

# The Stability and Growth Pact: Bad Economics and/or the Politics of Least Resistance?<sup>\*†</sup>

Patrick M. Crowley<sup>‡§</sup>

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## Abstract

Since the December 2003 decision not to apply the penalties embodied in the Stability and Growth Pact (SGP), considerable doubts have emerged as to the meaning, purpose and effectiveness of the pact. The European Commission decided to challenge the decision to hold the coercive elements of the SGP in abeyance, by pursuing a case in the European Court of Justice, but even so, there is some doubt as to whether the fines and penalties in the pact can ever be properly enforced. This paper takes both a back-wards and forwards look at the SGP, and provides some insights into the purpose, pitfalls, and future evolution of the pact. The paper takes an economic, psychological, and political economy approach to the pact, and makes evaluations and predictions about future options for the reform or replacement of the SGP.

**Keywords:** Stability and Growth pact, deficits, public debt, economic integration.

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<sup>‡</sup>Research department, Bank of Finland, Helsinki, Finland and College of Business, Texas A&M University, Corpus Christi, TX, USA.

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"Rules matter." Inman (1996)

"We must constantly re-examine our rules and be prepared to question every single one of them" Von Hayek (1979)

## 1 Introduction

Taken together these two quotes sum up this paper. Inman believes that rules matter, in the sense that if there is a rule in place then we are more likely to take notice of this fact and alter or at least marginally modify our behaviour – but the form and content of the rule also matters too, and so rules must be appropriate for the circumstance in question. There is also a sociological and psychological context to rules as well: if it becomes accepted behaviour to break a rule, then although not everyone will break the rule, there will be a certain (perhaps time-varying) proportion of the population who will. Clearly as circumstances change, our rules should change to match those circumstances, and if we want them to apply to all circumstances then they have to be general and flexible enough to encompass all circumstances. For if rules don't appear to be useful, then they lose their meaning and should be scrapped or changed so that they are useful.

In this paper the Stability and Growth pact (SGP) of the European Union (EU) is treated as a collection of procedures and rules which determine the monitoring of and the limits for member state fiscal policy within the context of European Monetary Union (EMU). On one level the SGP is clearly a set of procedures for monitoring fiscal policies of member states so that coordination can take place in the context of the economic interdependencies within EMU, but on another level the pact contains explicit rules governing limits for the outcome of macroeconomic policy to more clearly define the excessive deficit procedure contained in the Maastricht Treaty (of the European Communities (1992)) which was part of a set of criteria to foster economic convergence before EMU. Although the pact was not formally included into the Treaty (see Crowley (2002c)), it still forms the basis for fiscal policy coordination in the EU, in the sense that it provides the link between a decentralized fiscal policy and a centralized monetary policy (see Feldstein (2005)), and most politicians now interpret as being inextricably linked to the Maastricht Treaty, so it is desirable to obtain unanimity for any substantive changes to the pact<sup>1</sup>.

The Stability and Growth pact was meant to partially counterbalance this EU fiscal policy vacuum by introducing a degree of implicit but coerced coordination among EU

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<sup>1</sup>As the pact itself is not included in the Treaty, it can be changed with a simple qualified majority vote.

EMU member states. It does not apply directly to non-EMU EU member states, although these member states are included in the surveillance part of the pact as their fiscal stances can obviously impact the pan-EU economic situation. When the SGP was first introduced in 1996 it was quite controversial, as at that time there was some speculation as to which member states would qualify to proceed to the next stage of EMU. Theo Waigel, then Finance Minister for Germany, first proposed various fiscal codes to ensure fiscal stability in EMU in mid-1996<sup>2</sup>. The fear voiced in the popular German media was that highly-indebted member states would join EMU and then destabilize the project if there were no fiscal restraints in place. Many political commentators also recognized that domestic political factors in Germany were also at play: Germans were, by quite a substantial majority, not in favour of eliminating the German mark for the euro, and so the SGP was proposed as a way to placate German fears about EMU. The pact was originally proposed as a “stability” pact, but after the need for such a pact had been agreed upon, the French objected to the overt emphasis on fiscal stability when French unemployment levels suggested a large output gap, so to allay French concerns about ensuring growth, clauses that dealt with the “exceptional” circumstances of recession were clarified, the word “growth” was inserted into the pact title, and a largely symbolic political declaration was made on creating more employment and growth in the EU.

The SGP did not attract any attention for its first few years in operation, and indeed, because of strong economic growth and the political focus on the successful completion of EMU and establishment of the ECB, there was little in the way of any academic work done on the SGP in either the economics or political science fields during this time. This has all changed in the last 2 years as fiscal policy in EMU has become an extremely controversial topic, with France and Germany being issued automatic warnings by the Commission, and the acrimonious environment in which the decision by both these countries to ignore these warnings was taken in early 2004. Indeed, both countries, plus Italy and Greece exceeded the SGP guidelines in 2004, which prompted legal manoeuvres by the Commission to try and retain some vestiges of credibility for the pact. While EU member states appear to accept that some form of fiscal pact is needed<sup>3</sup>, the current form of the pact is viewed as too restrictive in present circumstances (a low-inflation, low-growth environment). As the

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<sup>2</sup>Waigel initially proposed a medium-term target for government deficits of 1% of GDP, with automatic sanctions if there was an excessive deficits and a “stability council” as a decision making body.

<sup>3</sup>Former Commission President Romano Prodi though, acknowledged the weaknesses of the pact, and went as far as to call the SGP “stupid” in an interview with *Le Monde* (October 17th, 2002), a view held by many of the larger member states.

Commission's review of the SGP is now complete, agreement appears to have been reached to delay any fines or actions on the part of the Commission for 5 years from the declaration of an "excessive deficit" and inclusion of a longer list of "exceptional circumstances" that would justify deficits "slightly and temporarily" above 3 percent of GDP. As of writing, if agreement to modify the SGP is not reached, then, in effect, the coercive elements of the pact (which were effectively suspended in early 2004) will likely continue to be ignored for the foreseeable future.

The motivations for this paper are three-fold. First, the question "what is the purpose of the SGP?" needs to be addressed. This is an important question, as its purpose and functional design are clearly inter-related. Second, given the controversy over the SGP, there have been several suggestions made by economists on how to reform the SGP so these suggestions (for improvement) need to be reviewed in light of the current design of the pact. Third, and perhaps most importantly, additional alternatives to the current offerings in the literature for improvement of the SGP are offered and appraised alongside other suggestions from academics. The paper proceeds by briefly describing what the SGP is in section 2. Section 3 then offers a framework for analysis based on existing economics and psychology literature, and section 4 then extends this analysis into the political economy domain. Section 5 looks at modifications and alternatives to the pact, and section 6 then concludes.

## **2 What is the SGP?**

### **2.1 The workings of the SGP**

The SGP itself consists of 3 components:

- i) 2 European Council regulations (1466 and 1467/97);
- ii) a resolution/directive (17/6/97, #26); and
- iii) an opinion of the monetary committee ("Opinion on the content and format of stability and convergence programmes", 12 October, 1998, revised July 10, 2001).

