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978-0-521-19750-2 - Ruling Europe: The Politics of the Stability and Growth Pact

Martin Heipertz and Amy Verdun

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Ruling Europe

The Stability and Growth Pact (SGP) is central to Economic and Monetary Union (EMU) in Europe. Initiated by Germany in 1995 and adopted in 1997, it regulates the fiscal policies of European Union Member States. Following numerous violations of its deficit reference value, the Pact's Excessive Deficit Procedure was suspended in 2003. The decision to suspend was brought before the European Court of Justice in 2004 and the SGP then underwent painstaking reform in 2005. After a period of economic prosperity and falling budgetary deficits, the global economic crisis is putting the system under renewed stress. *Ruling Europe* presents the first comprehensive analysis of the political history of the SGP as the cornerstone of EMU. It examines the SGP through different theoretical lenses, offering a fascinating study of European integration and institutional design. One cannot understand the euro without first understanding the SGP.

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Dedicated to Frances Heipertz and Paul Schure

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Foreword

Since its inception in 1997, the Stability and Growth Pact (SGP) has lived through times both good and bad. It has been berated by politicians, academics, trade unionists and many other participants in the public debate. It has been called simultaneously too rigid and too lax, harmful to economic growth and outright ‘stupid’. At the same time, the constituency has grown in number of those who strongly believe in the merits of a rules-based framework to rein in the fiscal appetite of the executive branches and to bring the issue of the sustainability of public finances to the fore of the political debate. Today, the SGP is the cornerstone of European economic policy coordination and surveillance framework for nationally determined fiscal policies in the single currency area. It is as intimately linked with Economic and Monetary Union as is the European Central Bank or the euro itself. Yet every crisis, be it political or economic, puts to the test the effectiveness, the credibility and the political sustainability of the Pact.

In order to withstand the test of time, it has been important to recall repeatedly and to emphasise the economic and political ‘doctrine’ underlying the SGP, while avoiding dogmatically enforcing its rules without due regard for the specific economic and political circumstances.

In 2004, a combination of economic, political and legal constraints implied that a revision of the fiscal surveillance framework had become unavoidable in order to stop the *de facto* demise of the Pact. Its comprehensive reform that was undertaken in 2005 under the Luxembourg Presidency of the European Union responded to the criticism of insufficient flexibility, introduced greater symmetry in the application of the rules throughout the economic cycle and made the Pact more enforceable. It emphasised the importance of greater *ex-ante* coordination of fiscal policies, leading to the inception of a ‘mid-term review of budgetary policies’ to be carried out at the level of the euro area and the importance of ‘peer pressure’ as an effective deterrent.

Although the 2005 reform of the Pact drew a lot of criticism and even triggered ‘serious concerns’ in some quarters, it was always clear to me

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that only time could tell whether it had been a success or a failure. In fact, in order to assess the effectiveness of the reformed Pact, it would be necessary to observe its functioning through an entire economic cycle.

Prior to the 2005 reform, the main problem of the Pact had been the asymmetry between ‘good’ and ‘bad’ times. In fact, the Pact was not very prescriptive regarding the adequacy of fiscal policy in ‘good times’. This has changed with the 2005 reform and the results of the period 2006–8 were indeed very encouraging as structural deficits across Europe shrank quickly, public debt levels dropped and all euro-area Member States gradually exited the Excessive Deficit Procedure.

However, the true test of the Pact started with the world financial crisis in 2008 and the ensuing unprecedented economic downturn. Deficit and public debt levels shot up to levels unheard of since the 1970s. The added flexibility introduced in 2005 allowed us to carry out enhanced surveillance of public finances while remaining within the confines of our fiscal framework. As governments prepare to exit from the unparalleled support measures for the financial sector and the economy at large, it is crucially important that the flexibility provided by the Pact is used with economic intelligence and political guile in order to ensure that it is still around when we need to address the next crisis. In this way, we shall contribute collectively to restoring both much-needed growth and stability in Europe.

To most members of the general public, the SGP is dry material. Yet it is one of the few instruments of EU policy-making that has a tangible and direct impact on the living conditions of all our people. As such, it has often been at the centre of heated discussions and it has been subject to many criticisms. However, an informed debate about the usefulness and sensibility of a policy instrument like the Pact needs to be framed by objective analysis. I therefore congratulate the authors of this book for casting an objective yet critical eye on the issues at stake. The readers will certainly become better informed about the purpose of the Pact and the constraints that have shaped its current existence, thus enhancing their ability to participate fully in the public debate.

