germany meant that Chancellor Schröder avoided getting such a warning in an election year. In autumn 2003, the Commission judged that the deficits in France and Germany were excessive and that they would continue, and it attempted to begin the sanctioning process against each Member State. The ECOFIN Council, however, balked at following the Commission’s recommendation. The Commission’s response in January 2004 was to take ECOFIN to the European Court of Justice. In its judgment, the Court ruled that the Council could not suspend a procedure without the Commission’s recommendation. (European Commission 2004; Morris, et. al, 2006, 17-8).

There was a clear sense both in the academic and policy communities that something was wrong with the Pact, resulting in a slew of reform proposals (e.g., Begg et. al 2004; Schuknecht 2004; Schelkle 2005).[3] The Member States themselves agreed to a concrete reform in March 2005. Under the revised Excessive Deficit Procedure (EDP), more factors are now explicitly considered when determining whether a country has an excessive deficit, such as if their spending fosters international solidarity or if it promotes

[3] The best summary of the proposals appears in Fischer, Jonung, and Larch’s (2006) appropriately-titled paper “101 Proposals to Reform the Stability and Growth Pact. Why so Many?”

the unification of Europe.[4] Member States also set their own medium-term objectives, which can include the future fiscal effects of major structural reforms in their calculations. Once a state is found to have an excessive deficit anyway, it may receive extended deadlines so that it has a longer period to correct the deficit than before the revision. Countries experiencing negative growth are now exempt, whereas the previous requirement for automatic exemption was a decline in economic output of 2% of GDP.

These changes weaken the Commission's position vis-à-vis Member States, but the Commission does now have a new mechanism that supplements the previous early warning system: the ability to issue policy advice directly to Member States without prior Council approval. The "early warning" mechanism remains, but it is meant to be used only when it is likely that a country will exceed the 3% deficit limit without further action.[5]

In summary, the process under the Stability and Growth Pact is more complex than a simple 3% deficit rule. Critically, there is an interaction between the Commission on the one hand and the Council that includes the Member States on the other. For example, the European Commission must initiate an excessive deficit process against a country. That process only results in an "excessive deficit" label for a country if the ECOFIN Council agrees with a qualified majority. This process is generally true for other parts of the Pact as well. The Commission is supposed to evaluate every Stability and Convergence Programme and issue recommendations for changes where it finds that the Member States are not taken actions it deems necessary. These recommendations,

[4] The clause on "international solidarity" was widely seen as a way to molify France, which wanted defense spending to be exempt, while "European unification" would allow Germany to include the costs of German unification.
[5] An excellent review of the changes in the Pact appears in Morris, Ongena, and Schuknecht 2006.

however, have to be approved by the Council, and the Council can (and does) change them. Conveniently for our purposes, the various recommendations at the different stages of the process on the programmes are public. In the empirical section, we will consider concretely the Commission's actions against states and whether ECOFIN followed the Commission recommendation. We also ask whether there are systematic biases in the types of recommendations the Commission makes and whether the Council accepts them.

b. Compliance under the Stability and Growth Pact

This process provides an especially fertile dataset to examine issues of compliance and non-compliance. Member states submit either convergence or stability programmes yearly to the European Commission. The Commission, in turn, evaluates the programme and submits a recommendation to Ecofin. Ecofin then decides whether to accept the Commission's recommendation as-is, strengthen the recommendation, or weaken it. The country then decides whether to comply with the Council's recommendations.

In this section, we provide the evidence of what each actor did at each stage of the process. In particular, we first examine variation between Commission assessments and Council opinions of the Stability and Convergence Programmes between 1998-1999 and 2006-2007. We then consider which countries received 'excessive' deficit labels. We finish with a comparison of Commission recommendations for explicit action on the part of a Member State and Member State compliance. The countries in the study consist of the EU-15, that is, it excludes the twelve countries that joined the European Union either in 2004 or 2007. These countries face different fiscal challenges than the original EU-15.

