Germany and Italy: Stumbling Giant and Prodigal Son?

Social Pacts and the Political Economy of Fiscal Consolidation (1991-1998)

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Abstract

In the run-up to European Monetary Union (EMU), Italy put in place an extraordinary fiscal adjustment, whereas Germany encountered serious difficulties that go beyond the re-unification shock. "War-of-attrition" models are employed to explain this puzzle. It is argued that Italy's high debt burden and soft currency regime from 1992 to 1996 turned out as an opportunity. The prospect of EMU membership opened up room for market-induced credibility gains. By allowing a sensible reduction of interest payments, the high-debt GDP ratio *de facto* reduced the scope for welfare retrenchment, thus minimising conflicts between socio-economic groups over the distribution of the fiscal adjustment burden. At the same time, social concertation offered a *locus* of conflict resolution. Social partners' fiscal preferences stemmed from an evaluation of the distributional impact of deficit reduction and of trade-offs in other policy areas, e.g. exchange rate policy. Thanks to Italy's soft-currency regime, domestic business agreed to unions' demands for a tax-imposed fiscal consolidation as the devalued Lira allowed them to maintain a competitive edge. The opposite is true for Germany, where the low debt burden and hard currency regime functioned, paradoxically, as straightjackets. With a low debt level, deficit reduction had to come from real government activities, either on the revenue or on the expenditure-side. Also, the appreciated Deutschmark did not offer an alternative "pressure valve" to Germany's export-oriented business. The failure of the 1996 social pact is understood against this background. This thesis sheds light on the political economy of EMU-induced fiscal adjustment as well as on the determinants of social concertation in the EU. In this respect, it contributes simultaneously to two strands of literature: the now flourishing research agenda on fiscal policy in EMU -of which it rejects the strong institutionalist flavour, and the equally recent revival of corporatist studies since the 1990s.

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Abbreviations

Abbreviations	**Name**
A	Austria
AES	Economic and Social Agreement
AN	Alleanza Nazionale
B	Belgium
BDA	Bundesvereinigung der Deutschen Arbeitgeberverbände
BDI	Bundesverband der Deutschen Industrie
CA	Cyclically Adjusted
CB	Collective Bargaining
CdL	Conquiste del Lavoro
CDU	Christlich Demokratische Union
CEO	Chief Executive Officer
CGIL	Confederazione Generale Italiana del Lavoro
CGTP	Confederação Geral dos Trabalhadores Portugueses
CIP	Confederação da Indústria Portuguesa
CISL	Confederazione Italiana Sindacati Lavoratori
CME	Coordinated Market Economy
CME	Coordinated Market Economy
CNEL	Consiglio Nazionale dell'Economia e del Lavoro
CPCS	Concelho Permanente de Concertacao Social
CSU	Christlich Soziale Union
D	Deutschland
DAG	Deutsche Angestellten Gewerkschaft
DC	Democrazia Cristiana
DDR	Deutsche Demokratische Republik
DGB	Deutscher Gewerkschaftsbund
DHIT	Deutsche Industrie und Handelstag
DM	Deutschmark
DPEF	Documento di Programmazione Economica e Finanziaria
E	Spain
ECB	European Central Bank
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
EU	European Union
F	France
FAZ	Frankfurter Allgemeine Zeitung
FCP	Fiscal Consolidation Programmes
FI	Forza Italia
FIN	Finland
FPD	Freitliche Partei Deutschlands
FT	Financial Times
GDP	Gross Domestic Product

GNP	Gross National Product
I	Italy
ILO	International Labour Organisation
IRL	Ireland
IRPEF	Imposta sul reddito delle persone fisiche
KA	Konzertierte Aktion
LMEs	Liberal Market Economies
LN	Lega Nord
NL	Netherlands
NRS	Nuova Rassegna Sindacale
OECD	Organisation for Economic Cooperation and Development
P	Portugal
PCI	Partito Comunista Italiano
PDS	Partito Democratico della Sinistra
PPI	Partito Popolare Italiano
PR	Proportional representation
PSI	Partito Socialista Italiano
RC	Rifondazione Comunista
RPP	Relazione Previsionale e Programmatica
SCGP	Savings, Consolidation and Growth Programme
SEM	Single European Market
SGP	Stability and Growth Pact
SMEs	Small and Medium Enterprises
SPD	Sozialistische Partei Deutschlands
SSC	Social Security Contribution
SVR	Sachverständigenrat
SZ	Süddeutsche Zeitung
TAZ	Tageszeitung
UGT	União Geral de Trabalhadores
UIL	Unione Italiana del Lavoro
US	United States
VAT	Value Added Tax

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CHAPTER I

Empirical Puzzle, Definitions, and Case Studies

1. Challenges to EU Fiscal Coordination

This dissertation is a study of how European candidates for the Economic and Monetary Union (EMU) dealt with the challenge of fiscal consolidation in the period 1991-98. It focuses on two case studies, Germany and Italy, whose experiences with budgetary adjustment contradicted any rational expectation. This analysis offers a contribution both to the literature on the political economy of fiscal consolidation and to recent studies on the re-emergence of neo-corporatism under austerity. I believe that the exercise of fiscal adjustment, just like the preservation of discipline thereafter, is strongly dependent upon the socio-economic environment in which it takes place. Any evaluation of austerity needs to take account of domestic factors, and of national socio-economic preferences and interests before everything else[1].

I argue that Italy's macroeconomic adjustment in the run-up to EMU benefited from a large social consensus in favour of fiscal discipline and, above all, of the way to achieve it, as also exemplified in the successful signing of a series of social pacts (1992; 1993; 1996). Converging societal preferences created an environment in which successive governments could pursue budgetary consolidation in spite of the presence of various real as well as potential institutional constraints (e.g. short-time horizons, political polarization, inefficient budget institutions, etc.). On the other hand, Germany's fiscal consolidation was constrained by weak social consensus –the responsibility for this clearly lies also in the distributional implications of re-unification. The failure of the 1996 Social Pact supports this view. In this context, relative political stability and well-functioning budget institutions were *per se* not sufficient to allow for fiscal rigour.

Not only is an *ex post* explanation of these counterintuitive trajectories a worthwhile research subject, but the approach adopted here should additionally provide some leverage to understand more recent trends in EU fiscal policies,

[1] For a discussion of the meaning of "preferences" and "interests", see footnote 6.

from when the Euro was officially launched in 1999 through to 2004. One of the strongest ideas within EMU, the coordination of national fiscal policies is currently in a crisis, if not actually on the verge of failure. From 2001/2 to 2004, Germany and France have been in breach of the Stability and Growth Pact (SGP), a binding agreement designed to guarantee that Euro-zone countries preserve fiscal discipline even once in EMU by sticking, in the short-term, to the same 3 percent deficit target imposed by the Maastricht Treaty. Still, misbehaviour has not been punished. While the European Commission did initiate the excessive deficit procedure against Germany in November 2002 and, in April 2003, against France, but the ECOFIN did not endorse it (http://europa.eu.int/comm/economy finance/about/activities/ sgp/main_en.htm). Thus flaws emerged in the institutional set-up of the sanctioning system, so demonstrating that the latter is unrealistically designed. If considerations made at the time of shaping EMU were grounded in reality – but the consensus is in fact now weakening[2] - the possible collapse (real or perceived) of the SGP should pose then a significant threat to the European Central Bank (ECB), currently striving to take efficient one-fit-all monetary policy decisions.

