“Hard Law in the Shadow of Soft Law in EU Economic Governance”,

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Introduction

Economic governance in the EU relies on rule-based policy coordination, in particular ‘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. A key question for the evolving framework of economic governance is whether the reforms in March 2005 have rendered the SGP more similar to BEPG coordination in that the revised rules acknowledged the need for country-specific assessment and for negotiation over stability programmes rather than for more effective quasi-automatic sanctions. This paper will explore whether this move towards open method coordination is a move *away* from rule-based policy coordination, as many critics of the Pact reform maintain, or a move towards *another form* of rule-based policy coordination.

In order to make sense of this move and what it implies for the relationship between hard and soft law, the paper contrasts two justifications for ‘rules rather than discretion’. One goes back to Kydland and Prescott (1977) and originates in optimal control theory in economics; the other goes back to Elster (1979) and his interpretation of the Sirens episode in Ulysses. The latter implies that rules must be designed with a view to ‘foreseeable unforeseen contingencies’ (Lohmann 2000), in other words take precautions for situations in which the rules do not apply in the ordinary way. The paper then explores three main sources of uncertainty and thus 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 paper concludes by assessing tentatively to what extent the reform of the Pact has responded to these challenges, which arguably wrecked the original SGP, and whether the lesson for policy coordination is that hard law needs accompanying soft law measures to work at all.

[*] Comments by Deborah Mabbett (Birkbeck) have been extremely helpful, as usual.

What does the reform of the Stability Pact tell us about rule-based policy coordination in the EU?

Economic governance of the EU can be characterized as consisting of three elements: an independent monetary policy of the European Central Bank (ECB), member states' fiscal policy coordinated only by the SGP, and various reform processes softly coordinated under the Broad Economic Policy Guidelines (BEPG). All three elements can be seen as manifestations of the belief that rules should rein the conduct and coordination of monetary and fiscal policies and to some extent even structural reforms.

- Monetary policy is committed to achieve price stability, defined as an inflation rate of 'below 2%' (Issing 2002), for which it has adopted a two-pillar strategy that signals when the bank is likely to tighten monetary policy.[1] This makes it a rule in that indicators (a money supply and a composite economic indicator) , rather than the deliberations of a committee or policy network, are supposed to trigger policy changes whenever the target is not fulfilled. A review of the strategy in May 2003 has led to a greater emphasis of the second pillar which made some ECB watchers suggest that the Governing Council has abandoned the two pillar strategy in favour of another, namely inflation targeting. This strategy would be less binding as regards the instruments to be used; the ECB denies any such shift (ECB 2004: 65).
- Fiscal policy coordination is based on two rules, first the corrective rule that EMU 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. The reform of the Pact in March 2005 relaxed the quasi-automatic trigger of an Excessive Deficit Procedure (EDP). The revised corrective rule allows to extend the deadline by another year and to repeat steps of the Procedure under certain conditions (Directorate General 2005: 67-68). A number of constraints on discretion have been introduced and budgetary surveillance under the BEPG, applicable to EMU and non-EMU members alike, has been strengthened (Directorate General 2005: 68-69).
- Structural reform policies in labour, financial and commodity markets are coordinated with fiscal policy under the BEPG. In particular, the Employment Strategy is 'streamlined' with the discussion of stability and convergence programmes of EMU and non-EMU members respectively (CEC 2002). This coordination process over the policy cycle is arguably a rule-based measure in that a fixed time schedule and not an ad hoc decision by policymakers sets the agenda for discussion and action. Moreover, member states are supposed to take action if they underperform with respect to common indicators and guidelines, such as the target of an overall employment rate of 70% by 2010.