One might question why we include the three countries that chose not to join EMU, namely Denmark, Sweden, and the United Kingdom. We see these states as potentially interesting sources of variation. They must submit convergence programmes yearly, and those programmes undergo the same review as the stability programmes that the eurozone members face. As "outs," they are not subject to the same possible sanctions that eurozone members face, and in particular they are subject to possible fines, so it may be that they do not face the same incentives as the others, but this is something we can empirically assess.

For contrasts between Commission assessments and Council opinions, we code them as falling into one of the following three categories: 1) "No change"—there is no noteworthy or substantial variation (defined more precisely below); 2) "Weakening"—the Council Opinion has placed less stringent demands or in general is less critical of a country programme than the Commission assessment; 3) "Strengthening"—the Council Opinion has placed more stringent demands or in general is more critical of a country programme than the Commission assessment.

Before one accepts our results, a few words about coding are in order. Statements that are substantively similar yet vary in level of detail are not generally considered significant.[6] Omissions in the Council statement are considered significant if the Commission holds a country to a specific outcome but the Council does not. Treatment of omissions is especially relevant because there is variation in the length and detail in

[6] For example, for Greece 1998-99, the Commission indicated that "structural reform is needed in order to improve the efficiency of the Greek economy, particularly in its large public sector."
The Council's response was as follows: "The Council welcomes the structural reforms included in the programme which are geared towards the labour market, the social security system and the wider public sector. The Council urges the Greek Government to implement them as scheduled and pursue further the reform effort in order to enhance the potential and efficiency of the Greek economy." This case was coded as no significant change.

various reports. For instance, Commission assessments are publicly available only in extended summary format prior to the 2003-2004 round of updates.[7] If summarized/full-length version comparisons of later years are any guide, the extended summaries capture the significant points, but we cannot be sure this is true. Finally, we do not record a distinction in the magnitude of weakening or strengthening; if there is a perceived change in one direction or the other, we simply record it as such. Commission and Council documents are simply recorded as having a weakening or a strengthening (or both) in a given year. Table 1 provides examples from each.

[7] The Europa website, the official online portal of the EU, states explicitly that Commission statements are released in full only since the 2003-2004 round of updates. See: http://ec.europa.eu/economy_finance/about/activities/sgp/ca_en.htm .

**Table 1: Example of Commission and Council Assessments of Stability and Convergence Programs**

| Examples | Country and Year | Commission Assessment | Council Assessment |
|---|---|---|---|
| No Change | Italy (2002-2003) | 8/1/03:"Given Italy's high debt, large primary surpluses will be required for many years." | 21/1/03: A) "Given Italy's high debt, primary surpluses on the order of 5% of GDP will have to be maintained for many years." |
| Strengthening | Netherlands (2005-2006) | 22/2/06: "With regard to the sustainability of public finances, the Netherlands appears to be at **low** risk on grounds of the projected budgetary costs of ageing populations." | 14/3/06: "With regard to the sustainability of public finances, the Netherlands appears to be at **medium** risk on grounds of the projected budgetary costs of ageing populations. |
| Weakening | United Kingdom (2004-2005) | 16/2/05: A) "Deficit projections to 2006/2007 have been revised upward relative to the previous update **despite an essentially unchanged macroeconomic outlook**, while…" B) Paragraph concerning possibility of crossing 3% deficit rule (see Council cell) C) "For 2004/05, evidence of significant progress remains unconfirmed in outturn data and there is a high degree of uncertainty over both expenditures and revenues, leaving the risk noted above of a deficit higher than 3% of GDP." | A) "Relative to the 2003 update, deficit projections for both this financial year and the next have been revised upwards; beyond…" B) In a paragraph warning of UK's potential to break 3% rule, Council adds the following sentence: **"However, given the decreased volatility of the UK economy in recent years and the cautious approach on the growth assumptions underlying the public finance projections, the risk appears small in the outer years."** C) "There is a clear risk that the budgetary outcome could be worse than projected in the programme in the short term." |

Given these provisos, our dataset includes 133 annual Commission and Council reports on member state programmes.[8] There were 42 instances of the Council opinion

[8] We drop one observation for Denmark in 2002-03 because the Commission posts the UK assessment in its place on the Europa website. We have been unsuccessful in getting the Commission assessment, but given good fiscal performance of Denmark we would expect "no change."

