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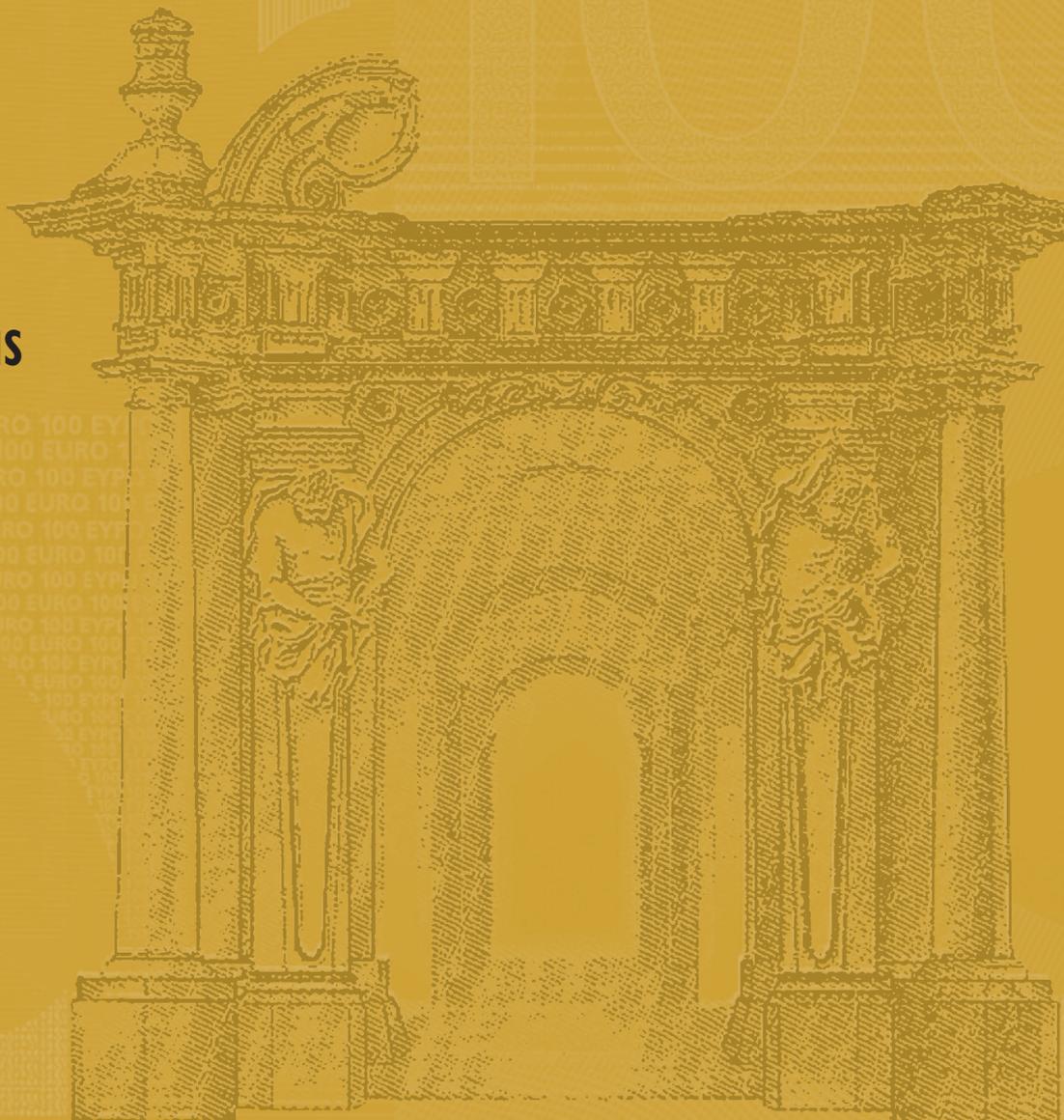
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**EU FISCAL RULES**

**ISSUES AND LESSONS  
FROM POLITICAL  
ECONOMY**



by Ludger Schuknecht



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## WORKING PAPER SERIES

NO. 421 / DECEMBER 2004

# EU FISCAL RULES ISSUES AND LESSONS FROM POLITICAL ECONOMY <sup>1</sup>

by Ludger Schuknecht <sup>2</sup>

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<sup>2</sup> European Central Bank, Kaiserstrasse 29, 60311 Frankfurt am Main, Germany; e-mail: [ludger.schuknecht@ecb.int](mailto:ludger.schuknecht@ecb.int)

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**Address**

Kaiserstrasse 29  
60311 Frankfurt am Main, Germany

**Postal address**

Postfach 16 03 19  
60066 Frankfurt am Main, Germany

**Telephone**

+49 69 1344 0

**Internet**

<http://www.ecb.int>

**Fax**

+49 69 1344 6000

**Telex**

411 144 ecb d

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## Abstract

*The paper analyses the EU fiscal rules from a political economy perspective and derives some policy lessons. Following a literature survey, the paper stresses the importance of appropriate incentives for rule compliance in an environment where national fiscal sovereignty precludes the option of centralised enforcement. In addition, the paper stresses the importance of clear and simple rules and in particular the 3% deficit limit in anchoring expectations of fiscal discipline and facilitating public and market monitoring of public finances. This, in turn, strengthens incentive for rule compliance. Moreover, the paper discusses the interests of the most important players in European fiscal rule formation and the importance of choosing the appropriate time for initiating a reform debate.*

*Keywords: political economy, fiscal rules, Stability and Growth Pact, deficits, institutional reform*

*JEL classification: D7, H3, H6*

### *Non-technical summary:*

The EU fiscal framework as laid down in the Maastricht Treaty and the Stability and Growth Pact (SGP, the Pact) aims to preserve fiscal sustainability while allowing room for automatic fiscal stabilisation. These two objectives are also at the heart of the ECB's interest in the EU fiscal framework because their attainment facilitates monetary policy making in the short and long run.

The paper analyses the EU fiscal rules from a political economy perspective and derives some policy lessons. The literature review of the first part reveals that fiscal rules can help solve deficit/debt biases and time inconsistency problems by constraining the behavior of policy makers. But rules can also mitigate biases if they facilitate financial market and public scrutiny of fiscal policies.

Thereafter, the paper analyses the institutional environment in which EU fiscal rules are applied. It argues that EU rules reflect a “contract” amongst countries that retain sovereignty on fiscal policies. Enforcement, therefore, ultimately has to be undertaken by the contracting parties. Due to this constraint, the rules can also be characterised as “soft law (with the 3% limit being nevertheless a much “harder” constraint than the other elements). But this does not necessarily imply that the rules are ineffective (or “dead”). Soft law reduces political transaction costs (by improving transparency and providing a forum for peer pressure). Moreover, if well-designed, such law can boost incentives towards making the rules “self-enforcing”. Evidence speaks in favour of this view: while EU fiscal rules were bent in a number of cases and compliance is undeniably of concern, major and rapid fiscal balance deteriorations have been largely prevented since the start of EMU.

The paper also looks at potential trade-offs between “complex” rules where a “fine-tuned” economic rationale may boost acceptance of the rules versus simple and clear rules that allow easy monitoring. It is argued that clarity and simplicity of rules are important especially when formal enforcement is limited (“soft law”) and public monitoring becomes more important. By facilitating public and market monitoring of compliance, clear and simple rules are also more costly to breach.

The benefits of “complexity”, and in particular the use of administrative discretion to fine tune the rules to country situations have limits, in particular when it comes to the excessive deficit procedure (EDP). It is argued that the 3% deficit limit and the time frame for correcting excessive deficits already provide some room to accommodate economic circumstances. The 3% limit must be clear, simple and strictly implemented to anchor expectations of fiscal

discipline and to facilitate public and market monitoring. Further discretion and relaxation would conflict with this need. From this angle, other risks (e.g., efforts not materializing, structural reforms producing surprise costs etc) are hard to justify as a reason for extending deadlines to correct excessive deficits.