[1] The notorious (or infamous) two-pillar strategy to achieve the asymmetric inflation target of less than 2% supposedly signals to markets that interest rates will be raised whenever (i) monetary growth exceeds 4.5% p.a. (projection based on a three-month moving average) in the first pillar and/or (ii) a composite economic indicator rises in the second pillar. This composite indicator includes all kinds of economic variables, such as output growth, public debt and deficits, capital and labour market conditions, exchange rate developments etc (ECB 2004: 55-66). Nobody is quite sure what happens if only one of the pillars signals the need for action.

In the following, I will concentrate on the SGP and the BEPG and confine myself largely to fiscal policies. Both are rule-based coordination processes. But 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, are 'soft law' as well as 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. In the following, I use the terms soft law, OMC and new mode of economic governance synonymously to characterise the BEPG although I am aware that this usage warrants possibly more elaboration.[2] These terms have in common that (i) they stand for a periodically repeated routine of reviewing policies; (ii) sanctions for non-compliance with the rules are self-imposed, namely exposing governments to the critique of their peers at home or at the EU level, and (iii) the enforcing agency is not a delegated independent body but governments themselves in the Council; the Commission has only a monitoring role. All this makes soft law, the OMC and thus the BEPG "open-ended, non-binding, non-justiciable" (Trubek and Trubek 2005: 344).

So assuming that soft law exists, the following discussion is meant to contribute to the debate about whether soft and hard law are alternative, distinct forms of regulation or whether the former is just a 'stepping-stone' to hard law (Cini 2001: 196). I explore this by asking, first, whether the reform of the Pact abandoned the principle of guidance by rules altogether or whether it merely constituted a change in the form of rule-based coordination and shifted it from a hard law to a soft law process. The view that soft law is an alternative would be endorsed, secondly, if the SGP reform can be interpreted as conceding that hard law cannot be made effective in fiscal policy coordination, at least for the time being, say, because that would require nothing short of a fiscal federation and political union (Buiter et al 1993: 58, 90). The view that soft law is a stepping-stone would be endorsed if we find that the Pact reform indicates the need for a phase of consensus formation and possibly reforms of domestic budgetary institutions, while maintaining a stance that calls for stricter enforcement of discipline in the future – a view that the ECB and DG Ecfin seem to hold when they stress the need to build 'ownership' or renew the political commitment (Papademos 2005, Directorate General 2005: part 2.3).

The suggestive evidence I will provide for either view is twofold. First, if the reformed Pact does not require a complete break with rule-based policy coordination but only a somewhat different interpretation and practice of that concept, then this is weak evidence for the view that hard and soft law can co-exist. More precisely, it would suggest that they are opposite ends of a hermeneutic continuum. Second, if the reasons for why the original Pact could not be enforced as a hard law measure are not likely to go away with a deeper policy consensus and some reform of domestic budgetary institutions, then again I would conclude that soft law measures may be necessary as a complement to or even substitute for hard law rules like the EDP.

[2] Meaningful questions can be raised as regards each one of these concepts: whether soft law is law at all (Cini 2001: 194), how relevant and legitimate the OMC is (Chalmers and Lodge 2003) or how novel new forms of governance really are. In Schelkle (2005), I have argued that the OMC on inclusion and employment is a distinct mode of integration and an alternative to the Community Method.

What form of rule-based coordination does the reformed Pact entail?

In order to answer the question of this section, I first explain why economic policy coordination under the reformed Pact can be characterised as being still rule-based. This is, for instance, in contrast to the view that "the OMC […] has general and open-ended guidelines rather than rules" (Trubek and Trubek 2005: 344). More specifically, I will show that it is rule-based in the eyes of the guardians of the Treaty, the Commission and in particular DG Ecfin. The Commission's monitoring role has been strengthened in the enforcement process and thus its use of that role will make economic policy coordination a non-discretionary policy process for governments and the Council. In part II of the 2005 issue of 'Public Finances in EMU', the Commission outlines its interpretation of the Pact reform.

