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EU fiscal governance: Hard law in the shadow of soft law?

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Summary

A key element of economic governance in the EU, the Stability and Growth Pact, underwent a major revision in March 2005. The many critics of this change claim that what was once a hard law institution for fiscal surveillance has now become so soft as to jeopardize its functioning. This article examines, first, how exactly the fiscal rules have changed, using the framework of Abbott et al (2000) which distinguishes hard law from soft law along a continuum in three dimensions of governance: obligation, delegation and precision. Then it reviews the experience of the first round of surveillance after the revision which so far suggests that the revised Pact is more effectively constraining countries that are officially in 'excessive deficit', contrary to expectations. Finally, the article offers an interpretation why the revised Pact may work more effectively. This interpretation suggests that the weakening of obligation has been compensated by changes in the other two dimensions, delegation and precision, casting a shadow of soft law on the operation of the Excessive Deficit Procedure. The argument is based on a theory of precautionary commitment by democratically elected governments that combines credibility with flexibility (Elster 1979, Lohmann 2000). Fiscal governance after the Pact revisions is now arguably better equipped to address major contingencies of fiscal policymaking.

Contents

I. INTRODUCTION* 3

II. HOW HAS THE REVISION OF THE STABILITY PACT AFFECTED THE MODE OF FISCAL GOVERNANCE IN THE EU? 4

II.1 THE MAJOR REVISIONS OF FISCAL GOVERNANCE IN MARCH 2005 4
II.2 DIMENSIONS OF GOVERNANCE 6

III. HOW HAS THE REVISED PACT CHANGED FISCAL GOVERNANCE IN PRACTICE? 9

III.1 CHANGES IN OBLIGATION 9
III.2 CHANGES IN DELEGATION 10
III.3 CHANGES IN PRECISION 12

IV. HOW CAN A SHADOW OF SOFT LAW MAKE FISCAL SURVEILLANCE MORE EFFECTIVE? 13

IV.1 STRUCTURAL MEASUREMENT 16
IV.2 ASSIGNMENT OF RESPONSIBILITY 18
IV.3 ENDOGENOUS UNCERTAINTY 20

V. CONCLUSION 22

VI. REFERENCES 25

Table of Figures and Graphs

TABLE 1: MAJOR REFORMS OF THE SGP 5

TABLE 2: DIMENSIONS OF GOVERNANCE IN THE ORIGINAL AND THE REVISED PACT 8

FIG.1: DIFFERENCE BETWEEN STRUCTURAL BUDGET BALANCES BASED ON TREND AND ON POTENTIAL OUTPUT 17

FIG.2: RESPONSIVENESS OF STRUCTURAL BALANCES (EXCLUDING INTEREST PAYMENTS) TO CHANGES IN OUTPUT GAPS 18

FIG. 3A: STRUCTURAL BALANCES AS % OF GDP 19

FIG.3B: STRUCTURAL BALANCES AS % OF GDP EXCLUDING INTEREST PAYMENTS 20

I. Introduction*

Economic governance in the EU relies on rule-based policy coordination, in particular of what has been characterised as 'hard law' coordination under the Stability and Growth Pact (SGP) for EMU members and 'soft law' coordination under the Broad Economic Policy Guidelines (BEPG) and the Employment Strategy. The Pact underwent a major revision in March 2005. The many critics[1] of this revision claim that what was once a hard law institution for fiscal surveillance has now become so soft as to jeopardize its functioning. The revisions have introduced country-specific assessments of compliance and various exemptions from the rules and thus replaced what were intended to be quasi-automatic sanctions.

This article examines, first, how exactly the fiscal rules have changed, introducing the framework of Abbott et al (2000) to describe 'legalization'. This framework distinguishes hard law from soft law along a continuum in the dimensions of obligation, delegation and precision. It thus allows for a richer classification of the SGP revisions than the one-dimensional 'softening' of obligation that the hard law-soft law distinction typically implies. This will be crucial for my assessment in section 3 of how the revised Pact works in practice. Paradoxically, fiscal surveillance seems to assert itself more effectively now in that countries which are officially in excessive deficit perceive the new rules as binding constraints that shape domestic consolidation efforts.

Finally, the article offers an interpretation of the apparent paradox that a weakening of obligation may have rendered the Pact harder to evade. It is argued that the complementary changes in the other two dimensions, delegation and precision, cast a shadow of soft law on the operation of the EDP. This interpretation draws on the Ulysses interpretation by Elster (1979) and the institutional political economy of Lohmann (2003). They provide compatible explanations for why and how precommitment of policy needs to combine credibility with flexibility. Democratically elected governments incur political costs both if they are seen as unprincipled and if they are seen as mere servants of an outside diktat. Fiscal rules thus have to allow for the 'foreseeable unforeseen contingencies' (Lohmann 2000) in policymaking in order to be constructive, thus be binding but not crippling. These contingencies can be specified as three challenges for rule-based policy coordination: (1) the problem of measuring the indicators that set the rule in motion; (2) the problem of assigning responsibility for breaking a rule; (3) and the endogeneity problem of rule-based policies that Goodhart's Law implies. The conclusions discuss to what extent fiscal governance is now better equipped to address major contingencies of fiscal policymaking.

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[1] Among them the European Central Bank, cf Papademos (2005).

II. How has the revision of the Stability Pact affected the mode of fiscal governance in the EU?

Fiscal governance in the EU takes place in two policy processes. The BEPG, applicable to members and non- members of the monetary union alike, coordinate fiscal policies with structural reform policies in labour, financial and commodity markets. In particular, the Employment Strategy is 'streamlined' with the discussion of stability and convergence programmes of EMU and non-EMU members, respectively (European Commission 2002). If a non-EMU member incurs an 'excessive deficit', it will get a reprimand under the BEPG but no fiscal sanction. This coordination process over the policy cycle is rule-based insofar it is a fixed format of reporting and follows a predetermined time schedule rather than ad hoc decisions by policymakers that set the agenda for discussion and action.

Fiscal policy coordination in the narrow sense is based on two rules for all EU members, first the corrective rule that member states should not have an 'excessive' deficit defined as more than 3% of GDP, except in severe recessions, and a preventive rule that the budget should be 'close to balance or in surplus' over the business cycle. If an EMU member incurs an 'excessive deficit', an Excessive Deficit Procedure (EDP) can be triggered by the Council of Economic and Finance Ministers (ECOFIN Council) that will eventually lead to pecuniary sanctions.

The SGP was meant to be a 'hard law' measure for EMU members in that non-compliance with the corrective rule could trigger pecuniary sanctions under the EDP. The BEPG, by contrast, were interpreted as 'soft law' or Open Method Coordination (OMC) in the sense of Hodson and Maher (2001: 719, 722, 730): the policy process follows a codified practice of benchmarking, target-setting and peer review. While this characterisation made (more or less) sense to academic lawyers and political scientists, most academic macroeconomists were extremely critical of the original Pact, even at the planning stage (e.g.. Buiter et al 1993, De Grauwe 1992, Goodhart and Smith 1993, Hughes Hallett and McAdam 1998). The bottom line of most critiques was that one should not tie governments' fiscal hands in a monetary union where the monetary authorities of a country have lost the opportunity to pursue a domestic interest rate policy. Most economic critics also noted the problem of moral hazard, ie a Pact that is meant to be hard law should not have the Council to decide on the EDP with a qualified majority of two thirds of the vote (excluding the government under consideration) as this would amount to 'the Turkeys deciding on the menu for Christmas'.

So, what were the major changes that the revisions of fiscal coordination in March 2005 and how can we characterize these changes in terms of 'soft' and 'hard' law?

II.1 The major revisions of fiscal governance in March 2005

The following table 1 summarises what seem to be the most relevant differences between the old and the new SGP. It follows the 2005 issue of 'Public Finances in EMU' where the guardian of the Pact, the Directorate General for Economic and Financial Affairs (DG Ecfin) of the Commission, outlines its interpretation of the Pact revisions.

