

# **The Stability and Growth Pact: Enforceable, Flexible or Dead?**

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## **ABSTRACT**

The paper reflects the nature of the Stability and Growth Pact capturing its innovative essence as a 'more-than-federal' device, following an alternative classification I propose. This classification is based on a comparative method using other countries as case studies, seeking their main characteristics when the rules of fiscal discipline states have to comply with are concerned.

Then the attention shifts to a highly sensitive question – whether enforceability of the Stability and Growth Pact is the expected outcome. This is an important discussion since recent debates on the desirability to make the pact more flexibility fuelled intense controversy among scholars, member states and supranational institutions. Also recent events showing how key member states are unable to respect the rules of the pact feed further doubts about its strict implementation. Using several scholars' judgment that the pact's main shortcoming is its rigidity, the question is to know whether the pact is geared towards enforceability without any variation that undermines its original meaning.

The methodology uses three types of sources. On the one hand, a literature review emphasising the main theoretical conclusions that emerge on this issue. On the other hand the results of interviews carried over at the Commission, the European Central Bank and a sample of nine member states at the level of Finance and Foreign Affairs ministries. Some divergence is found between the solutions devised by academics and the answers given by practitioners. This gap is heightened by the third methodological element: an examination of national governments' recent performance in terms of fiscal discipline, as well as the reaction of the Commission. This is a crucial task for concluding about the likely fate of the Stability and Growth Pact.

## **1. Introduction**

The Stability and Growth Pact (SGP) was created to secure the political-economic orthodoxy supporting Economic and Monetary Union (EMU). This paper seeks to explain why the SGP is categorised as a ‘more-than-federal’ mechanism, something that goes well beyond other federations’ features when their fiscal architecture is examined.

Before showing the arguments for the ‘more-than-federal’ nature of the SGP, section two reviews the pact’s rationale. This exercise provides valuable insights to understand the qualification of the pact and its prospects for enforceability. Section three discusses the outcome of the SGP, notably if this fiscal rule is a roadmap for centralisation or decentralisation in fiscal policy. Section four focuses on the arguments enabling the ‘more-than-federal’ qualification of the SGP. Section five touches the sensitive issue of enforceability, because the possible qualification of the pact as ‘more-than-federal’ becomes threatened by the potential shortcomings arising from a non-enforceable scenario. Finally section six reviews recent events feeding the discussion surrounding the rationale and the prospects for a strict or flexible implementation of the SGP.

## **2. The rationale of the Stability and Growth Pact**

There are three different reasons lying behind the SGP: the first relates to the natural implication arising from EMU macroeconomic orthodoxy; a second reason accommodates member states’ interests on a supranational setting with deep fiscal externalities; and, thirdly, normative judgements supporting the existence of the SGP, as well its long-term consequences. These elements provide an analogy between the SGP and a human body: it is made of flesh (ideational beliefs underneath EMU), bones (the supranational setting), and blood (the long-term consequences of the pact, putting forward some unanswered questions).

Germany was the most vocal supporter of fiscal rules among those member states with sound fiscal policies. The result was the proposal laid down by the then German Minister of Finance, Theo Waigel, in order to extend the climate of sound fiscal policy beyond the

inception of stage three of EMU<sup>1</sup>. The SGP is seen as a case of strict *negative integration* because the underlying purpose is to establish the conditions under which unsound fiscal policies are not accepted within the Euro-zone. There is no additional effort to define what is the ‘appropriate substance’ required for member states’ public finances (Dyson 2000: 45).

The most striking reason supporting the maintenance of fiscal policy discipline relied on the need to avoid fiscal profligacy after the inception of stage three of EMU. Putting a stop on national fiscal authorities’ obedience to fiscal rules could bring a dangerous outcome, since

*(c)ountries going through the convergence game may act opportunistically, i.e., they may do this today so as to gain access later. Once they are in the Union, they will reveal their true preferences (de Grauwe 1997: 146),*

and these could be to loosen fiscal discipline. The first motivation of the SGP was the extension of fiscal policy discipline from stage three of EMU onwards (Issing 1996: 26, and Eichengreen and Wyplosz 1998: 75). It was backed by a strong rationale, notably the positive effects that fiscal policy soundness conveys both to EMU’s operation and for member states as coherent and efficient fiscal authorities.

Focusing first on the extent to which the SGP encourages EMU’s coherent operation, the belief is that rules should be enforced to cushion the negative effects from the imbalance between a supranationalised monetary policy and national fiscal policies (if they have different directions). It was feared that the ECB could be severely affected by the irresponsible fiscal behaviour of national governments. Consequently, the constitutional guarantees of political independence granted to the ECB and its embryonic credibility would be threatened (Padoa-Schioppa 1994: 168, Beetsma and Uhlig 1997: 2, Buti, Franco and Onghena 1998: 86, Artis and Winkler 1998: 87, and Eijffinger and de Haan 2000: 45).