First of all, it is noticeable that the Commission's interpretation stresses the continuity between the old and the reformed Pact (Directorate General 2005: 67-68): the agreement of the March 2005 Council merely "updates and complements" the SGP, "the Treaty's reference values for government deficit and debt remain the anchors of the system", the "preventive arm of the Pact has been strengthened" while it is admitted that the "modifications in the corrective arm" "will increase the room for judgment in the application of [EDP]". This emphasis on the continuity with the old Pact is in stark contrast to editorials in the financial press as well as in many of the assessments in the academic literature which declared the Pact dead as a fiscal rule (Buiter 2006).

What are then the major changes that solicit such different verdicts? The following table summarises what seem to me the most relevant differences between the old and the new SGP.

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

Continued	Original Pact	Reformed Pact
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; 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 that the Pact has indeed 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. It no longer confronts governments with the stark choice of complying or breaking the 3% deficit rule. In turn, these softer conditions have now become 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 when and how they have to adjust to 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. The reform has, by contrast, defined the space within which governments will have to negotiate country-specific terms in the application of the fiscal rules every member has to follow. Only the future can tell how narrow this definition is in practice and whether the burden of proof really is on the delinquent member state, as

Commission officials argue.[3] But it seems that the softening has, somewhat ironically, left less room for open-ended deliberation. In this sense, the SGP has become no less rule-based even though it has become a form of open method coordination similar to the BEPG.

Why this apparent continuity of rule-based policy coordination, given that the rules have changed considerably? There are at least two rationales for subjecting policy-making to rules, thus delegating the decision to act to an observable trigger or mechanism outside of the immediate control of policymakers. The original Pact was arguably based on a rationale that originated in optimal control theory in economics (Kydland and Prescott 1977) while the reformed Pact can be explained with reference to the interpretation of Ulysses and the Sirens by Elster (1979, 2000).

The ingenious idea of Kydland and Prescott (1977) was to apply an insight of control theory to show 'the inconsistency of optimal plans' in economic policy. Whenever policymaking is subject to a constraint that involves expectations that policymakers can manipulate, their policy will be dynamically inconsistent.[4] The announcement of a policy that is optimal at the time of the announcement becomes suboptimal and thus the policymaker could get more satisfaction by changing the policy, once expectations are formed on the basis of this announcement. The constraint that Kydland and Prescott (1977) and their followers had in mind was, of course, the Phillips curve. The authorities may announce a monetary policy that would yield their preferred inflation-unemployment tradeoff; but if the wage bargainers believe this and strike deals based on these inflation expectations, the authorities can do even better by stimulating the economy more than announced, getting lower unemployment immediately with slightly higher inflation later. Yet, in a rational expectations equilibrium where all actors exploit their information sets optimally, the incentives of the authorities will be anticipated and wages and prices set accordingly so that inflation cannot generate any additional employment. The economy ends up with a combination of unemployment and inflation that is worse than anything that the government would want to announce.

Giavazzi and Pagano (1988) have argued that in such a situation there is an 'advantage of tying one's hands'. By subjecting themselves to policy rules or putting an independent agency in charge of the policy, governments signal to markets that they will no longer be able to manipulate their constraints. Supposedly, this anchors expectations and gives rise to a virtuous circle or self-validating commitment: if "the monetary authorities will be better off, […] they will be happy to tie their hands. This is in fact the only guarantee that they will feel committed to the system - and, in turn, only if their commitment can be expected to last, the system will enhance their current credibility." (Giavazzi and Pagano 1988: 1057)

The general thrust of this literature is to show not only that government intervention is harmful to the economy but that it is in the government's own interest to avoid these harmful interventions. Rational policymakers commit to hands-tying arrangements not because they have changed their preferences but because it serves their given preferences

[3] At a NewGov Practitioner's Forum on 'Policy learning and experimentation in EU economic governance' at LSE, 30-31 March, 2006.

[4] I am grateful to Jochen Mankart (LSE) for enlightening me on this point.

better. The rules that bind them must therefore be of a disciplinarian, even draconian nature since governments would do harm again if unfettered.