The preventive arm of the Pact with its requirement of close-to-balance-or-in-surplus budgetary positions defines sound medium term budget positions and adjustment paths. This may be appropriately fine-tuned to address concerns about the Pact's underlying economic rationale. For example, a symmetric application in good and bad times and less time inconsistency would be desirable.

Finally, the timing of a debate on fiscal rules needs to be carefully chosen. In the EU context (and perhaps in other contexts as well), there seems to be much inherent pressure to make the rules more "complex". Moreover, for the debate initiated in summer 2004, there was also no willingness by countries to give up sovereignty nor was there a sense of urgency to strengthen public finances via tighter rule implementation and enforcement. In such an environment, it is likely that changes to fiscal rules make them more complicated, discretionary and, thereby, potentially less enforceable.

## 1. Introduction

The debate over the EU fiscal framework splits the academic and policy community: it is judged both necessary and superfluous, economically sound and unsound, dead and alive, to be changed and to remain untouched. Nevertheless, it is important to keep in mind that, first, there is an existing set of rules and regulations as laid down in the Maastricht Treaty and the Stability and Growth Pact (also referred to as SGP or Pact). An analysis and discussion of EU fiscal rules has to take these as the starting point. Second, though the EU fiscal framework is by no means “optimal” from all perspectives of analysis, the framework nevertheless fulfills certain key requirements for “economically sound” fiscal rules. By preserving fiscal sustainability while allowing room for automatic fiscal stabilization in EMU they prevent excessive distortionary losses to output and welfare and intergenerational inequity. Sustainability and stabilizing properties are also at the heart of the ECB’s interest in the EU fiscal framework as they facilitate monetary policy making in the short and long run.<sup>3</sup>

Following these premises, the paper analyses the EU fiscal rules from a political economy perspective and derives some policy lessons. The paper will, first, look at the political economy of deficits and fiscal rules to answer the question of “why fiscal rules” (section 2). Subsequently, it will address enforceability (section 3) and the relation between enforceability and simplicity of rules (section 4) to discuss the question of “what fiscal rules”. Section 5 deals with political interests in rule setting and implementation and implications for the reform debate. Section 6 concludes.

## 2. The political economy of deficits and fiscal rules

### a. Deficit and debt biases

The economic literature has identified a number of reasons why deficit and debt biases are likely to emanate from the democratic political process despite the economic spillovers/inefficiencies such biases create (for surveys, see Alesina and Perotti, 1996 and Mueller, 2003; for new evidence in industrialized countries see Balassone and Francese, 2004). The biases ultimately derive from transaction costs for voters/economic agents in the political

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<sup>3</sup> Such policies prevent, e.g., higher interest rates and departures from the optimal intertemporal allocation of resources (Detken, Gaspar and Winkler, 2004) and also facilitate consumption smoothing. For more formal modeling and simulation exercises see Marin (2001), Annachiario and Giammarioli (2003) and Fernandez-Huertas and Vidal (2004). See also ECB (April 2004) and Buti (2003) for a broader discussion of the relevant arguments and literature. Rother, Catenaro and Schwab (2004) provide a quantitative assessment of ageing-related costs.

process that include, for example, the costs of staying informed and making a judgement, of exchanging views and forming interest groups and of influencing policies. Because of such costs, voters/economic agents in democracies are represented by politicians who themselves are aided by administrations. The resulting institutional setup differs significantly across countries but it invariably gives rise to principal agent relationships with monitoring costs, asymmetric information and moral hazard problems.

The first well known origin of the deficit bias is fiscal illusion. Voters do not understand the intertemporal budget constraint because they have too high information costs. Therefore, politicians can raise spending more than taxes. This leads to asymmetric stabilization with deficits in recession and more limited or no surpluses in booms (Buchanan and Wagner, 1977).

Biases can also arise from electoral cycles. For example, rational (but imperfectly informed) voters can induce politicians to conduct expansionary policies before elections. There are numerous other variants of election cycle models and evidence on fiscal cycles has been growing.<sup>4</sup> Recent empirical studies relevant in the EU context are Buti and van den Noord, 2003 and Hughes-Hallet, Strauch and von Hagen, 2001.

Asymmetries in the allocation of costs and benefits of spending programs can produce spending and deficit biases. If the costs of spending programs are incurred by the national tax base while benefits accrue to a local constituency, a common pool problem of politicians voting for inefficient spending ratios and insufficient financing can arise (Buchanan, Rowley and Tollison, 1987; von Hagen and Harden, 1994, Persson and Tabellini, 2000).<sup>5</sup>

Distributional conflicts across interest groups or generations can also give rise to deficit and debt biases. Asymmetric information is at the root of delayed stabilisation due to “wars of attrition” across interest groups (Alesina and Drazen, 1991). Public debt can be a means of distributing money from tomorrow’s rich (taxpayers) to today’s poor (benefit recipients) as children and the unborn do not have much of a lobby and are underrepresented in the political process (Cukierman and Meltzer, 1989).

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<sup>4</sup> The two main strands of the literature look at so-called opportunistic cycles where governments use fiscal policies for expansionary purposes before elections (Nordhaus, 1975; Rogoff, 1990; and Rogoff and Sibert, 1990) and partisan cycles where fiscal policies depend on the government’s preference for price stability versus full employment (Hibbs 1977).

<sup>5</sup> A prisoners dilemma problem refers to a setting where collectively, actors would benefit the most from co-operating while individually, they have an incentive not to co-operate. This results in a non-cooperative and collectively inefficient outcome.

Spending biases and inefficiencies can also be reinforced by self-interested bureaucrats who, through various mechanisms, are able to secure budget allocations (=expenditure) that are higher than economically efficient (Niskanen, 1971).

The discretionary correction of fiscal imbalances is also marred by time inconsistency problems (Kydlund and Prescott, 1977). Ex ante, the government may announce fiscal adjustment, but ex post, there may always be economic or political reasons why the government wants to renege on these promises.

In a monetary union, the deficit bias can be augmented if deficits of individual countries not only give rise to higher spreads on their own bonds but cause higher interest rate levels (=negative spillovers) for everybody when bond markets are integrated in the union (but not yet globally). Higher financing costs, in turn, give rise to lower growth, inefficient intertemporal resource allocation and financial instability (Beetsma and Bovenberg, 1998; Detken, Gaspar and Winkler, 2004). Or in other words, additional spillovers can arise from the incentive of governments incurring deficits as the costs are born by the Union as a whole.

The literature on deficit and debt biases, however, is largely limited to analyzing such biases due to an under-informed and asymmetrically represented public and the budgetary impact of bureaucratic incentives. Much of the public finance literature ignores the role that financial markets play in scrutinizing public solvency. This is either due to the presumption of imperfect or absent financial market monitoring or the assumption that governments are solvent by definition.

A growing literature looks at financial market monitoring of government balances and the impact of deficits and debt on government financing conditions. Some evidence of financial market monitoring has been found (Afonso and Strauch, 2003; Bernoth, von Hagen and Schuknecht, 2004; Faini, 2004; Balassone, Franco and Giordano, 2004). However, asymmetric information and incentive problems (e.g. short-term oriented herd behaviour) have been identified as reasons for monitoring problems and poor (i.e. delayed, volatile and non-linear) financial market reactions to changing fiscal positions just as in the case of private creditors. Or from yet another angle, financial market monitoring of fiscal policies may suffer from similar problems as voter monitoring. Moreover, markets may be uncertain about the credibility of rules that would induce them to monitor public finances carefully and discriminate across countries. In the EMU context, the no-bailout clause (that governments “shall not be made liable” for each other’s fiscal difficulties) is particularly relevant and its credibility is yet untested.

These shortcomings in financial market monitoring and the above-mentioned spillovers that could arise from unduly expansionary fiscal policies in monetary union are an additional argument in favour of rules (such as the Stability and Growth Pact) to complement public and market monitoring.