The European Union (EU) has become aware of these shortcomings and agreed, on 21 March 2005, to reform the Pact with the submission of a proposal under the title "Improving the implementation of the Stability and Growth Pact" (ECOFIN 2005). It is uncertain how Euro-zone governments will interpret and react to this recent reform. In addition, it is in doubt if they will be able to explain the changes both to financial markets and public opinions, with one of the explicit objectives of the reform being that of making the Pact's rules more transparent before the public (p.3). Leaving predictions aside, the important message behind the recent history of the SGP is that fiscal policies continue to be subject to significant national politico-institutional constraints that impede proper coordination at the EU level and that any reform of the Stability Pact should recognise the existence of these constraints. Even if only between the lines, the

[2] It is fair to say that, even if in the formative years of EMU there was a large consensus on the need to guarantee a reasonable degree of fiscal coordination, then not long after dissenting voices started to surface with some supporting the view that coordination of national fiscal policies is not necessary for the good functioning of the monetary union and others going as far as to argue that this is even counter-productive (Beetsma and Bovenberg 1995). For a brief overview of the debate, see (Pisani-Ferry 2002).

ECOFIN report does acknowledge the need to "enhance the national ownership of the fiscal framework" and by stating: "the Council confirms that enhanced coordination of fiscal policies must adhere to the Treaty principle of subsidiarity, respecting the prerogative of national Governments in determining their structural and budgetary policies, while complying with the provisions of the Treaty and the Stability and Growth Pact" (p.4).

The general argument underlying this thesis corroborates the recent official EU reading of the status of fiscal policies in EMU, adding to it by showing that domestic politics have always been an important factor even during the so-called convergence process in the run-up to the single currency (1991-98) when failure to reach a public deficit target of 3 percent and a debt target of 60 percent of GDP, as envisaged in Art.109j and Art.104c of the Maastricht Treaty, would have jeopardised candidates' applications for EMU membership. At the time, only the commitment to the realization of the monetary union for some member states (e.g. Germany, France) and the threat of exclusion for others (e.g. Italy, Belgium) muted cross-country differences. This is not to say that they did not exist. This research proceeds from the strong assumption that nominal convergence achieved in 1997 by no means coincided with real convergence. As indicated earlier, this thesis' explicit focus is on fiscal consolidation episodes, where convergence towards common inflation and interest rate levels is also accounted for, albeit only at the margins, in that it was mostly intertwined, either *ex post* or *a priori*, with fiscal policy decisions.

As a matter of fact, if by 1997 most EU countries had succeeded in bringing down their deficits to below 3 percent of GDP, they did so to different degrees and following different strategies. More specifically, this research distinguishes between four dimensions of budgetary adjustment. First, there is some, though small, variation in the timing of reform, with few countries following the Maastricht timetable very strictly. Secondly, deficit reduction has been more extensive in some countries than in others. The size of adjustment is not evaluated in absolute terms, as it would obviously depend upon countries' starting positions, but in relation to the experience of similar countries and previous adjustment attempts in the same country. Thirdly, some governments reduced expenditures; others increased revenues or implemented both strategies simultaneously. In other words, the composition of adjustment differed from one country to the other. Finally, there are disparities with respect to the short-term persistence of stabilization. In parallel, it is worthwhile noting that budget consolidation took place against quite different domestic contexts (e.g. business cycles, political and budget institutions, degrees of corporatism, public opinion, etc.). My primary objective is to identify the (societal) reasons behind EMU candidate countries' different approach to macroeconomic adjustment during the 1990s. In so doing, I hope to shed light on current concerns around the socio-political feasibility of fiscal discipline in individual Euro-zone countries.

1.1.Existing interpretations of fiscal adjustment

Considering the ambitious politico-economic experiment of European monetary unification, it is no surprise if, in recent years, the relevant theoretical literature has been expanding rapidly. However, existing research usually celebrates the achievement of nominal convergence. The Maastricht Treaty gave renewed *élan* to policies of deficit reduction after attempts to correct undisciplined behaviour in the preceding decade had failed in most Western European countries (e.g. Italy, France). Not only was the new effort successful if compared with previous experiences, but it was also achieved against a relatively short-time horizon (Rotte and Zimmermann 1998; OECD various issues). The same literature tends to ignore the complex domestic interactions that precede and accompany any fiscal stabilization policy. As convincing as it might be, the literature on the "*vincolo esterno*"[3] fails to account for the fact that budget consolidation has far-reaching distributional implications and that EMU-induced macroeconomic adjustment had to confront a number of domestic veto players[4] (Dyson and Featherstone 1996; Dyson and Featherstone 1999; Featherstone 2001). Even state-centred explanations do not appear sufficiently persuasive. They support the argument that monetary unification was made possible thanks to the commitment

[3] *Vincolo esterno* stands for external constraint.
[4] One could say that exclusion from monetary unification would have such across-the-board distributional effects on late adjusters (e.g. Italy, Greece) that consensus was rapidly and uncontroversially achieved. Still, in the area of budget policy, it is reasonable to expect different preferences on the ways to achieve balanced budgets.

of high-profile bureaucrats and experts convinced of the merits of macro-economic stability (Verdun 1999; Marcussen 1999; Radaelli 1999; Dyson and Featherstone 1999). But there is ample evidence showing that many fiscal decisions were far from optimal in purely economic terms. On a similar note, Alesina argued: "the solution to the debt problem has very little to do with the criteria of optimality; instead it is the result of a political struggle" (Alesina in Giavazzi and Spaventa 1989, 39).

There is another strand of literature, which has been specifically concerned with the domestic politics of EMU-induced adjustment. The so-called *New Politics of the Welfare State* literature has insisted on the resilience of welfare states even in the face of fiscal discipline pointing to the impediments government come across when trying to implement unpopular policies. The central argument is threefold. First, generous welfare states in continental Europe represent the *status quo*; in this sense any policy change would require extensive resources to be committed (Pierson 1996a; Esping-Andersen 1996, 266-7; Kitschelt et al. 1999). Second, governments refrain from implementing unpopular fiscal measures because they are afraid of electoral costs (Weaver 1986; Bonoli 1999; Bonoli 2000; Pierson 2001). In this respect, these works provide also an answer to the issue of partisanship in that they *de facto* acknowledge that the ideological orientation of the government in power is less significant than governments' strategic pursuit of the median voter preference. Third, well-organised interest groups oppose welfare retrenchment (Pierson 1994; Castles 1998; Ferrera 1998; Brugiavini et al. 2000). However, this literature does not account for the fact that in many cases macroeconomic adjustment as well as welfare retrenchment did take place. Moreover, and most importantly, it proceeds from an *a priori* conceptualisation of domestic interests. These analyses underestimate the role of socio-economic preferences with respect to the trade-off between spending restraints and revenue increases under conditions of austerity.