Table 1: Major reforms of the SGP

	Original Pact	**Reformed Pact**
Preventive rule: Medium-term objective (MTO)	All MS have a MTO of 'close to balance or in surplus';	**Country-specific differentiation** of MTO depending on debt level and potential growth, allows for 1% deficit if debt is low
In case of deviation from MTO	No adjustment path or action specified	Commission can issue direct '**early policy advice**'; adjustment path specified to be a minimum fiscal effort of 0.5% of GDP and counter-cyclical; **structural reforms** can be taken into account to allow for deviation
Corrective rule: Monitoring if deficit exceeds 3%	No obligation for Commission to prepare report; no mitigating 'other relevant factors' (ORF) specified	Commission will always prepare **report**, taking into account whether - deficit exceeds investment expenditure - **ORF** can justify temporary 'excess'
Debt position	No specific provisions	'Sufficiently diminishing' **debt** can be taken into account qualitatively; **Systemic pension reforms** can be taken into account for five years if reform improves long-term debt position
Excessive deficit procedure	Excessive deficit has to be corrected in the year following identification; if not, a non-interest bearing deposit has to be made with the Commission that is turned into a fine of 'appropriate size' if the situation persists; No 'minimal fiscal effort' defined; No repetition of steps foreseen	Correction can be postponed for one year if **ORF** apply; **Minimal fiscal effort** of 0.5% of GDP to reduce excessive deficit required; **Deadlines** for correcting deficit can be extended if necessary steps are taken or unforeseen adverse circumstances occur

Source: Directorate General (2005: Table II.1)

This comparison indicates why most commentators agreed that the Pact has been 'softened'. It is very unlikely that the EDP will ever bite: 'other relevant factors' such as medium-term growth and the debt position can be invoked to postpone its start or steps can be repeated if the required measures, such as a 'minimal fiscal effort', are undertaken. However, these 'escape clauses' as well as the adjustment measures required are specified in meticulous detail and the monitoring role of the Commission has been considerably strengthened. For instance,

the original Pact did not tell governments exactly how they have to go about fulfilling the medium-term objective or to correct an excessive deficit. The Commission could neither give direct 'early policy advice' nor did it have an obligation to file a report if a budget deficit of 3% occurred. These simultaneous changes call for a more detailed taxonomy of what the alleged softening of the Pact means.

II.2 Dimensions of governance[2]

This section briefly describes dimensions of governance, namely obligation, delegation and precision to characterize the changes that the Pact revisions brought about in terms of effectiveness rather than 'hardness'. These dimensions have been proposed by Abbott et al (2000) to characterise degrees of legalization, interpreted as moves from soft to hard law primarily in international agreements. At this stage, these dimensions are simply used to characterise the changes brought about by the Pact revisions; I will come back to the question how they fit into an explanation in the fourth section. There are two advantages of using the Abbott *et al* framework in the present context. First, its three dimensions allow us to compare the effectiveness of instruments (which is preferable to 'hardness' which implies that the only truly effective instruments are legal ones) generated by different modes of governance. Second, the relationships between the dimensions counter the view that legalization or the hardening of a governance framework simply means stricter legal obligation, which implies that soft methods of policy coordination are the unruly teenage children (or perhaps the poor second cousins) of grown-up hard law.

In Abbott et al's framework, *obligation* means that states are bound by a commitment arising under the 'general rules, procedures, and discourse of international law' (Abbott et al 2000: 401). At one end of the spectrum we find 'hard' rules which create well-defined, sanctionable obligations, at the soft end are norms which are too general to create specific duties. These include exhortations to engage in reform or promote structural adjustment. For the purpose of comparing the original and the revised Pact, I am less concerned with the specifically law-like character of obligations. Legalization in terms of obligation can also be brought about by a specific type of discourse, in which arguments are framed in terms of norms and principles while positions based on interests or power are disallowed. I suggest that this normative discourse can be drawn from, for example, a shared economic analysis, rather than being a specifically legalized discourse based on 'the text, purpose and history of the rules' (Abbott et al 2000: 409).

On *delegation*, Abbott et al (2000) focus on whether powers to resolve disputes are delegated to a third party. At the 'hard' end of the spectrum, we find an international court or organization, while diplomacy is at the soft end of that spectrum (Abbott et al 2000: 404). However, they then move on to a wider view of what might be delegated, suggesting that 'a range of institutions—from simple consultative arrangements to full-fledged international bureaucracies—helps to elaborate imprecise legal norms, implement agreed rules, and facilitate enforcement.' (Abbott *et al* 2000: 417) The discussion suggests that there can be different 'moments' of delegation within a single instrument. It will prove important for the interpretation of what makes the revised Pact more binding to highlight the distinction between administrative or operational delegation, such as determining the statistical basis for key indicators, and 'adjudicative' delegation, meaning powers to judge disputes or to determine whether a party complies with a condition or not (Abbott *et al* 2000: 406).

[2] The following and section 3 draws on Mabbett and Schelkle (2006).

As regards the dimension of *precision*, Abbott et al (2000: 412) state that '[a] precise rule specifies clearly and unambiguously what is expected of a state or other actor (in terms of both the intended objective and the means of achieving it) in a particular set of circumstances.' The bracketed proviso is an important one: goals specified in the BEPG which prescribe only the objective but not the expected action are imprecise, in the sense of lacking the basis for determining whether a country has taken steps to comply with its obligations or not. Furthermore, goals such as fiscal sustainability and structural reform may conflict with each other and therefore present participants with choices and tradeoffs. Such goals can be said to lack precision in the sense of being 'related to one another in a noncontradictory way' (Abbott et al 2000: 413).

Abbott *et al* (2000: 406-407) see arrangements exhibiting high degrees of obligation, delegation and precision as 'hard law'. However, they also note that there is potential for substitution as well as complementarity among the three dimensions, so the dimensions do not add up to a single-valued ordering. This is illustrated by Table 2 which summarises the changes that have been made in terms of modifications in governance dimensions, suggesting that there was not a uniform move from hard(er) to soft law.

Table 2: Dimensions of governance in the original and the revised Pact

	Original Pact	**Revised Pact**
Obligation	**high to medium**: Quasi-automatic sanctions under EDP but political decision by Council required (with qualified majority, the government under scrutiny has to abstain)	**medium to low:** Correction of excessive deficit can be postponed or high investment and ORF classify the excess as temporary; but conditions apply; achieving MTO depends on country-specific circumstances
Delegation	**low (operational and adjudicative)**: supervisory and monitoring role of Commission optional or contested; less detailed reporting requirements specified in Code of Conduct	**high (operational) to medium (adjudicative)**: strong and detailed supervision by Commission and Eurostat, detailed reporting requirements specified in Code of Conduct; reporting to Council by Commission now mandatory in the corrective arm; option of 'early policy advice' in the preventive arm
Precision	**Medium (goals) to low (means):** Excessive nominal, later structural deficit of 3% to be avoided but measurement issue unresolved until June 2005 (not directly linked to revisions); no specification of means to achieve correction or adjustment MTO	**Low (goals) to high (means):** Excessive structural deficit of 3% to be avoided, measurement issue resolved for the time being, but long-term sustainability (growth potential, debt position) and structural or systemic reforms are competing goals specification of 'minimum fiscal effort' to prevent unsustainable deficit or correct excessive deficit; country-specific exemptions (ORF, MTO etc) defined in detail

The original Pact arguably combined a high to medium degree of obligation with low delegation to the Commission and medium precision as regards the goal[3] but low precision on the means. This implies a fairly high amount of legalization, the revisions seem to have weakened obligation but strengthened delegation and precision, as will be discussed in detail below. Thus, if obligation is not the overriding characteristic of legalization or if it is conceded that the original Pact was not as obligatory in practice as its architects thought, it is not obvious that the revised Pact is less hard or binding.

[3] The goal of no excessive deficit was originally defined as 3% in nominal terms but was changed to structural measurement. However, the filtering out of cyclical components is contested. The Council of Economic and Finance Ministers asked the Commission to develop the production function method for estimation in May 2004 and the Economic Policy Committee resolved the outstanding issues in June 2005 (see Denis et al 2006: 15-16). I will come back to this at the end of section 4.

III. How has the revised Pact changed fiscal governance in practice?

The following section uses all three dimensions to give a preliminary assessment of the changes that the Pact has brought about in practice, based on the formal revisions summarised in table 2. This empirical investigation is based on qualitative interviews with senior Treasury officials in four countries (DE, GR, IT, NL) and the report 'Public Finances in EMU 2006' on the stability and convergence programmes after the revisions.