JEAN-CLAUDE JUNCKER

Prime Minister of Luxembourg and President of the Eurogroup

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Preface

The year 2009 marked the tenth birthday of Economic and Monetary Union (EMU) in Europe. The Stability and Growth Pact (SGP) is one of the cornerstones of that enterprise. EMU itself is perhaps the most ambitious project of regional integration in the world: the merging of national monetary policies first by eleven, later sixteen, nation states into one is unprecedented in modern history. This phenomenal enterprise is characterised by transferring monetary policy to the supranational level on the one hand while retaining national sovereignty over all other fields of economic policy on the other. However, monetary policy is interdependent with the other areas of economic policy, notably the conduct of public finances. The viability and success of EMU therefore depends on the ability of the participating, but independent, nation states to conduct their fiscal policies in a manner that is compatible with the pursuit of a single, common monetary policy.

In theory, EMU functioning well along these lines is a collective good. We know that, short of subjecting themselves hierarchically to some Leviathan (the state), people as well as nations rely on *norms* to ensure the reliable provision of collective goods. One could compare it to a club. If members of a club are found not to contribute – i.e. to free-ride – or even to damage the club goods, the group enforces its norms through *sanctions*. Depending on the club, such sanctions take on various forms, from verbal bullying to brutal fighting. Among sovereign nations, norms are enshrined in treaties and other types of international law, but ‘hard’ sanctioning is difficult to the extent that the realm of international politics still remains one of a Hobbesian *bellum omnium contra omnes*. Ultimately, a sovereign nation must consent to being sanctioned if an international regime is to persist.

Being an integral part of the institutional architecture of the European Union (EU), the SGP is as of yet the most complex and far-reaching version of such a norm-setting arrangement among sovereign nation states. In fact, it submits important aspects of the very core of parliamentary democracies – i.e. the setting of taxes and the formulation of the

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public budget – to common principles by regulating the residual between the expenditures and revenues of governments: the budgetary deficit. Issues of public finance go to the heart of a polity. In consequence, the very nature of the SGP is a political compromise among competing national interests. Its purpose is to align national fiscal policies along one common doctrine. As such these rules are complex, intricate and technical.

Despite its highly technical and complex features, the SGP has a tendency to hit the headlines. Repeatedly, it has been the subject of major international controversies in the EU as well as among commentators and academics. Opposing and changing interests and convictions, even cultures, resurface over time and clash in the name of fiscal policy, as framework conditions, above all the macroeconomic environment, oscillate and public finance priorities react to political swings. In this sense, the creation, implementation and adaptation of the SGP over fifteen years provide a prime example of institutional design within the process of European integration and have great potential to highlight the mechanics of the more general, underlying processes at work in the EU among experts and politicians alike.

We had two particular reasons for writing this book. First, the SGP itself is sufficiently important to be understood properly not only from an economics perspective but also from a political science one. Having been exhaustively treated in the economics discipline, we see the need for a book-length, comprehensive coverage of its politics – in order to tell and understand its history since 1995 and to inform readers of its evolution as EMU moves into uncharted territory following the 2008 financial meltdown and the subsequent economic recession. Second, more fundamentally, we believe that the case of the SGP provides important theoretical insights for explaining and analysing the process of European integration more generally. In studying the origins of the SGP, we develop a methodological apparatus that we apply subsequently to the analysis of its implementation and reform as well as in the hard times of autumn 2008 and after. We think that the approach developed in this book could be applied usefully to more instances of integration – economic and other – in Europe and beyond.

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This book would have been impossible without support. We had both been working on the SGP when we first met at the Max Planck Institute for the Study of Societies in Cologne in July 2002, thanks to its former Director, Fritz W. Scharpf. We collaborated at the Institute on an early version of the book manuscript, focusing our research at the time on the origins of the SGP. Subsequently, work was continued at a joint research visit at ‘Sciences Po’, Paris, in 2004, before Amy Verdun returned to the University of Victoria in Canada, where she held the Jean Monnet Chair in European Integration, while Martin Heipertz joined the European Central Bank (ECB) in Frankfurt as a fiscal economist, closely following the reform of the SGP as well as its further evolution, in part also during a secondment to the fiscal policy division of the German Ministry of Finance. It was at the premises of the ECB that we produced the penultimate version of the manuscript, in the summer of 2007 during the beginning of the financial crisis – at a turning point in the macroeconomic environment that could some day cause the SGP to return to the fore of European politics, ten years after entering Stage III of EMU. Final revisions to the manuscript were made in early 2009, which enabled us to incorporate some of the effects of the financial crisis on European budgetary policies of autumn 2008 and speculate on its implications for the SGP.

We are grateful for institutional and financial support from a variety of institutions, including notably the Max Planck Institute for the Study of Societies under its Director Wolfgang Streeck, the Social Sciences and Humanities Research Council of Canada (Grant 410–2002–0522 held by Amy Verdun), the Centre d’Études et de Recherches Internationales at Sciences Po and the ECB, which facilitated several extended visits by Amy Verdun to Frankfurt, and the European Commission, who paid for Martin Heipertz’ visit to Victoria in January 2009, before he joined the European Investment Bank in Luxembourg. Despite this repeated and generous institutional support, any views and opinions expressed in this book are personal and do not reflect the views and opinions of any institutions with which the authors are affiliated.