1.2.Consensus signals a solution to the "war of attrition"

While all domestic interest groups could agree on the desirability of fiscal discipline, they would place themselves on different points along the indifference curve between revenue-based and expenditure-based deficit reduction. Along these lines, there are reasons to believe that of the different dimensions of fiscal adjustment composition is the most relevant from a political economy perspective. Only where powerful interest groups have agreed on the content of fiscal reform will stabilization become feasible. In recent times, economists have moved composition of budget consolidation to the centre of their analysis and explained that this dimension bears a fundamental impact both on the size and on the persistence of deficit reduction (Alesina and Perotti 1994;Alesina and Perotti 1995; Alesina and Perotti 1996; Perotti 1996; Perotti 1998; Perotti, Strauch and von Hagen 1998; Alesina and Ardagna 1998; Alesina et al. 1999; von Hagen, Hallett and Strauch 2001). Yet, these studies do not acknowledge that decisions about the most appropriate fiscal strategy are embedded in domestic socio-political institutions (Granovetter 1985) and that the size of deficit reduction could be, for instance, endogenous to its composition or that persistence may be merely a sign of a social consensus that has been reached over fiscal discipline – rather than deterministically deriving from a "good" decision on composition.

Bearing these observations in mind, the model I am employing in this research work is inspired by Alesina's and Drazen's "war of attrition". The departing point is that fiscal adjustment is a relatively unpopular exercise but, once accepted as a desirable objective, then the true battle will develop with reference to the content of fiscal reform. As deficit reduction will have to be achieved either on the revenue or on the expenditure-side of the budget[5], its successful implementation depends primarily on competing domestic (partisan) interests agreeing to the distribution of its costs and benefits. From a top-down

[5] Of course, the distinction is not so dramatic in reality, as deficit reduction could well come from a mixture of both strategies. However, in the present discussion, such a simplistic categorization is preserved and should be taken as a mere prototype. Instead, in the empirical section where the two case studies are discussed, I will then look at mixed strategies as well as differentiating between types of taxes and types of expenditures.

perspective, it is also about governments' ability to forge such a consensus. Nevertheless, for the purpose of the present study, the government is understood as just one of the players in the game, alongside the social partners, with only the distinction of being more committed than the others to providing the public good of fiscal discipline. Along similar lines, Alesina and Drazen suggested in their model that competing interests are there to supply a public good (Alesina and Drazen 1991). By extension once this consensus exists, fiscal, monetary and wage policies will more efficiently coordinate with one another with inevitably positive implications for deficit and debt levels, as will be further explained below.

Most of the existing political economy literature is deficient to the extent that it departs from an *a priori* definition of socio-economic preferences, and this is even more evident when fiscal policy preferences are at stake. The policy preferences of domestic interest groups can hardly be determined *ex ante*[6]. The empirical work behind this thesis consists of the identification of these preferences on the field through the analysis of official documents and public statements (Appendix 1a and 1b). In addition, semi-structured interviews have been used to confirm the results obtained from the abovementioned exercise (Appendix 2a and 2b). Already in the early stages of my fieldwork, there emerged *prima facie* evidence of the fact that social partners' views about macroeconomic adjustment tend to internalise trade-offs between different but related policy areas (i.e. tax and welfare, monetary, exchange rate and wage policies). In this sense, one of the major difficulties consisted in the selection of relevant information considering that most economic preferences entail, in one way or another, a fiscal component. In turn, I have devoted special attention to written pieces and interview fragments where actors have looked simultaneously at the following key issues: preferences over the degree of fiscal discipline and, secondary to this, the trade-off choice between expenditure restraints and tax

[6] In this thesis, I use the term "preferences" to indicate social partners' views of fiscal adjustment as they are established empirically. By contrast, "interests" are theoretical views of fiscal adjustment derived from the existing literature, and would include, for example, the traditional distinction between labour and capital. In a sense, they are hypothetical preferences. At times I do refer to one or the other, but in most cases the two terms are interchangeable, considering that the core of my argument is constructed around a combination of empirically derived data and theoretical assumptions.

increases. Moreover, to better visualise the potential trade-off between the desirable size of budgetary adjustment and its composition, I have ordered preferences according to their relative intensity, distinguishing between high-, moderate- and low-intensity preferences. The identification of different intensities has not been unproblematic. It was immediately manifest that fiscal preferences are to some extent endogenous, i.e. shaped by actors' understanding of the government's fiscal objectives and plans. By way of example, Italian unions' opposition to welfare retrenchment was stronger under the 1996 Prodi Government than in previous and subsequent years just because, in the early stages of the budgetary process, the cabinet announced significant expenditure restraints (Appendix 1a). Appearing like a limit at first, this turned out quite convenient. Where the present approach is to look at the real-time interaction between fiscal authorities and social partners, then endogenous preferences should incorporate actors' evaluation of factors that range from the ideological orientation of the government in power to its budget policy announcements. This makes them "strategic preferences"[7].

In most existing research even specifically preference-based explanations of macroeconomic adjustment fall short of recognising that preferences are neither linear nor static. My ranking allows for the visualising of first-, second- and third-best choices as well as their natural evolution from 1991 to 1997 as I have provided for yearly rankings together with the median over the period 1991-97. More specifically to the methodology, in order to identify stated preferences I have used a form of soft content analysis[8]. I have organised preferences into the following categories: support for fiscal discipline, support for or opposition to expenditure cuts –mostly with reference to welfare cuts, support for or opposition to tax increases. I have employed a simple coding system attributing 3 points to the most intensive preference, 2 to the moderately intensive one, and 1 to the

[7] For a discussion on "strategic preferences", see (Scharpf 2000). Considering the soft game-theoretic approach here adopted, "strategic preferences" shall be more significant than "raw preferences".

[8] The methodological literature distinguishes between stated and revealed preferences, where the latter should be "revealed" by actors' actual behaviour (Flick 1998). The distinction is not necessarily relevant to this research. Rather I have used a common-sense approach for attributing preferences that hinges on my own understanding of the conditions under which agents act. In a similar vein, Scharpf argued that the best recollection of actors' preferences is the one counting on researchers' own understanding of options, constraints and trade-offs (Scharpf 1997; 2000).

least intensive. As mentioned above, I provide these rankings for every year from 1991 to 1997. Where I generally refer to the distribution of fiscal preferences over the 1990s, then the data used represent the median calculated from every single year. Overall, the findings for Italy rest on 84 observations, whereas the German case is constructed on 78 observations[9]. While taking the calendar year as the reference timeline is probably not necessarily accurate as preferences would not respect the diary, this is nonetheless the most immediate and simple way to set preferences against a precise time frame so as to capture their evolution. In the case of Italy, this temporal classification has worked particularly well as the calendar year coincided for most of the 1990s with a new government so that this segmentation of preferences incorporated into social partners' *Weltanschauung* the characteristics and partisan complexion of the government in power. I have employed the results therewith obtained, on the one hand, in Chapter VII where I compare the two cases of Italy and Germany. Identifying the constellation of socio-economic preferences is a fundamental precondition for understanding the "game" around fiscal stabilization. And indeed, the main assumption underlying this thesis is that, if preferences are dissimilarly structured in the two countries, one should expect their domestic games to be dissimilar, *ceteribus paribus*. On the other hand, I have used the same information contained in the selected public documents, official statements and semi-structured interviews to reconstruct large part of the narratives in Chapters III, IV, V, and VI, where I adopt a qualitative approach.