III.1 Changes in obligation

Early comments tended to interpret the Pact revisions as if the new framework imposed no obligation on member states any more, sometimes even before they actually happened (Gros et al 2004). This seems plausible from a legal and disciplinarian point of view: a number of exemptions and procedures were introduced which make it very unlikely that fines will ever be imposed under the EDP. But it is a problem to conclude that there is no obligation, because it would leave the remaining dimensions of delegation and precision up in the air: what is the point of defining precisely a rule that no-one has to comply with? However, a political economy perspective suggests that obligations can be created in other ways than through financial sanctions. Finance ministers may feel bound by obligations to their 'club' which, as Puetter (2006) has documented for the Eurogroup, has a strong sense of identity. This sub-Council of Finance Ministers from the Euro area can be thought of as having 'club goods' at its disposal, that create the incentives to comply and stay a respected member of it. Political resources would be one such good: finance ministers have some capacity to reinforce or undermine each other politically. Perhaps the main club good is the forum itself and the 'decision space' it creates: the more respected and relevant it appears to be, the more members feel obligated to comply so that the process continues to be seen as meaningful. It is of interest in this context that interview partners saw the differentiation of rules according to a country's specific circumstances as an obliging feature of the revised Pact: 'you have no excuses any more', as two interviewees put it, using almost identical expressions.

This does not necessarily mean that the continued existence of the EDP is without significance. As all the interview partners in the Treasuries confirmed, it makes a considerable difference for the diligence with which they undertake the minimum fiscal effort (MFE) of reducing the structural deficit by 0.5% or the scrutiny they experience for what might look like one-off measures that are now enumerated in the Code of Conduct. But the question is whether this is due to the sanctions that may be imposed[4], or because of the heightened political significance that fiscal surveillance then assumes, ie. the 'shadow of soft law' it creates. Our interviewees gave conflicting interpretations, 'discipline' was mentioned as the main reason but also the tighter scrutiny implied by the new instrument of 'minimum fiscal effort' (MFE).

A particularly interesting case in this context is the stepping up of the EDP of Germany. In spring 2005, the German budget deficit was again predicted to be 'excessive' according to Art.104. However, as the Commission stresses in its careful wording of the recommendation, the new administration under Chancellor Merkel and Finance Minister Steinbrueck was well advanced in its budgetary consolidation strategy and the "envisaged structural budgetary adjustment in the years 2006 and 2007 can be considered consistent with the SGP provisions, including [MFE]" (European Commission 2006: 3). Thus, the German government could

[4] In the conceptual framework of Héritier (2005), this would be the 'shadow of hierarchy' that makes soft(er) fiscal surveillance work.

have invoked 'effective action' and postponed notification under Art.104(9). Instead, the Commission recommended putting Germany one step further and thus closer to sanctions under the EDP. This was justified by referring to a provision under the original Pact that seems strangely out of line with the thrust of the revised Pact, that medium and long term sustainability is what matters. This original provision makes the actual nominal deficit the benchmark for the onset of the EDP: 'According to Article 10(3) of Council Regulation (EC) No 1467/97, if "actual data" provided by the Commission "indicate that an excessive deficit has not been corrected by a participating Member State within the time limits specified (…) in recommendations issued under Article 104(7) (…) the Council shall immediately take a decision under Article 104(9)", that is, "give notice to the Member State to take, within a specified time-limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation".' (European Commission 2006: 2)

A political economy interpretation suggests that this legal provision was used strategically and creatively to move Germany to the next step in the EDP and that it is very likely that the new German government gave the Commission a green light to apply the Pact in its most original form. It was too obviously helpful to the new government in arguing its case in favour of unpopular consolidation measures, such as a rise in the central VAT rate. Moreover, it allowed the Merkel administration to signal its commitment to the spirit and the letter of the Pact which, after all, a conservative government had once championed. This way the German government could hope to regain some of the moral high ground on the strict application of fiscal rules that was lost under its immediate predecessor. The Commission, in turn, showed some gratitude for the government's cooperation, in that it did not insist on 0.5% structural adjustment annually but allows for a cumulative MFE, ie. for 2006 and 2007 combined, adding up to 1% of the structural deficit.[5] This seems to be a piece of evidence in favour of the hypothesis that hard law (the EDP) may be more effective if shadowed by soft law fiscal surveillance. An explanation for why and how this may work is provided in section 4.

III.2 Changes in delegation

The crisis that led to the revision of the original Pact came to the fore when, in November 2003, the Ecofin Council accepted that France and Germany were in breach of their Treaty obligations to avoid excessive budgetary deficits but also decided not to impose any sanctions and instead issued its own recommendation to the delinquent member states. Subsequently, the Commission launched an action in the European Court of Justice (ECJ) asking the Court to rule on whether Ecofin was legally entitled to act as it did. In its judgement rendered on the 13th of July, 2004[6], the ECJ found largely in favour of the Commission and annulled the November Council decision. The ruling clarified the procedural aspects of the EDP, stipulating that the Commission has the sole right to make recommendations to the Council. The Council in turn has the prerogative of not following the recommendations but must then wait for new advice from the Commission. The Court alluded to the analogy between the EDP procedure

5 The recommendation by the Commission reads: 'The consolidation strategy aims at a budgetary adjustment in structural terms equalling more than one percentage point to be delivered by 2007. The fact that such strategy will only have limited effects in 2006 partly reflects that some of the measures already implemented will show full effect only with a lag. [..] In the light of these factors, it appears that the excessive deficit should be corrected by 2007 at the latest. The benchmark of 0.5% of GDP p. a. structural improvement should be respected in cumulative terms in the years 2006 and 2007.' (European Commission 2006: 3).

6 European Court of Justice (2004) 'Commission of the European Communities v. Council of the European Union (C-27/04)'.

and the Community Method, in particular as regards the agenda-setting role of the Commission.

The central element in the Commission's delegated authority is the preparation of reports, here the assessment of stability and convergence programmes (S&CP). In these reports, it evaluates each country's performance against the agreed criteria for debt and deficits, measured in the agreed way. The Commission can exercise its own initiative in the sense that it can comment on weaknesses and lacunae it sees in the S&CP.[7] Interview partners confirmed, with the exception of the Greek Treasury, that the communication with the Commission has intensified noticeably. The communication seems to be rather formal and standardized and to have become even more so, in other words requests are strictly based on what the Code of Conduct specifies in the tables of Annex 2.

An interesting twist about *who* has delegated *what* should also be noted in light of the explanation given in the next section why the Pact revisions may have created a shadow of soft law which makes the fiscal rules now more effective. In a standard intergovernmental framework, the member governments make an agreement and delegate its enforcement to a third party, such as the Commission supported by the ECJ. One difficulty with this is that the national executives who are party to the agreement can themselves be seen as exercising delegated authority on behalf of the legislature. This problem is particularly sharp in the area of fiscal surveillance as the authority to pass and amend the budget proposed by the executive remains one of the central powers actively exercised by national legislatures. Ideally, legislatures would endorse the delegation by governments by making it their own: by delegating some aspects of scrutiny to the Commission. They may not think they have done this, but the Commission has adopted the standpoint of an 'agent of the legislature' by insisting that its reports are laid before national parliaments.[8] Not only does this address the obvious criticism of the Commission that its surveillance activity substitutes for the job of democratically legitimate institutions rather than complementing it. As I will argue below, this insistence on involvement of national Parliaments also creates an audience for the Commission's oversight that makes it more effective.

Where there are decisions to be made about how the deficit is to be measured and how cyclical adjustments and GDP projections are to be done, they have been delegated to Eurostat. This delegation and empowerment of a second EU agent was triggered by the misreporting of the Greek authorities; thus the revision of the Pact reinforced rather than caused this change in delegation. Eurostat is now entitled to visit Treasury departments and national statistical bureaus and inspect how they arrived at their figures. As one interviewee put it, Eurostat's status has de facto become that of 'an independent auditor'.

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7 This is a noticeable difference if compared to what the Commission can do under the integrated reporting on structural reforms and consolidation efforts in the National Reform Programmes (NRPs). Here, the Commission can only comment on what the governments themselves put forward but not on what they left out, ie. if member states do not admit any reform imperatives regarding their pension systems, DG EcFin must not comment on this lacunae in a NRP while it could do so in a stability programme.

8 The Code of Conduct (2005: 11) prescribes that the following must be stated in each S&CP: 'Each programme mentions its status in the context of national procedures, notably with respect to the national Parliament. The programme also indicates whether the Council opinion on the previous programme has been presented to the national Parliament.'