The risks for credibility were real, particularly if the ECB was driven by political pressures to bailout profligate member states (Eichengreen and Wyplosz 1998: 71) or to loosen monetary policy, knowing in anticipation this doesn’t match the supranational

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<sup>1</sup> To see good historical records of the negotiations leading to the SGP, see de Grauwe (1997: 197), Heisenberg (1998: 270-7), Buti, Franco and Onghena (1998: 83-6), Walsh (2000: 157-9), Costello (2001: 106-36), and Stark (2001: 83-104).

bank's own preferences (Eichengreen 1998: 27, Beetsma and Uhlig 1999: 546, and Ardy 2000: 11)<sup>2</sup>. The SGP insulates the ECB from political pressures, helping the central bank to build its credibility and to anchor itself to successful patterns of independence (Wyplosz 1999: 13, and Virén 2001: 265). These fiscal rules reinforce the ECB and emphasise the dominance of monetary policy as the template for EMU's macroeconomic regime (Fitoussi and Creel 2002: 53-4). This enables the central bank to freely deliver monetary offsetting if the SGP is threatened by member states' fiscal indiscipline (Brunila, Buti and Franco 2001: 4, Collignon 2001: 24, and Tsoukalis 2003: 2). It is important to notice that the ECB has been a low-profile actor in this game. For the moment it is difficult to conclude what is going on with the SGP: it isn't easy to conclude whether the pact was being violated or just adjusted to a flexible operation. This can be the crucial yardstick to measure the prospective ECB reaction.

The second implication from the SGP is on member states when they act as fiscal authorities. Standing on the assumption that intense economic interdependence undermines national fiscal authorities' ability to run autonomous and efficient fiscal policies, the argument is that the SGP is a helpful device for improving national fiscal authorities' performance. With EMU member states lost monetary and exchange rate policies as instruments for macroeconomic adjustment. They only keep fiscal policy. This means that national governments face increasing obstacles to neutralise country-specific shocks. As a result, national governments are forced to improve the efficiency of fiscal policy. For that purpose they are challenged to build an insurance margin to tackle the effects of an asymmetric shock (Apelt 1998: 134, and Gramlich and Wood 2000: 13-4). The rationale behind the SGP is that '*(...) strong fiscal discipline in good times goes hand-in-hand with fiscal stabilization in bad times*' (Artis and Buti 2000: 568).

The recent experience might reflect the need for enhanced fiscal discipline at the national level. National governments must be aware that fiscal laxity during a boom is not a

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<sup>2</sup> Pegging to the same line of reasoning, de Grauwe argues that the final result is likely to be the opposite. From the moment the ECB has no option other than loosening the monetary policy against its own will, this reveals a situation where the SGP can paradoxically expose the ECB to more political pressures and hence to diminish its political independence (de Grauwe 1997: 207). An opposite perspective was conveyed by a majority of the officials interviewed: the SGP constitutes another element supporting the status of political independence enjoyed by the ECB. Without the SGP national fiscal authorities could easily derail in terms of fiscal policy, with the implication of increasing political pressures on the ECB.

reasonable option (Korkman 2001: 308). The unwillingness to avoid expansionary fiscal policies during booms might explain the fiscal profligacy that some key member states currently face. The absence of prudence when there is an upswing exacerbates trouble when recession hits the ground. Then it is more difficult to respect the SGP.

The final justification for the pact comes from normative judgments that strengthened the faith on fiscal soundness. Borrowing from the public choice analysis, some scholars claim that the pact was necessary to avoid the problematic lessons from the past, notably the detrimental effects ensuing national governments' irresponsible fiscal behaviour. The SGP is normatively interpreted as a valuable external constraint in the face of national governments' deficient performance in the fiscal arena (Buti, Franco and Onghena 1998: 86-7, Artis and Winkler 1998: 90, and Cukierman 2001: 12). Furthermore the SGP was shaped to protect taxpayers' interests against the misbehaviour of national fiscal authorities (Dyson 2002: 352).

Keeping the public choice reasoning in mind, it is instructive to assess past experience in member states. The conclusion is that politicians have a strong incentive to devote their priorities to short-term solutions in order to solve long-term problems; and even to short-term targets, the ones they admittedly recognise that impact on their performance (Healey 2000: 25, Dyson 2000: 31, and Loedl 2002: 128-9). By implication, politicians face the temptation to run excessive deficits as an attempt to extend their staying in office – notably because the public's perception is directed towards the short-term effects of policy-making, disregarding its long-term effects (Beetsma and Uhlig 1997: 2, Watson 1997: 109-13, and de Sousa 2001: 3).

This approach is rejected by the SGP, because national fiscal authorities are forced to behave with responsibility. As a result, the quality of national fiscal policies is likely to increase, as there is a diminished room for mistakes (Virén 2001: 259). The pact also stops national governments from imposing serious constraints on their successors by relaxing fiscal policy with the aim of creating difficulties to those who come into office after them (Beetsma and Uhlig 1999: 548).

Still on a public choice reasoning, the SGP has inter-generational impacts. Some critics argue that the SGP should be relaxed in order to accept a golden rule allowing investment

expenditures not being considered for measuring a member state's deficit (Apelt 1998: 153). This proposal is rejected with the argument that investment expenditures should be financed through current revenue, because the SGP is a stimulus to drive the burden of capital expenditures away from future generations to current taxpayers (Buti, Franco and Onghena 1998: 94, Balassone and Franco 2000: 209, and Buti, Eijffinger and Franco 2003: 17-8).