The focus on socio-economic preferences is *per se* not necessarily new. Economists have already suggested that social consensus is normally supportive of fiscal stabilization (Alesina in Giavazzi and Spaventa 1989; Boltho 1992; Bruno 1993). However, they have failed to conceptualise it and to explain how it is formed. The value-added of the present work consists in the attempt to identify the conditions under which consensus is more likely to emerge[10]. Of course, the greater the political polarization in one country, the more difficult it is to build

[9] Out of a sample of more than 500 observations, I have selected and used only those where the agents discuss simultaneously the size and extent of budgetary consolidation, often revealing their perception of the links between the two dimensions.
[10] As was implicitly hinted at above, by social consensus I mean the existence of a potential for compromise between competing socio-economic interests.

such a consensus, and here the two cases under investigation present a puzzle in that partisan polarization was far greater in Italy than it was in Germany (Budge et al. 2001). Yet, it is also true that starting fiscal positions are likely to matter. Paradoxically, the greater the necessary adjustment, the easier the distribution of the adjustment burden as sacrifices will have to be by and large widespread. When the adjustment is smaller and has in turn to focus either on the revenue or on the expenditure side of the budget, or even on one item or on another, then competition between opposing groups is harsher. This is evident even just in the rhetoric: Italian social partners did not refrain from referring unsophisticatedly to the choice between a revenue- and an expenditure-based adjustment, whereas German actors distinguished between types of expenditures and of taxes –so that, when organising and ordering preferences for Germany, I have made an explicit distinction between general taxation and social security contributions (SSC) (see Appendix 1b).

I further argue that specific macroeconomic conditions allow for consensus formation. The first condition concerns the level of outstanding debt. I show that high-debt countries are better able to consolidate public finances, especially under a short time frame. This is a point economists have not failed to raise (von Hagen, Hallett and Strauch 2001). They have stated that the amount of pressure for adjustment high-debt countries are subject to explains comparatively better performances. As it is, the argument is hardly disputable. However, it misses the complex dynamics that precede (and follow) any stabilization episode. There are examples of countries that failed to consolidate in spite of barely sustainable debt paths, Italy in the 1980s being an interesting case in point. By the same token, some low-debt countries proved successful adjusters even if public finances were relatively under control (e.g. Germany 1982-88). Arguably, the perception that a financial crisis is incumbent is not sufficient to catalyse domestic interests towards budget consolidation[11].

[11] Also, the concept of a "fiscal crisis of the state" is far from objective. Some governments may believe that the level of their public debt is unsustainable and others that a similar level is perfectly manageable. To be sure, neither economic theory nor empirical provide us with an indication of a precise debt ratio to GDP that should be regarded as unsustainable (Giavazzi and Spaventa 1989).

Fiscal policy decisions cannot be taken in a vacuum. Governments face the reaction of social partners, in corporatist realities, or more generally of voters. In turn, I offer an explanation of high-debt countries' paradoxical comparative advantage that is grounded in society. First, in high-debt countries, part of the adjustment can stem from credibility gains once financial markets are persuaded by deficit reduction efforts or even by their mere announcement. This strategy does not have a tangible distributional impact and is thus, from a political economy perspective, perfectly feasible. Secondly, as stated above, where the size of adjustment is significant, as is the case for highly indebted countries, then there are good reasons to believe that sacrifices will be imposed on most groups. In other words, there is less scope for free riding. Thirdly, business actors in high-debt countries will manifest their opposition to high interest rate and inflation differentials once market conditions change. And, with the completion of the Single European Market (SEM), their "living space" was transformed relatively fast. In this new context, organised capital was prone to lobby public authorities for extensive deficit reduction in the expectation that this would finally induce a relaxation of monetary policy. In turn, cheaper money was perceived as an easy stimulus to investment, especially under conditions of low labour productivity (e.g. Italy).

The exchange rate regime is the second macroeconomic feature expected to shape fiscal preference formation. As stated above, it seems reasonable to believe that socio-economic interests formed their preferences after having taken trade-offs between different policy areas into account (i.e. fiscal, exchange rate and wage policies). Where the exchange rate offers a pressure valve to preserve competitiveness, business actors in high-debt countries will try to impose their preference over the size of deficit reduction but allow labour unions to shape the content of budgetary interventions. Italian unions were largely in favour of a revenue-based adjustment. Producers accepted it because the depreciated Lira continued to fuel exports, in spite of higher fiscal pressure. Moreover, with the elimination of wage indexation, there was no risk of imported inflation. Finally, under a weak (floating) currency regime, monetary authorities were able to increase the money supply in reaction to fiscal restriction without being constrained by the need to support the external value of the currency. By the same token, it is quite paradoxical how the stability of the DM, if not its appreciation from 1991 to 1995, reduced monetary authorities' room for manoeuvre. Faced with a weakening competitive performance, export-oriented producers did not accept unions' proposal for a fiscal adjustment based on higher (progressive) direct taxation. Under these conditions, the striking of a deal between unions and producers appeared extremely difficult, revealing weak underlying social consensus.

The different fate of social pacts in Germany and Italy is to be interpreted against this background. Social concertation is the epiphenomenon of the presence of social consensus, even if it concerns only socio-economic elites (i.e. trade unions and employers' organizations). Seeing the presence of corporatist arrangements as a manifestation of social consensus is a position that might be subject to some criticism. In trying to correct for this potential weakness, I have correlated the emergence (and frequency) of social pacts with the number of strikes and street demonstrations. The negative sign of the correlation supports the view that these pacts can be seen as good functional equivalents to the rather vague notion of social consensus[12]. The puzzle with respect to the two case studies analysed here is that tripartite agreements were successfully concluded in a country like Italy where the institutional preconditions to corporatism were in fact lacking, i.e. united labour movement and centralization of collective bargaining (CB). Thus, even when it comes to accounting for corporatist patterns, the contribution of the present thesis consists in the appreciation of interest-based as opposed to institutionalist approaches, the argument being that social concertation emerges there where the preferences of social partners are distributed in such a way that a compromise is possible.

[12] To be sure, Cameron and Keman already anticipated that labour quiescence associates systematically with corporatism (Cameron 1984; Cameron in Goldthorpe 1984; Keman 1984).