Why then could the original Pact, based on this rationale, not be enforced? One major flaw, according to many observers, was that it fell to the Ecofin Council to decide on starting an EDP against a member. Even if the member under discussion is not allowed to take part in the vote, it is obvious that there is a moral hazard problem if 'the turkeys decide on the menu for Christmas', ie. potential sinners issue a verdict on actual sinners knowing that in the future they may be in the same situation. However, this should not be a major problem if there is an 'advantage of tying one's hands'. The collective of potential sinners should then remind those who slip that it is in their own best interest that they be punished so as to maintain the self-validating character of a credible commitment device. Either the rationality assumption is questionable, and the Schroeder or Chirac administration did not act in their best interests when they twisted the arms of other members to avoid the opening of an EDP, or the assumed setting of no uncertainty is called into question by the Pact's operation in practice.

I will come back to both issues in the next section. Suffice it to say that the optimal control rationale for rules is compatible with the notion that the hard law measure of the EDP can be combined with the soft law element of peer review, namely that the enforcing agency is the Council rather than an independent enforcement agency such as the Commission. This brings us to an alternative rationale for rules that can also explain why soft law measures now do not only play this supplementary role but have arguably become the main pillar of fiscal policy coordination.

Around the same time as Kydland and Prescott (1977), Elster (1979) developed a much richer 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 for a combination of inflation and unemployment of which they apparently know that it is not 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 Kydland-Prescott conceptualisation in that the problem is inconsistent or shifting *preferences*, not that the *constraint* can be manipulated. The underlying concept of government is less activist than that of Kydland and Prescott (1977) or Giavazzi and Pagano (1988): Ulysses fears himself to be too weak to resist rather than too strong for his own good.[5] Governments are also not necessarily myopic if the mythical hero is a pertinent analogy to modern government. He knows that preferences may change and thus delegates the oversight over policies to the sailors with useful blind (or deaf) spots, ie. non-majoritarian institutions, such as Supreme Courts or independent central banks.

While the conceptualisation of government is different, the Ulysses analogy justifies the same institution: precommitment of policy-making. In his follow-up, Elster (2000: part II) discusses five devices for precommitment – imposing costs, eliminating options,

[5] Although Elster (2000) also discusses the problem of dictatorial governments who cannot credibly claim to delegate or to abstain from intervention.

creating delays, requiring supermajorities and separation of powers. Obviously, the commitments in EMU realise the first two options: with the creation of the independent ECB, governments have foregone the option for a national interest rate policy; with the fiscal rules enshrined in the Pact, governments meant to impose costs on themselves in terms of being forced to a pro-cyclical policy and ultimately a fine under the EDP.

The softening of the Pact can be interpreted as imposing another form of cost, exposing governments to criticism by their peers at home and in the Council (‘shaming’). Arguably, however, the apparent softening also introduces another form of pre-commitment that resembles the separation of powers. Ministerial bureaucracies now must implement ‘minimal fiscal efforts’ or calculate the discounted value of savings from systemic pension reforms. This gives the administration a key role in shaping what their political masters present for approval by the Commission and in the Council. Thus, the conditioning of exceptions and escape routes can be seen not only as constraining the room for open-ended deliberation but as enabling a shift and division of responsibilities for budgetary outcomes within the executive.

Elster (1979: 93-96) also points us to a political cost involved for the enlightened guardian of precommitment, the European Commission. Fetters are likely to be portrayed as externally imposed and they are meant to be felt at times when a member state is in dire straits. The institution of pre-committing policies entails a dilemma or paradox: by protecting democracy against its flaws, pervasive precommitment undermines democracy. Precommitments are meant to protect policy-makers against opportunistic policy changes to ensure re-election, but by ensuring time consistency they eliminate the democratic accountability of policy.