### **3. The Stability and Growth Pact: towards centralisation or decentralisation?**

From the public choice reasoning important implications arise for the position of the SGP in terms of centralisation/decentralisation. I assume that when national governments' powers are curtailed, and this does not mean an increase of supranational institutions' powers, the result is the empowerment of civil society and markets (Przeworski 2003). When this reasoning is applied to the SGP the conclusion is that the pact is strongly oriented towards decentralisation. Consequently *the SGP implies less state and more market, as it reinforces civil society's guarantees against the intrusion of excessive and irresponsible (national) governments.*

The question of whether the pact includes a centralist or decentralist nature also sheds light on another important dimension: *whether the SGP undermines national governments' ability to play a stabilisation role.* Several criticisms against the SGP give emphasis to this argument, saying that the pact prevents national governments from achieving stabilisation. Member states lost monetary and exchange rate policies and this constitutes a powerful reason for making national fiscal policy more flexible than allowed by the SGP (de Grauwe 1997: 206, Begg and Green 1998: 16, Fátas 1998: 191-2, Majocchi 1999: 92, McNamara 1999: 471, Eichengreen 2000: 96-7, Jacquet and Pisani-Ferry 2001: 7).

Against this common wisdom other scholars suggest that the pact doesn't curtail member states' ability to play a prominent role in macroeconomic stabilisation. On the contrary, *the rationale of the SGP is to enhance the performance of fiscal stabilisation at the national level.* In fact,

(...) *fiscal consolidation might be necessary precisely in order to regain room of manoeuvre that allows automatic stabilizers to operate effectively* (Artis and Winkler 1998: 92. My emphasis).

If the political-economic orthodoxy of EMU is oriented towards sound money, fiscal policy shouldn't be allowed to interfere with the goals of monetary policy. This acknowledgment bears the recognition that fiscal policy can jeopardise monetary policy goals. These are the reasons why national fiscal policy must respect stringent rules. The assumption of this political-economic template brings another explanation for the SGP: the pact leads to fiscal policy soundness, uncovering the message that member states should follow precautionary fiscal policy that accumulates public resources in upswings enabling national governments to tackle downturns (Artis and Buti 2000: 566). The SGP acts as a *safety net* driving national governments towards surplus or close to balance budgets when there is a prosperous business cycle, while allowing them to reach the GDP 3% deficit ceiling in times of hardship (Artis and Winkler 1998: 92).

The teleology of the SGP allows a flexible operation of national fiscal policies – of course, within the quantitative ceilings defined by its rules, and as long as national governments stick by the rules they created (and agreed with) in the past. As long as member states stick by the pact's rationale, it is easier for them to let automatic stabilisers work when their operation is mostly needed, that is, in the event of downturn. Instead of viewing the pact as the death sentence for national governments' ability to use automatic stabilisers, the SGP eases national responses (at least in theory) (Gramlich and Wood 2000: 13-4, Ardy 2000: 6, Brunila, Buti and Franco 2001: 9, Cabral 2001: 156, Issing 2002: 60, Huhne 2002: 119, Rhodes 2002: 309, and Breuss 2002: 60)<sup>3</sup>. This conclusion is not confined to the theoretical dimension. A small proportion of the practitioners interviewed (17%) also acknowledged this essence behind the SGP.

Assuming that the pact's intentions were the aforementioned, the SGP contains inherent aspects of functional decentralisation. Here the extent to which centralisation and decentralisation are assessed dwells on the relationship between supranational and

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<sup>3</sup> An opposite opinion stresses the infeasibility that national automatic stabilisers work efficiently under the SGP (Beetsma 2001: 36, Canzoneri and Diba 2001: 56, Casella 2001: 395, and Fitoussi and Creel 2002: 57-8). But probably the issue is overstated in this heated debate, as some authors call the attention that automatic stabilisers are ineffective in the event of a supply shock (Barrell, Hurst and Pina 2002: 94, and Brunila, Buti and in't Veld 2002: 417).

national levels of decision-making. Considering that national representatives within the European Council sanctioned the rules of the pact; being true that the Commission has a strong role in triggering the procedures when a member state infringes the rules of the pact; the fact is that *the final say is on member states' finance ministries*. For all these reasons I conclude that the pact promotes the decentralisation of fiscal policy, moreover because member states are still endowed with a considerable room of manoeuvre to undertake fiscal policy engineering (that is, where to spend and how to tax) (Artis and Winkler 1998: 92, and Balassone and Franco 2000: 208)<sup>4</sup>.