2. Fiscal Consolidation: Old and New Definitions

Any study of fiscal adjustment runs against an important limitation; namely the technical complexity of the subject matter and the fact that fiscal policy outcomes are typically over-determined. Multiple factors, many of them out of government control, have an impact on fiscal stabilization. This explains why this policy area creates economic complexities for bureaucrats themselves, as they will have to simultaneously control for all these different factors and often face trade-off choices. With the aim of clarifying the most important determinants and intervening variables, this section looks at the economics of fiscal adjustment and at its different dimensions, focusing mainly on the aspects upon which politics is more likely to exert an impact. In addition, it should be stressed at the outset that wider fiscal policy decisions (e.g. welfare and tax reform) come into the picture only to the extent that they allow for public saving, hence for deficit, and in the long-term, debt reduction. In this research context, only those fiscal policy choices that have beneficial implications for the state budget matter, and more so when, also in the rhetoric, policy-makers have justified them as induced by the need to preserve fiscal discipline. In this respect, wider evaluations of fiscal reform –e.g. if welfare retrenchment is dramatic or incremental, or whether it impinges upon social rights (Pierson 1994; Clayton and Pontusson 1998; Pierson 2001; Green-Pedersen)- are not part of this research project.

2.1.The economics of fiscal consolidation

Fiscal consolidation can be broadly described as the adjustment of fiscal trends towards the budgetary targets to which a government has politically committed itself, either domestically or internationally (as in the case of EMU). More precisely, borrowing from other works, adjustment arises when the primary structural budget balance (i.e. the cyclically adjusted deficit excluding interest payments) has changed by more than 0.5 percent of potential GDP in one or more consecutive years (Perotti, Strauch and von Hagen 1998; von Hagen, Hallett and Strauch 2001). As apparent from the definition above, the focus is on deficit reduction, and this for a number of reasons. First, it soon became clear that EU institutions would be more indulgent in the interpretation of the debt criterion, but would not allow deficits higher than 3 percent of GDP. Second, debt management is an exercise in which governments are highly constrained by market conditions (e.g. interest rate evolution, business confidence) as well as by the characteristics of the debt exposure itself (e.g. maturity structure of state bonds, category of creditors). Finally, debt stabilization occurs against long-time horizons. By contrast, this study is an evaluation of the domestic micro-foundations of fiscal adjustment within a relatively short time frame (1991-98).

The external macroeconomic environment has a significant bearing, firstly on the choice of the most appropriate fiscal strategy and secondly on the actual results. As mentioned above, fiscal adjustment is conditioned by multiple factors. Amongst those out of government control are growth rates and long-term interest rates. As to the former, growth projections condition decisions about the most appropriate deficit reduction strategy. Were the government to expect slow growth, it would not be likely to build a stabilization programme that relies heavily on direct tax increases, for instance. In terms of outcomes, output growth determines the actual extent of public revenues. Thus in a booming economy, private incomes increase and so do revenues from direct taxation at constant tax rates. On the expenditure side of the budget, recession leading to unemployment would exercise a strong pressure on social security budgets pushing the net borrowing requirement upwards. On the other hand, long-term interest rates have a more focused target, as they would affect just one peculiar spending item, i.e. interest payments on the outstanding public debt. In addition, interest rate developments would have differentiated impact on countries according to their initial positions. In particular, high-debt countries are much more dependent upon the structure of interest rates than low-debt countries (Commission 1994, 171).

The budget constraint equation offers a good representation of the evolutionary characteristics of fiscal consolidation (see Equation 1). In order to stabilise the public debt, the primary surplus will first have to grow substantially and continuously, the larger the debt ratio to GDP – no surprise then that Italy's primary surplus followed this trend in the 1990s, whereas Germany's was subject on a more uncertain evolution. Second, to achieve this target, growth rates should be greater than interest rates. By implication, fiscal consolidation is easier where monetary authorities allow for an increase in the money supply. Were this not happen, then growth needs to be remarkably rapid, a condition that did not occur either in Italy or in Germany during the 1990s. Equation (1) suggests also that high public indebtedness represents an important constraint on fiscal authorities, as it does not allow the use of revenues for more urgent needs than debt repayment. Interestingly enough, this thesis will show that, from a political economy perspective, a high level of public debt is instead an advantage when a government is asked to put budgets in order against a short-time horizon. This is because it induces socio-economic interests to form fiscal preferences that are largely reconcilable with one another.

Equation (1) $$\Delta \frac{B}{Y} = \frac{G - T}{Y} + (r - g) \frac{B}{Y}$$ [13]

2.2.The dimensions of fiscal consolidation

Fiscal consolidation is not a monolithic episode. To be sure, most of the economic adjustment literature is keen on distinguishing between different dimensions of reform (Haggard and Kaufman 1992). When it comes to debt stabilization in particular, the most studied aspects of the process have been its timing (Alesina and Drazen 1991; Fatas and Mihov 2003), extent (Alesina and Ardagna 1998), composition (Alesina and Perotti 1995; Perotti 1996; Fatas and Mihov 2003) and persistence (Maroto Illera and Mulas-Granados 2001; von Hagen, Hallett and Strauch 2001). Most of the time, they have been evaluated separately. However, because they are somehow reciprocally related and are

[13] Where $\Delta B/Y$ = change to the debt ratio to GDP; G = government spending; T = government revenue; and (r-g) B/Y = difference between real interest and growth rate applied to the amount of debt ratio to GDP (Burda and Wyplosz, 2001, 377).

often endogenous to one another, where possible, I intend to consider these four dimensions together.

The timing gives an idea of a country's intention to reform. In the case of EMU candidates, it is rather uncontroversial that the timing of extensive deficit reduction was shaped by the so-called Maastricht effect. However, the latter was more evident in some cases than in others. In Germany, for example, the re-unification shock postponed the fiscal restriction to the second half of the 1990s. The Maastricht effect was certainly more visible in the case of Italy. After a series of attempts to put budgets in order in the 1980s, the country took the right steps on the way to fiscal discipline only once under the EMU constraint. Still, it is to be said that the dramatic adjustment put in place in 1992 was also a response to the financial crisis. Hence, the top-down explanation of the timing of reform ignores the fact that debt stabilization becomes viable only at the moment in which the "war of attrition" between competing interests has been solved. Therefore, it would be appropriate to analyse the timing of fiscal adjustment together with both its extent and composition.

The extent of consolidation is measured as the change in the primary structural balance so as to better isolate discretionary fiscal interventions[14]. Often, I use also the cyclically deficit to pinpoint differences between the two variables. Needless to say, this depends directly on a country's initial position. For this reason, the size of budgetary retrenchment is analysed here by looking at groups of countries that started from similar deficit and debt levels and in comparison to previous consolidation episodes in the same country. From a political economy perspective, it is interesting that, in some countries, large restrictions were politically more viable than in others. Quite paradoxically, one of the arguments that cuts across the present work is that larger interventions were somehow easier

[14] Cyclically adjusted data are available from the European Commission's database AMECO. Here, the influence of cyclical fluctuations on budget balances is calculated by multiplying the output gap by the marginal sensitivity of revenues and expenditures to GDP. The output gap consists of the difference between actual and trend GDP (Buti, Franco and Ongera 1997, 8; EU Commission 2000, 137-8). In this thesis, I use the adjusted primary surplus, where possible. This is the best approximation to discretionary fiscal policy and a better measure than the adjusted deficit considering that the latter incorporates a few factors that are out of government control, i.e. inflation, real interest rates, exchange rate fluctuations, and receipts from natural resources (Blanchard 1990).

to sell; first, because they could rely on credibility gains on financial markets – especially there where credibility was low to start with - and secondly because sacrifices were imposed across-the-board, thereby minimising competition between opposing groups. For a thorough understanding of the socio-political feasibility of fiscal reform, a closer look at its specific content is necessary.