The pact itself is essentially the two Council regulations, with the resolution as a confirmatory measure and the opinion as a clarification for purposes of implementation. The first Council regulation (1466/97), originally proposed in Dublin in December 1996, strengthens the surveillance and monitoring of fiscal stance based on Article 99 of the Treaty on

Union (originally Maastricht which has now been succeeded by Amsterdam). The stability programmes have to contain a medium-term objective for fiscal policy with the budgetary position close to balance or in surplus, the dynamic towards this goal and the assumptions in the programme, and measures proposed to achieve the goal and a sensitivity analysis. The programmes are public, and are updated annually. The Council monitors the implementation of the programmes, and if a significant divergence is detected, an “early warning” can be issued to a member state, in the form of a recommendation under Article 99(4) of the Treaty. In essence, then, this is the preventative part of the SGP.

The second Council regulation (1467/97) speeds up and clarifies the excessive deficit procedure from the Treaty. The pact adds definition to terms such as “exceptional and temporary” and specifies the timeline for the original excessive deficit procedure from the Maastricht Treaty. It also implements a system of non-interest bearing deposits for transgression of the guidelines or non-implementation of EU recommendations and the possibility of converting these deposits into fines if satisfactory action is not taken after two years. This represents the coercive part of the SGP.

A resolution was then made at the Amsterdam European Council meeting which although not legally binding, essentially invited all participants to abide by the Treaty and the Stability and Growth pact in a strict and timely manner. The resolution referred to the Council regulations “as a rule”, because an automatic procedure was ruled out as it would go beyond the terms of the original Maastricht Treaty. It is somewhat strange then that the regulation 1467/97 has an exhaustive list of situations in which the excessive deficit procedure is to be held in abeyance and, as noted by the European Court of Justice<sup>4</sup>, the decisions of the Council in regard to the operation of the SGP are "intended to have legal effects". Hence the interpretation that the resolution was largely politically motivated.

The last component of the pact consists of an opinion given by the Monetary Committee during 1998, endorsed by Ecofin in October of the same year and then updated as part of a code of conduct in 2001. The opinion essentially gave the “medium term” adjustment to budgetary positions close to balance or in surplus a timeline, and also that the assessment of completion of the adjustment should take into account the business cycle and therefore the cyclically-adjusted (or structural) budgetary position. This cyclically-adjusted budgetary position is certainly used more prominently in the assessment than it has been since the 2001 revision (see ?).

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<sup>4</sup>ECJ Press Release No 57/04 on Case C-27/04.

In terms of the process of the SGP, it is the Commission that makes recommendations to the Council on the basis of whether either actual or planned government deficits exceed the reference value of 3% of GDP, given that the surveillance has taken place as per 1466/97. Once a recommendation is made, the Council votes by qualified majority on whether an excessive deficit exists, although the member state is only put into an "excessive deficit" position when the actual data are published. If the Council deems that an excessive deficit does indeed exist or is likely to do so, it must also adopt a recommendation to the member state in question as to how to correct the situation. The recommendation must contain a four month deadline which is the length of time allowed for the member state to take action, and a further deadline which specifies that the correction should be made in the following year. The most important feature here is the four-month deadline, as economic circumstances can adversely affect the outcome, in which case as long as action has been taken by the member state concerned, the procedure iterates back to the recommendation stage by the Commission. If, however, the member state does not respond to the recommendation, then the timetable for sanctions and fines begins.

## **2.2 The economics of the SGP**

The Maastricht Treaty economic convergence criteria were originally proposed in a paper by Lamfalussy (1989) and were taken up by the Delors Committee as a way of ensuring economic convergence before EMU was launched. Much ink has been spilled over the Maastricht Treaty convergence criteria ( - for example see Fratianni, Von Hagen, and Waller (1992) Buiters, Corsetti, and Roubini (1993), Eichengreen (1993) and Crowley (1996), to name a few), and there was little consensus in the economics profession as to the desirability of these criteria for EMU membership ( - particularly the fiscal and ERM criteria). The agreement in Dublin, Ireland, for post-1999 conditions for continuing membership of EMU which essentially defines the SGP (of the European Communities (1996) and of the European Communities (1997)), effectively entrenched the budget deficit criteria for the foreseeable future to act as a quasi-condition for continuing member-in-good-standing of EMU.

As emphasized in Von Hagen (2002) and Crowley (2002b), the 3 percent deficit rule, as incorporated into the Maastricht convergence criteria, possessed both an incentive and a penalty instrument - the incentive instrument was being in the first wave of EMU and the penalty instrument was not being a member of EMU right from the start, when the framework for EU monetary policy was determined. Many economists have mused as to

why the debt criterion was not also explicitly part of the SGP. This is because politically the debt criteria had to be “soft” in terms of the entry criteria to EMU, otherwise countries like Belgium and Italy would not qualify for membership - in other words it was modified in the Maastricht Treaty to ensure that even temporary movements in gross public debt towards the 60 percent level would satisfy the criteria. But this "softening" of the Maastricht convergence criteria led to the focus in the SGP being on budget deficits rather than gross public debt.

Turning to the SGP itself, the design of the SGP features benchmarks but only penalties for not obeying the pact. The SGP therefore substitutes the penalty of not taking part in EMU which was the hallmark of the Maastricht Treaty with a potentially large penalty instrument, but the direct benefits of complying are no longer there - i.e. there is no positive incentive mechanism. From a domestic political perspective, politicians have an incentive to keep the general public as content as possible so as to increase re-election probability, while at the same time imposing the lowest possible level of taxes on the population, implying that budget deficits should rise before in an election year or the previous year. The other part of the pact does require that member states keep a budget balance or surplus in unexceptional times - but there are no benefits for doing this or penalties for not doing this, so the compliance incentives are minimal<sup>5</sup>. Thus, from an economic standpoint, the lack of a strong incentive mechanism means that politicians, besides that of providing as much public expenditure as needed to get re-elected up to where the penalty kicks in, have an optimal strategy of running surpluses or small deficits in non-election years, with incentives to increase expenditures so that the deficit comes in at around 2.9 percent of GDP in an election year!<sup>6</sup>

Given the origins of the numbers in the pact what was the rationale for an SGP from an economic behaviour point of view? These reasons are well documented in the literature so are presented in the form of table 1 below.

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<sup>5</sup>In fact, it clearly depends on an assessment by the party in power as to whether the next election or the next economic downturn occurs first. If the economic downturn occurs first, then presumably there is an incentive to try to balance the budget now so as not to have to fiscally retrench during an election campaign. On the other hand if the election is forecast to come before the next economic downturn, then clearly there is no incentive to achieve “medium term” balance

<sup>6</sup>Strauch and Von Hagen (2001) and Hughes Hallett, Lewis, and Von Hagen (2003) show empirically that the SGP has not stopped governments from using fiscal policies to pursue electoral interests. Obviously exceeding the 3% level might prove unpopular with the electorate, as it would not demonstrate fiscal responsibility, or perversely, it could prove politically popular, as a way of demonstrating national sovereignty by flouting Brussels.