weakening the Commission assessment. This amounts to approximately 32 per cent of the observations. There were also 7 instances of the Council opinion strengthening the Commission assessment (or about 5 per cent of observations). Especially striking is the clustering of weakened Council reports. The Commission's fight with France and Germany certainly got the most press in autumn 2003, but most states received lighter Council recommendations that year than what the Commission first proposed. Also noteworthy is that at least two states received a weaker report in every year but 2006. The lack of cases of weakening in the most recent year may reflect the steady convergence of text between the Commission and Council reports starting in 2004-05. Indeed, the texts are nearly verbatim in recent years.

**Table 2: Weakening and Strengthening by Year**

| | Weakening | Percent of Total | | Strengthening | Percent of Total |
|---|---|---|---|---|---|
| **Year** | | | | | |
| | | | | | |
| 1998-99 | 3 | 7.1% | | 0 | 0.0% |
| 1999-00 | 2 | 4.8% | | 0 | 0.0% |
| 2000-01 | 4 | 9.5% | | 0 | 0.0% |
| 2001-02 | 8 | 19.0% | | 0 | 0.0% |
| 2002-03 | 5 | 11.9% | | 0 | 0.0% |
| 2003-04 | 11 | 26.2% | | 0 | 0.0% |
| 2004-05 | 5 | 11.9% | | 3 | 42.9% |
| 2005-06 | 4 | 9.5% | | 3 | 42.9% |
| 2006-07 | 0 | 0.0% | | 1 | 14.3% |
| | | | | | |
| **Total** | 42 | 100% | | 7 | 100% |

There is also notable variation when the numbers are examined by state. Total number of cases of weakening, for instance, varies from a high of five (France and Germany) to a low of zero (Ireland and Spain). Collectively, France and Germany had nearly 24 per cent of all cases of weakening, despite constituting around 14 per cent of

the dataset. If one compares the large states (i.e., 10 votes in the Council most of the period) with the small ones, they had 38 per cent of the weakenings but were 27 per cent of the sample. While this relationship is in the expected direction, the surprise is that many states received lighter comments from the Council. The 'out' states of Denmark, Sweden, and the United Kingdom seemed to be treated like the others; while they constitute 21 per cent of the weakenings, they also represent 20 per cent of the cases. When it comes to the strengthening of recommendations, the sample here is much smaller: Spain has the highest amount with two, whereas the majority of countries have a total of zero. For the purposes of the analysis that follows, we treat these cases as "no change."

We next consider instances where the Commission has issued a concrete, unambiguous recommendation to a member-state government, and whether the respective government complied. Our definition of recommendation has several requirements:

- The Commission must make explicit reference to a specific, clearly measurable economic goal to be reached by a particular date. It should, in other words, be an unmistakable tripwire set up by the Commission.[9]
- The Commission must employ language indicating that it expects action on the part of the member-state government. In contrast, instances where the Commission mentions aspects of a country programme and notes that such plans "are justified" are not considered a recommendation in our study.[10]
- Lastly, we include instances where the Commission notes Council statements that satisfy the conditions of a strict recommendation.[11]

[9] For example, as in the Commission assessment of the French economic programme of 2005-2006, in which the Commission recommended that France "bring the general government deficit below 3% of GDP in 2006." This qualifies as a recommendation. If the Commission assessment had written "bring the general government deficit below 3% of GDP as soon as possible" it would not be specific.

[10] For example, "high government surpluses are justified in view of future expenditure pressures posed by a rapidly ageing population…" is not considered a recommendation by our strict coding.

[11] For example, for Netherlands 2004-2005, the Commission notes the Council decision that an excessive deficit existed in the country, and further restated the Council's recommendation that the excessive deficit be corrected by 2005 at the latest.

With a clear definition of what constitutes a recommendation, one can code compliance. Most of the required economic information on annual budget deficits comes from the European Union's online AMECO—"Annual macro-economic database."[12] For compliance, we code as 'no information' those instances where the Commission has issued a recommendation but country compliance cannot be assessed given the time frame.