## **b. The reason for rules**

Political institutions such as voting rules, political systems, the tax system or budget rules can reduce or increase the deficit and debt bias and solve or worsen the time inconsistency problem (Mueller, 2003; Persson and Tabellini, 2002). From a normative perspective, most economists strive to find those fiscal rules that solve biases and time inconsistency problems in the most sensible manner by constraining government behaviour (Buchanan, 1985).

The way fiscal rules can solve the deficit bias and time inconsistency problem is by anchoring expectations about the sustainable course of future policies. Or in other words, rules constrain the behaviour of governments and, thereby, convince the public and markets that sound public finances in the future ensure favourable tax and financing conditions. But this expectation can only materialise if implementation is unconditional and the involved actors accept ex post inefficiencies in individual cases.

The literature distinguishes between the objectives/targets of the rules and the budgetary procedures defined by rules. Targets such as balanced budgets or the golden rule ( $\text{deficit} \leq \text{public investment}$ ) aim to constrain deficits in a manner that secures fiscal sustainability and, in more complex constructions (EU's Stability and Growth Pact, Switzerland's "debt-brake") also the stabilizing role of public finances.

Institutional factors that reduce or reinforce fiscal biases have received much attention in the literature. By contrast, institutional influences on financial market monitoring in industrialized countries that could reinforce or reduce deficit and debt biases have not been given much attention (in contrast to emerging markets and developing countries; an exception is e.g. Tanzi, 1998).

The importance of rules in encouraging or undermining financial market monitoring, however, can not be overemphasized (and much more research is warranted on this issue). Take the extreme case, when forced purchases of government securities at pre-determined interest rates can completely eliminate market scrutiny. More indirectly, regulation of pension funds, life insurances, collateral rules with banks and central banks etc. can artificially raise the demand for government paper and distort monitoring incentives and financial market signals on

the solvency of government. By contrast, institutions that facilitate market responses via transparency and low transaction costs can enhance financial market monitoring and reduce policy biases. If, for example, the collateral treatment of government securities was not guided by the implicit assumption that governments are solvent (see e.g. the new Basle II rules where government debt is part of Tier I capital as long as it has a certain minimum rating), markets and regulators might differentiate much more between “excellent” and “less excellent” public debt. The IMF work on fiscal rules and transparency and related codes of conducts has the objective of facilitating financial market monitoring (Kopits and Craig, 1998).

Fiscal rules and institutions can also facilitate or render more difficult public monitoring of policy makers’ performance in the fiscal field (and hence pressure to comply with the rules). A simple numerical rule is much easier to follow for the public than a complicated rule with many contingencies.

### **3. Enforceable fiscal rules: an institutional analysis**

Many argue that fiscal rules are important for Europe. They help solve political market failures due to transaction costs and time inconsistency problems. The founders of EMU felt that such rules are even more important in a European Monetary Union, given the EU history of fiscal profligacy in the 1970s and 1980s. They negotiated an elaborate fiscal framework, first embedded in the Maastricht Treaty and later extended in the Stability and Growth Pact. A main element is the surveillance process that includes the provision of timely and high quality data.<sup>6</sup> Moreover, member countries are to attain close to balance or in surplus budgetary positions in the medium term (the so-called preventive arm of the Pact). Most importantly, members must avoid excessive deficits that are to be measured against deficit and debt thresholds (3% and 60% of GDP, respectively). An elaborate process, called the “excessive deficit procedure” can ultimately lead to pecuniary sanctions against members of the euro area (the corrective or dissuasive arm of the Pact).

There is by now a significant literature on these issues. Fatas, von Hagen, Hughes Hallett, Strauch, Sibert, 2003, Buti, Franco, Eijffinger, 2003, and ECB 1999 provide a detailed discussion of the institutional details. Briotti, 2004, and Gali and Perotti, 2003 analyse the effect of the SGP on fiscal strategies in EMU countries. Von Hagen and Wolf (2004) and Koen and van den Noord (2004) examine creative accounting.

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<sup>6</sup> This issue has received much attention since Portugal has reported in spring 2002 a strong “surprise” upward revision of its 2001 deficit above 3% of GDP and since Greece deficit figures have been revised significantly upwards in the course of 2004.



There are two dimensions from which this framework can be assessed.<sup>7</sup> First, how sound is its economic rationale, or how does it fare in attaining its main objective: sustainable and stability-friendly public finances? And second, how does its implementation/enforcement fare given the political economy challenges outlined above? When looking at the ongoing debate, most of the discussion focuses on the economic rationale of EU rules. The political economy incentives undermining implementation and enforcement is still little analyzed but frequently seen as the greater problem (Fatas et al, 2003; Inman, 1997).

### **a. The need for “self-enforcing” contracts**

Given the extensive literature on the first dimension, let us focus on the question how implementable and enforceable rules should look like. First, there must be ex-post monitoring of compliance/performance. The surveillance process required under EU law provides for such ex post monitoring and the fiscal thresholds (also called reference values) are formulated relative to ex-post outcomes. The necessary condition for enforcement is hence complied with (see also Inman, 1997 on the importance of ex post monitoring).

Second, there must be a means to sanction inappropriate compliance/performance. The principal-agent or optimum contract literature provides a very useful conceptual toolkit to analyze this question (Furobotn and Richter, 1997). The EU fiscal framework is based on EU law which means that fiscal rules are applied in an international law context. This and some built-in features have important implications for enforceability. First, the ECOFIN Council, comprising the Member countries’ finance ministers, takes all relevant decisions. This implies that the decision making body is not independent and impartial but partisan with all parties, those creating spillovers and those paying for it, sitting around the table. Second, fiscal rules are not litigable so that nobody can go to court if the ECOFIN Council does not “punish a sinner”. And third, there is no army or police that can force governments to comply and, thereby, give up their fiscal sovereignty.

Institutional economists refer to contracting environments in the absence of an independent Court (or other agency) as one where there is an incentive of “ex-post

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<sup>7</sup> See Inman, 1997. Buti, Eijffinger and France (2003) assess the framework on the basis of criteria defined by Kopits and Symansky (1998), which include well-definedness, transparency, simplicity, flexibility, adequacy to reach the goal, enforceability, consistency and the incentives for structural reform. Transparency is particularly important for rules to work and includes reliable and high-quality reporting and statistics. Apart from enforceability, all other elements form the “economic rationale” of rules. Inman focuses on implementation by differentiating between “timing for review”, overriding possibilities, enforcement and amendment provisions. See also Tanzi (2004) and Beetsma and Debrun (2004) on the future and the reform of the Pact.

opportunism”. Or in other words, agents (governments) may not be willing to comply with the contract (the deficit and debt limit) because they opportunistically hope to pass the costs to other parties (e.g., via higher euro area interest rates).

“Self-enforceable” contracts, where the incentives of participants are set in a manner that it pays to comply, are the solution to an international contracting problem without a “proper” (non-partisan) court/enforcer. One way to achieve self enforceable contracts is repeated games with sufficiently large profits from behaving cooperatively so that they exceed the gains from opportunism/non-cooperation in net present value terms. If a contracting party does not co-operate, the other party/parties would not continue the contractual arrangement. The forgone profit is an effective deterrent.

In the EU fiscal policy context we face repeated games with significant “profits” from co-operation (better financing conditions and a more stable macroeconomic environment). But the issue is nevertheless complicated. On the one hand, governments can not simply exit or force another country’s exit—they are locked into the EU and EMU, the sunk costs of membership are enormous and so is the possibility for ex post opportunism. This reduces the costs of “opportunism” and deficits are more likely to rise beyond the “optimum” as the related spillovers are not internalized. On the other hand, governments know very well the potential long run costs of breaking the contract via severely delinquent behaviour: it would put their own economic and financial stability if not that of EMU as a whole at risk . It would also raise the scepter of more federal/centralised institutions with the concurrent loss of fiscal sovereignty.