<b>Explanation</b>	<b>Evidence</b>	<b>References</b>	<b>Solution design</b>
i) Terminate end game of EMU	Sales of gold, and other temporary measures to enhance the 1997 data	Fratianne, Von Hagen, and Waller (1992)	SGP for a specified period of time (i.e. to the end of EMU phase 3 and during an "initiation" period)
ii) Benchmarking on German policies	Germany initially proposed the SGP	Eichengreen and Wyplosz (1998)	SGP in relative terms (c.f. Maastricht inflation and interest rate criteria)
iii) Establishment of a fiscal coordination mechanism	Member states all agreed on a pact in 1996 and voted for it in 1997	Crowley (2002a) ?)	SGP without penalties (e.g. Australia's fiscal coordination body)
iv) ECB reputation enhancement	EMI and ECB encouraged and supported the establishment of SGP	Artis and Winkler (1997)	SPG for a specified period (i.e. until ECB signals pact should be lifted)
v) Protect bailout clause credibility	None	Buiter and Grafe (2004)	SGP with debt limits
vi) Interest rate spillover effects	None	Eichengreen and Wyplosz (1998)	SGP with debt limits
vii) Financial market inefficiency	GSP monitoring procedures for fiscal policy	Feldstein (2005)	SGP with debt limits
viii) Experience elsewhere	USA, Canada, Australia in particular	Eichengreen and Von Hagen (1995) Inman (1996)	National self-restraint (c.f. US state budget laws)

Table 1: Economic Explanations for the SGP and Implied Solution Designs

Several points arise from table 1. First, none of the solution designs match the original design of the SGP, even in combination. All the explanations for the pact have been cited as possible reasons why a fiscal pact is necessary, although some of these explanations perhaps have greater strength with politicians than others. Explanations iii), iv) and vi) are most cited by politicians and the European Commission as the rationale for the pact, political scientists appear to focus on explanations i), ii) and iv) as the reason why the pact was originally introduced by Germany, and economists usually cite explanations v), vi) and vii) as to why a pact is desirable. Terminating "end games" was likely the original motivation, so as to give fiscally profligate countries second thoughts about entering EMU, as in hindsight it is difficult to imagine Germany proposing a similar pact under current circumstances. Supranational fiscal coordination would certainly be enhanced by the preventative part of the SGP, and does apply elsewhere (Australia). The enhancement of ECB reputation would also imply a limited-period pact which could be annulled once the ECB felt that policy coordination and fiscal rectitude were a thing of the past. More than likely, a multi-faceted set of economic reasons mediated through a political process resulted in the current pact, as other member states were clearly convinced that such a pact was necessary for EMU to be successful.

Second, the main economic explanations for the pact, entries v), vi) and vii) imply a solution design that uses public debt as the appropriate variable, not budget deficits. One of the themes of this paper is that a continuation of the bad economics and politics of least resistance which characterised Maastricht were used to construct the SGP, but unlike the Maastricht criteria where these were only applied instantaneously, the SGP has become a permanent feature of EMU.

The initial concerns that Germany voiced for needing a pact appear to have metamorphosed into mostly ECB concerns that more heavily-indebted EU member states might cause higher pan-EU interest rates through their fiscal policies. As Von Hagen (2002) suggests, once in a monetary union though, highly-indebted small member states really do not impact the monetary policy of the monetary union (as their debts are still small in comparison with EU GDP), so that only larger highly-indebted member states could possibly cause such spillover effects.

## 3 Framework for Analysis of Rules

### 3.1 Rules and Individual Behavior

In everyday life we live by rules - rules relating to such mundane things as traffic, taxes, modes of social behavior, and on a more personal level rules which dictate our interactions with others, such as social etiquette, relationships and marriage. These rules get broken by some people and others stick to them religiously, depending on their desirability, societal context and how others behave with respect to these rules. Some rules are enforced by law, some are more social conventions perhaps backed up by laws that are rarely enforced, and others are perhaps best viewed as social norms that are not enforced by law but are rarely transgressed. Of course, depending on culture, rules and laws can be blatantly ignored by citizens, despite the fact that there may be heavy fines and penalties associated with transgression. In most European cultures, though, rules are usually taken quite seriously, so widespread flouting of rules is not usually an issue<sup>7</sup>.

As the SGP is basically a rule-based coordination mechanism, an inter-disciplinary approach to rules might be able to help shed some light about if, when, and how such rules should be devised, and when they might be breached (see Greenburg (1990) for a game theoretic approach to some of the material discussed below and see Pettit (2002) for an overview of the philosophical and psychological context in which the study of rules and norms occurs, and the issues therein). It is important here first to distinguish social norms from rules. Social norms are dictated by "expected" social behaviour, and as such can often be culturally acquired. According to psychologists, norms are both descriptive (what people do in certain situations) and prescriptive (what people should do in a specific situation) in that they characterize behaviour or what behaviour ought to be (presumably in the opinion of the ruling majority)<sup>8</sup>. Rules, on the other hand, are usually backed up or dictated by law. Rules may have been acquired by social convention, but as they are rules they either embed social norms into a legal framework or dictate rules that govern how society should operate in relation to a specific situation or issue (- sometimes in cases where there have been no social norms to appeal to - e.g. euthanasia). For example greeting others in various social situations is usually culturally embedded and is learned through

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<sup>7</sup>Of course this is not true of many developing or transition economies, where tax avoidance and bribery are commonplace.

<sup>8</sup>An example of a descriptive norm is "pedestrians wait until the lights are green before crossing the road" and an example of a prescriptive norm is "pedestrians should wait until the lights are green before crossing the road".

schooling and through various other social interactions with others and as such these norms vary from place to place<sup>9</sup>. Thus when rules which embed social norms are enforced by law, these laws can differ substantially from place to place according to what has been accepted as appropriate behavior in those places - rules might be seen as legitimating those norms, and as a way of enforcing those norms as the view of the majority. Driving is a good example of this. Learning to drive implies knowing a set of rules as to how to interpret signs and appropriate behavior in various situations involving other automobiles. Rules and ways in which traffic is manipulated though can vary from country to country - not only on which side of the road vehicles drive, but also how vehicles negotiate particular circumstances<sup>10</sup>.

The study of rules and when we need them crosses over into the realms of philosophy (see ?)), but here we can abstract to the socio-economic function of rules, as this most closely relates to the justification for the SGP from a political-economy perspective. From this perspective then, why are rules necessary and why are social norms insufficient? One could argue that there are three reasons for rules over and above social norms – the first being a problem of coordination of social norms when numbers become large, the second being that of externalities which in certain circumstances dictate that rules are less socially costly and third, a free rider problem.

The coordination problem arises because the costs of obeying social norms can more than outweigh the enforcement costs of legalizing those norms (see Collett (1977)). An example here in terms of traffic rules might be the efficiency of four-way stops versus traffic lights at the same junction. Four-way stops often are more costly in terms of time taken to negotiate, and it is often a matter of judgement as to who has the right of way at such junctions. This is not a great issue if there are few lanes approaching the junction so that the social norm can easily be interpreted and implemented. But if there are eight lanes approaching a junction, then who has the right of way becomes more difficult to establish, and the coordination problem of who goes first becomes a major obstacle to negotiating the junction safely. Hence on busy or complex junctions, traffic lights enforce the right of way, giving a safer and on average a quicker passage through the junction – in other words,

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<sup>9</sup>For example, there are various accepted "greeting norms" even in Western countries, such as shaking hands or hugging in the UK, kissing one cheek in France, kissing on two cheeks in Quebec and kissing on three cheeks in the Netherlands.

<sup>10</sup>For example in the UK, "roundabouts" are usually governed by a yield principle ( - vehicles yield to others already on a roundabout, and wait for a gap in order to get into the traffic stream), where as in Canada the interweaving principle is used ( - one vehicle goes round, and one vehicle enters the "rotary"). In other words the situation is the same, but the rule is different.

the traffic lights solve the communication problem.

Second is the problem of externalities. From a legal perspective, we need rules as a way of protecting others if there is an incentive to behave differently from what should be the social norm. River fishing or fishing treaties between nations might be good examples here, as over-fishing a river or marine environment can benefit the fisher who does the fishing, but leaves others with much less fish. From an economic perspective we can think of rules ensuring or protecting the common social good particularly if the private net benefit exceeds the social net benefit because of the existence of externalities.