Some interesting patterns emerge. First, the distribution of Commission recommendations is clearly non-random. There is a statistically significant relationship (chi2 p-value below 0.05) between the variables for Commission recommendation and state as well as Commission recommendation and year. There is also a statistically significant relationship (chi2 p-value below 0.001) and high correlation (r=0.59) between a Commission recommendation and excessive deficit. Commission recommendations are typically issued to a state when it is undergoing the excessive deficit procedure or in the preceding year. In other words, the Commission makes concrete suggestions when the reference value has either been violated or is about to be violated.

Moreover, it is when the state is in most trouble and after it receives a strong Commission recommendation that it will also get a report weakened in the Council. There is a strongly significant relationship (chi2 p-value= 0.005) between the existence of a weakening in the Commission assessment by the Council and whether the Commission

[12] Some codings for compliance are judgment calls concerning what constituted compliance on "correcting" an excessive deficit by a certain year. We coded positive compliance by a member state if its annual budget deficit fell below 3% of GDP within/by a given period of time mentioned in the Commission recommendation. Thus, it is possible for a country to be coded as complying with a Commission recommendation to correct its excessive deficit by a given year, even though the Council may not yet have abrogated the excessive deficit procedure. This does not affect other codings, however, such as for the variable for whether a country is in excessive deficit. This value is determined by the Council opinion.

assessment includes a recommendation. In cases where the Commission assessment included an explicit recommendation, nearly 57 per cent of the time (or 13 of 23) the Council issued an opinion with weakened language.

In terms of compliance, we code compliance as 1 if the member state followed the specific Council recommendation and 0 if it did not. There are a total of 21 recommendations capable of being assessed for compliance in our dataset. States complied in nine of these cases. In the empirical section, we use a two-stage model to predict when states will comply and when they will not.

**Possible Explanations**

There are several possible explanations for the level of compliance and non-compliance we observe. The first is a relative power argument, namely that big states tend to ignore treaties while small states play by the rules. The second argument is that audience costs—either domestic and/or international—constrain states even when they are big. The third argument focuses on domestic institutions. In each case, we discuss below the logic of the argument and indicate how we measure each in the empirical section that follows.

**A. Country Size**

One way to view the behavior of states under the Stability and Growth Pact is through the theoretical lens of collective action (Olson 1965). One might conceive of EMU as a group of states cooperating to provide the collective good of a fixed-exchange rate. Olson argues that in unequal groups above a certain size, it typically falls to the largest members to bear the burden of providing the collective good. This provides a puzzle for EMU and the SGP, where rather than small states shirking, we find that the large states are more often cheating.

In understanding this puzzle, the simplest explanation may be relative power. The big states are likely not to comply because the potential punishment they face is less than for small states. That is, what can the European Commission do if Germany fails to comply with the Pact? In contrast, if Portugal receives specific recommendations for adjustments to its budget policy, it is more vulnerable to pressure from other states.

One should note that there is strategic interaction between the European Commission and the member states through their representation on the Council of Ministers, that is, a Commission that anticipates big state dominance may be reluctant to recommend specific actions for the large states in the first place. In this case, the Commission would make recommendations only for small states.[13]

This is the baseline model, and if it explains everything other possible explanations are not relevant. This goes in particular for the argument that interaction in the eurogroup among ministers constitutes peer pressure, and if there is enough pressure

[13] There is evidence that the Commission engages in such strategic behavior in cases it brings to the European Court of Justice. That is, it presents the cases it expects to win. See x (year).

on offenders in this of-the-record arena then the offenders will reform their ways.[14] We would like to emphasize that we know of no academic piece that makes this argument, but discussion in Brussels and elsewhere on the utility of the Eurogroup focuses on peer pressure to resolve disputes. It may very well be, of course, that peer pressure is useful for smaller issues, but that the more visible compliance or non-compliance under the Stability and Growth Pact would not be subject to peer pressure.