III.3 Changes in precision

On the third dimension, precision, we observe ambiguous developments as already indicated. Some of the evidence suggests that the precision of the fiscal rules has been sharpened, contrary to what early comments on the apparent softening and blurring of the Pact would lead one to expect:

- The data requirements have been increased considerably and member states are now asked to fill out a template that requires them to produce more than 100 figures (Annex 2 of the Code of Conduct). In contrast to the old Code of Conduct, the new tables include data on labour market developments and more detailed tables on price and fiscal developments. As one interviewee put it, the S&CP are now 'more about reporting than explaining'.
- 'One-off' measures or other measures of creative consolidation are now explicitly excluded while they were accepted in certain instances before, as one interview partner reported9. These one-off measures, such as the receipts from licensing broadband spectrum, are enumerated in a footnote which presumably signals that the list must not be seen as definitive and exhaustive but can be revised and expanded at the discretion of the guardians of the Code of Conduct.
- There is much less leeway for country-specific methods, as both the wording in the Code of Conduct and our interviews suggest. The measurement of MTOs is subject to 'regular methodological discussions' in the Economic and Financial Council. Long-term projections of fiscal sustainability must adopt an agreed method. In particular, the definition and measurement of a country's fiscal balance is more tightly specified by Eurostat. There is now a unified methodology, the so-called production functions approach, to account for and eliminate cyclical influences on budget figures (Denis et al 2006). Some of these specifications conflict with national practice and countries have been given time to adjust.
- As already mentioned, there is also more precision about the adjustments that states are expected to demonstrate. In particular, the MFE of 0.5% adjustment of the structural deficit was seen by some interviewees as creating considerable uncertainty because its measurement is not straightforward and can easily be contested; others saw this as a welcome new instrument to discipline opposition to consolidation measures.

While there is thus a definite move to more detailed and penetrating surveillance, the evidence becomes less clear-cut once we look at precision in terms of establishing a direct and immediate link between goals and means. First of all – and not entirely initiated by the Pact revision in March 2005 – fiscal surveillance serves now multiple goals. This has been partly triggered by the integrated reporting on structural reforms and fiscal performance. But is also due to the fact that structural or systemic reforms can stop the EDP from proceeding to the next step and prevent sanctions actually setting in. However, multiple goals muddy the water because it is not clear whether not meeting the fiscal targets is due to a lack of fiscal effort or due to the tradeoffs involved in trying to meet both fiscal and reform goals.[10] The Commission has made it clear that the burden of proof is on the member state who wants to invoke the ORFs (Directorate General 2006: 78). Our interview partners shared that interpretation and, with the ex-

[9] The new Code of Conduct (2005) enumerates them in footnote 2: 'Examples of one-off and temporary measures are the sale of non-financial assets, receipts of auctions of publicly owned licences, short-term emergency costs emerging from natural disasters, tax amnesties, revenues resulting form the transfer of pension obligations.'

[10] See the contributions of Roeger as well as Deroose and Turrini in Deroose et al (2006) on the short to medium term tradeoff between fiscal consolidation and reform.

ception of the Dutch Treasury official, did not see much by way of easy 'escape routes' in the revised Pact.

Secondly, the combination of fiscal surveillance with promoting reforms brings together two very different processes that work with rather different indicators, follow different timelines, report to different DGs and have a different legal basis. Again, our interviewees saw this less as an opportunity for exploiting loopholes but as a risk of being held responsible for outcomes in fiscal terms they can hardly control. There is simply no agreement in theory and practice on how reforms affect budget developments and vice versa. Growth of income is an intermediating variable but may itself be cause as much as effect of reform and budgetary performance. The Commission and member states are aware of the problem and are now trying to develop and agree on a model that links reforms, growth and fiscal performance.[11]

IV. How can a shadow of soft law make fiscal surveillance more effective?

The analytical classification of Abbott et al (2000) suggests it is simplistic to maintain that the Pact has been 'softened'. Obligation has been weakened but the complementary changes in delegation and precision make a verdict on the overall direction rather difficult. Yet why should we attach any significance to these changes in delegation and precision, given that these are just categories in a taxonomy of legalization, here applied to fiscal governance? The following section argues that these dimensions and their changes in the recent Pact revisions make sense in a theory of institutional commitment and rule-based policy-making that draws on the Ulysses interpretation of Elster (1979) and the institutional political economy of Lohmann (2003). Even in emerging democracies, a government perceives or actually incurs political costs, both when it is seen as unprincipled or unable to keep electoral promises, but also when it is seen as a mere servant of a non-majoritarian institution or an outside diktat. Key for the design of policy-making institutions is thus to combine credibility with flexibility of commitment. But how can 'an institutional commitment that leaves the back door open for flexible responses' then avoid '[unravelling] in full because a back door exists' (Lohmann 2003: 99)? The revisions of the Pact may reconcile this tension more constructively than the old Pact did. It now emphasizes the procedural aspects of fiscal governance, through sustained observation and detailed evaluation of whether the conduct of fiscal policy moves in the right direction, relative to the result-oriented dimension of obligation, i.e. the periodical assessment of compliance. This allows expert audiences, such as financial analysts, social partners or members of parliament, to assess whether it is government or something else that is to blame if fiscal performance gets off target (Lohmann 2003).

The original Pact was based on a disciplinarian view of commitment in which the Pact is a way to tie governments' hands.[12] Thus government can no longer manipulate certain constraints on its policy-making, such as inflation expectations, which created an inadvertent credibility and time-consistency problem. However, in this world view, governments tie their hands only because they fear punishments, not because they have changed their preferences, say for an inflationary policy. Rooted in optimal control theory, this conceptualisation has no role for the limitations and dilemmas of commitment. Elster (1979, 2000), by contrast, alerts us to the dilemma of precommitment for any democratically elected government while Loh-

[11] See for preliminary attempts the proceedings of a DG Ecfin workshop in December 2005 (Deroose et al 2006).

[12] The basic theory goes back to Kydland and Prescott (1977) and was applied to monetary integration by Giavazzi and Pagano (1988). Schelkle (2005, 2006) discusses this disciplinarian view of commitment and credibility in general and of fiscal rules in particular.

mann (2000, 2003) analyses the dilemma of commitment when policy-making is confronted with 'deep uncertainty'.

Elster (1979) developed his concept of precommitment as a rational means to deal with irrational preferences, both at the individual and the society level. Irrational preferences are, for instance, addictions which the individual knows will do harm, or policymakers' temptation to spend more than they know is sustainable. The classic incarnation for such behaviour and how to deal with it in terms of instrumental rationality is the mythical hero Ulysses. He anticipates and therefore withstands the seduction of the Sirens by taking the precaution of tying himself to the mast. The interpretation based on the Sirens episode differs from the disciplinarian conceptualisation in that the problem is inconsistent or shifting *preferences*, not that the *constraint* can be manipulated. This seems to capture the nature of economic policy-making by a succession of democratically elected governments better than the activist picture drawn by optimal control theory (Kydland and Prescott 1977): Ulysses fears himself to be too weak to resist rather than too strong for his own good. Governments are also not necessarily myopic if the mythical hero is a pertinent analogy to modern government. Ulysses knows that preferences may change and thus delegates the oversight over policies to sailors with useful blind (or rather deaf) spots, ie. non-majoritarian institutions, such as Supreme Courts or independent central banks, that are not susceptible to the same political pressures.

Elster (2000: part II) discusses five devices for precommitment – imposing costs, eliminating options, creating delays, requiring supermajorities and separation of powers. EMU provides examples for any of these commitments. 1) With the fiscal rules enshrined in the Pact, governments impose costs on themselves, originally in terms of being forced to a pro-cyclical policy and ultimately a fine under the EDP, now and then in terms of being seen as too weak to keep promises. 2) With the creation of the independent ECB, governments have foregone the option for a national interest rate policy but not for fiscal policy. 3) Any reform in governance, be it opportunistic or not, is delayed by the requirement of consultation among member states with the Commission, and the need for approval by the Council. 4) Any change of the Pact or the mandate of the ECB requires Treaty changes by qualified majority or even unanimity vote. 5) Fiscal surveillance is based on separation of power between the Commission as the delegated monitor and the Council as the ultimately executing organ.