Third, we also have rules when there is a potential free-rider problem. A good example here might be taxes. Rules are made so that costs are imposed on people who cheat with their taxes, as there are immediate financial benefits from not revealing income so as to lower tax payments (or obtain a higher tax rebate), with clear social costs as taxes fund public expenditures. Here, through the state, social values determine both the amount of the taxes and the benefits derived from these taxes, but also the penalties for free-riding if income is not revealed.

What are the characteristics of these three types of rules in terms of enforcement, incentives, and fines? In the first case (rules that internalize communication problems) enforcement tends to be relatively light and there is little need for incentives or large penalties for breaking the rules, particularly if these rules embed social norms. In the second case (externalities), there is usually much tighter enforcement (as in the case of hunting permits, smoking laws and traffic) particularly if there are powerful pressure groups which can exert political influence, and so the penalties can potentially be much larger. In the third and last case (free-rider problem), there is usually only light or mutual enforcement, as this can add to social costs, but large fines/costs if caught transgressing the rules (either in terms of broken trust, or in terms of monetary penalties). In this last case fines and penalties are often heavy so as to set an example for others not to break these rules.

Given these rules, and the rationale given above for them, do we observe compliance, and if so, when? Clearly individual decision-making determines when rules are broken, but the strength of social norms and cultural factors can play a major role. Kenrick, Li, and Butner (2003) looked at individual decision rules and how these rules impacted the emergence of social behaviour and found that indeed the individual decision-making mechanisms and group (societal) dynamics determine the outcome and the "socio-spatial geometry".

Another closely-related question is "when is it acceptable to break these rules?" Obviously there are some individuals who do break the rules, and likewise there are companies

and governments that also break rules. Verkuyten, Rood-Pijpers, Elffers, and Hessing (1993) offer an analysis of rules and rule-breaking behavior among individuals. In introducing their study, they state:

“As Abel (1973) pointed out, this perspective of policymakers in essence is grounded on a somewhat naive positivistic idea about what legal rules are and how they operate in social life. A legal rule is seen as an order to be complied with by everyone. To guarantee such compliance, tangible and immediate incentives and penalties are believed to be the most suitable instruments.” (p486)

Put in other terms, just because a law is in place as a legal instrument doesn't necessarily mean that people will abide by it. Having incentives and penalties in place will better ensure that the law becomes embedded in social behaviour. As further noted in Verkuyten, Rood-Pijpers, Elffers, and Hessing (1993), in breaking rules such as running a red light or filing a falsified tax return the evidence points to acceptance by the majority of the population for rule-breaking, but only in certain special circumstances. So for example running a red light would be acceptable in the case of an emergency. Interestingly, 18% of the respondents stated that it would be acceptable to fill out tax forms dishonestly, depending on the circumstances of the individual, and the amount of the deception. Given individual preferences and the absence of information asymmetries, breaking rules is much more likely when these rules are less strictly enforced, when the penalties are lower for doing so, and when there are no long-term incentives in place for compliance.

Lastly, two further observations can be made here: first, when a rule is embedding an already-existing social norm, incentives are less likely to be needed to ensure compliance - penalties are only usually present to ensure that errant individuals are rare. Second, when a rule is not embedding a social norm, it clearly helps if there are incentives to obey the rule, and usually greater enforcement and penalties are needed to encourage socially optimal behavior. Table 2 below summarizes the discourse above:

## 3.2 Rules and Governments

Given our analysis of rules pertaining to individuals above, we now turn to rules relating to the conduct of governments. Most analyses of government and rules in the political economy domain has focused on rules to limit the growth of government (see Von Hayek (1973)). As it is rare that a supranational institution should attempt to enforce strict economic rules governing the behavior of national governments, this requires a somewhat

Type	Enforcement	Incentive to abide	Fines
Coordination based	Lax	Not usually relevant - socially/culturally determined	Light
Externality based	Strict - depending on size of externality	High/low - depending on the nature of the externality	Usually heavy, but depends on size of the externality
Free rider based	Lax - often trust/altruistically based	Low	Heavy - usually as a means of "example setting"

Table 2: Rules: Penalties, Enforcement, Violation Acceptability

different approach. So who imposes rules on governments, and what are the nature of these rules? International law obviously is a set of pre-agreed rules relating to the behaviour of states, and usually by Treaty. But one of the problems in international law has been persuasion or enforcement as in many instances international institutions possess only weak enforcement mechanisms. In the political arena, probably the most important international body, the United Nations, has only resolutions as a way of condemning the actions of individual members and the regular flouting of these has had a weakening effect on the credibility of the institution. The only time that rules can effectively be enforced is likely in an armistice Treaty context where an enforcement mechanism can be applied through continued occupation at the end of a war or the real threat of re-occupation after the end of a war<sup>11</sup>. In the economic domain, there are perhaps four specific examples of the imposition of rules on governments or nation states that are worth mentioning:

- i) the IMF, which imposes "conditionality" rules on economic policies of developing countries in return for loans and structural support;
- ii) the WTO, which imposes sanctions on countries that break international trade rules, although the imposition of these sanctions is usually levied indirectly by way of allowing another member of the organization to impose tariffs or quotas on the exports of the country to be penalized; and
- iii) the self-imposition of rules by states which are then enforced by citizens or corporations through litigation by individuals or other states in federal or supranational courts.

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<sup>11</sup>Reparation payments by the axis powers after the First World War are a good example here, and most economic historians acknowledge that the inability to repay such large amounts likely resulted not only in the hyperinflation episodes of the inter-war period, but also in the rise of extremist parties in Germany.

Examples of the adjudication of these types of rules include the European Court of Justice, the tribunal system of NAFTA, and balanced budget legislation in individual US states.

**iv) the SGP**

In terms of this list, the SGP clearly stands out as being different from other types of rules imposed on governments. The IMF polices countries by writing annual economic reports and then imposes conditionality as the "stick" which yields the "carrot" of IMF lending and then (increased) access to international capital markets. If the country reneges on a commitment to follow certain economic policies then further IMF funds are often withheld or not as much will be forthcoming in following years. The WTO doesn't police individual countries and usually imposes penalties indirectly - so the incentive mechanism here is to follow international trade rules or another country will bring a case to the WTO, and ultimately the imposition of the fine is up to the prosecuting country, although from an economics standpoint in welfare terms both countries are made worse off by its imposition. Only in the third case above are sanctions directly and automatically imposed on governments with a compulsion to pay, and these are only policed through individuals or corporations bringing judicial cases against the countries or states concerned, and then the fines or other penalties are decided by the judicial system. Turning to the SGP, it is immediately apparent that there is really no enforcement mechanism for dealing with payments, plus it makes little sense to impose penalties or fines on member states who breach the SGP limits, as this only exacerbates the economic problem it is attempting to solve.

In terms of the rationale for these rules or obligations, the IMF tries to give countries an incentive to follow sound economic policies so that the population will have higher welfare levels in the longer term<sup>12</sup>, thereby suggesting an externality-based reason for imposing rules. Of course, and perhaps Argentina is the best example of this, the general population could be myopic or perceive that the short run austerity might outweigh any longer term gains. In the case of the WTO, the organization has as its general aims the maintenance of freer world trade, so that if governments introduce policies that unfairly favour their citizens or corporations, then a case can be brought against a country by another member country - in this sense countries might be viewed as free-riding on the free trade system.