If one looks just at simple bi-variate comparisons, two trends emerge. First, the large countries of France, Germany, Italy, and the United Kingdom constituted 16 of 23 (nearly 70 per cent) of recommendations despite making up only 27 per cent of the sample. Second, once those recommendations are made, in 11 of 16 cases the large state failed to comply with the Commission's recommendation. In the remaining five cases for the small states, only once did a small state fail to comply.[15]

**B. Audience Costs**

"Audience costs" are those costs to reputation governments suffer when they do not live up to commitments they have made. The "audience" can be at the international and/or domestic level. At the international level, Finlayson and Zacher (1981) contend that the General Agreement on Tariffs and Trade (GATT) provided a forum for states to observe each other's behavior. Governments that chose to "cheat" or "defect" under the Treaty would acquire a reputation for not honoring agreements, and other governments would be reluctant to cooperate with them in the future.

This argument has been extended to the domestic level. Mansfield, Milner, and Rosendorff (2002) find that democracies are more likely to sign and, later, to comply

[14] The Eurogroup is composed of the economic and finance ministers from the states in the eurozone only, and it meets before Ecofin. Its deliberations are secret, and it has no formal power.
[15] That state was Portugal.

with international trade agreements because of domestic audience costs. In this model, government leaders who violate the terms of an agreement suffer a reputational cost in the minds of voters; these voters, in turn, are inclined to vote out the offending government at the next election. Similarly, Jensen (working paper) suggests that democracies create audience costs for leaders who might wish to expropriate property of foreign firms. He argues that expropriation leads to a reputation loss in the minds of international market actors, who would then seek to undermine the ruling government (withdraw investment, etc.). Voters, for their part, may then observe drops in foreign direct investment and vote out the incumbent.

Despite being used in a variety of subject areas with variation in the type of audience, all of these models share general traits. First, they assume that an informational signal is clear to the audience. Second, they make an implicit assumption that the audience cares, i.e., that it prefers compliance over defection; lastly, they assume that the audience can, and will, act in such a way that may deter the government from defection in the first place.

Using experimental research methods, Tomz (2006) provides micro-level evidence that individuals do, indeed, care about abiding by the terms of international agreements. He demonstrates that citizens' preferences for policies are conditioned by whether or not particular policies are sanctioned by international law/agreements. While much of the literature on audience costs speaks to the reputational costs of reneging (and potential impact on individuals' material interests), Tomz allows that the mechanism of audience costs may simply be individual norms, i.e., that it is simply wrong to cheat on agreements.

Finally, recent work suggests that democratic governments may be aware of the dynamic of audience costs and systematically attempt to mitigate the effects. With respect to states abiding by the terms of trade agreements, Kono (2006) argues that some democratic governments have adopted the strategy of "optimal obfuscation"—that is, shifting protectionist measures away from easily understood and transparent policies (such as tariffs) towards measures that are more complicated to understand (such as non-tariff barriers). Leaders understand that citizens would punish them at the polls for pushing protectionist policies; but, by using this strategy, they can avoid undue audience costs while reaping rewards from particularistic groups that are able to obtain rents from de facto protection.

In our dataset, we do not have a way to measure the international costs, but we do have a proxy for domestic costs. As noted above, arguments about audience costs usually assume that populations want to see a treaty honored. In our case, however, it may be that the population of the international organization conditions the effects of audience costs. Specifically, countries with citizens who are generally eurooptimists may expect their leaders to follow what the European Union says a country should do on fiscal policy; on the other hand, countries with more a more euroskeptic citizenry may feel less compelled to abide by European Union recommendations. We measure a population's favorability towards the European Union with data from Eurobarometer. We code the values for each country in response to a question that gauges a population's sense of the benefits provided by EU membership.[16]

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[16] "Taking everything into consideration, would you say that (your country) has on balance benefited or not from being a member of the European Community (Common Market)?"

**c. Domestic Explanations: Elections**

The principle domestic explanation is that elections affect the likelihood that a state violates the Stability and Growth Pact. As elections approach, governments may try to boost the domestic economy by spending more and/or cutting taxes. Such opportunistic political business cycles may push countries that have deficits just below 3% over this reference value for deficits. Countries that have elections are more likely to have "excessive deficits" according to the letter of the Stability and Growth Pact.