#### **4. The qualification of the Stability and Growth Pact: non-federal, federal, or more than federal?**

It is important to see whether the SGP adds some more pieces to the federal qualification of EMU, especially after concluding that the pact emphasises decentralisation. In the European integration context there are strong reasons to take this task seriously, as the SGP is a central piece in EMU's operation. It is useful to pay attention to McKay's words as the starting point for developing this issue:

*(...) EMU member states will find themselves in more fiscally constrained than the American states, for the (...) Stability Pact requiring fiscal rectitude will be imposed centrally. Fiscal discipline in the American states, including constitutional prohibitions on deficit financing, are imposed locally, not by the federal government (1999: 134). Unlike the states in many federations (...) central authorities have placed a fiscal straightjacket on member states. Individual countries suffering from localized recessions will be deprived both of traditional monetary and exchange rate stabilization devices, but they will also be constrained fiscally (1999: 150).*

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<sup>4</sup> Intriguingly, Artis and Winkler (1998: 95) argue that the final balance of the SGP entails a clear-cut example of 'transference of sovereignty' from the national towards the supranational level. They claim that national governments are no longer able to autonomously design their fiscal policy preferences. This position is the opposite of decentralisation. The mere fact that member states lost power to the supranational sphere can be interpreted as an evidence of centralisation.

In my opinion Artis and Winkler seem to fall into a trap for dealing with political science concepts. They miss an accurate concept of sovereignty; furthermore, it is wrong to assume that member states lose powers just because they tie their hands in this process of fiscal policy tightness that is formally supranationalised, but whose procedures depend on national representatives' decisions on the Ecofin. A final remark to the incoherence revealed by these authors: they claimed that member states 'regain' (as I emphasised before, in the quotation) room of manoeuvre in what concerns the efficient operation of automatic stabilisers; how do they realise, later on, that the SGP meant a transference of sovereignty from member states to supranational institutions?

Standing on a comparative perspective, McKay focuses mainly on the US federation and concludes that, unlike this federal state, fiscal discipline in the EU depends on a central (supranational) decision-making process (also Beetsma 2001: 26). From this viewpoint there is no parallel between the SGP and other measures devised to get states fiscally sound in federal states (also Szasz 1999: 155, Eijffinger and de Haan 2000: 89, and McKay 2001: 139). Therefore a possible conclusion is that the SGP is not federal at all.

My source of disagreement emanates from the absence of centrally managed fiscal constraints on national governments in the EU. As it was emphasised in the previous section, the decision-making process involved in the SGP is decentralised because in the end national representatives play a prominent role within the Ecofin. Assuming that the Council is a supranational institution encompassing intergovernmental vested interests, it is more important to ascertain its goal nature (intergovernmental, thus decentralised) than its mere formal clothing (supranational, akin to centralisation).

The argument that fiscal discipline is included in supranational rules (be it the Excessive Deficit Procedure as a para-constitutional rule, or the SGP as a supranational ordinary rule) is ruled out as the evidence that the imperative of fiscal soundness comes from the centre and not from member states. The most powerful evidence is the means through which both constitutional and ordinary rules laying down the foundations of fiscal policy discipline were created: the initiative came from national governments and member states gave their consent. Aside this input dimension one cannot ignore that, on the output side, national governments have the final say when the implementation of the pact is assessed. Here again a cornerstone of decentralisation is at stake, denying McKay's perception. The rejection of McKay's assessment disregards the possible qualification of a 'non-federal' device for the SGP. On the opposite side stood a large number of practitioners interviewed (43%) who accepted the dissociation between the SGP and federal elements.

Two other possibilities remain open: the SGP as a federal instrument, or even more ambitious than that, a 'more-than-federal' connotation. The recognition that the SGP includes a decentralisation characteristic makes it very similar in nature with other federations where states also face binding rules geared towards fiscal discipline. Viewed from this angle, the SGP can be classified as federal. The instructive finding from the

interviews is that the number of answers that accepted the federalist label of the SGP was not far away from the majority perception that federalism and the pact are dissimilar (35% against 43%, respectively).

However the judgment must be extended to examine the extent to which pecuniary sanctions fit with the environment of fiscal discipline in other federations. Here lies the dissimilarity between European integration and other federations. The limits on deficits and public debts that member states face through the SGP are more accentuated than in other federal states, because *no comparable mechanism of pecuniary sanctions exists elsewhere* (Costello 2001: 126, and McKay 2002: 88). The conclusion is that the SGP, as a proxy of fiscal policy discipline, goes beyond other federal countries' established patterns. By implication, my claim is that *the SGP is a 'more-than-federal' device*<sup>5</sup>.

The problem with this theoretical proposition is the low enthusiasm among the interviewed practitioners (only 13% of the answers). This alternative seems neglected mainly by national representatives (only one among the eighteen persons interviewed at that level). The same doesn't happen with the Commission, where half the respondents accepted such classification. Probably the explanation for the absence of such common denominator is the interviewees' own perception of federalism. Before answering the question few asked me what was the conception of federalism used, while the large majority took it for granted their particular understandings that certainly reveal some differentiation if one covers the widely divergent frameworks beneath all people interviewed.

This confusion arising from the analysis of data is telling of how difficult it is to reach an uncontested symbology of the SGP. I find it very difficult to achieve a consistent conclusion from the practitioners' answers. By implication, I don't find reasons to reject the 'more-than-federal' alternative because there were some answers accepting it.

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<sup>5</sup> I find this qualification rather similar to the one proposed by Balassone and Franco (2001a: 52) – of a 'radical federation'. They emphasise that '*(t)he solutions adopted in several countries with federal structures are more flexible than the rules defined (...) in the Stability and Growth Pact*' (Balassone and Franco 2001b: 602).