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<sup>12</sup>In the short term, though, the IMF has been accused by many of imposing harsh economic conditions which lowers the average level of welfare for the population as a whole.

With international agreements or domestically imposed laws, the main incentive to break these agreements can be either externalities<sup>13</sup> or free-rider benefits<sup>14</sup>.

The SGP clearly has elements of all three reasons for rules – first there are possible coordination problems both with the ECB and potentially between themselves given spillover effects – but most of these are dealt with by the regulation 1466 and the "no bailout" clause in Maastricht; second, there are potential externalities if one member state pursues fiscal policies that lead to higher interest rates elsewhere ; and third, so the argument goes, there are free-rider problems in that with a common monetary policy, without fiscal restraints there is an incentive not to retrench if others do so, so that you can "experience the gain without the pain". It would be difficult to determine which of these is most important in deciding to implement fiscal rules at a pan-EU level, but table 2 suggests that if the reasons for instituting rules for individuals were valid for the EU, then the coercive part of the SGP is designed more with externalities and free-rider problems in mind, as there are both close enforcement and large penalties.

Compliance is another issue with the SGP, but some recent academic work has focused on member state compliance with EU directives/regulations. As Tallberg (2002) outlines, there are two theoretical approaches that have been adopted, the first being an enforcement approach, which stresses coercive strategies for compliance, and the second being a management/problem-solving approach, which includes capacity-building and rule interpretation. Tallberg claims that indeed this tendency to combine these two approaches has made the EU remarkably successful in terms of member state compliance rates, reducing it to largely a temporal problem. On the other hand where only one of these approaches has been used, high non-compliance rates have been a problem within the context of the EU<sup>15</sup>.

Ignoring the management/problem-solving elements of the pact - which roughly translate into the monitoring mechanisms of regulation 1466/97, why the coercive element (the excessive deficit procedure) then<sup>16</sup>? Presumably this was originally thought of as mainly an

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<sup>13</sup>An example might be breaking a balanced budget law at a state level, which would clearly have debt implications in the longer term, implying higher taxes for the electorate in the future - this is clearly an externalities problem.

<sup>14</sup>An example might be breaking the Kyoto accord on environmental pollution reduction, which would clearly be free-riding on what others have done to reduce environmental pollution.

<sup>15</sup>Some political scientists (see Neyer (2004)) have gone so far as to claim that the EU represents a new type of political order in the sense that centralized coercion does not appear necessary in order to achieve compliance with directives/regulations. Although this may be true in many policy areas, it clearly doesn't apply to the SGP.

<sup>16</sup>Paul De Grauwe perhaps has some of the strongest views on the pact, stating that "It is quite surprising that EU countries have allowed this to happen, and that they have agreed to be subjected to control by European institutions that even the IMF does not impose on banana republics" (Financial Times, July

incentive mechanism that likely be a backup to the embarrassment of being given a warning by the Commission, and so put pressure on the member state to rectify the situation. The penalties and fines appear to have been designed as a "stick" of last resort. So, as the Commission is the arbiter and guardian of the SGP, this essentially gives a supranational institution say in the fiscal affairs of member states, although the rules of the SGP dictate that only a qualified majority vote of the European Council (without the member state concerned voting), sets in train the penalties associated with the pact<sup>17</sup>. In this sense the SGP itself has been criticised as the rules-based part of the pact involves potential future "sinners" sitting in judgement on whether a member state has or has not "sinned"<sup>18</sup>.

In terms of the analysis of rules presented earlier, table 3 summarises the discussion here and the analysis of the SGP.

Rule imposed by	Reason for rule	Incentive mechanism	Enforcement
i) IMF (conditionality)	Externalities	Withholding of present /future funds	None
ii) WTO	Free-rider	Offsetting imposition of tariffs or quotas	None
iii) International agreement or domestic law (self imposed)	Externalities/ free-rider	Penalties and fines	Judicially determined
iv) SGP	Coordination/ Externalities/ free-rider	Penalties and fines	None

Table 3: Governments and International Rules

25, 2002).

<sup>17</sup>It is quite ironic that most commentators writing after the SGP had been put in place (for example Artis and Winkler (1997)) viewed the penalties as unlikely to ever be levied given that the extended nature of the process in the runup to this decision. Many view the acts of Germany and France in 2003 as an effort to avoid the possibility of penalties, given that deficits in both these member states are likely to persist for some time to come.

<sup>18</sup>Although there are no instances yet of the European Council voting to levy a penalty against a member state for breach of the SGP, the process has reached the point where such a vote should have taken place, although because the Council decided to hold the pact "in abeyance" and issue a political declaration instead, this bridge has yet to be crossed.

## 4 The SGP as a Rule

### 4.1 The Institutional and Legal Shortcomings

The SGP is a very different rule from most rules that governments put in place in relation to the behaviour of the state. Hayek is one of the few economists who has studied the role of rules and government in our lives from a political economy perspective<sup>19</sup>. He outlined the rationale for rules for government in several bodies of work: his view was that rules should be general enough to ensure proper functioning of the market, in other words should be restricted to the realm of private property rights and maintaining public order in a civil society. Hayek said that “we can plan a system of general rules which provides an institutional framework within which the decisions as to what to do...are left to the individuals” (Von Hayek (1939), p88). This describes the basic design of the SGP, which doesn't dictate to member state governments how to run their fiscal policies, but rather focuses on the outcome of fiscal policy in terms of a general limit on fiscal stimulus. So far so good. But what about rules that governments impose on themselves for governing their own behaviour? Hayek would likely say that such rules must be determined by the will of the people in terms of allowing the greatest latitude in personal liberties.

Following this Hayekian approach, one might ask "was it really the will of the member states to impose an SGP?". As the member states agreed to the SGP it is, in an inter-governmental sense, self imposed, so could be thought to be similar to iii) in table 3, but on the other hand it is monitored and the penalties and fines are decided by the European Commission and Council, so also appears similar to i) in the same table. This is a major weakness of the pact referred to earlier – it was decided by member state governments as part of a Treaty that had an excessive deficit procedure defined for the purpose of the creation of EMU, and yet the continuing element of the procedure was put in place as a directives/a resolution at a later date. As the European Court of Justice noted in its decision on the workings of the pact in July 2004, the Commission has the right of initiative but the Council has the right of decision<sup>20</sup>. This collectivity of decision-making clearly leads to problems in terms of application of the SGP given that a qualified majority has to be reached (with the possibility of reciprocity in voting – see Irlenbusch, Leopold-Wildburger, Schutze, and Sutter (2001)), and if attained, there is no defined collection mechanism if member states do not comply. This is an awkward configuration, in that the "rules of the

<sup>19</sup>Other notables are John Stuart Mills, Milton Friedman and George Stigler

<sup>20</sup>The judgement of the European Court of justice last year (of Justice of the European Communities (2004)) makes this clear.

game" are uncertain (there is no clear collection mechanism), as well as the "game" itself (there is no automaticity). So any new proposals, if passed by the Council in the form of a resolution would be non-binding, and once again, could easily be effectively ignored<sup>21</sup> (see Crowley (2002c) and De Haan, Berger, and Jan Jansen (2004)).

The second weakness, as noted by many economists, is that the pact consists of a big "stick" but no "carrots". With other international organizations, the carrot is usually the release of funds (e.g. the IMF) or the looming threat of some kind of economic reprisals (e.g. the WTO) and the stick is suspension or expulsion from the organization (e.g. the British Commonwealth). In contrast, with the punitive parts of the SGP, member states are given no benefits from fiscal rectitude, and are only punished for fiscal excesses.