The incentive to behave opportunistically can be exacerbated by the short time horizon of election-oriented policy makers (i.e., the high discount rate of future returns). Even if long term costs of opportunism are very high, fiscal irresponsibility may pay for policy makers in the short term (e.g. before an election). This may result in non-compliance. Fiscal rules can in principle deal with this latter type of “temporary” opportunism if the underlying incentives decline again, (e.g., after an election) and mechanisms for correcting such temporary non-compliance exist. In such a case, the rules may not prevent temporary and moderate mistakes (such as election-cycles) but they may prevent more long-lasting and important imbalances (“gross policy errors”) and, thereby, preserve sustainable public finances.

The institutional economics literature has identified a number of means to reduce the incentive for opportunistic behaviour. The obvious way is national fiscal rules that constrain policy makers and thereby, opportunistic behaviour at the EU level (Fatas et al, 2003,

Commission, 2004). Less prominently, these means also include so-called specific investments that raise the benefits for governments to behave co-operatively. For example, governments may invest in a reputation of fiscal rectitude towards voters and interest groups by making statements on fiscal balance targets. (This reputation would be forgone if such policies are then not pursued). Or contracting parties create so-called hostages (for example, governments can put money into an account which they forfeit in case of non-compliance, or policy makers make their salaries dependent on attaining deficit targets). “Solemn declarations and commitments” have at times been publicised in the EU in the recent past but their reputation effects seem to have been limited. Much more work on the potential use of such mechanisms in the EU context could be conceived.

#### **b. “Soft” law as a means to reduce transaction costs**

The contracting problem in an international law environment with partisan enforcement as discussed in the previous sub section is examined with another label by the political science and international relations literature: it is called “soft law” (Abbott and Snidal, 2000). Economists typically do not pay much attention to such institutional intricacies and some economists are, consequently, arguing that EU fiscal rules are unenforceable, ineffective or dead. The grey of soft law does not exist for many between the “white” of hard law and the “black” of no law enforcement. But the relevant literature has identified a number of advantages of soft law over “no law” especially in the international context so that at least some contract compliance and internalization of spillovers can be attained (De Haan, Berger and Jansen, 2003; Abbott and Snidal, 2000).<sup>8</sup>

First, in the international context information and lobbying costs are higher than at the domestic level. Soft law can reduce transaction costs by resulting in secondary regulation and processes that facilitate transparency and create a forum to exercise international peer pressure. Even if this does not create very fine-tuned and complex law enforcement it may help prevent gross policy errors and thereby, grave spillovers from non-compliant policies abroad. At the same time, when sovereignty costs are high (or in other words special interests and electorates must be pleased and hard law is impossible to attain) soft law might imply that the rules can be bent to some extent to reduce political costs at home.

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<sup>8</sup> There are of course many shades of “softness”. In the SGP framework, the preventive arm with its close to balance or in surplus provision and without sanctions is rather soft. By contrast, the corrective with the ultimate threat of sanctions comes much closer to hard law, even though the above-mentioned shortcomings apply.

In the EU context, this sounds familiar. There was the stated commitment by France and Germany to delay but not to abandon adjustment on November 25, 2003 after the ECOFIN Council had rejected a Commission request to move to further procedural steps under the excessive deficit procedure against the two countries. Or in other words, the rules were not implemented in a strict manner but with these commitments, worse policy errors were perhaps avoided. There is some evidence in favour of this claim as regards the Stability and Growth Pact. Briotti and Lamartina (2004) find that the downturn in the early 1990s saw a much larger number of “extreme budgetary deteriorations” than the 2001-2003 slowdown (in absolute terms and relative to the size of output loss).

The quoted incidence involving Germany and France points to an inherent problem of soft law that may also be hard to swallow in Europe: compliance is hard to fine tune and may be shifting depending on the prevailing political interests. But if behaviour is modified to a certain extent, the rules, thereby, help to internalise international interests in the domestic policy calculus. What then looks like a failure from a “hard law” perspective, because deficits went above 3% of GDP, is perhaps none from the “soft law” view, because deficits did not reach much more damaging 5% or 8% of GDP. Economically, the “success” of the EU framework is then an empirical issue that must be assessed relative to the behaviour that is needed to preserve sustainability.<sup>9</sup>

When is the likelihood higher that soft law “works”? Soft law is more effective when so-called co-operation and competition incentives are strong. The first refers to the interest of parties in seeking co-operation by all others which determines the incentives for exercising peer pressure. This is closely related to the magnitude of spillovers of non-compliant behavior. The second refers to costs of non-compliance via, for instance, competition for international investment. Both effects refer to the costs of non-cooperative behavior in repeated games discussed above.

These effects are not likely to be very strong in the fiscal domain for small to moderate breaches of the fiscal rules in the EU in the short run. The immediate costs to politicians at home and in the rest of EMU are small. By contrast, major policy errors would be more threatening to have domestic backlashes and would be more likely to generate enough peer pressure for the rules to do their job. The information and attention generated in the process

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<sup>9</sup> Inman (1995) argues that independent of the fiscal rule, if enforcement is partisan, the deficit outcome is likely to be the maximum to which the pivotal player will not object. Given qualified majority voting with weighted votes in the ECOFIN Council and log-rolling/vote trading opportunities, only gross policy errors are, therefore, likely to be sanctioned.

would then also facilitate public and financial market monitoring. We will come back to this point below.

Finally, we need to look at the dynamic dimension. Here expectations should be modest. Soft law can be a first step towards better enforcement/hard law when it helps learning and trust-building across politicians, when institutions converge and when vested interests in the hardening of the law are created. This dynamics is not likely to be strong in the fiscal field as there are no special interests that would directly and immediately suffer from non-compliance and counter-lobbying.<sup>10</sup> This in combination with the incentive for non-compliance and ex-post renegotiation by opportunistic politicians may be an important reason why fiscal rules seem to be degrading rather than strengthening over time not only in the EU but also in the US and elsewhere (see Berndsen, 2001 for “rule cycles” in the Netherlands).

### **c. Rules in a contract versus delegation environment**

When seeking rules that are enforceable and, thereby, secure fiscal discipline it is also worthwhile looking at the fiscal institutions literature which has identified two approaches to this problem (see von Hagen, Hallerberg and Strauch, 2004). In a country where a strong finance minister internalises potential spillovers from prisoners’ dilemma games across spending ministries by imposing a budget envelope, the literature speaks of the “delegation approach”. When ministers/coalition parties sit together and design an agreement on the allocation of spending to different constituencies/line ministries, this is called the contract approach. In fact, both approaches try to create self-enforcing contracts in the domestic policy environment where there are normally significant incentives to behave opportunistically.

Given the built-in “shortcomings” of the EU fiscal framework discussed above and the unwillingness of countries to fully give up sovereignty, the only option for EU fiscal policy coordination seems to be the contract approach. But as it stands now, the EU fiscal rules and the SGP do not seem to apply either approach fully consistently. The enforcement by the ECOFIN Council of Ministers constitutes a core element of a contract approach. More importantly perhaps, there is no ex ante contract on targets (even though they are presented in stability

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<sup>10</sup> Debt holders could be considered a lobby for sound fiscal policies. However, short term links between “bad” fiscal policies and adverse effects on debt (e.g. wealth effects in an environment of growing inflation and solvency concerns) have been found to be rather small. This is different in the trade area. Schuknecht (1992), for example, showed that trade liberalisation within the EU coincided with increasing intra industry trade that broke up industry-specific vested interests in protection (more spillovers and co-operation incentive). A common trade policy also increases the level playing field as regards attracting investment and, thereby the competition incentive.

programs and discussed in the ECOFIN Council). Or in other words, ministers have to decide on targets ex post which were not part of an agreement that is perceived as binding.