In the present research setting, composition appears probably like the most significant dimension of adjustment. It is measured as the contribution of each budgetary item to the consolidation episode. Borrowing from von Hagen et al, consolidation is expenditure-based when spending cuts contribute to at least half of the total yearly deficit reduction (von Hagen, Hallett and Strauch 2001, 20). The EU Commission provides figures on changes to cyclically adjusted primary expenditures –which exclude interest payments, and to adjusted total revenues (AMECO Database). A strategy for economic stabilization can be based on tax increases or expenditure cuts, or a mixture of the two. Put another way, it should be characterised by an overwhelming dimension of retrenchment, but it could also entail elements of short-term expansion when a government strategically decides to reduce fiscal pressure to stimulate economic growth in T1 and therewith minimise public spending in T2. Here, again, starting positions are due to play an important role. High-debt countries are unlikely to go for tax alleviation. While theoretically lower fiscal pressure could boost the economy and create growth, in practice the unstable macroeconomic environment characteristic of highly indebted systems will probably not allow this to happen[15]. Initial conditions matter also if it is true that, in the 1990s, only countries with small tax burdens opted for revenue-based adjustments (Fatas and Mihov 2003)[16]. In recent times, economists have extensively studied composition indicating that expenditure-based deficit reductions are more successful. As spending cuts are perceived as definitive with economic agents expecting lower fiscal pressure in the short to medium term, both consumption and investment are stimulated. By the same token, revenue-based adjustments are detrimental, as they tend to come

[15] Panel data analyses confirmed that high-debt countries tend to opt for expenditure-based adjustments (Von Hagen at al. 2001). The Italian case does not fully support this hypothesis.
[16] Again, the research conducted by Fatas and Mihov looks at panel data so that the results hold only at the aggregate level. In fact, while certainly not being part of the group of low-tax-burden countries, Italy relied extensively on (direct) tax increases to balance public budgets.

with stronger wage pressures with bargainers incorporating higher fiscal pressure in their wage demands (Giavazzi and Pagano 1996; Alesina et al. 1999; Ardagna 2004). In these analyses, successful adjustments are those that last longer. This leads back us to the four dimensions considered here, namely the persistence or duration of fiscal discipline.

Table 1. Composition of budgetary consolidation in EU countries in the 1990s

Revenue-based retrenchment

	Consolidation Period	Change in Structural Balance	Change in Structural Revenue	Change in Structural Pr. Exp.	Of which Capital Spending	Of which Current Pr. Exp.	Change in Interest Payments
F	1995-97	**3.3**	**2.6**	**-0.9**	**-0.1**	**-0.8**	**0.2**
IRL	1990-94	**2.3**	**3.0**	**2.5**	**0.6**	**1.9**	**-1.8**
I	1991-97	**9.4**	**6.4**	**-3.1**	**-1.0**	**-2.1**	**0.0**
P	1992-96	**3.6**	**7.4**	**6.1**	**0.9**	**5.2**	**-2.3**

Expenditure-based retrenchment

FIN	1993-99	**4.0**	**-4.6**	**-9.5**	**-0.7**	**-8.8**	**1.0**

"Switching" Strategy

A 1st phase	1995-96	**1.3**	**2.3**	**0.8**	**-0.4**	**1.2**	**0.2**
2nd phase	1997	**2.2**	**-0.4**	**-2.3**	**-0.9**	**-1.4**	**-0.4**
B 1st phase	1992-93	**1.7**	**2.9**	**0.5**	**0.2**	**0.3**	**0.7**
2nd phase	1994-96	**3.6**	**1.4**	**-0.2**	**0.1**	**-0.2**	**-1.9**
D 1st phase	1992-93	**1.4**	**3.3**	**1.3**	**0.1**	**1.1**	**0.6**
2nd phase	1994-97	**1.7**	**1.5**	**-0.7**	**-0.8**	**0.0**	**0.4**
NL 1st phase	1991-93	**4.3**	**4.2**	**-0.4**	**0.0**	**-0.4**	**0.2**
2nd phase	1994-97	**1.7**	**-4.5**	**-5.4**	**0.9**	**-6.4**	**-0.8**
E 1st phase	1992-93	**-0.3**	**3.9**	**2.8**	**-0.6**	**3.5**	**1.3**
2nd phase	1994-97	**3.5**	**-1.4**	**-4.6**	**-1.0**	**-3.6**	**-0.2**

Key: Pr. Exp. = primary expenditures

Source: European Commission, *Public Finances in EMU,* European Economy, 2000, p.20.

Persistence is defined as the absence of significant deficit deterioration in the period under investigation[17]. It is a sign of serious commitment to fiscal discipline, especially when it overcomes potential politico-institutional

[17] It should be stressed that persistence is by no means referring to sustainability.

impediments, such as electoral cycles, new veto points, new international commitments etc. Empirical evidence indicates that the momentum in favour of fiscal discipline is not necessarily maintained by external pressures nor conditioned by fiscal starting positions. It refers instead to national authorities' capacity to preserve a social environment favourable to austerity. In turn, the emergence (or not) of social consensus around fiscal adjustment is likely to depend on the ways in which stabilization policies are pursued. This takes us back to the content of fiscal reform. In a sense, the persistence of deficit reduction is conditional upon the acceptance of its very composition.

3. Stumbling Giant and Prodigal Son?

In the accounts on the run-up to EMU, Germany and Italy figure as two extremely interesting case studies. At the level of anecdotes, the European convergence process seemed to revolve around the striking of a compromise between Germany, with its authorities' resistance to any relaxation of the Maastricht fiscal criteria, andItaly, travelling dangerously on the tightrope between satisfying the criteria and being excluded from EMU. This atmosphere prevailed until 1996 when Prime Minister Prodi successfully put in place an extraordinary budget correction, thereby securing EMU membership (Chiorazzo and Spaventa 2000). Just as Italy was about to conquer this goal, growing unemployment and decreasing productivity in Germany were putting the country's easy landing on the EMU platform at risk. If diplomatic economic relations played a role at all, the "waltz" between Germany and Italy is a significant component of this process. At the same time, it is interesting to note that whereas in Italy a series of successful social pacts contributed significantly to austerity, in Germany, notwithstanding a long tradition of social concertation, government, employers and unions proved unable to come to a comprehensive agreement on public finance issues.