This can lead to resentment of the precommitment, however sensible it may be. Soft law is arguably more susceptible to such resentment than hard law. The latter can undergo a well-defined procedure of change by elected legislators in parliament; soft law or open method coordination by contrast is opaque as regards the exact procedure of change (cf. Chalmers and Lodge 2003). Elster (2000: 95, fn.15) mentions research that has shown 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.” This observation in the psychological literature may be even more pertinent in politics. 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.[6] 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 despotism of a past majority and its policy consensus. Institutions, such as escape or emergency clauses, allow for shifting political priorities under defined conditions.

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[6] The difference between precommitment as precaution against the temptation for optimal control and precommitment as precaution against irrational preferences corresponds to the difference between delegation to an agency and delegation to a fiduciary in order to solve credibility problems (Majone 2001). The latter is more pertinent if the policy is an open-ended task and only incomplete contracts can be written for its delivery.

The softening of the Pact can be understood as allowing for such a constrained or defined rebalancing of precommitment and adaptation to democratic accountability. The next section will explore whether the underlying reasons for this rebalancing are of a temporary nature, preparing for the later hardening of the Pact, or whether the reformed Pact meets permanent challenges of rule-based policy coordination that only soft law can adequately deal with.

What are major challenges for rule-based policy coordination?

The rules that are relevant for economic coordination in EMU depend on the exact measurement of quantitative indicators such as a 3% structural deficit to GDP. The indicator should also be reliable and accurate in its assignment of responsibility for breaches of the rule. Finally, the rule should remain an exogenous constraint that does not change by being used to coordinate policies or control for compliance.

Measurement problems

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).

Horn (2006: 11) shows in his ex-post evaluation of output gap projections that both the IMF and the OECD had predicted, in 1999, a negative output gap for Germany in 2000 and 2001, suggesting that Germany should have a budget deficit to compensate for weak private demand. It turned out that Germany had positive output gaps in both years, as the OECD and IMF statistics show in April 2005, and the government was criticised for its pro-cyclical policy. 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.

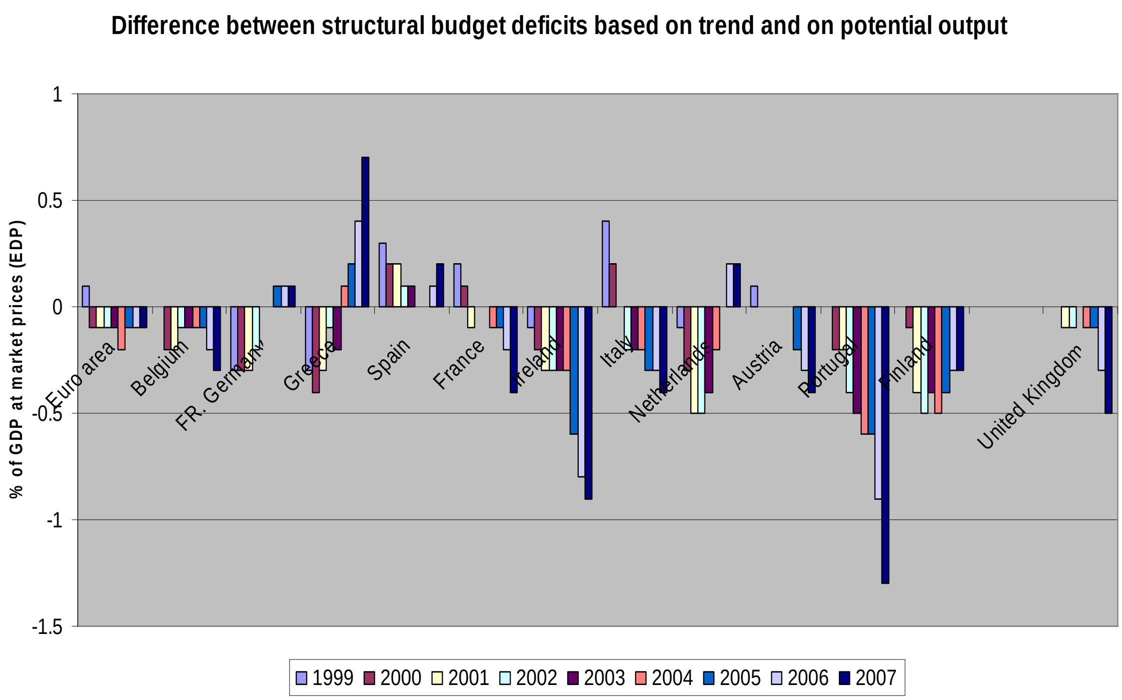
For the SGP and the BEPG this means that the rule of not exceeding a ‘structural’ or cyclically adjusted deficit of precisely 3% of GDP becomes quite problematic. A ‘structural deficit measures the size of the budget deficit as it would be if output were at the full employment level” (Fischer and Easterly 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.[7] The July 2002 Ecofin Council has agreed to use