However, the incentives of all involved parties that the rules create have to be carefully balanced so that a system of checks and balances emerges that supports rule implementation and compliance. The fact that the initiative on rule implementation and interpretation is not with the ECOFIN Council but it is delegated to the Commission may work in favour of compliance if the Commission has an incentive to conduct an independent and impartial assessment and to use this to recommend a strict implementation of the rules to the Council. But it may also undermine compliance if the Commission has incentives to deviate from this line. More specifically, a strict and independent Commission assessment that leads to a Commission recommendation confronts the Council with two alternatives: accept the initiative and implement the required fiscal adjustment at the country level, or reject the initiative and face the costs in terms of bad press and public scrutiny (reputation costs).<sup>11</sup> If the Commission were to recommend a lenient interpretation, the outcome may be the same as if the Council rejects a strict Commission recommendation. But the exposure of “sinning” governments’ to public scrutiny would be much reduced and peer-assessment and pressure would be precluded.

There are other obstacles to creating a functioning contract environment. For the contract approach to work, there has to be an exit threat. At the national level, coalition parties can threaten to leave the government. Ministers can break the agreement by acting non-cooperatively in next year’s budget negotiations. This exit threat does not exist in EMU. Neither can the Dutch throw the German’s out of EMU nor can they credibly threaten not to play co-operatively in the next contract negotiations because there are none (as mentioned, the stability program discussions can hardly count as such). The carrot of trading fiscal adjustment for lower ECB interest rates can also not be used as this would go to the heart of the ECB’s independence and undermine another institutional pillar of macroeconomic stability. And finally, the threats of fiscal profligacy by small euro area countries may not be credible as they can benefit disproportionately from discipline by being attractive to investors via sound fiscal policies and stable and investor-friendly tax regimes (i.e. Ireland, the Netherlands). The only threat is the above-mentioned economic instability risk (that ultimately could also lead to more centralised fiscal policy making and an erosion of national sovereignty over fiscal policies).

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<sup>11</sup> A good example of such costs is the enormous attention and bad press the Council decisions as regards Germany and France got in autumn 2003.

How should these considerations affect proposals to reform the EU fiscal framework? (for a list of ideas and plans see, for example Sapir, 2004 et. al, Commission, 2004 and the draft European constitution). Many of these ideas and proposals follow the intuition that more “delegation” with moving towards a strong central agency is needed. However, the effect of these changes on enforceability is not unambiguous if they conflict with the national sovereignty over fiscal matters. Such changes could blur the clear responsibilities between the independent assessment agency (the Commission) and the contracting parties (the Council). They could lead to less ownership and more countries blaming and refusing the dictate of “heartless” Brussels. They may undermine incentives for an independent and strict assessment role by the Commission. Or in other words, the incentive effects of any proposal given the constraint of national sovereignty need to be carefully taken into account.

There have also been proposals of independent fiscal councils at the national and/or EU level that provide information and an independent assessment (e.g., von Hagen/Harden, 1994, Fatas et al, 2003; Wyplosz, 2002). Such councils may be desirable as their assessments facilitate financial market and public monitoring of fiscal performance. Thereby, they would constitute an additional pressure point for compliance with the rules.

#### **4. Fiscal rules: away from simplicity?**

Most observers see complexity/rationality of rules and enforceability as key but they do not discuss the interdependence and potential incompatibility of these two criteria.<sup>12</sup> On the one hand, fiscal rules must be economically reasonable, or else they lose the public’s and policy makers support and, thereby, their enforceability. On the other hand, rules must also be clear and simple or else the public’s monitoring costs are too high and the scope for discretion and disagreement amongst policy makers undermines their enforceability and credibility. This potential trade off (and hence the optimal degree of complexity with a given complexity of a problem) is dependent on a number of economic considerations and on the legal-institutional environment in which rules are embedded. These issues and their implications are discussed in the following.

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<sup>12</sup> In this respect, observers have criticised the rules for focusing on deficits rather than debt, not considering the special situation of low debt countries and those who want to undertake structural reforms, and the lack of symmetry in good and bad times.

### **a. Enforcement versus complexity: a trade-off?**

There is potentially an important trade off when rules become more complex. They become less clear and transparent for the public, thereby, raising monitoring costs and reducing pressure on policy makers to comply. They may also become less valuable as signals for financial market monitoring of sustainability if they become less transparent so that relevant decisions (e.g. rating changes, portfolio shifts) are undermined. They are also more prone to disagreement, which undermines enforcement and compliance in the political sphere (peer pressure). These points need further elaboration.

When judging on enforceability, we argued above that one should not only look at “traditional” enforcement (by a judge etc) but by all the main actors involved. We identified three main channels: (i) the public (which ultimately has to foot the bill of fiscal imbalances), (ii) the policy makers (who are the agents of the public but who typically create the above-mentioned political market failure and who can comply themselves and exercise peer pressure on others) and (iii) financial markets/asset owners (who should have an incentive to protect their wealth by pricing solvency risks appropriately but who also face asymmetric information and a monitoring problem).

Enforceability of fiscal rules has to be assessed as the result of a system of checks and balances whereby the monitoring efforts by the public and financial markets complement the incentives provided by fiscal rules. In the international “soft” law context, enforcement by political actors depends more strongly on the public and financial market signals than in a “hard law” environment. In a “soft law” environment, simple rules may be essential as they reduce transaction costs in the political market.

This claim is supported by anecdotal evidence. The public in particular only seems to take notice of issues that relate to easily understandable, simple, clear criteria as this is more compatible with high monitoring costs. One can observe that the public debate on the SGP does not focus on the intricacies of cyclical adjustment but only on the 3% deficit limit—one single number! Simple and transparent indicators also dominate the financial market debate on fiscal issues as these indicators allow participants to extract “signals” about the fiscal situation of a country. This reduces the risk of abrupt and seemingly “irrational” responses by financial markets. Monitoring by the public and financial markets that focuses on simple indicators can also be observed in other domains (unemployment, inflation). It is rational when considering transaction costs.

Complexity can also undermine monitoring and enforcement via conflicts over technicalities, discretion in the implementation, high transaction costs in terms of administration, abuse of the lack of clarity by politicians, surveillance fatigue and confusion in rather than supportive monitoring by financial markets and the public. Problems of moral hazard and asymmetric information could then be reinforced rather than solved.

The experience with the SGP again provides ample anecdotal evidence: the growing focus on cyclically adjusted balances (CAB) intended to deal with the criticism that nominal budget targets alone can promote unduly pro-cyclical policies. But the result of addressing this criticism has been a new problem: conflicts over the measurement of the CAB and of adjustment efforts. The discretion applied by the Commission in autumn 2003 by making the correction of excessive deficits contingent on growth also arose from economic arguments (as discussed in more detail below). But this step resulted in conflicts, confusion and growing doubts about the constraining effect of fiscal rules as it was felt that correcting excessive deficits was increasingly becoming an issue of discretion rather than automaticity.

The optimal degree of complexity is likely to depend very much on the institutional context in which the rules are embedded. It is likely to be lower in a “soft law” context where contracts must be self-enforcing and easy monitoring is key. In such an environment, enforceability and economic complexity of rules would conflict with each other. By contrast, rules that are enforced via a court or an independent arbiter, require legitimacy and a certain degree of immunity from opportunistic political attacks. Economic complexity is a way to gain such legitimacy and immunity. Higher monitoring costs do not matter so much because the public’s direct pressure on politicians becomes less relevant when enforcement is delegated. Complexity and enforceability then complement each other.

Figure 1 (see end of document) illustrates in a very simplified manner the optimality of fiscal rules in different contexts of enforceability. When rules are not enforceable they must be very simple so that monitoring institutions with high transaction costs can put pressure on policy makers. At the other end of the spectrum, well-enforced law may require complex rules to enhance their acceptance. The EU fiscal framework can probably be most fairly judged as lying somewhere in between the two extremes.

In light of these arguments, what should be done about the suggestions to make the rules more complex? The costs of accommodating some of these suggestions may be limited if they only concern the preventive arm with the close to balance provision. This is the part of the

Pact where some “fine-tuning” has already taken place and more discussion is provided in the next sub-section.