In particular the incomplete separation of powers has often been seen as a major weakness of the Pact, largely because the Council's role seems to unleash the moral hazard of potential sinners who are invited to judge the sins of their fellows and prove to be rather forgiving. Yet, this may not be an opportunistic feature of commitment among democratically elected governments. Elster (1979: 93-96) points us to an inherent dilemma of precommitment in democracies: by ensuring time consistency, a precommitment eliminates the democratic accountability of policy. This also limits the effectiveness of precommitment through hard rules. Elster (2000: 95, fn.15) mentions research showing that 'if people's preferred option is imposed on them rather than chosen, they may develop a preference for an option that was originally ranked lower.' Thus, it may be voters as well as sovereign governments who set these limits to hard rules. It is politically not attractive for a government to appear to be driven by external constraints. The Pact revision with its emphasis on 'country ownership' has acknowledged that (Directorate General 2005: 82)

More generally, the periodic change as well as the endogeneity of collective preferences is an inherent feature of democracy: the government is meant to change and with it the policies that the predecessor implemented, if only to signal that a new administration has taken office. What may appear to be dynamic inconsistency if we think of government as Leviathan, ie as a powerful unitary actor, is no longer an instance of inconsistency if we abandon this model.

Precommitments may be still necessary to ensure due process and prevent capricious, exploitative policy changes but they need to be changeable in order to prevent the real or apparent despotism of a past majority and its policy consensus.

This line of reasoning suggests that there is a higher degree of time inconsistency no democracy can escape: because they are democracies, democracies may turn against the precommitments that they have once implemented to remedy the weaknesses of democracy. The question is then how credible commitments can be maintained when there is a case for discretion and sometimes for abandoning a commitment (Lohmann 2003). Institutions, such as escape or emergency clauses, allow for shifting political priorities under defined conditions. But who decides whether the conditions have been met? Lohmann (2000, 2003: sect.4) discusses three solutions.

- First, *accommodation* which means 'delegation to a human being', for instance to the notorious conservative central banker who may decide to accommodate political demands if reasonable: The conservative central banker can do so because, by definition, that institution has a reputation of being resistant to political demands. Thus, we could also call it the 'Nixon goes to China' strategy. The conspicuously hard line Presidents of the ECB play that role successfully in the sense that the reputation of ECB policy is more hard line than her actual policy (Goodhart 2006: 765-767).-- This form of flexibility is compatible with the commitment devices of 'eliminating options' and 'separation of powers'.
- Second, the institution of a 'Sollbruchstelle' which is that part of the (political) machinery that is meant to take the hit if a machine breaks down: This is to protect the more valuable parts of the machine, ie an institutional framework. Resignation of the minister in charge, over the failings of his or her administration, is a case in point. It can also explain why it was the Council that had to take the decision and the blame for the Pact revisions that eliminated the EDP as the centre piece of the fiscal framework. This had political costs but the blame for this breakdown and repair was easier to bear for the Council than for the Commission. The theory of precommitment outlined above suggests that this is not necessarily the case because of a higher degree of legitimacy of the Council. The nature of legitimacy of these two institutions is categorically different[13] and thus hard to compare. But the members of the Council change regularly and are meant to, so they are not bound by the same consistency and continuity requirements as a bureaucracy. On the contrary, Council members have the opportunity to take a different stance in order to mark the democratic break with the past and, as the German example illustrates, to signal the difference to the predecessor government.—This form of flexibility goes with virtually all ways of precommitment and the more 'hard-wired' a precommitment is, the more it is in need of this engineering device.
- The third and arguably most relevant solution in the present context is 'expert audiences'. They are inevitably created with the institutionalisation of a specific commitment. The independence of a central bank replaces the parliamentary audience of monetary policy by financial markets; along with a specialised media the central bank watchers in financial institutions can be seen as a fourth power. -- Expert audiences are not only a form of flexibility but at the same time a precommitment device in that they follow the strategy of 'imposing costs', in addition to whatever primary commitment device is in place. In the case of the revised Pact, I would argue, it works on top of the 'separation of powers' in

[13] Legitimacy of the Commission is largely based on output legitimacy, delivering overall desirable policies, while that of the Council is based on input legitimacy inthat heads of government or ministers become members of this institution though democratic elections at home (Scharpf 1999).

that the new rules give legislatures back the opportunity to hold the administration accountable for the conduct of fiscal policy; and empowers those parts of the executive that are ex officio concerned with fiscal sustainability, e.g. the Treasury vis-à-vis the social spending ministries.

Detailed fiscal surveillance directs the performance of national budget policies, providing different expert audiences with comparable data to watch. The sheer proliferation of data, on labour markets and fiscal outcomes, short-term stability and long-term sustainability, invites not everybody but a variety of audiences to judge and comment. Each criticism has the potential of imposing political costs, embarrassment or disappointment for key constituencies, on the government. But the surveillee has, thanks to the proliferation of precise indicators to meet, the opportunity to pick and choose which of the criticisms are to be responded to as long as it is not under simultaneous attack from financial experts, social partners and the opposition in parliament. A communication strategy for different observers of that contingency is then required, in particular for an expert audience that is able to evaluate the authorities' plea for innocence (Lohmann 2003: 102-103). The precision of reporting requirements gives part of the bureaucracy a key role in shaping of what their political masters present for approval by the Commission and the Council. Moreover, it is the Treasury and the national accountants within each ministerial bureaucracy that must implement 'minimal fiscal efforts' or calculate the discounted value of savings from systemic pension reforms. Thus, the separation of powers within the executive is at the same time creating audiences for each other.

In the following, I identify three major challenges for fiscal policy in EMU that require commitment to be partial or revisable in a controlled way so as to sustain credibility. In other words, precision and delegation in fiscal surveillance must attract those audiences who have an incentive and the capacity to judge the flexible application of the rules. The revised Pact is arguably better equipped to meet these challenges because it is not so hard as to break under stress.

IV.1 Structural measurement

Uncertainty can affect compliance in that both the steering of a budget deficit and the recognition of the cyclical situation are less straightforward than the optimal control rationale must assume. Even if the Treasury has a strong prerogative and central government is largely in control of the budget, it may be difficult to determine with any precision where the economy is in the business cycle in time to adjust the fiscal stance appropriately. Different methods of estimating structural deficits produce notoriously different results because there is large uncertainty in the projection of output gaps (Blejer and Cheasty 1991; Denis et al 2006).

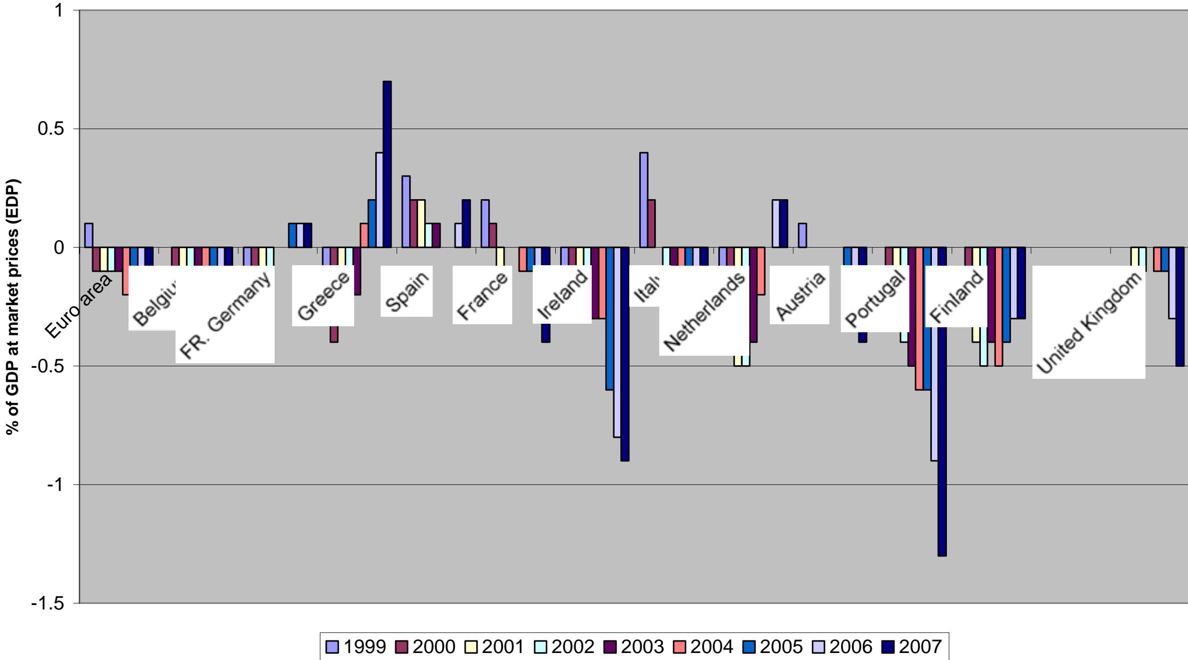
A study by the German Macroeconomic Policy Institute shows in an ex-post evaluation of output gap projections that, in 1999, the IMF had predicted a negative output gap for Germany in 2000 of -2.8%, suggesting that Germany should have a budget deficit to compensate for weak private demand. In spring 2006, the IMF statistics show for 1999 an output gap of +0.1% -- '[…] not only a difference of almost 3 percentage points but also a change from minus to plus. An equally stark picture emerges when looking at the figures provided by the EU Commission and the OECD.' (Horn et al 2006: 3)[14] The German government was criticized for its pro-cyclical policy later. The same holds for Italy, and to a lesser degree, for France. This implies that governments may inadvertently engage in pro-cyclical policy while intending to act counter-cyclically.