The underlying question this thesis is tackling is why Italy performed so unexpectedly well, while at the same time Germany showed more visible signs of an incumbent demise. The following two sections set out the methodological advantages as well as the constraints of such a comparison and suggest that a look at the raw economics of fiscal adjustment in Germany and Italy, while offering good guiding principles, is in fact not fully satisfactory.

3.1.Most-dissimilar-systems research design

From a methodological perspective, this research work follows a most-dissimilar- systems design. Most evidently, the two countries started from very different fiscal positions. In 1991, Germany's public deficit was at 2.9 percent of GDP, or 4.8 percent in cyclically adjusted terms, to large part as a result of unification-induced spending, with but the overall consolidated gross debt at just 40.3 percent of GDP. On the other hand, in Italy, the deficit amounted to 11.7 percent of GDP in 1991, or 12.1 in cyclically adjusted terms, and the debt burden was at a record high of 100.6 percent of GDP (European 2004). Given these significant spreads, it is reasonable to ask if the comparison is really justifiable. I believe it is considering that, interestingly enough, their primary surpluses were quite similar, with Italy at 0.2 percent of GDP and Germany at just –0.1 percent of GDP in 1991. If the focus of the present work is deficit reduction rather than debt stabilization, then the fact that primary surpluses were more or less aligned is by itself a significant piece of information. It justifies the comparison on the grounds that the portion of the deficit that is manageable by discretionary fiscal policy was at the time similar in size. It is instead the ratio of interest payments that varied from one country to the other; something that depended upon the two countries' different debt levels. Even if this is just tentative, then these elements could lead one to believe that there is something about the size of interest payments or, to put differently, about the overall public deficit that can account for the two countries' unexpected fiscal performances. Rather than being a limit to a sound comparison, divergent starting positions will translate into the explanation for their divergent trajectories, where the intriguing empirical puzzle revolves around the fact that their respective fiscal consolidation episodes ran against what one would have expected in the light of their initial (debt) positions.

On other fronts, the juxtaposition of these two cases is justified by the fact that (1) they are countries of similar size; (2) they have similar degrees of openness as in both exports account for about 20 percent of GDP[18]; (3) in both countries, primary expenditure levels amounted to around 40.2 percent of GDP in 1991 (European 2004); (4) in addition, fiscal pressure was also similar at the beginning of the Maastricht convergence process. These aspects are not free of significance if, as the relevant literature has extensively insisted upon (Amenta and Skocpol 1986; Immergut 1992; Ferrera 1993; Pierson 1996b; Thelen 1999), social and tax policy inheritance exercises feed back effects on reform efforts; (5) finally, from a macro qualitative perspective, both fall under Esping-Andersen's categorization of "continental welfare states" (Esping-Andersen 1990)[19]; this means that any proposal for structural reform would have to face similar, even if not identical, institutional constraints (and opportunities).

True, Germany was subject to a historically unprecedented challenge with the unification of the Western and Eastern parts. However, in a sense, so too was Italy. To qualify for EMU in the first wave, the country had to put in place a proper macroeconomic regime change. Besides achieving balanced budgets, the country also had to reduce interest rate and inflation levels; at the same time, it was required to maintain exchange rate stability, abandoning the competitive devaluations extensively pursued in the past. A look at longer fiscal trends suggests that, in the German case, unification-induced deficit deterioration was not greater than the one resulting from lavish spending in the late 1970s and that, overall, fiscal policy outcomes were set under a sign of relative continuity with the past. Confirming this point is the fact that the 1990s are recalled as a period of blockage -the reference is to *Reformstau* (reform blockage), where institutional constraints impeded any structural reform. In this sense, unification is just an external contingent event impinging on resilient structures.

[18] The relative openness of a national economy is a significant determinant of economic policy decisions to the extent that governments need to make sure that fiscal, wage and exchange rate policies are compatible with the preservation of international competitiveness.
[19] It is fair to say however that the definition is contested. For example, Ferrera suggested that Italy together with Spain, Portugal and Greece should be classified as "southern welfare state" (Ferrera 1993).

There is another societal development that indicates how Germany and Italy did in fact follow different paths, but in a manner that was totally unexpected. The emergence of social pacts in Italy somehow challenges the existing corporatist literature, according to which social concertation emerges only where there are the appropriate institutional preconditions. But the country lacked those as the labour movement was ideologically fragmented and collective bargaining was not typically centralised. Still, social pacts seemed to be the norm in the 1990s, first in 1992 and 1993, and then in 1996. On the contrary, Germany's traditional social partnership failed to materialise in the same period, in spite of the Kohl Government's repeated attempts at bringing social partners together, most notably in 1996. This was associated with the crumbling of social consensus at large, as the 1990s witnessed a period of unprecedented social unrest with historically high number of strikes and street demonstrations in West Germany (ILO Database). It is worth noting that the 1996 German social pact failed as a result of disagreements around the most appropriate fiscal strategy, as will described below.

I have also introduced shadow cases so as to strengthen the case of a society-based fiscal adjustment and to corroborate one the main finding behind this research, namely that debt levels and currency regimes bear an important impact on fiscal preference formation and in turn, if the above is true, on fiscal outcomes. Belgium appeared like the best possible counterweight to the two central cases, as it is the only EU country with a debt burden comparable to Italy's. Here, deficit reduction in the 1990s was certainly successful and was achieved without a social pact in the background. Differently to the Italian case, however, the country's hard currency regime twisted unions' arms into wage moderation without the need for an explicit political exchange. In a sense, the peculiar macroeconomic environment the country was in during the 1990s explains the failure of the attempted social pacts in 1994 and 1996, and this is where this work contributes indirectly to (neo)-corporatist literature. Portugal, the second shadow case, had a debt level similar to the German one and a hybrid exchange rate regime, where governments attempted to preserve the external value of the national currency but were not always capable of doing so. The Portuguese experience with budget consolidation in the run-up to EMU has been disappointing somehow and the social pacts concluded were certainly limited in their actual impact on the economy with the largest union confederation refusing to sign them.

3.2.Italian and German budget consolidation: raw economics

When focusing on fiscal policy outcomes, the impact of business cycles can be hardly overstated - the European Commission has calculated that this amounts an average budget balance adjustment of 0.5 percent of GDP when the output gap changes by 1 percentage point (European Commission 2000, 137). In order to control for the interference of cyclical fluctuations, I am mostly using cyclically adjusted data as a good measure of discretionary fiscal policy[20]. Still, as with most constructed figures, they have some drawbacks, amongst them in particular the fact that potential output is kept constant whereas there are good reasons to believe that it changes along with the implementation, for example, of welfare and tax reform. While the impact of GDP growth, employment and short-term interest rates is more or less controlled for by the use of cyclically adjusted data, long-term interest rates attributed by financial markets should be considered independently.