By contrast, the costs of “fine-tuning” are likely to become very significant when it comes to the excessive deficit procedure. Here the simplicity of the target (the 3% limit) is part and parcel of the public’s and markets’ ability to scrutinize policy makers. One should also not have illusions that further refinements bring much additional benefit in terms of securing sustainability. A fine-tuned deficit limit would suffer from serious measurement and agreement costs. Alternative measures of the deficit such as net borrowing requirements would invite circumvention into off-budget activities (such as debt-accumulation in public enterprises). Additional concepts such as public debt and contingent liabilities are also difficult to operationalise. We therefore conclude that the 3% deficit limit is not perfect but simple and conducive to strengthening enforcement of the sustainability-related component of the EU fiscal rules. There is nevertheless an important issue as regards the distribution of risk of non-performance in the context of the excessive deficit procedure and we will elaborate on this in the following as well.

#### **b. Complexity and risk allocation under the corrective arm of the Pact**

Complex fiscal rules can, *ceteris paribus*, be beneficial if they allow a desirable and more adequate fine tuning of fiscal behavior to circumstances. While the considerations of the previous section should be taken into account, the issue of fine tuning arises when it comes to analysing who should bear the risks/costs of non performance. Or in other words, should there be escape clauses for countries when it comes to correcting excessive deficits? What should be the borderline beyond which there are no excuses and the country should not be permitted “non performance”? These questions can be analyzed with the help of the above-mentioned principal-agent approach. This literature has analyzed contracting behavior under different assumptions about information and risk preferences.

One could characterize the European environment as follows: the fiscal contract is the SGP, the principal is the ECOFIN Council and the agents are the national governments. Moreover, the efforts exerted by governments to comply with the contract and eliminate imbalances is not fully observable (asymmetric information) and the outcome is to a certain extent uncertain (as there can be surprise developments that improve or worsen fiscal balances).

It is probably reasonable to assume that the agents/governments are “risk averse” and prefer lenient escape clauses from the rules so that they do not have to bear the full risk of budgetary outcomes not developing as planned. The reason is that this would imply much in year adjustment and negotiations with line ministries. However, the principal does not want to bear the full risk (and grant lenient escape clauses) as budgetary shortfalls could also be the result of insufficient effort and hence induce moral hazard.

In this environment, the optimum contract is a sharing contract. But which risk should be shared and how? As governments are not very able to affect economic growth in the very short run (one of the main factors determining outcome uncertainty) “insuring” them against this risk seems reasonable. But given that the effort is not fully observable, there is a significant risk of moral hazard if this risk is insured. Hence, effort related risk should remain with the agent/government. Of course, there are other surprises that may neither be due to effort nor to growth (e.g in the implementation of structural reforms). However, the impact of these other factors is often difficult to measure and to distinguish from effort. This risk is, therefore, probably also best born by the agent to prevent moral hazard. Putting it another way, budgetary shortfalls due to lower growth could be “insured” (and automatic stabilisers should be allowed to operate) while budgetary shortfalls due to other factors should not be excused and governments should secure additional safety margins, or take ad hoc measures or else face the consequences of non-compliance.

Nevertheless, even this kind of risk-sharing is problematic. Governments have an incentive to overestimate their economic growth outlook and then blame fiscal shortfalls on this channel (moral hazard). Governments may also face long periods of low growth where an insurance contract is not feasible because growing deficits would force the country to undertake adjustment even if such rules provide leeway. The reason is that continued and growing breaches of deficit limits would undermine the expectation of fiscal discipline and macroeconomic stability. Moreover, the measurement of the impact of the cycle is uncertain which, in turn, is likely to result in disagreements over contract compliance.<sup>13</sup>

These elaborations on balance have led some observers to argue that the “risk sharing” implicit in the SGP is appropriate. Excessive deficits have to be corrected in the year after its identification. Automatic stabilisers can operate when countries are close to balance or when following an appropriate adjustment strategy but not when needing to correct excessive deficits in a timely manner unless the existing escape clauses apply. Implicitly, this is the definition of

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<sup>13</sup> See Jaeger and Schuknecht (2004) or Eschenbach and Schuknecht (2004) for more detailed elaborations.

the borderline when concerns about anchoring expectations of fiscal discipline (and, thereby, sustainability and macro stability) become more important than risk sharing and “insurance”.

This line of reasoning is being questioned more openly in the published proposals to reform the SGP. Some countries try to renegotiate the risk sharing in the SGP contract by making the time frame for correcting excessive deficits more conditional on growth. As mentioned, this was already before well accepted for the close to balance provision as it supports stabilisation but not for the EDP where the risks to macroeconomic stability were considered more important than the desire for risk sharing. Moreover, there are efforts to tie the assessment of compliance to ex ante delivery of adjustment efforts instead of ex post outcomes. If measures do not deliver, countries would also get an exemption from their commitments. This approach is to be rejected because eliminating the ex post assessment of contract performance would give rise to a moral hazard problem (Inman, 1997).

The issue has also caught up with the corrective arm of the Pact. Although the excessive deficit procedure already grants a two-year period to correct excessive deficits the ECOFIN Council have in November 2003 extended this period to three years in the case of unexpected growth shortfalls (European Union, 2003). The ECOFIN Council conclusion (annulled in summer 2004) contained a further clause that made the correction of excessive deficits contingent to growth developments. In course of the debate, some observers have even argued that the effort risk should not be born by governments. While understandable from a risk-sharing perspective, more generous escape clauses that inevitably increase discretion under the excessive deficit procedure risk to make the 3% limit a moving target. Without clear time limit, the deficit limit would become non-credible, the anchor of expectations would be lost and sustainability would be perceived to be more at risk.<sup>14</sup>

When balancing these two objectives (risk-sharing versus anchoring of expectations) from a long term perspective, it is probably safer to err on the cautious side as regards sustainability and forgo some risk-sharing—and hence require a strict interpretation of the time limit of correcting excessive deficits.

### **c. Complexity and the preventive arm**

Many people accuse the Pact of not being sufficiently complex and fine-tuned. Many of these criticisms and proposals have merits when seen in isolation because if the economic

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<sup>14</sup> In other words, the application of the EDP (and ultimately the prospect of sanctions is not only at risk from non-application but from increasing discretion and a, perhaps well-meant, watered down application.

rationale or complexity of rules is enhanced, their acceptance and support by the public and policy makers rises (Sapir, 2004 et. al, Annett, 2004).

Following the arguments of the previous section, the opportunity costs of accommodating requests for complexity (in terms of simplicity) may be lowest if some of them are considered in the context of improving the implementation of the preventive arm. This way the economic rationale of the preventive arm is strengthened, the assessment of fiscal developments under this arm becomes less controversial. Valuable information is provided on the appropriate medium term benchmarks for sound fiscal policies.

One important shortcoming that refers to the implementation of the preventive arm of the Pact should be pointed out in this context. The implementation of this part of the Pact to attain “close to balance or in surplus” budgetary positions is governed by the Eurogroup agreement that was later confirmed in the spring 2003 ECOFIN Council conclusions (ECOFIN, 2003). It requires adjustment of at least 0.5% of GDP per annum for countries not close to balance or in surplus. However, by emphasising adjustment only when a country is in deficit and not limiting expansionary policies in good times, the agreement reinforces the asymmetric implementation of the Pact (i.e. only in bad times). Or in other words, symmetry should require to also limit expansionary policies to 0.5% of GDP in times of surpluses. This would help address one of the key concerns about the Pact.

Second, the way the agreement is interpreted and implemented, it is not time consistent and invites moral hazard. Insufficient consolidation in  $t_0$  does not require more adjustment in  $t_1$  and countries either have an incentive to ignore the requirement or overstate the impact of their efforts. Targets are only defined and evaluated ex ante (conditional consolidation). It creates incentives to overestimate the impact of measures as this makes the adjustment effort look bigger. And it induces countries to overestimate trend growth as this makes ex post slippages look like they are cyclical. The lack of ex post follow up and of a “catch-up” requirement, implies that the “close to balance” objective is in fact a moving target.