## 5. The prospects of enforceability of the Stability and Growth Pact

Before the first serious blow on the SGP (Ecofin meeting of 24 November, 2003, allowing France and Germany to escape pecuniary sanctions), scholars were involved on a discussion about the enforceability of the pact. A vast majority of scholars anticipated that the SGP will not be respected by member states. In general, it was argued that

*(...) enforcement of the pact will be relatively loose, but still tight enough to affect some member states' deficits. EU officials will be reluctant to levy fines and lose good will. Member states will be reluctant to incur fines and suffer embarrassment. As in most EU affairs, a negotiated settlement just acceptable to both sides is the likely outcome EU decision-makers will compromise, allowing the 3% ceiling to be violated. Governments will compromise, eliminating deficits that egregiously violate the Stability Pact. They will modify their fiscal policies just enough to avoid forcing their neighbours to impose fines (Eichengreen and Wyplosz 1998: 101).*

As all that it is going on in European integration calls for intense negotiations, at the end of the day it is highly feasible that the pact is going to be breached. Four arguments support the belief that the SGP would not be enforceable:

- i) Considering that the rules of pact are so stringent to member states, it was anticipated that inter-state solidarity would emerge when the prospect for fining a certain member state is discussed. Accordingly, it would be difficult to reach the necessary qualified majority threshold in the Ecofin because member states collude with each other. Each fears that in the future it can slide into the position of a profligate member state, being at the mercy of other countries' decision (de Grauwe 1997: 208, Harrop 2000: 222, and von Hagen 2003: 8). This is especially likely in the event that several member states simultaneously face the prospect of being fined for having an excessive deficit (Eijffinger and de Haan 2000: 93). Furthermore national governments can insist rhetorically that they are facing huge difficulties at home because the rules of the SGP prevent a different fiscal policy approach. If this message touches the public's sensitiveness huge pressures might be exerted calling for the non-enforceability of the pact. In this case it was expected that inter-state solidarity works against the respect of the pact (Eichengreen and Wyplosz 1998: 68). Alternatively, if several member states' electoral cycles are synchronised the likelihood of breaching the pact's rules is higher (Dyson 2000: 22, and Hodson and Maher 2000: 18).

- ii) The rules of the SGP are so inflexible that member states face a strong incentive to cheat (Leslie 2000: 205). Tactics like creative accountancy and off-budgeting are likely to increase. Member states will then respect the quantitative targets imposed by the pact, even though this is accomplished through cheating that hides these countries' actual situation (Person, Roland and Tabellini 1996: 14). Moreover the SGP depends on a complex procedure that must be implemented when pecuniary sanctions are at stake. This paves the way for political compromise allowing member states to escape fines (Beetsma 2001: 37, and Casella 2001: 395).
- iii) The prospect of non-enforceability is higher as more cases of asymmetric shocks come to the surface (Hodson and Maher 2000: 18).
- iv) The SGP has an important flaw – its institutional weakness arising from partisan implementation. In fact the same people responsible for breaching the SGP rules (as they design and implement national fiscal policy) judge whether the fine should be implemented to the profligate member state (Eijffinger and de Haan 2000: 92, Strauch and von Hagen 2001: 478, and Buti, Eijffinger and Franco 2003: 5-8). The implication is the low feasibility for implementing pecuniary sanctions to those member states that violate the rules of fiscal discipline (Person, Roland and Tabellini 1996: 14)<sup>6</sup>.

Against this sceptical view comes the perception that member states and supranational institutions are deeply committed to make the rules of the pact respected by all. The rationale builds on a rational choice perspective emphasising four arguments for the enforceability for the SGP. Firstly, *national governments don't act as rational agents if they know in anticipation that the rules of the pact can be easily violated without triggering the sanctions* (Wyplosz 1998: 7, and Buti, Franco and Onghena 1998: 95). It is unwise to envisage a scenario where the rules of the pact were created and the actors

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<sup>6</sup> Buti, Eijffinger and Franco (2003: 27) prefer a non-partisan external enforcer solution, with an independent power to the Commission on technical issues. In the second stage the Council takes political decisions about the measures devised to curb and monitor an excessive deficit. Finally there is a shared power when the implementation of sanctions is at stake: the Commission delivers a proposal (and not a mere recommendation), and the Council decides by unanimity if this institution refuses the Commission's proposal. Another, more radical proposal owes to Uhlig (2002: 29). It consists of automatic implementation of fines, removing the participation of the Ecofin in the decision-making process related with the SGP.

involved know from the outset that these rules can be breached because national governments will be tolerant and won't be willing to implement the pecuniary sanctions.

In this case, an unreasonable outcome emerges: what was the aim of member states' governments when they reached a consensus to launch the SGP if they knew the rules can be violated without leading to the implementation of sanctions? Is it reasonable that the SGP only encompasses preventive rules pushing national governments away from unsound fiscal behaviour, but at the same time the political conditions are not met for making dissuasion effective (Apelt 1998: 135)? Would this outcome be harmful because it hurts the Euro-zone's credibility vis-à-vis markets, especially from the moment that markets become aware of national governments' unwillingness to abide by the rules they have created in the past (Beetsma 2001: 32, and Strauch and von Hagen 2001: 479)? All this suggests member states' governments have strong reasons to push for a scenario of enforceability.