[14] This summary is available at URL: http://www.boeckler.de/pdf/v_2006_09_21_summary_imk.pdf

For the SGP and the BEPG this means that the rule of not exceeding a 'structural' or cyclically adjusted deficit of precisely 3% of GDP becomes quite problematic if applied quasi-automatically as foreseen in the original Pact. A 'structural deficit measures the size of the budget deficit as it would be if output were at the full employment level" (Fischer and Easterly 1989: 128). This full or equilibrium employment level can be either estimated with respect to trend output or to potential output. Trend output is a statistical measure and boils down to a moving average of output levels over a medium term horizon, say the last five or ten years. Potential output is based on neoclassical microeconomics, using a standard production function to estimate the aggregate supply side capacity of an economy which supposedly determines the scope for non-inflationary growth. The July 2002 Ecofin Council has agreed to use the latter measure 'as the reference method for the calculation of output gaps when assessing the stability and convergence programmes for a large number of the EU's Member States' (Denis et al 2006: 7) which has been extended in the meantime to all EU-15 member states. For the new member states, a hybrid version is used, based largely on the trend method (Denis et al 2006: 15).

The following graph shows why the Council and the Commission had to opt for one method. Using both would have generated considerably different results for structural deficits, showing compliance under one measure and breach of the Pact under the other. In most countries, the difference between the two measures seems to be increasing in absolute terms over time, yet there is no systematic pattern to these differences.

Fig.1: Difference between structural budget balances based on trend and on potential output



Source: own calculations based on AMECO database (projections for 2006-2007)
Note: A positive difference means that the trend deficit is lower than the potential deficit.

The difference is minimal for the Euro area as a whole but substantial for some countries. Thus, there is not a predictable distortion in one direction for all countries that could be taken into account by a corrective factor; rather they go in opposite directions and thus cancel each other out in the aggregate. For all countries for which the difference is negative, indicating

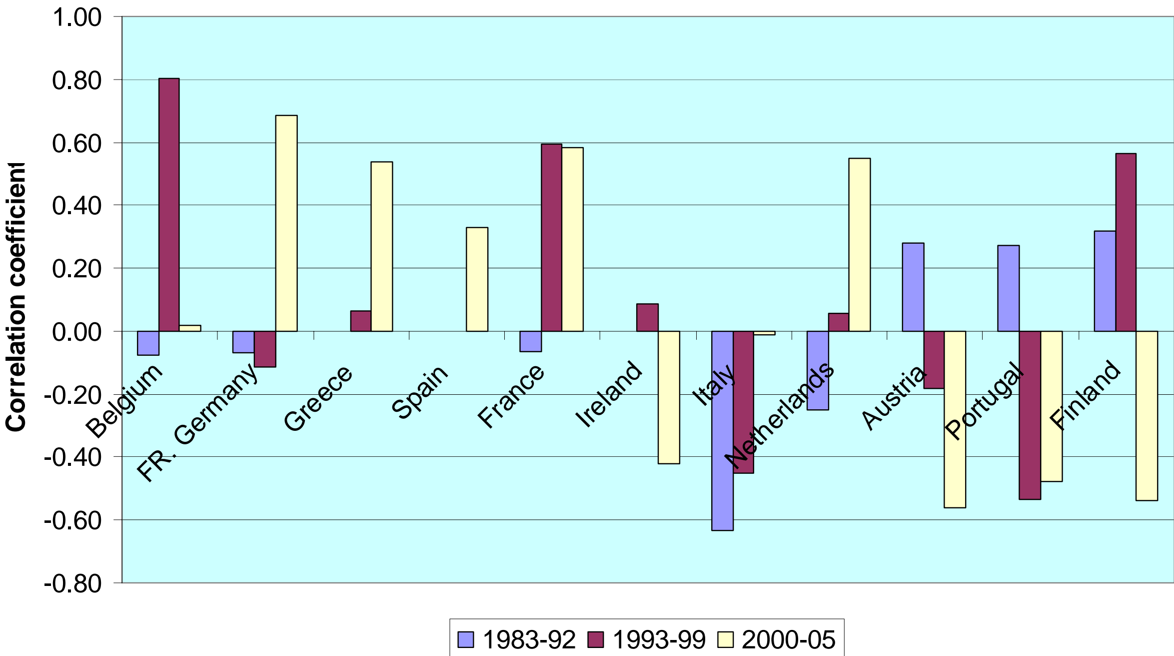
that the trend deficit is higher (Portugal) or the trend surplus lower (Ireland), the choice of the production function method is favourable in terms of compliance. This is true for the majority of member states but not all.

What these non-trivial differences in measures also imply is that the measurement of 'minimum fiscal effort' under the revised Pact rules will be extremely difficult. An effort of 0.5% of GDP is close to the statistical margin of error and thus the indicator may suggest that a government has not exercised enough effort even though it has complied – and vice versa. Thus, the stipulation of a MFE can only be under soft law and then amounts to a quantifiable requirement of working towards preventing and avoiding the violation of the hard law constraint in fiscal surveillance.

IV.2 Assignment of responsibility

Is there evidence that, in the member states where the budget balance exceeds the corrective 3% deficit rule, governments were responsible for the breach? One piece of evidence is provided by looking at how governments exercised discretion in their fiscal policies. The structural or cyclically adjusted deficit, excluding interest payments, can be interpreted as a measure of the deliberate budgetary measures that a government has taken. If it is positively related to the output gap, this implies that discretionary actions supported a counter-cyclical working of automatic stabilisers (the deficit went up when the output gap rose and vice versa); if it is negatively correlated, then discretionary actions were pro-cyclical (higher spending or tax cuts in an upswing or reducing the budget deficit in a recession).

Fig.2: Responsiveness of structural balances (excluding interest payments) to changes in output gaps