A more robust rule would require catching up of past shortfalls. One way to do so would be adding adjustment shortfalls in period  $t_0$  to that required for  $t_1$ . Another solution would be to move to proportionate adjustment (e.g. 1/4 of the total imbalance) so that shortfalls in  $t_0$  have to be recovered partly in  $t_1$ . Again, the rule should also operate symmetrically by limiting in the same way the amount of expansion that a country can undertake in good times.

However, changes towards more complexity would also render the preventive arm more unwieldy. More leeway would raise the risks of more frequent breaches of the 3% limit. Such costs would have to be counted against the benefits of more complexity.

## **5. Political interests in rule setting and the content and timing of reform**

### **a. Interests at the constitutional and implementation stage**

A final issue to cover is the interests of the actors that are involved in reforming the SGP and the impact this has on the content and timing of reform. For conceptual clarification, one can distinguish two levels of political decision making: the constitutional stage where policy makers decide about the rules of the game and the post-constitutional/implementation stage where policy makers “play” within the rules of the game (and comply or try to circumvent them). Interests may differ depending on the stage of the debate as will be discussed in more detail below.

First, there are the “vested interests” in complex rules.<sup>15</sup> Politicians may prefer complexity when this opens room for interpretation and discretion and renders a strict implementation more difficult (especially when they seek ways out of painful measures that the rules would require). Some academics may also have a stake. The assumption of government as a welfare maximizing, unitary agent in a significant share of the public economics literature (though extremely important for abstraction) almost by definition leads to “optimal rules” that are at odds with rather simple ones.<sup>16</sup> The administering agency (the Commission) may also not be immune to the fact that via complex rules it can gain more influence on the process and receive higher budgetary appropriations. This is not cynicism but normal self-interest (Niskanen, 1971). By contrast, financial markets and even more so the public, will have an interest in rather simple and clear rules due to transaction/monitoring costs and signal extraction needs, without, of course, ignoring economic rationale.

Incentives as regards enforcement are difficult to determine. At the post-constitutional stage, politicians are, as discussed above, interested in a “soft” application of the rules unless this risks a crisis/gross policy errors that have quick and significant spillover effects on interest rates, growth and stability. At the constitutional stage, politicians will want rules that secure

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<sup>15</sup> The same arguments apply not only to the rules but also to the underlying statistics and assessment methods. The more complex the data and the assessment methods, the more the involved actors can try to use this complexity to further their interests.

<sup>16</sup> Political economy analysis that takes into account the underlying political institutions and incentives has long taken a different view (e.g. Willet, 1999).

sound public finances and relatively efficient governments. But they will want the rules to bind the next rather than the current government (witness the lagged implementation of the Maastricht Treaty and SGP). And the subsequent government will then have an incentive not to comply.

Proposals for rule changes are likely to be determined by those with agenda setting power (the Commission) and influenced by those who affect the public debate (academics) and, most importantly, those who ultimately take the decisions (governments). Most of them, we argued above, want rather “complex” rules.

As regards enforcement, the Commission, who is the agenda-setter, will want strong provisions. The Commission may also have a preference as to enforcement via a centralized/delegation approach. If they can take this role, this certainly looks more desirable than one of being simply an assessment agency and “secretariat” for fiscal contracts between European countries.

The politicians’ interests are ambiguous. Unless they receive strong signals from the public and financial markets they will not want to strengthen fiscal rules (and, thereby, curtail their discretion). Only if there is a sense of urgency (e.g., due to a crisis), “constitutional thinking” emerges and more enforcement provisions may be desired. However, as of the autumn 2004 when this paper was written, there seemed to be no sense of urgency to strengthen enforcement. The financial environment was benign and other political pressures (towards tax cuts, elections) were also not conducive to strengthen fiscal rules.

## **b. Implications for dynamic rule implementation and reform**

Figure 2 illustrates how the constellation of political interests may have determined the implementation of fiscal rules in the EU. In the pre-EMU phase, the Maastricht rules applied. They were very simple and they were perfectly enforceable due to the EMU exclusion threat (point A in figure 2). With EMU entry and the application of the SGP, EU fiscal rules became both more complex and less enforceable. As the EMU entry threat fell, Council decisions remained as the only instrument to secure compliance and with it came the enforcement problems described above (movement to point B). In the period since the start of EMU, rules have become both more elaborate and less enforced (hence, the move to point C).

What are the implications for reforming the SGP? We had argued above that there is much interest in more complex rules. As this is a quasi-constitutional process, it is not clear

what the interests of players are as regards enforcement. But given the lack of urgency, there is little chance to move in that direction. The shaded area in Figure 2 reflects a stylized representation of the range of reform proposals and outcomes for EU fiscal rules after conclusion of the debate. If countries only agreed on more complexity without more enforcement they would move to point D in this figure.

Reforms and post-reform dynamics, however, are not independent. More complex rules are likely to raise the monitoring costs of the public and financial markets. Hence the “preference” of politicians (which is a function of public and financial market reactions) is likely to shift towards less enforcement. This argument is reflected in Figure 3. Starting from the outcome of the reform (point D), the equilibrium of implementation for the reformed rules would shift to point E (with less enforcement).

In summary, political economy incentives are likely to move the implementation of rules further away from simplicity and enforcement if the rules are rewritten in an environment where “constitutional thinking” is absent. Unlike in the late 1980s and early 1990s, in the environment of 2004, there is no “sense of urgency” to get the rules sufficiently enforceable to solve the above-mentioned spillover and prisoners dilemma problems. This holds the lesson that the timing to initiate reforms of rules should be chosen very carefully.

## **6. Conclusion**

This paper has analysed the EU fiscal rules from a political economy perspective and has derived some policy lessons. A summary of the literature on the political economy of deficits and debt reveals that fiscal policies in democratic societies are prone to deficit and debt biases. These can be exacerbated in a monetary union with decentralised fiscal policies. Fiscal rules can help solve deficit/debt biases and time inconsistency problems by constraining the behavior of policy makers. The paper also identified two other channels by which rules can affect fiscal policies. They can reduce fiscal policy biases if they reduce the transaction costs for financial market and public monitoring.

When characterizing and assessing EU fiscal rules based on the criteria identified in the literature a number of important features become apparent. By including ex post monitoring of performance, the rules contain an important prerequisite for effective implementation. However, the rules have a number of built-in restrictions to independent enforcement due to

national sovereignty over fiscal policies. Effective enforcement would then require that the rules are designed like a so-called self-enforcing contract.

Due to the restriction to enforcement, EU fiscal rules can also be characterised as “soft law”. This kind of law may not always prevent that the rules are bent, but they reduce political transaction costs (transparency, forum for peer pressure) and, thereby, help internalise strong spillovers towards preventing “gross policy errors”. Or in other words, monitoring by the public and markets can help make the rules/contract more self-enforcing. As long as countries are unwilling to give up sovereignty, enforcement can only be strengthened via a more consequential “contract” that countries take ownership in. Moreover, a strong and independent assessment and agenda-setting agency (i.e., the Commission) is desirable to strengthen transparency of public finances and accountability of countries.

An important characteristic of the Stability and Growth Pact that is frequently being debated is its simplicity. On the one hand, fiscal rules need to be complex and economically sophisticated enough to find political support. On the other hand, simplicity and clarity facilitate public and financial market monitoring. As regards this trade off, the paper argues that clarity and simplicity of rules are important especially when enforcement in the political process is weak, such as is the case with the SGP. It concludes that the 3% deficit limit should not be “fine-tuned” as it reflects the need for a clear and simple anchor of expectations and public monitoring.

Another important issue of debate has been the appropriate application of the escape clauses of the SGP. Some “insurance” against growth shortfalls is already provided for, e.g., in the EDP’s exceptional circumstances clause according to which deficits above 3% are not excessive in certain economic environments. However, fine-tuning the implementation of this limit to ensure countries against other risks (e.g. from ineffective adjustment efforts, adverse effects of structural reforms etc) are problematic due to moral hazard problems. The implementation must remain significantly strict to maintain the 3% limit as the nominal anchor of expectations of fiscal discipline and, thereby, sustainability.