This was asked to the national and supranational representatives interviewed. The awareness that the SGP only includes a preventive dimension was the answer that largely matched the respondents' opinion (65%). Some officials (22%) argued that both the preventive and the dissuasion dimensions are equally valued when the SGP is envisaged. Taking these results into consideration, I recognise that the feasibility of strict implementation of the SGP faces serious hurdles. Consequently there is scope to review these propositions, or at least to scale down the conclusion that all conditions meet to make both the preventive and the dissuasion dimensions successful when the implementation of the SGP is at stake.

I have to raise some doubts to my initial proposition because national governments are considerably empowered in the final stages of the SGP, and a large proportion of national representatives interviewed (78%) stated that prevention is more valued than sanctions. Nonetheless, the questionnaire included other questions designed to consolidate practitioners' opinion on how enforceable the SGP might be. These questions work as an additional test to corroborate or invalidate this conclusion – and they will be incorporated later.

A second reason adds to this persuasiveness. Those national governments with sound fiscal policy shoot in their foot if they agree with other member states' violation of the rules. This sounds like self-punishment behaviour for those member states who probably took huge sacrifices to achieve fiscal consolidation (Buti, Franco and Onghena 1998: 95). From a rational choice approach, it is hard to find a motivation that leads these member states to easily accept the non-enforceability of the pact. In the end of this process the decision of rewarding the bad student by those who behaved well conveys an unreasonable solution. Theorisers of international relations would easily show how governments don't have this propensity for a masochist self-punishment.

Some striking results from the interviews come to the surface: 48% of the people interviewed concluded that when objective conditions meet the SGP should be geared towards the implementation of pecuniary sanctions; and only 9% of the answers revealed an opposing preference, ascertaining the likelihood that national governments will act in collusion to prevent the implementation of sanctions (the remaining 43% of answers dispersed among residual options). *The relevance of these findings is that they act as counter-factual evidence. On a previous question a large majority of the people interviewed acknowledged the prevention dimension as the most prominent feature the SGP, thus underestimating the implementation of sanctions; now the findings for another question show the opposite – that the majority of the respondents concluded that national governments possess a strong incentive for voting in favour of the fines proposed when conditions meet for their implementation.*

Thirdly, since the rules of the SGP include an early warning mechanism (when a member state deviates from the targets included in its national convergence programme), this member state has a strong incentive to make an additional effort for getting in line with the target previously defined. Otherwise this member state is under the shame of being named by the Commission (thus jeopardising its position vis-à-vis their citizens and the markets) and is monitored by the Council (Canzoneri and Diba 2001: 72, and Beetsma 2001: 32). In theory, this system of surveillance is a powerful device for each member state respecting the conditions settled down in the SGP – and thus sheds light on additional evidence of how the pact can be enforceable (Buti, Franco and Onghena 1998: 95-6).

Obviously practice sometimes doesn't go hand in hand with theory. The turmoil created with the reiterated excessive deficits in France and Germany (see below) shows that at least these member states didn't eat the carrots provided by the rules of the SGP (particularly the effects created by the early warning). Stronger reasons lie behind this behaviour, since both member states certainly relied on their far-reaching influence within the EU to push towards a flexible solution. The implication is that the aforementioned carrots only seem to work for those member states whose influence is lower. The problem with this interpretation is the asymmetric implementation of the pact, creating discriminations between the member states. I will get back to this issue in the end of this sub-section.

Finally it is important to realise that the SGP became EU secondary law. Consequently it is triable before the European Court of Justice (ECJ) (Stark 2001: 104). The first manifestation was given by the Dutch Government willingness to take the Commission to the Court if this institution refused to issue recommendations suggesting that fines should be paid by Germany and France<sup>7</sup>. Later, following the Council deliberation that avoided the implementation of sanctions to those countries, again the Netherlands threatened with action before the ECJ. The Commission also considered this option for some time, although its reaction was somewhat dubious and muddled.

In addition to these arguments, another one lacking the same persuasiveness is put forward. In a rather naïve reasoning, it is claimed that the pact meets the requirements of enforceability for the simple reason that national actors accept the values embedded in the rationale of fiscal discipline. National governments are committed to respect the rules of the pact because they recognise sound public finances constitute an ideational value underpinning European monetary integration (Ardy 2000: 12, and Wessels and Linsenmann 2002: 68). Nevertheless a shortcoming comes to the surface: since a majority of member states was not used to live with fiscal policy discipline, it is hard to convince national citizens that times have changed and discipline is now the key value to watch for (Laffan 1998: 246).

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<sup>7</sup> According to news published in September 11<sup>th</sup>, 2003 (in <http://www.euractiv.com/cgi-bin/cgint.exe/1?204&OIDN=1506165>).