[7] Cf. Denis et al (2006: 5; 9-12) The Commission’s approach is to use a Cobb-Douglas function for linking inputs to outputs. This functional form treats labour, capital and technological progress as different and exogenously given input factors of production (ie. capital not as embodied labour or technological progress as resulting from the level of inputs). They can substitute continuously for each other although with the factor used more intensely yielding a declining additional output. All these features of a Cobb-Douglas

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:



Source: own calculations based on AMECO database (update from December 2005)

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 (eg 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.

production function do not commend themselves for being 'realistic', in fact they are probably unrealistic, but have proven convenient properties for statistical and methodological reasons (Denis et al 2006: 10, fn.3).

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.

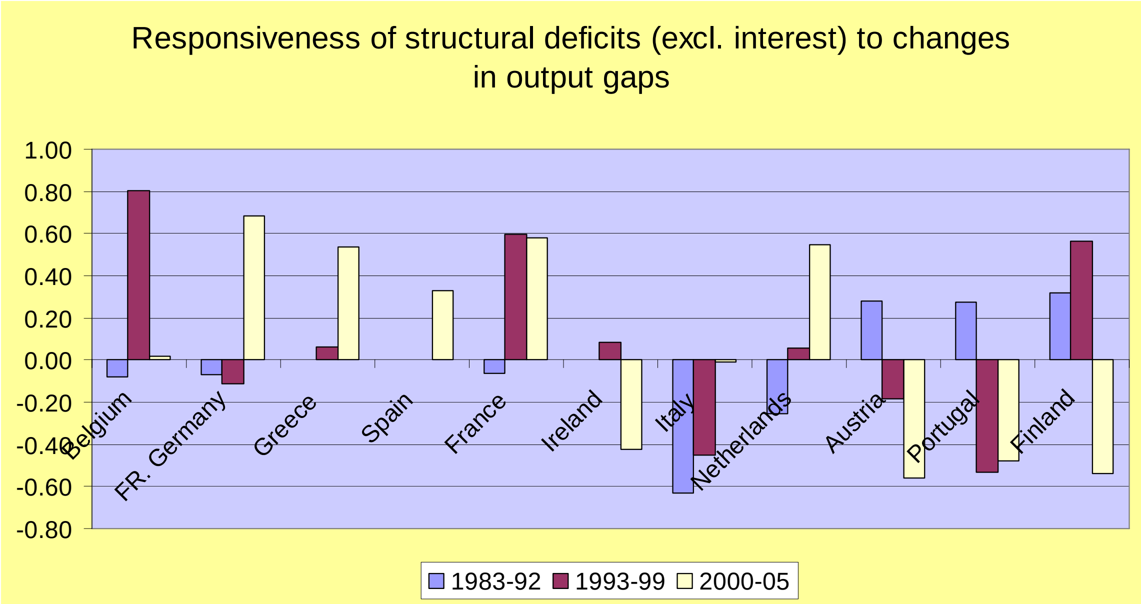
Assignment of responsibility

The problem of assigning responsibility can also be framed in terms of uncertainty. By locating the problem in optimal control, the literature that backed the original Pact assumed that inflation can be optimally controlled. Thus, the rate of growth of the money supply determines inflation and all instability is due to accommodation of the wage bargain or to cheating by the authorities. A commitment device to address this type of dynamic inconsistency