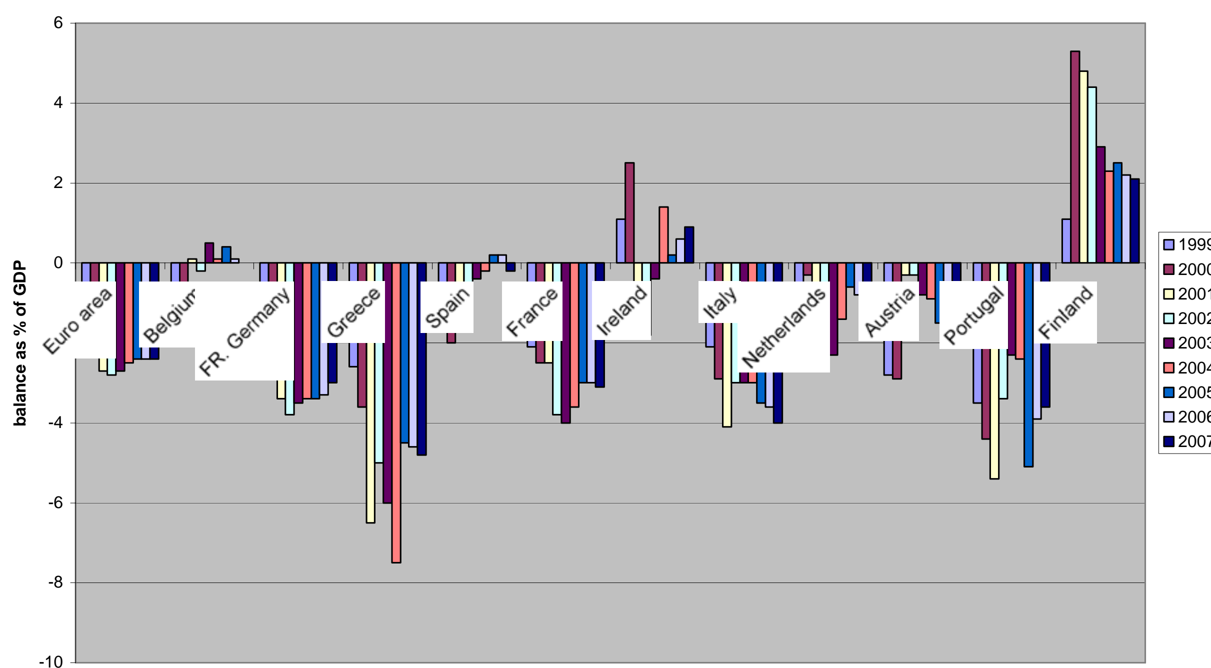


Source: own calculations based on AMECO database

What this simple exercise[15] shows is that among the delinquent countries (GE, GR, FR, IT, PT; NL for one year), only Portugal can be accused of having exercised pro-cyclical discretion. Interestingly, the fiscal policies of Germany and Italy have improved in EMU, they were pro-cyclical in the pre-Maastricht era and in the run-up to EMU.

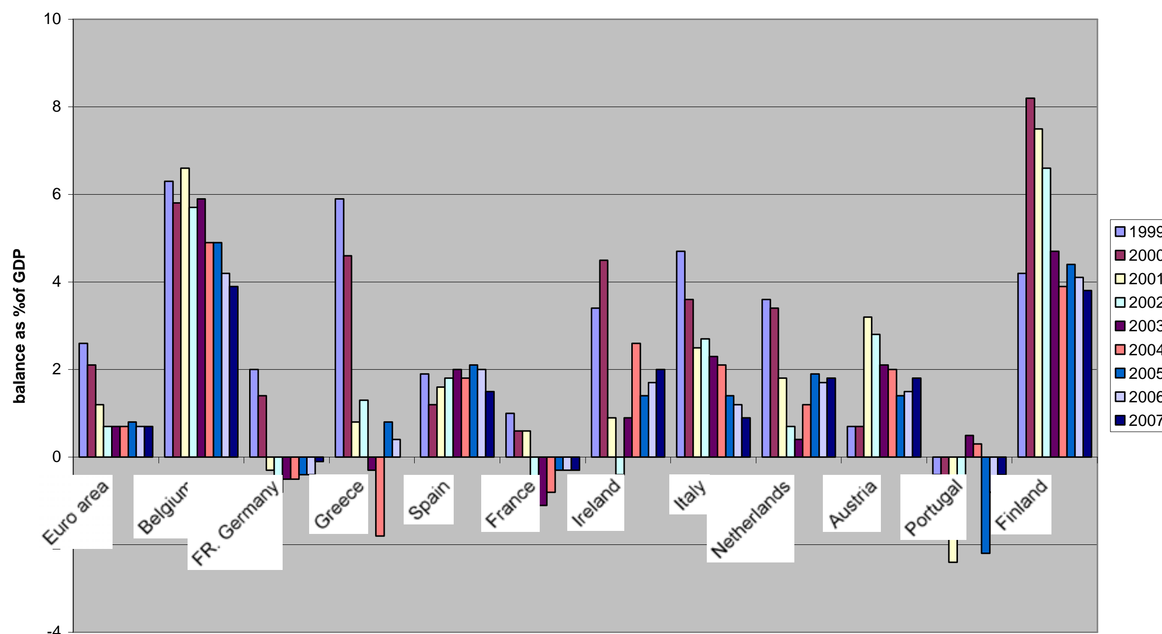
Thus, even if we could measure structural deficits with the precision required for implementing credibly a hard law, quantitative fiscal rule, it is not obvious which would be the appropriate measure for holding governments accountable. If governments should only be held accountable for what they (optimally) control, then the proper measure is the structural deficit excluding interest payments. On that basis, it is not clear that all of the governments that are in breach of the deficit rule can be accused of misbehaviour. The following two charts show that countries may be in breach of the structural deficit rule (Fig. 3a), but it is less clear to assess whether they are in breach as far as the controllable part of the budget deficit (Fig. 3b: structural deficits excluding interest payments) is concerned.

Fig. 3a: Structural balances as % of GDP



[15] There is obviously a problem of how to take lags between government intervention (structural balances) and economic response (output gap) into account, thus one should correlate balances with lagged output gaps (of one or more years later). The length of these lags differs between countries and possibly even from year to year in the same country. I circumvent this problem to some extent by correlating these indicators over longer time periods.

Fig.3b: Structural balances as % of GDP excluding interest payments



Source: AMECO database (projections for 2006-2007)

One may conclude that only Portugal has a discretionary policy which is not in line with its obligations under the Pact. Germany and France could arguably do more but their low 'discretionary deficits' might be justified as a mildly counter-cyclical stance to support the automatic stabilisers. And Greece has actually tried to consolidate except for the years 2003/04 when it went on a spending spree for the Olympics. In sum, what the fiscal authorities of most delinquent countries can be accused of is that their efforts to generate a structural surplus are not enough, given the need to service the debt that they have accumulated and inherited over the past. But except for one, they are not obviously out of tune with their membership obligations. This again supports the case for instruments in fiscal surveillance that are less blunt than hard and fast rules. The revised Pact with its proliferation of indicators can be seen as one way of attracting different audiences – committees of the legislature, commentators in financial markets, social partners – that can assist in more sophisticated surveillance.[16]

IV.3 Endogenous uncertainty

There is finally a fundamental problem with the commitment device of any policy rule. Goodhart's Law states that "any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes" (quoted after Crystal and Mizen 2001: 4), then tying government's hands just shifts the locus of uncertainty. Thus, the problem of uncer-

[16] Another source of uncertainty in the assignment of responsibility is that compliance problems may reflect the interplay of multiple interests within the government. Buiter (2006: 706) mentions that the budget deficit in the US is largely a result of many uncoordinated decisions: it 'just happens'. The veto power of the Treasury over spending in other ministries has been extensively scrutinized in the literature, suggesting that a weak position of the Treasury is largely responsible for non-compliance, especially if combined with a coalition government (Hallerberg, Strauch and von Hagen 2004). Another reason may be the devolved set-up of fiscal policy in federations like Germany where the central government controls only a fraction of the overall budget (Joumard and Kongsrud 2003: table 1). This lack of steering capacity is particularly acute in member states where social security is largely financed by contributions and administered by semi-autonomous 'parafisci'.

tainty cannot even be ruled out by rule-based policy. This is not only due to adjustments in the expectations of the private sector which the authorities may not be able to fully anticipate. It may also be caused by parts of the public sector adjusting their behaviour to the rules imposed on another part, as Goodhart's Law emphasizes in contrast to the Kydland-Prescott approach (Crystal and Mizen 2001: 16). For instance, fiscal entities will respond to central bank independence, or social policies to overall fiscal constraints. The result is that the link between the intermediate target, here a deficit that does not exceed 3% of GDP, and the goal, sustainable public debt, becomes tenuous (Egebo and Englander 1992: 55).

Creative accounting is the most obvious response to quantitative fiscal rules, making fiscal policy less predictable and transparent in the process (Buti et al 2003: 11). The practice of creative accounting has been reported from outside the European Union; empirical studies of fiscal rules in the United States reveal several techniques that may give us hints of what to expect in the future:[17]

- If certain forms are restricted, state and local governments in the US have shifted to non-constrained forms of debt;
- If the fiscal rule applies only to the state level, the issuance of debt shifts to the local level;
- Constitutional expenditure limits lead to a shift in debt finance from constrained current expenditures to unconstrained investment expenditure.

In the run-up to EMU, it has been found that fiscal authorities in candidate countries had large incentives to privatise public assets in order to lower their debt levels. But looking just at the effect on public debt while ignoring that public assets are reduced at the same time is a distortion caused by the Maastricht criterion that focused only on public debt. Proper accounting would require to take both sides of the balance sheet into account. Moreover, in order to lower deficits, governments tended to substitute long-term debt for short-term debt because interest rates on the latter were lower than those on long-term claims at the time.[18]

Systematic biases in forecasting errors also suggest that fiscal gimmickry plays a role. In the present EMU, Koen and Van den Noord (2005) provide estimates of forecasting errors in the stability programmes that member states have had to submit since the third stage of EMU started in 1999. It turns out that, in the aggregate, governments underestimated their fiscal surplus by 0.3% in 1999-2000 while they overestimated it by 1.1% in 2001-2003. As might be expected, the same countries that eventually breached the Pact were responsible for this forecast bias in the second period.