The third major weakness of the pact is that there appears to be no convincing political-economy rationale for it. Not only does it interfere with automatic stabilizers (see ?) for an assessment of how the SGP may undermine the Maastricht architecture), but also it acts as an opposing force to the process of democracy. Having rules that are imposed supra-nationally to potentially limit member state governments in their obligations and responsibilities in a democratic context seems to fly in the face of fiscal sovereignty. Should governments of other member states have the right to limit fiscal policy on the basis of the potential for externalities and free-rider problems? Taken to the extreme this implies that voters in the Netherlands have an ability to sanction and fine and maybe benefit from the French population, because of its choice of government. Put in any other context, this would sound absurd - and yet it is fully implied by the SGP. The most telling observation, though, has to do with the interaction of politics and economics surrounding the SGP. From an economics standpoint, politicians are elected by the populace - their primary aim is to serve their constituents and their country. The incentive to do so results in re-election, or promotion within their party/government. There is no incentive for a politician to obey rules imposed at the EU level as the EU does not elect them, nor does it promote them for good behavior. If, as stated above, there are doubts about the legal efficacy of the SGP, there is little incentive to abide by the pact, as even if fines are levied against a member state, there would be significant difficulties in collecting the fines, given the level of popularity that the EU enjoys among the European population. Put another way, politicians have a mandate to enact policies that reflect their election promises, and this is mostly done

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<sup>21</sup>?) make the point that in fact the Council didn't ignore the Commissions recommendations, rather it decided to issue a political declaration. The ECJ made it clear that an abeyance can result from the inability of the Council to adopt a Commission recommendation, but the Council itself cannot make new recommendations.

through fiscal policy, the right to tax and spend. Restricting the ability of politicians to do their job is an interference in the democratic process. In this regard, the SGP would prove extremely unpopular in some quarters if strictly implemented, and would likely have far-reaching effects, perhaps endangering further integration in the EU<sup>22</sup>.

## 4.2 Economic shortcomings

From an economics perspective, there are several observations that can be made regarding the SGP and the literature surrounding it. First, most of the commentary and analysis appears to come from European economists – there is very little written by North American economists. Second, there seems to be an acceptance among most economists writing on this issue, that some kind of fiscal pact is necessary – most of the discussion in the literature is indeed based around the form and detail of the pact. Third, that the pact currently focuses on the variable that correctly gives rise to the rationale for the SGP - the budget deficit.

As outlined above in section 3, rules are necessary to embed social norms or to solve coordination problems, externalities or free-rider problems. As fiscal prudence can hardly be described as a social norm then this reason becomes moot. There is a coordination problem that needs to be addressed here though, and this is the coordination of fiscal and monetary policy with the ECB<sup>23</sup>. As a representative from the ECB attends the meetings of the eurozone subgroup of Ecofin, there is at least some semblance of the usual relationship that exists between finance ministries and central banks elsewhere in the world now operational in the eurozone. But this coordination problem would mostly be addressed by the preventative and surveillance part of the SGP rather than the coercive part. Of more concern to the ECB is that the ECB continues to purchase member state debt issue<sup>24</sup>, and the fear is that without effective fiscal restraints on member states, the ECB may not wish to continue to purchase debt, which could lead to a precipitous decline in bond prices for heavily indebted member states. These ECB concerns naturally lead to other conclusions about the SGP from the point of view of the central banker. Clearly budget deficits are not the major concern for the ECB, but rather the level of public debt, and the size of the member state concerned running the debt. The fact that the SGP was

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<sup>22</sup>This is already proving to be the case, as decisions over the reform of the SGP have been perceived to have the potential to impact the outcome of the member state referenda on the Constitution.

<sup>23</sup>Hence the ongoing concerns expressed by the ECB about the "watering down" of the SGP.

<sup>24</sup>This is one reason why eurozone bond yields have converged to a very narrow spread: different central bank policies for debt purchase have now been supplanted by a single policy under the ECB.

put in abeyance on November 25th, 2003, due to fiscal developments in Germany and France has the ECB particularly concerned, as both these member states are large member states so the debt purchasing implications are large. The ECB would be much less concerned about a smaller country breaching the SGP, as there would be little ramifications for debt purchase compared to the ECB's current holdings of public debt. So, ignoring other problems that the pact might solve, if there is only a coordination problem with the ECB, then an optimal design for the SGP would allow more exceptions for smaller countries and give larger member states less weight in any voting system, as larger countries have the potential to do much more damage to the ECB than smaller countries!

The jury for the case that there are significant and proven externalities from fiscal excesses is still out though. Agell, Calmfors, and Jonsson (1996) originally constructed a theoretical model which suggests that inflation prone countries making a commitment to a monetary union with low inflation might lead to a deficit bias in those higher inflation countries. The argument then used by the Commission and others is that this deficit bias will translate into higher interest rates for the rest of the monetary union<sup>25</sup>. But if this is the case, then this should be evident in other federations or monetary unions, in that a higher debt in one sub-state should lead to higher interest rates in other sub-states. Eichengreen and Wyplosz (1998) found little strong evidence that externalities or spillovers were a problem in the context of North America, but suggested that there might be a case here if the member state or collection of member states was large in comparison to the rest of the EU. ?) analyse the Canadian bond market, looking at externalities from Canadian federal government debt to provincial government debt, and find using a standard ordered probit model and credit rating data that there are significant spillovers here<sup>26</sup>. They then go on to analyse inter-provincial externalities and find that there are indeed significant negative externalities for a large province such as Ontario having a larger debt<sup>27</sup>, but for other provinces there are insignificant externalities. Codogno, Favero, and Missale (2003) analyze bond data to evaluate what the effect of increased debt to GDP ratios is on interest rate spreads when controlling for international factors, and find that with the exception of Austria, Italy and Spain, the effects are not significantly different from zero. Also the authors go on to test for a structural break in the data in 1999 when EMU was initiated,

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<sup>25</sup>An interesting corollary of this view is that fiscal rules might lead to lower interest rates, regardless of whether there are any spillover effects. ?) find that there is evidence in the US context that deficit rules do lower borrowing costs.

<sup>26</sup>This would be the equivalent of externalities from EU debt to individual member state debt.

<sup>27</sup>Hence a larger Ontario debt increases the credit rating and lowers the interest rate charged on other province's bonds.

but with the exception of Ireland, no significant structural break was found.

While there appears to be no firm evidence that externalities pose a problem for the eurozone, there is perhaps a case to be made for a potential free rider problem, but in theory the Maastricht "no bailout" clause should take care of this as if the EU does not proceed to establish a fiscal union, national debt will still be priced on a member-state by member-state basis. A casual observer might claim that as European bond yield spreads are so narrow, perhaps this is due to the SGP, but this narrowing of yield spreads is observed in other countries such as Canada, where provincial bond yield spreads are also nearly always narrow, without the Canadian equivalent of an SGP<sup>28</sup>.

So to sum up, in reality the main cause for concern is with public debt levels, and the coordination of fiscal and monetary policy in EMU. It is beyond the scope of this paper to review the considerable body of work in the economics literature which documents the views of those economists who consider the shortcomings of the SGP<sup>29</sup>, so instead table 4 below documents these criticisms with the suggested changes to the pact in the literature.

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<sup>28</sup>The Bank of Canada is permitted to hold provincial bond issues in its portfolio, and there is a line entry in its balance sheet, but historically it has not held any provincial paper.