conveys the message ‘no more surprises if government’s hands are tied’, implicitly blaming the authorities whenever surprises occur for having stripped themselves of their handcuffs. However, policy-making is sometimes afflicted by ‘deep uncertainty’ (Lohmann 2000) about the causes of surprise inflation and the behaviour of different public agencies. The policy environment of EMU is a case in point. If so, precautions must be taken for the foreseeable case that unforeseeable contingencies occur (Lohmann 2000: 394). 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.

Another challenge to rule-based policy coordination is that a government is obviously not a unitary actor, and compliance problems may reflect the interplay of multiple interests within the government. Buiter (2006) mentions that the budget deficit in the US is largely a result of many uncoordinated decisions: ‘it just happens’. In many countries, the Treasury does not have veto power that would enable it to enforce an overall budget constraint on other ministries. This budgetary institution 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’.

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:



Source: own calculations based on AMECO database (update from December 2005)

What this simple exercise 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 while countries may be in breach of the structural deficit rule (Fig. 3a), it is hard to judge 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:

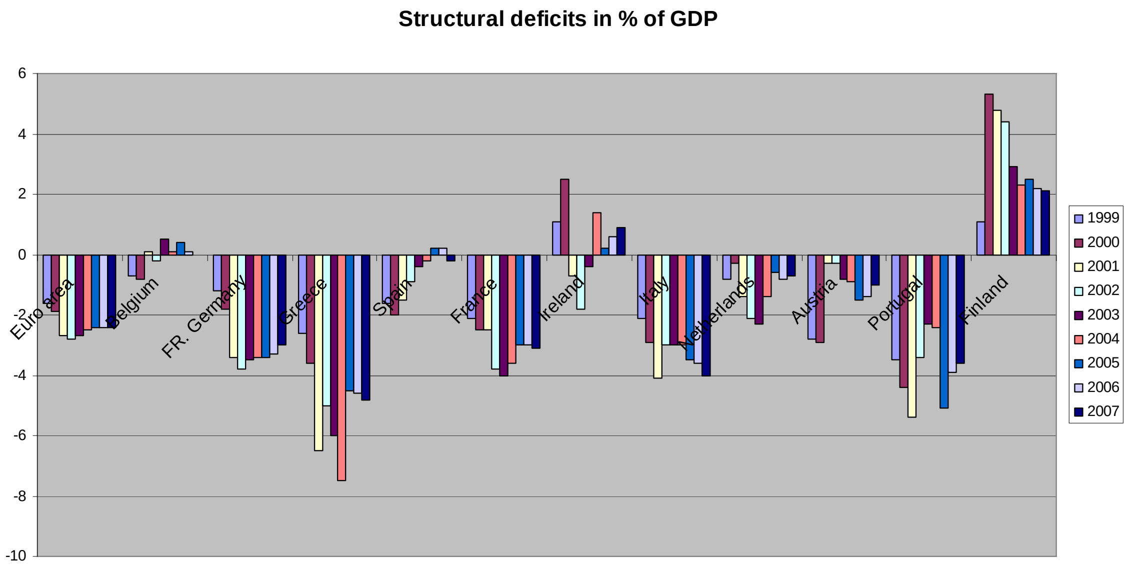
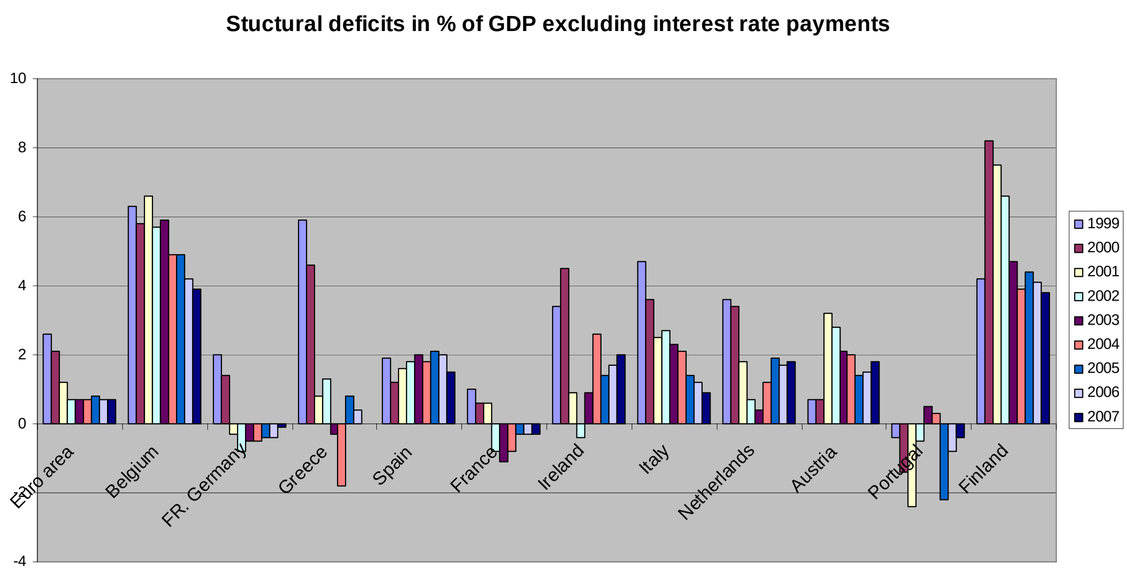