The preventive arm of the Pact with its requirement of close-to-balance-or-in-surplus budgetary positions defines appropriate medium term budget positions and adjustment paths. This may be appropriately fine-tuned to address concerns about the Pact’s underlying economic rationale. For example, a symmetric application in good and bad times and less time inconsistency would be desirable.

Finally, the timing of a debate on fiscal rules needs to be carefully chosen. In the EU context (and perhaps in other contexts as well), there seems to be much inherent pressure to make the rules more “complex”. Moreover, for the debate initiated in summer 2004, there was also no willingness by countries to give up sovereignty nor was there a sense of urgency to strengthen public finances via tighter rule implementation and enforcement. In such an environment, it is likely that changes to fiscal rules make them more complicated, discretionary and, thereby, potentially less enforceable.

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Figure 1: Complexity and enforcement of rules under “soft” and “hard” law

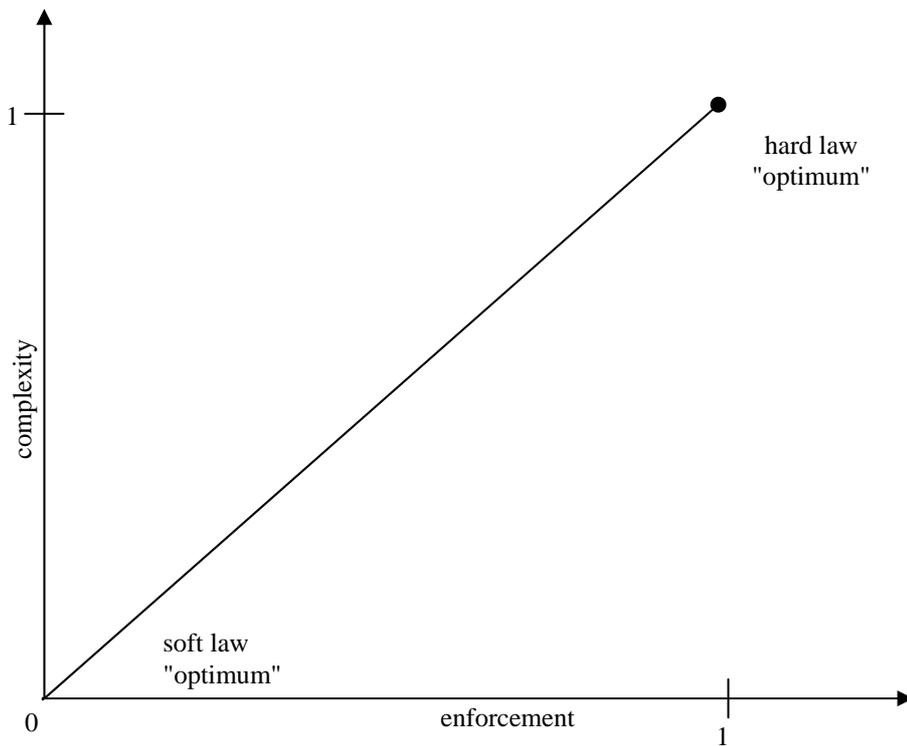


Figure 2: Dynamic implementation of EU fiscal rules, pre-EMU – post EMU entry – reform debate

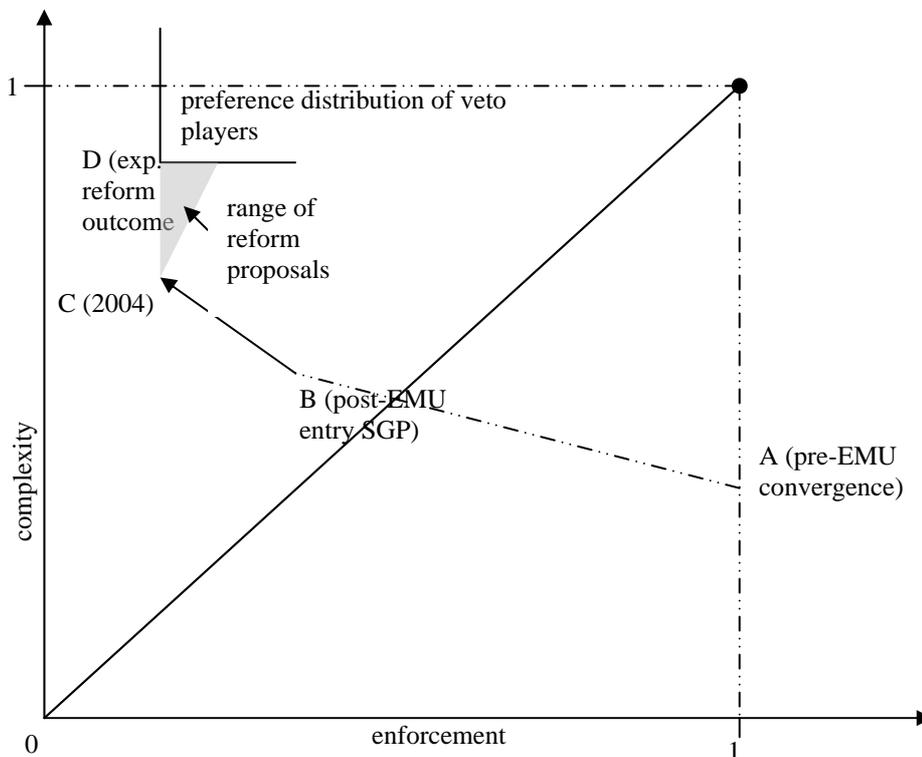
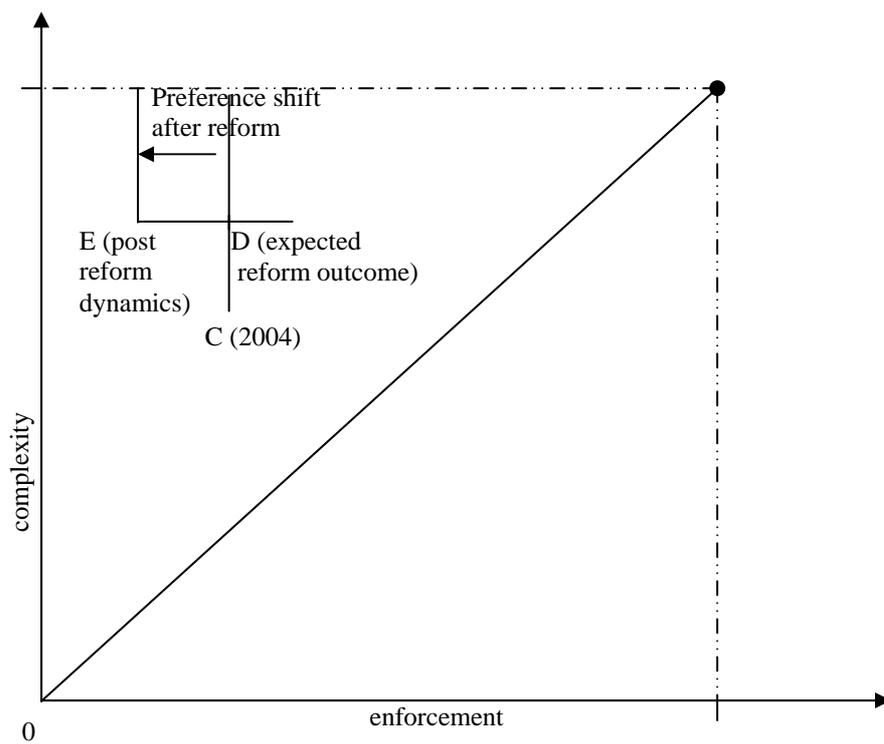


Figure 3: Reform and post-reform dynamics



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