<sup>29</sup>An excellent review of the SGP literature can be found in Treasury (2004)

Criticism	Proposed solution	References
Uses cyclically unadjusted deficit figures, so automatic stabilizers not included	Cyclically adjusted budget deficit	Eichengreen and Wyplosz (1998)
Doesn't take into account needs of CEE accession countries	Permanent balance rule	Buiter and Grafe (2004)
Focuses on deficits rather than debt, so acts asymmetrically	Debt sustainability pact	Pisani-Ferry (2002)
Inconsistency in application, due to Council taking the decision ("sinners sit in judgement on sinners	Commission to make decision  Independently determined fiscal index	Wyplosz (2005a) Hughes Hallett, Lewis, and Von Hagen (2003) Eichengreen (2003) Eichengreen, Hausmann, and Von Hagen (1999)
Doesn't take into account positive aspects of public investment	Commission proposal rather than recommendation	Eijffinger (2004)
Definition of recession as a fall in real GDP of 2%	Exclude net capital formation from budgets  Redefine a recession as 0% growth in real GDP	Blanchard and Giavazzi (2003)  of the European Communities (2003)
Budget "close to balance or in surplus" implies excessive reduction in debt levels	Choice of budget deficit limit made taking into account consideration of debt levels and on a member state-by-member state basis	De Grauwe (2003)

Table 4: Criticisms of the SGP

## 5 Where do we go from here?

### 5.1 The Commission's Review and the Agreed Revisions

After the events of late 2003 and 2004, culminating in the overhaul of the SGP on March 22nd 2005 after the review by the Commission, there is really still no consensus among academic economists about what to do with the pact. Clearly this lack of consensus is not a good state of affairs, as it gives no guidance to the policymakers who have to abide by the pact on a day-to-day basis.

It was clear from (1), (2) and Buti, Eijffinger, and Franco (2003), that the Commission was in favor of maintaining the current general framework, and making incremental changes to improve the implementation of the pact and the surveillance of member state fiscal policy. Their reasons were simple: the pact appears to have maintained some degree of fiscal austerity after the inception of EMU. To quote (1):

"In spite of recent difficulties, there has been no return to the profligate budget policies of the past. The SGP and multilateral surveillance have played a decisive, albeit sometimes difficult, role in containing the deficit levels during the economic slowdown" (p17)

In some senses making incremental changes to the existing arrangements was not the best approach though, and for noteworthy reasons. Many economists viewed the Maastricht Treaty as flawed, and maintained that at some point, if continued, the criteria used for continuing membership of EMU would run into trouble, even with the existing member states. This has now happened. Was it better to patch up a flawed pact, or to design something that is durable and makes economic sense? Second, as Buiter and Grafe (2004) point out, the new accession states throw an additional spanner into the works, one which will only provide further evidence for the accession countries that the initial EU members are inflexible to their concerns, and then if maintained, will create a permanent "three-speed" EU.

Although novel ideas for replacing the SGP have been proposed in the literature, none of them seems likely to be adopted, so a more realistic series of options for the pact is considered in the light of the analysis undertaken in section 3 above. These options should be seen as adding to the largely cosmetic options given by Begg and Schelkle (2004), which is represented below by option 3. Before proceeding it should be noted though that not all economists think that the SGP is in need of major reform (see Gali and Perotti (2003)

for example). Indeed these economists claim that scrapping or reforming the pact would carry greater costs than insistence on enforcing the SGP as is.

## 5.2 Options for Real Reform of the SGP

### Option 1 Scrap the pact

The pact is scrapped, but the Maastricht convergence criteria are still be maintained as a means of ensuring a certain degree of economic and monetary convergence for new EMU members. The no-bailout clause in Maastricht would still remain in force, and financial markets would be encouraged to properly price member state public debt according to risk of default and the degree of fiscal prudence by allowing as much transparency in public sector accounting as possible. The ECB would make it clear that it will not automatically underwrite member state debt, and that debt levels in excess of 60 percent of GDP would likely be the cutoff point. This suggestion follows is a modified version of the Canadian model, and is also partially supported by De Grauwe (2003). Now that EMU has been successfully launched there is really no need for supranational fiscal constraints on member states. This option would likely involve a Treaty amendment, unless the excessive deficit procedure could be "reinterpreted" as only being relevant for the transition period into EMU for newly joining member states.

### Option 2 Member state budget legislation

Rules require appropriate incentives and penalties, and if there are insufficient incentives then the potential penalties must be such that personal reputation and liability is at stake. Any rule that originates at the EU level is liable to political manipulation, favorable interpretation, and in any event as established above, is not fully enforceable. Member states should adopt balanced budget amendments (or specific levels of permitted deficit amendments) which are enforceable by law, while at the same time "rainy day" funds be permitted for smoothing the business cycle at the member state level (see Inman (1996)). This is the general means of ensuring fiscal prudence at the state level in the US (and in some Canadian provinces) and although states are prone to put fewer funds into "rainy day" funds than might be considered prudent by some, the laws do provide accountability, transparency, and some scope for automatic stabilizers to work. From a legal perspective, any state government auditor that does not balance the books in any given year is personally liable for any shortfall, so that the incentive to allow a shortfall is usually resisted

and there is a general understanding that hard decisions sometimes have to be made, so this often doesn't adversely affect re-election probabilities. In 3 US states the balanced budget rules can be over-ridden by a 75 percent vote of the legislature, but this has rarely been done. This option would clearly have to be enforced at the EU level, in the same way that the independence of central banks was also enforced, and would likely require a Treaty amendment, as all EMU member states would be expected to comply. Member states that did not comply and scrapped their budget laws would automatically be suspended from EMU. An appendix shows the types of balanced budget legislation currently in operation in the US. Wyplosz (2005b) also implies that he favours this type of arrangement.

### **Option 3 Tweak the current arrangements**

One of the major criticisms of the SGP is that it leads to pro-cyclical fiscal policy at the margin: that is, that as growth falls and tax receipts correspondingly fall, if the member state is near the 3% deficit limit, the SGP forces member states to also reduce expenditures, which exacerbates the fall in growth and hence reduces budgetary flexibility. To increase flexibility, rainy-day funds have been proposed to allow member states greater leeway in establishing a greater degree of counter-cyclicity in fiscal policy. But it has been proposed that more allowance should also be given for allowing public investment if close to the 3% deficit limit, and an exceptional recession would be defined as 0 percent growth rather than the current fall of 2 percent. Begg and Schelkle (2004) label this type of option "bad economics", as it only marginally addresses the major economic failings of the SGP. The option would not require a Treaty change.

### **Option 4 Conditional SGP**

Given that the SGP is already in place, one option would be to modify the pact so that it contains better economic rationale. From above it is clear that the main focus in the pact should be on debt, not on budget deficits. Rather than shifting the focus entirely over to debt without the "soft" elements of the clause in Maastricht dictating that member states with gross levels of debt converging to 60% of GDP satisfy this constraint, use the debt criteria as a conditional rule to trigger the excessive deficit procedure. Thus, any member state having a debt level lower than 60% of GDP would not be subject to the excessive deficit procedure and the fines inherent in the SGP, while member states with debt levels higher than 60% would be subject to the excessive deficit procedure with the usual caveats. In this way, a real rules-based economic rationale for the SGP would apply,

while most transgressions of the 3% budget deficit limit would be monitored but would not be subject to the excessive deficit procedure's sanctions and fines. This option would not require a Treaty amendment, as this conditionality could be part of the "clarification" of the excessive deficit procedure as part of a new resolution.