Fig.3b:



Source: AMECO database (update from December 2005)

One may conclude that 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. 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 deliberately and blatantly out of tune with their membership obligations.

Endogenous uncertainty

There is finally a fundamental problem with any rule-based policy. Goodhart's Law implies that the problem of uncertainty cannot even be ruled out by rules-based policy. If, as the Law states, "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. This is not only due to the changes in the expectations of the private sector which the authorities may not be able to fully anticipate. This 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:[8]

- 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.

What about the European Union? 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. In order to lower deficits, they tended to substitute long-term for short-term debt because interest rates on the latter are typically lower than those on long-term claims.[9] 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 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

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

[9] Feldmann (2005: 6) reports on German fiscal gimmickry, based on data from the Council of Economic Advisors, that "[s]ince 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".

change in debt levels and the deficit, including interest rate payments, in the present period. This 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):

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 seems to me an inherent dilemma of all precise rules: they also indicate what precisely has to be circumvented.

Conclusion

This paper proposes that the recent reform of the Stability Pact has based the economic governance framework for fiscal policy more firmly on OMC. The analysis suggests to me that it was a move towards an 'OMC for fiscal consolidation' and another form of rule-based fiscal policy coordination rather than a move away from it. The rules were differentiated and specified in more detail so that the softening of the Pact seems to leave less room for open-ended deliberation. An interesting possibility to watch is whether the apparent softening of the Pact also introduces another form of pre-commitment, namely separation of powers. The specification of conditions under which exceptions and postponements of the EDP may be allowed amounts possibly 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. They are particularly constrained in federal countries and in welfare state arrangements with an important role for semi-autonomous social security funds. The deep institutional reforms of budgetary processes that would be required to tighten this control run into problems of legitimacy and democratic accountability. 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 around as decisionmakers 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[10] 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 more general study of a NewGov project on 'new forms of governance in the shadow of hierarchy' (Héritier 2005). 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

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

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. But the jury on how well this ‘hard law in the shadow of soft coordination’ works is still out.

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