The most startling, if somewhat esoteric, example of creative accounting is revealed by the use of stock-flow adjustments (Milesi-Ferretti 2003, Von Hagen and Wolff 2004). Stock-flow adjustments (SFA) are statistical residuals that account for the difference between the change in debt levels and the deficit, including interest rate payments, in the present period. If accounted for correctly, the SFA should be stochastic, sometimes negative and sometimes positive, and net out over time to zero. There are five major reasons why SFA occur (Von Hagen and Wolff 2004: 5-6):

[17] Cf Von Hagen and Wolff (2004: 2) with further references to the literature.

[18] This is characteristic of an inverse yield curve (higher long-term than short-term rates) which occurs quite regularly, indicating the turn of the business cycle to restrained activity. Feldmann (2007: 115) reports how German fiscal gimmickry exploited the inverse yield curve: 'Since the beginning of the 1990s, the share of loans with a period of less than two years in the total gross loans raised by the federal government increased from 9% to 36% in 1997'.

1. Issuance of zero coupon bonds: Such bonds are issued at a value that is lower (say €90) than the face value (say €110) at which it will be repaid (after say, 4 periods). The deficit is shown in the current period at the issue value (90) while debt increases by the amount of the face value (110), so the SFA is +20. The interest rate payment until maturity will be recorded as a negative SFA (of -5 in the following four periods). This means that the SFA from this operation would be zero after repayment of the zero coupon bond.
2. Revaluation of debt denominated in foreign currency: This changes the face value of debt without affecting the current budget deficit, the discrepancy is recorded as SFA. It should not play a big role for EMU member states since most of the debt that was once denominated in other European currencies is now denominated in Euros.
3. Time of recording: Deficits are measured in accrual terms, debt is a cash concept. For example, the sale of UMTS licences for mobile telephone networks means that the deficit is reduced in the year that receipts accrue while debt is only reduced once the cash payments arrive. This should net out once the transaction has been completed.
4. Privatisation of and state aid for public companies: This reduces public debt but has no impact on the deficit according to the accounting guidelines for the SGP and the EDP. Similarly, capital injections into state-owned companies increase the debt level but are not a deficit relevant operation under the rules. This can lead to persistent positive SFA, ie. a positive discrepancy between debt and deficit recorded.
5. Accounting for financial transactions: Debt is a gross concept while the deficit is a net concept. This means that if the government issues debt to increase its deposit holdings, gross debt increases while there is no effect on the deficit. Again, this can be source of persistent positive SFA.

SFA in EMU member states have been found to be persistently positive. Thus public debt levels have risen by more than they should have given the recorded fiscal deficits. This raises the question whether the SFA are due to creative accounting or legitimate discrepancies due to, for instance, privatisation that is going on even though the debt level is no longer a criterion for compliance. Von Hagen and Wolff (2004) find that positive SFA have increased significantly after the introduction of the rule-based framework. Moreover, they find that governments tend to use (positive) stock-flow adjustments to lower the cyclical components of budget deficits in particular. The authors explain this by the fact that the economic costs of complying with the asymmetric fiscal rule of the Pact is particularly high in times of recessions.

In sum, this is fairly clear evidence for Goodhart's Law as regards the deficit rule of the Pact: the 'statistical regularity' that the SFAs should be stochastically related to the deficit and have an expected mean of zero has 'collapsed under the pressure' of having to comply with a deficit rule but not a quantified debt rule in the original Pact. This is an inherent dilemma of all precise rules: they also indicate what precisely has to be circumvented. The revised Pact is better poised to deal with this phenomenon by giving more weight to a country's debt level, a more symmetric request for compliance over the business cycle and, in the same vein, by providing some room for judgment.

V. Conclusion

This paper proposes an interpretation of the revised Stability Pact that questions the critical comment it has received on two accounts: First, it is not clear that the Pact has been 'softened' if we look not only at the weakening of obligation but also note the hardening in terms of

delegation and precision of means to achieve the goals; the taxonomy of legalization by Abbott et al (2000) proved very useful for this assessment. Second, fiscal surveillance may now be more effective because it casts a shadow of soft law on the hard law element and makes the latter more binding; soft law may assume this role if the democratic dilemma as well as the problem of deep uncertainty are salient as was argued with reference to Elster (1979, 2000) and Lohmann (2000, 2003), respectively.

To sum up the most important arguments supporting the first thesis: The revisions rendered obligation medium to low given that the imposition of sanctions has become a remote possibility. However, country-specific medium term objectives of 'close to balance or in surplus' have bolstered the economic rationale of EMU's fiscal rules and arguably creates a non-legal sense of obligation by making the blame shifting to a 'one-size-fits-all' rule rather difficult. Delegation in the operational sense is now high, given that a third party, the Commission with the help of Eurostat, has been empowered to detailed scrutiny of budgetary policies and fiscal planning. Adjudicative delegation that gives a third party a role in dispute settlement is now stronger than before, largely due to the Commission's obligatory reporting of an imminent excessive deficit to the Council as well as the Commission's sole right of devising policy recommendations to member states that the Court confirmed in its ruling of 2004. Finally, the change in precision has turned the old assignment around: the revised Pact is now rather imprecise on goals because it combines the goals of fiscal consolidation and structural reforms which can be at odds; but the fiscal rule are now much more precise on how a government is meant to fulfil its obligations, namely by making an annual fiscal effort of reducing the structural deficit by 0.5% at least.

The argument that backs up the second thesis is, in sum: Constant observation is potentially better equipped to maintain credible commitments that sometimes have to be broken, generally to assert democratic primacy over non-majoritarian institutions and specifically to respond flexibly to the 'deep uncertainty' of fiscal policymaking. It would be misguided to interpret this combination with flexibility as 'softening'. Hard fetters are crippling and may simply break while somewhat elastic ties give some room for manoeuvre while they are resilient. It may very well be, although it is too early to tell, that the specification of conditions under which exceptions and postponements of the EDP may be allowed amounts to shifting the responsibility for compliance by incremental adjustments to the administration and away from the political masters. All this makes me conclude that the reformed Pact is an instance of "soft law may be harder than you think" (Trubek and Trubek 2005: 356).

To what extent has the reform of the Pact responded to challenges that do not go away but will always afflict rule-based coordination?

- The problems of measurement are unlikely to go away over time and this will in particular affect the measurement of 'minimum fiscal effort' under the revised Pact rules. An effort of 0.5% of GDP is close to the statistical margin of error. Thus, some room for negotiation under the pretext of 'other relevant factors' makes sense as a permanent feature of the rule-based framework.
- The assignment of responsibility will remain difficult. This is not only because governments have incentives to find all kinds of excuses. It also has to do with their limited ability to control their budgets. Again, soft peer pressures are likely to be required permanently to find a compromise between conflicting requirements.
- There is fairly clear evidence for Goodhart's Law as regards the deficit rule of the Pact. This means that every rule – and in particularly the better defined, more precise and harder rules – will be afflicted by endogenous uncertainty, ie the sources of uncertainty

shifting as decision-makers adjust to the rule. Soft methods are then necessary to renew a consensus on what the rules for policy coordination are meant to achieve, thus preventing pervasive circumvention of the rules.

My findings are thus conceptually in line with other authors[19] who argue that the combination of soft and hard law is what we observe in most successful cases of European integration. Moreover, the case of the SGP reform is a potentially interesting case of reversing the role of soft and hard law. Cini (2001) finds a hardening of the soft law regime in state aid regulation to make it work better which resonates with the study of Héritier (2005) and collaborators on 'new forms of governance in the shadow of hierarchy'. Thus, both see soft and hard law as co-existent and complementary to each other. However, both look for how hard law makes soft law work. My particular case alerts us to the phenomenon that hard law measures in fiscal policy coordination may require soft law measures to be acceptable and enforceable. More specifically, the reform of the Pact suggests that coordination under soft law is not just a stepping-stone and soft law may also make the harder parts of an institutional arrangement work.

[19] Trubek and Trubek (2005: 359-362) with references to Best, de Burca, Kilpatrick and Scharpf.

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