Another set of arguments pointing to enforceability starts from the assumption that the ECB is committed to loudly show its political independence. It is suggested that *member states themselves will create the conditions for an enforceable SGP*. In fact, the ECB can perform the role of a watchdog of the pact's enforceability. Faced with the prospect of one (or more) member state(s) being unable to obey the rules of the game, and anticipating that situation will bring unwanted effects for the overall macroeconomic goals of the Euro-zone, the ECB can react vigorously. If the supranational central bank concludes that the violation of the SGP entails a negative externality with inflationary effects, it can mitigate that externality channelling the inflationary effect to the remaining (well-behaved) member states (Ardy 2000: 12-3). These member states face a strong incentive not only to respect the rules of the pact but also to enforce them when a certain member state threatens to insist on excessive deficits (Beetsma and Uhlig 1999: 548). In this context, the SGP is like a 'collective public good' that ensures externalities arising from a national government's fiscal profligacy won't hurt those member states who managed to stick by the rules of fiscal discipline (Balassone and Franco 2001a: 52-3).

Among those practitioners who acknowledged that the ECB can react through monetary policy offsetting, some (18%) emphasised this is the best illustration that the pact would be enforceable. The behaviour of the ECB is pictured as a kind of pressure on national politicians to get back to their previous commitments about fiscal discipline. Denying the common wisdom that conflicts will happen between the ECB and national governments as a whole, other officials (8% of the answers) anticipated that such divergences will take place among member states. Sound member states will feel the unfairness of being affected by higher interest rates dictated by the ECB and will put pressure on the profligate member states (and not to the ECB) in order to comply with the rules of the pact.

## **6. How to interpret recent events affecting the operation of the Stability and Growth Pact?**

Recent events fed the intensity of the debate about the enforceability of the SGP. Some of these events took place on a single week (14-18 July, 2003), indeed a ‘crazy week’ for those persons interested in EMU developments.

On 14 July, 2003 the French president, Jacques Chirac, plead for a flexible SGP. This was required, according to Chirac, to avoid a harmful effect arising from the pact: it prevents economic growth that is necessary to overcome the damages of the downturn suffered by the European economy. One must be aware of the specific context in which Chirac called for a flexible SGP. On the one hand, France was facing huge difficulties to avoid an excessive deficit. Recent official data clearly announced this member state would go into fiscal profligacy for the third consecutive year, thus putting France on the road of pecuniary sanctions. On the other hand, Chirac’s statements were made on the French national holiday, the Bastille Day. The huge symbolism is inexorable, considering that nationalist feelings are more embedded in people’s behaviour. The two aspects taken together might explain the specific context of Chirac’s statement.

Taken in isolation, this opinion brings out the perception that the strict enforceability of the SGP was facing serious risks. France is a leading member state in European integration and at the same time was facing severe hurdles for putting fiscal policy in line with the pact’s requirements. Bearing in mind that the other main locomotive of European integration (Germany) was also dealing with the same problems, Chirac’s statements were the first serious call for a flexible SGP. Nonetheless the German counterparts gave no feedback to Chirac’s plea.

On the day after Chirac’s statements another development came against the scenario of non enforceability: at the end of an Ecofin meeting *all* finance ministers (including the French) reassured their commitment to a strict operation of the SGP, without any changes towards flexibility. This was an interesting development for several reasons. Firstly, it constituted a formal de-authorisation of the French president coming from the college of member states’ finance ministers. This might be the evidence that finance ministers were then more committed to the pact than the French president. It reflected the

acknowledgement that the former were technically motivated, and thus showed their willingness to respect the pact, while the latter was politically concerned with the short-run political damages from the implementation of sound fiscal policy as established in the SGP.

It is remarkable that the French finance minister didn't agree with his President view. Such differentiated behaviour heightens an interesting domestic conflict revealing again the different perceptions (expert-led, and politically motivated) coming out from contrasting opinions about the pact. All in all, this episode showed a clear-cut message coming from finance ministers: that the SGP should be taken seriously in its current clothing, even though some member states were facing trouble for breaching the GDP 3% deficit ceiling. The meeting of the Ecofin Council on 15 July embodied a strong political message of commitment vis-à-vis the SGP, as this message came from those actors (national governments) who are generally seen as the main focus of reluctance for accepting the whole implementation of the SGP. Nonetheless this consensus proved short-lived as subsequent events forced a split within the Ecofin Council (see below).

Maybe this event corroborates the perception that *'(...) both France and Germany have too much to lose from abandoning EMU or from undermining it. (...) Franco-German economic relations will continue to lie at the centre of Europe and their economic self-interest will remain a primary motivation for EMU'* (Jones 2002b: 164). Viewed from this angle, it is unreasonable to anticipate how these locomotives of European integration can put at risk monetary union (and the ongoing discussions in the Intergovernmental Conference about the Constitution of the EU) because of the short-run difficulties both face on the fiscal arena. It would be imprudent to damage a project that was accomplished after a tough transition period just for the sake of short-run considerations that neglect the interests of a vast majority of member states.

Surprisingly the European Commission threw more fuel into the fire at the end of the same week. In 17 July the Sapir Report (Sapir et al. 2003), made on behalf of the Commission, was released. Notwithstanding the different reactions from commissioners (from severe opposition, to muddled reactions made of partial refutation and partial acknowledgment, to Romano Prodi's silence), it is undeniable that this report was

sponsored by the Commission and, to a certain extent, this institution is committed to its outcome. Among other things (not relevant to the issue under discussion), the Sapir Report concluded how indispensable it is to make the SGP more flexible, notably by loosening the exceptionality clause that enables a profligate member state to avoid the pecuniary sanction. According to the report, whenever negative growth hits a member state this condition should be enough to allow such country to automatically escape the sanctions envisaged by the pact.