Whether the European Commission is then more likely to make specific suggestions, however, is an open question. It is also possible that the Commission is aware of the political constraints on governments facing re-election. If this is the case, we might expect selection issues as the Commission may issue fewer recommendations to member states in the first place. A strategic Commission would realize that the country in question is unlikely to introduce painful fiscal adjustments in an election year, and it may wait until after the election to insist on any changes in behavior. If there is a recommendation, this argument suggests that it is more likely the country will ignore it in an election year.

It should be noted that, if domestic audience costs truly bite, then one would expect the opposite effect of elections than the one hypothesized here. That is, governments would be *less* likely to violate the Treaty, and if there were a recommendation the likelihood that the government would comply would increase.

To measure the impact of electoral considerations on government fiscal policies, we code for the percentage of a given year that precedes an election (see Franzese 2002).

That is, an election held on July 1 would be coded as .5 in the same year and .5 in the previous year.

Other domestic-level explanations are less relevant. A "usual suspect" would be partisanship. One could imagine a situation where a qualified majority from one partisan block used decisions in the Council to reward governments with the same political stripe and to sanction their opposition. Yet there are a few flaws with this logic. First, given the presence of coalition governments in most EU-15 countries and that some of them include parties from both the left and the right (e.g., Belgium and Finland), it is hard to envision a clear qualified majority from one partisan block ever in place at the Council level. Second, the argument does not seem initially appealing based on the empirical evidence—Germany and the United Kingdom were both left-leaning when the European Commission suggested concrete recommendations while France and Italy were both right-leaning.

**Analysis**

There are two separate types of analyses to run given the nature of the dataset we now have. The first model focuses on the core question of this paper, namely under what circumstances will a country comply with the European Union's concrete recommendations. To answer this question, however, we expect that we will need to know as well under what conditions the Commission will issue the recommendation in the first place. Our expectation is that it is nonrandom when the Commission issues the initial recommendations. Moreover, the Council has the chance to weaken the Commission's recommendation. This is an interesting question in its own right—under

what conditions does the Council choose to change the Commission's recommendation—so we begin with a first model that estimates the probability that the Council will weaken what the Commission recommends given that the Commission issued a recommendation in the first place. The next step is to estimate the probability that a country complies with what the Council passes.

Given nonrandom selection, the most appropriate empirical model is a Heckman model.[17] In the first stage, we estimate the factors that explain why the Commission issued the concrete recommendation to a member state. Following on the discussion above, we include the dummy for whether a state is large. One might expect that non-euro countries may not receive the same level of comments from the Commission, so we include a dummy for the countries that are "euro-outs." Finally, we anticipate that concrete recommendations are more likely when a state has a budget deficit above 3% of GDP.

The second stage considers whether the Council keeps the Commission language for a given country or whether it weakens the content of the report. Here we hypothesize that the decision will be more political. An election in the given year may make the Council less likely to criticize a member state government. Moreover, in places where the population is more skeptical of the European Union, the Council may be reticent to encourage headlines about European Union action against a given government. At the same time, in places where the European Union is popular, such statements may have more effect. Finally, large states have more voting power in the Council. While they cannot vote on their case, they can vote for others, and the possibility of log-rolling

[17] In coding terms, we use the 'heckprob" command in Stata 10.0.

across votes may mean that large states face less criticism than small states. It should be noted that, if the Council simply passes along the Commission recommendations and weakens the language only when “random” shocks lead to unexpected improvements in the fiscal health of countries in the approximately two to three months between submittal of the programme and Council consideration, then the variables in the “weakening” equation should not be statistically significant and one would expect the two equations to be statistically independent from one another.

The final stage focuses on determinants of compliance and includes more explicitly political factors, such as whether there was an election in a given year and the proportion of a given population that has a negative opinion of the European Union according to eurobarometer polls. Once again, we include whether a country was a large state. We tried to include a dummy for contract states in the analysis, but there was not enough variation between the form of governance and whether a country complied to make an estimate possible.[18]

Table 4 presents the results.