Furthermore, we received important feedback along the way for which we are very grateful. Some results of the research were presented over a

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longer period of time at various conferences and different universities throughout the world at: the NYU Conference in London, 'Building EU Economic Government: Revising the Rules?' 25–6 April 2003; a seminar of the Max Planck Institute for the Study of Societies (MPIfG), Cologne, 29 April 2003; the Oberseminar of the Jean Monnet Chair, of Wolfgang Wessels, University of Cologne, 27 May 2003; the 19th IPSA World Congress, Durban, South Africa, 29 June – 4 July 2003; the European University Institute in Florence on 3 October 2003; the University of Leiden on 6 October 2003; at Simon Fraser University in Vancouver on 24 November 2003; 'Ruling Europe: Theory and Politics of the Stability and Growth Pact', at the UBC Institute for European Studies on 11 February 2004; at the Centre for European Studies, Fudan University, Shanghai, China, 27 February 2004; at the 14th International Conference of Europeanists, Chicago, 11–13 March 2004; at the CERI Faculty Seminar, Sciences Po, Paris, France, on 26 April 2004; at Dalhousie University, Halifax NS, 25 May 2004; at the Second Pan-European Conference on EU Politics: Implication of a Wider Europe, ECPR Standing Group on the European Union, Bologna, 24–6 June 2004; at the European Central Bank, Frankfurt, 21 December 2004; at the 46th International Studies Association Annual Convention, Hawaii, 1–5 March 2005; at the Ninth Biennial International European Union Studies Association Conference, Austin, Texas, 31 March – 2 April 2005; at the London School of Economics and Political Science, 9–10 September 2005; at the Conference at the Viessmann Centre, Wilfrid Laurier University, Waterloo, 28 April 2006; at the Jean Monnet Centre of Excellence Seminar Series, University of Victoria, 7 November 2006; at the 10th International Biennial European Union Studies Association, Montreal, 17–19 May 2007; and at a seminar of the Department of Politics at the University of Virginia in Charlottesville, on 13 February 2009. We wish to thank participants of the above-mentioned conferences and seminars for sharing their insights with us and providing useful and constructive criticism, comments and suggestions.

This book is based in part on fifty-five interviews with key informants, all of whom were close to the actual creation and/or the current politics of the SGP. Their contribution was invaluable for our insights into the matter. Most of our interview partners took around one and a half hours or more to discuss with us their views on the SGP and, where applicable, they filled out a project questionnaire. We found many of them readily available for follow-up questions in the wake of the November 2003 SGP crisis and the 2008 financial crisis. We wish to express a special word of thanks to these officials, many of whom are included in the list below, for their contribution to our understanding of the policy process and their

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Frankfurt and Victoria, 2009

Abbreviations

| | |
|---------|---|
| Art. | Article |
| BVerfG | <i>Bundesverfassungsgericht</i> (German Constitutional Court) |
| BEPG | Broad Economic Policy Guidelines |
| CDU | Christian Democratic Union (Germany) |
| CEC | Commission of the European Communities |
| COM | Commission |
| CPE | Comparative Political Economy |
| CSU | Christian Social Union (Germany) |
| CTBOIS | Close to Balance or in Surplus |
| DG Ecfm | Directorate General Economic and Financial Affairs |
| DNB | De Nederlandsche Bank |
| EC | European Communities |
| ECB | European Central Bank |
| ECJ | European Court of Justice |
| ECOFIN | Economic and Financial Affairs Council |
| ECU | European Currency Unit |
| EDP | Excessive Deficit Procedure |
| EFC | Economic and Financial Committee |
| EMI | European Monetary Institute |
| EMS | European Monetary System |
| EMU | Economic and Monetary Union |
| EP | European Parliament |
| ERM | Exchange Rate Mechanism |
| ESA | European System of National and Regional Accounts |
| ESCB | European System of Central Banks |
| EU | European Union |
| FTPL | Fiscal Theory of the Price Level |
| GDP | Gross Domestic Product |
| IfW | Institut für Weltwirtschaft |
| IMF | International Monetary Fund |
| IR | International Relations |
| MC | Monetary Committee |

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| | |
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| MTO | Medium-term Budgetary Objective |
| NCB | National Central Bank |
| OCA | Optimum Currency Area |
| OECD | Organisation for Economic Cooperation and Development |
| OJ | Official Journal |
| QMV | Qualified Majority Voting |
| RPR | Rally for the Republic (France) |
| SGP | Stability and Growth Pact |
| SPD | Social Democratic Party (Germany) |
| TEC | Treaty Establishing the European Community |
| TEU | Treaty on European Union |
| VAT | Value Added Tax |
| UK | United Kingdom |
| USA | United States |