To add more confusion, on 18 July the president of the Commission gave an interview emphasising that the rules of the pact should remain as they are. The maximum extent of flexibility must cope, on Prodi's opinion, with the proposal submitted by the Commission on 27 November, 2002 (Commission of the European Communities 2002). The president of the Commission moved away from some of the conclusions of the Sapir Report (those concerned with the SGP) on the day after the report was unravelled. How can this be interpreted? That the Commission does not support the view adopted by the Sapir Report on behalf of a flexible SGP? Hence, that the Commission stands firmly rooted on a strict enforceability of the pact?

These questions cannot be answered in a clear-cut way. Indeed in the same day Prodi's interview was published he went to Berlin and met with the German chancellor, Gerhard Schröder. On the top of the agenda was the issue of how to make the SGP operational in the face of the severe economic downturn affecting the European economy. The doubt is whether these talks between the president of the Commission and the German chancellor were motivated by the aspiration of making the SGP more flexible. All in all, the two largest national economies of the Euro-zone were facing trouble for sticking by the rules of the SGP. This is somehow consistent with the claim that a *syndrome of asymmetry* affects the operation of the SGP: the pact works well for small member states and not that well for the largest member states (Buti and Giudice 2002: 838, and von Hagen 2003: 22-3).

In mid-October 2003 the French government announced what was already expected: another year of excessive deficit. Furthermore this member state finance minister, François Mer, declared that France was not willing to pay the fines of the SGP because

this damages the goal of promoting economic growth. It is clear that France has revealed its preference for economic growth and is decided to sacrifice the goal of fiscal discipline. The Commission's first reaction was prudence, despite some threats that it would trigger the procedure that might lead to the implementation of pecuniary sanctions. This institution was aware that political turmoil must be avoided. Otherwise the Euro-zone credibility might be in danger. Nevertheless the Commission was definitely caught in a trap: between issuing a recommendation suggesting the implementation of pecuniary sanctions, and thus enforcing the pact's rules; and the tactical caution that acknowledged the unwise solution of enforcing these sanctions.

At the end the Commission decided to issue a recommendation favouring the implementation of sanctions if France was unable to curb the excessive deficit by 2005. The Ecofin meeting on 24 November, 2003 was planned with the purpose of deciding whether pecuniary sanctions should be implemented to France and Germany, because these member states presented an excessive deficit for the third consecutive year. After a first meeting in the 4<sup>th</sup> November, the Council postponed its final decision after the split between national ministries. The Netherlands, Austria and Finland reacted vigorously against the possibility of granting France an extra year for bringing down the deficit. Dutch and Austrian officials' statements were instructive of how these member states opposed any outcome that accepts a flexible solution to the French and the German cases. The Austrian finance minister, Karl-Heinz Grassner, emphasised the politics behind the economic decision: *'(i)t's a question of how the big countries are treated and how the small countries are treated. Countries that have done their homework are paying for the policies of France and Germany. I don't want Austrian taxpayers to be paying for that'*<sup>8</sup>.

After a protracted discussion, the Ecofin decided not to submit to vote the proposal of the Commission that called for the implementation of sanctions to Germany and France. Instead national ministers were called to discuss an alternative proposal that allowed France and Germany to remain in excessive deficit for 2004 without triggering the sanctions of the SGP. This proposal was approved, but the Netherlands, Austria, Finland and Spain voted against it.

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<sup>8</sup> EUObserver, 05.11.03.

In practice, two profligate member states escaped the pecuniary sanctions envisaged by the SGP. Hence the sanctioning side of the pact was violated, as it was already happening with the preventive dimension (due to the reiterated scenarios of excessive deficits in those member states). The Ecofin meeting on the 24<sup>th</sup> November revealed again certain characteristics of European integration: a bargaining process where national governments act strategically, searching for side payments that reward their vote alongside the interests of larger and powerful member states; and an asymmetric EU, where the interests of larger member states are so prominent and influence the outcome of Council meetings.

From a purely technical point of view there were strong arguments for saying that the SGP should be respected by all the actors involved in its operation. Nevertheless, political interests might oppose this technical rationale. This was what happened when a majority of national governments tolerated France and Germany fiscal misbehaviour. The outcome of this episode is rather unclear: does this mean that the pact was killed by member states' unwillingness to impose fines to Germany and France? It is important to realise, however, that the SGP was already being violated given that these member states showed excessive deficits for the third year in a row.

Ambiguity is the keyword, notably because German officials send the message that this decision is consistent with the operation of the pact (but perhaps of a flexible pact – something that was not yet decided by the Council). Thus, if the observation of events might be instructive of the pact's death, formally no such death sentence was signed by national governments. I ask whether this ambiguity fits with the perception that the fiscal architecture of EMU is 'work-in-progress', therefore opened to evolution (Brunila, Buti and Franco 2001: 20). The evolutionary essence is furthermore rooted on the evidence that it is easier to amend the SGP than the Treaty on the European Union (Strauch and von Hagen 2001: 479-80).

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