For the second part of the analysis, which focuses on state compliance, the first surprise is that there is little reason to use a Heckman selection model in the first place—the decision on whether the Council will issue a recommendation does not bias the result for the compliance estimation. The evidence for this is the likelihood ratio test for independent equations. The second surprise is that the results are not robust for the equation we care most about, namely the compliance equation. It is the case that the

[18] That is, delegation states usually do not comply while contracts states do. The question then is, does one drop this variable, or does one decide that this variable is the key one because it predicts the outcome?

coefficient for large state is just above the .05 level at .06.[19] There is much less support for the effects of population opinion on compliance, however, and no support at all for the effects of an election year.

The results for when the Commission makes a recommendation are interesting in their own right. One would expect more recommendations when a given state's budget deficit is above 3% of GDP, as we do indeed find. Rather than scare off recommendations, large states seem to attract them. One can speculate that large states may attract more scrutiny because their actions have a greater effect on the euro. Yet the fact that being an "out" state does not seem to matter suggests that the economic impact is not the deciding reason. Another possibility may be that concrete suggestions to larger states simply generate more press.

[19] Future versions of the paper will present a more sophisticated interpretation of the coefficients.

**Table 4: Heckman Selection Model for Compliance with Commission Recommendations**

| Outcome Equation | |
|---|---|
| **Dependent Variable: Compliance** | |
| Election Year | -0.33 |
| | (1.12) |
| Large State | -3.02 |
| | (1.78) |
| Negative Opinion, Europe | 0.01 |
| | (0.07) |
| Constant | -.67 |
| | (2.03) |
| Selection Equation | |
| Dependent Variable: Commission Recommendation | |
| Large State | -3.02* |
| | (1.78) |
| Deficit Above 3% | 1.23** |
| | (-0.33) |
| Euro "Out" | -.24 |
| | (.44) |
| Constant | -1.90** |
| | (.27) |
| Rho | -.015 |
| | (1.14) |
| N=133 | |
| Likelihood Ratio Test: Separate Equations | 0.9897 |

- p<.05, ** p<.01

There is a second question that is also of interest to us, namely what determines the Council's weakening of Commission reports on Member states. As we reported earlier in the paper, in roughly 1/3 of the cases the Council weakens the Commission statement. Here we report a simple probit analysis. In this specification, we are interested in explanations for why the Council would weaken a report. The Council does not change the Commission's statement in election years, for large states, euro outs, or states with fiscal contracts. It does, however, generally weaken the statement when a country has a

deficit above 3% of GDP. This is a curious finding when combined with the previous one, which indicates that a concrete recommendation is more likely to be forthcoming when the deficit is above this reference number. The analysis also indicates that the Council is more likely to weaken a Commission statement when it is applied to a country that has higher negative views of the European Union more generally among its population. It may be that the Council is more sensitive to how criticism from Brussels will be perceived at home than is the Commission.

| | Probit |
|---|---|
| | **Council Weakening of Commission Recommendation** |
| Election Year | -.56<br>(.40) |
| Large State | .13<br>(.33) |
| Negative Opinion, Europe | 0.02*<br>(0.1) |
| Fiscal Contracts | .12<br>(0.33) |
| Deficit Above 3% | .81**<br>(.31) |
| Euro "Out" | -.18<br>(.34) |
| Constant | -1.31**<br>(.34) |
| N=133 | |

- p<.05, ** p<.01

**Conclusion**

This paper has considered compliance and non-compliance under the European Union's Stability and Growth Pact. It has used a unique dataset, which we coded based upon annual evaluations of the behavior of the original EU-15 over the time period 1999-2006. The main finding seems to be that the characteristics of the state have the biggest

impact on its behavior. That is, country size affects whether countries originally comply under the Pact, whether the Commission tries to sanction them, and whether the country then complies with what the international body says it should do. Domestic institutions also play their part. While there is not enough variation to do the Heckman model with the inclusion of the variable, it is clear from the bi-variate tables that countries that have a contracts-based form of fiscal governance are much less likely to receive a recommendation and, once they get one, they comply. We do not find evidence that "audience" costs make any difference. This could be based on the way we code such costs, of course, and more work will need to be done.

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