### **Option 5 Fiscal Union**

As with the previous policies constraining EU member state governments ( - such as the ERM of the EMS), commit to using the SGP as a stepping stone to fiscal union at the EU level. The proposal would imply giving the European Parliament fiscal powers, and would be the last step in the EU integration process. This would make economic sense of the SGP as a rule to protect the 'no bailout' clause of the Maastricht Treaty, and would be directly in line with the free-rider explanation for rules, in that at some point the debt of member states would become common debt for the whole European fiscal union (even though, as in the US, some of the debt might still be held at the member state level). This option would clearly require a Treaty amendment.

Table 5 below summarises these options/scenarios. In the current environment, however, options 1, 2, and 4 are unlikely to be realized, but given the Commission's review of the SGP, option 3 seems to offer the best way out of the problem that the SGP has created in the EU.

Option description	Rules-based rationale	Economics rationale	Political rationale	Treaty amendment?
1. Scrap the pact	Only proven coordination problem with ECB	No threat to Maastricht "no bailout" clause if ECB does not underwrite public debt, financial markets will price public debt efficiently	Principle of subsidiarity	Yes (No)
2. Member state budget legislation	Member state legal system most effective arena for enforcement of rules	Fiscal consolidation desirable in all member states. Solves coordination problem for ECB	Fiscal sovereignty of member state governments respected	Yes
3. Tweak the SGP	None	Slight - only allows for greater counter-cyclical fiscal policy and more exceptional circumstances	Difficult to get consensus on making substantial changes to SGP	No
4. Conditional SGP	Externalities possible - but penalties should be reserved for those where most risk is apparent	Fiscal consolidation desirable in highly indebted member states, others allowed latitude	Leaves the SGP largely intact, while removing the current constraints on member states in good standing as well as new CEEC members	No
5. Fiscal Union	Large free-rider problem	Internalises the externality and justifies current SGP as a "stepping stone" - corrects OCA deficiencies	Further the integration dynamic of the EU	Yes

Table 5: Options for reform of the SGP

## 6 Concluding Remarks

To conclude we return to the title of the paper. As of writing, the coercive part of the SGP is currently not in effective operation, although with the re-write of the rules regarding "exceptional" circumstances, it will be back in operation for 2005 budgetary outcomes. But the future of the SGP needs to be taken seriously from an economics and a political science perspective, as without a proper rationale and implementation, the SGP will end up once again being the centre of attention in EMU, as further political wrangling occurs.

In this paper a multi-disciplinary approach was taken to the SGP. The aim of the paper was to present the rationale for having rules, and then combine this with a political economy approach to the SGP underpinned by "good" economics that address the issues at hand. The main rationale for having rules for individuals is to resolve coordination problems, externalities and free-rider problems. For governments, international rules usually lack teeth unless there are incentive mechanisms in place, and even then there is little to prevent them being broken and effective enforcement mechanisms to collect penalties or fines. The most effective rules for governments are self-imposed and enforced by citizens and corporations rather than being imposed from elsewhere, and penalty mechanisms are usually best decided by a domestic judicial system rather than other countries.

The analysis of rules in the paper led to the conclusion that the SGP is an unusual rule in that it is regulated by a supranational institution (the Commission) and yet fines and penalties are decided by an inter-governmental institution (the European Council). The latter characteristic of the SGP will likely lead to political decision making problems and difficulties with enforcement. There are also perceived shortcomings with the economic underpinnings of the pact, as the pact focuses on deficits rather than public debt. An analysis of the economic rationale for the pact showed that while there are some coordination problems that the SGP addresses, there is little evidence of externalities, and unless the SGP is a pre-cursor for a fiscal union, there is also little need for a pact on the basis of a free-rider problem.

Solving these coordination problems with the ECB is likely the most important aspect of the SGP, but this can mostly be done through the preventative part of the SGP. Externalities indeed could arise if the ECB continued to guarantee to be the "buyer of last resort" for eurozone member state public debt issue, and in this sense gross public debt is clearly the variable that the SGP should be focused on. The paper also explained how larger member states who amass large public debts are more likely to be of concern than

small member states, and in this sense the voting arrangements on the Council are not appropriate to address the coordination problem that the SGP is meant to address.

In the last section of the paper a range of options was given for dealing with the current impasse over the SGP, based on a rules-based analysis and political-economy considerations. The options were to scrap the pact, to replace the pact with a system of self-enforcement at the member state level, to make the excessive deficit sections of the pact conditional on the 60% debt limit and lastly to make the SGP into a stepping stone towards a fiscal union. All of these options are logically underpinned by both economic and political rationale, and accord with the need to have rules in this instance, or otherwise. Given the current situation in the EU, making the excessive deficit sections of the pact conditional appears to offer the best possibility of adoption, as politics will likely necessitate that the pact survives, if not in substance, then surely in form.

Finally, to answer the question posed by the subtitle for this paper, the answer is both. The SGP currently contains bad economics, but also these contents were arrived at by "the politics of least resistance". If the SGP is to contain good economics, then choosing a pact on the basis of the "politics of least resistance" is simply not an option.

## Appendix

### A US State Fiscal Rules

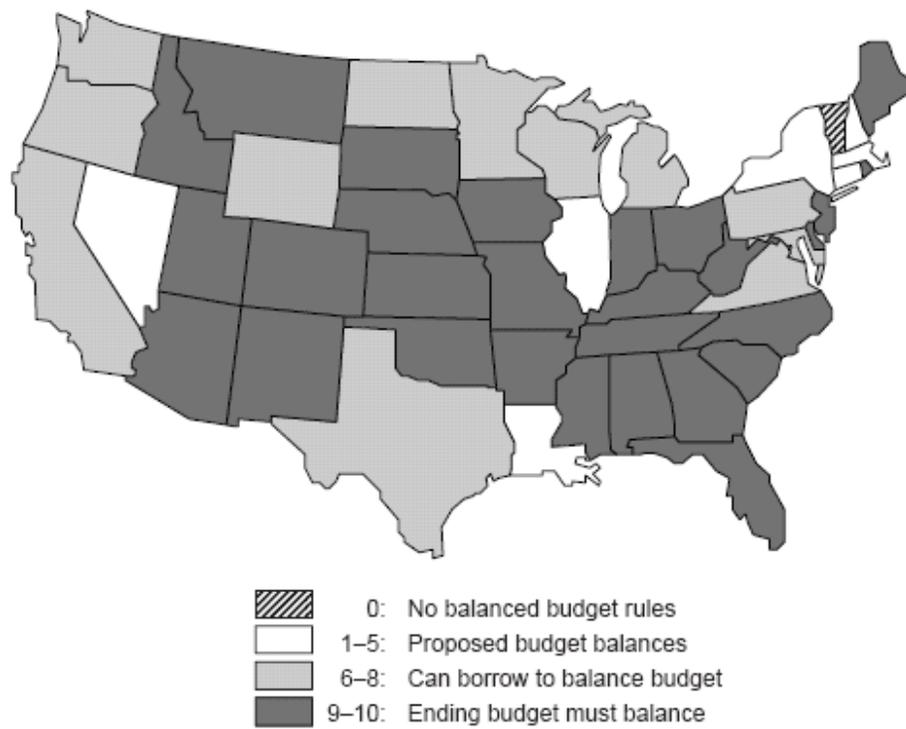


Figure 1: US State Laws regarding budgets (Source: ?)

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