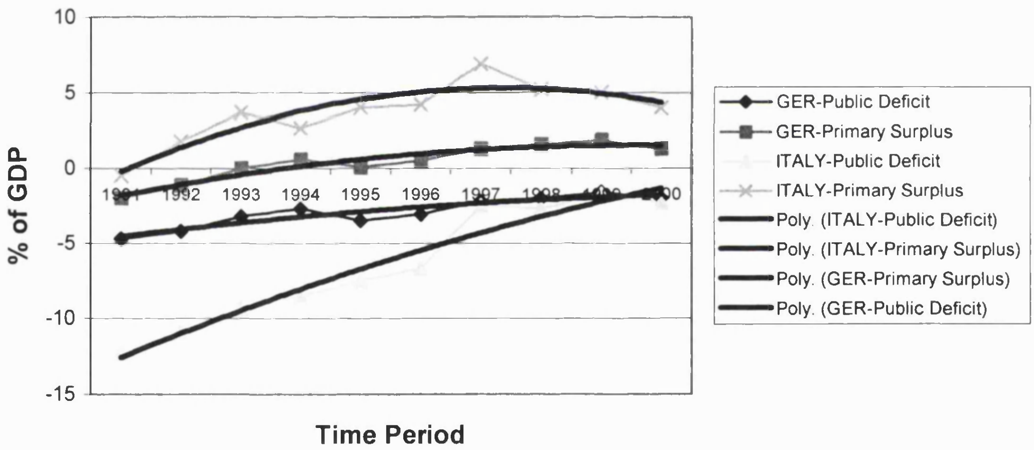
I have earlier hinted at the fact that markets tend to react quite promptly to real fiscal policy changes, and that their sensitivity is strongly dependent upon countries' starting positions, most obviously upon their debt burdens. Rising long-term interest rates can function as a significant constraint on macroeconomic management, and this is even more so in the case of high-debt countries, becoming notably more sensitive to interest rate developments. In this respect, it is interesting to note that the risk premium on Italy had been progressively decreasing in the 1990s and so had long-term interest rates –with the exceptions of 1994-95 and 1996-97. Nevertheless, they were much above those imposed on Germany, in spite of the fact that the public debt there continued to rise. In a sense, financial markets did not severely punish Germany in spite of the uncertainty created by unification and the transition process in

[20] See footnote 9.

former DDR. In this respect, it is to be excluded *a priori* that Germany performed comparatively worse because of unfavourable market developments.

Related to this is another important feature of the two respective fiscal adjustments. Graph 1 illustrates that Germany's actual public deficit was determined in full by the evolution of the primary surplus. Because the latter represents the best approximation to government discretionary fiscal action, it can be concluded that, overall, the markets played a limited role in affecting the country's fiscal performance. This was instead the result of alteration to real government activities, either on the revenue or on the expenditure side of the budget (Graph 1).

Graph 1. Evolution of Cyclically Adjusted Public Deficit and Primary Surplus, Germany and Italy (1991-2000)



Source: European Commission, AMECO Database (last reviewed May 2005)

On the other hand, Italy's budget consolidation was to some extent determined by discretionary policy interventions if the primary surplus was set on an upward trend throughout the 1990s. However, the fact that the public deficit and the primary surplus, while moving in the same direction, are not identical shows that there was greater room for financial markets to play a role, namely to allow for the lowering costs of public debt servicing. This confirms the general assumption according to which high-debt countries would be more sensitive to interest rate developments than low-debt countries, both because the debt ratio to GDP is greater and so the gain, and because of the catch-up potential typical of modestly credible economies. Part of the adjustment would then stem from a socio-politically irrelevant item such as interest payments (see Rhodes in Pierson 2001). To put it in a provocative way, when judging on the German and Italian fiscal performance in the run-up to EMU, one can say: *while it was not all Italy's merit, it was certainly all Germany's fault*!

Where raw economics are not persuasive enough, the attention should shift to politico-economic considerations. The next chapter is a review of existing theoretical interpretations of fiscal adjustment.

CHAPTER II

Theories of Fiscal Adjustment

1. A Synopsis of Theoretical Interpretations

"(Policy reform) is like an investment that should ultimately benefit the majority by enough to make them happy they made it, but that in the short run will –like all investments- involve sacrifices. The distribution of these sacrifices over time and across groups is at the heart of the politics of economic reform." Williamson and Haggard (1994, 531)

Macroeconomic adjustment is by definition an unpopular exercise, in the short-term at least. In turn, any theoretical conceptualisation of it has to account for strategies and conditions under which real or potential constraints are overcome. Theories of fiscal adjustment differ only in that they do not necessarily agree on the nature of the constraints and, therefore, on the means to overcome them. With some degree of simplification, one can distinguish between international and domestic intervening variables, where the former are predominantly institutional and the latter either societal or institutional. This equates to saying that explanations of successful fiscal adjustment vary from top-down to bottom-up according to the locus where constraints are believed to operate most intensively.

Amongst top-down explanations are those that recognise the overwhelming importance of the Maastricht commitment to account for successful fiscal consolidation after two decades of failed attempts. The presence of a *legal constraint* is believed sufficient to mobilise governments' support in favour of reform. This approach is somehow similar to the one revolving around the notion of "*vincolo esterno*", but the latter is more sophisticated in that it accounts for the role of ideas and for the fact that national policy-makers do instrumentalise an external constraint to acquire legitimacy at home. In this respect, such accounts are more similar to Putnam's *two-level game* than to pure top-down analyses (Putnam 1988). Acknowledging a more active role from part of governmental actors, the *tying one's hands theory* states that public authorities may impose upon themselves disciplinary devices usually capable of allowing a better economic performance, the notable example being policy-makers' enthusiastic embracing of the EMS project.

Domestically, there is likely to be an extremely high number of potential impediments to successful budget consolidation. To be sure, it is not necessarily true that everything that happens at the domestic level should develop from bottom-up. Where decisions are taken by politically insulated technocrats, then international factors are not relevant but the process can be still defined as top-down. An important strand of literature has succeeded in the task of *Bringing the State Back In* to show that dramatic policy change is initiated only by powerful state administrations. It does appreciate the significance of expertise, of policy legacies, and of state autonomy from the wider societal context. Somewhere between top-down and bottom-up explanations is the literature on political and fiscal institutionalism according to which the shape and functioning of political and budget institutions bear an indisputable impact on fiscal policy outcomes.

Conversely, pure bottom-up explanations of fiscal adjustment recognise the role of state-society relations. While probably all in favour of fiscal discipline (in the 1990s at least), governments of different ideological orientation may differ in their preference over the size and composition of fiscal reform considering that, for example, large adjustments that base interventions on the spending side of the budget tend to have quite different distributional consequences from small ones implemented on the revenue side (*partisanship*). Deficit reduction is destined to encounter strong opposition from specific socio-economic categories, depending on what fiscal strategy is being employed, as well as from the electorate at large. According to the so-called *New Politics of the Welfare State* literature, this should be the qualifying difference between welfare expansion and retrenchment. The intensity of social and political opposition to retrenchment would also depend on the partisan complexion of the electorate and on the degree of organised interests' involvement in fiscal policy-making, namely on *models of corporatism*. The latter aspect seems to be particularly important in accounting for the Italian and German experience with fiscal consolidation. If Italian social partners signed an unprecedented series of social pacts that aimed, among others, to secure fiscal discipline, German social partners by contrast failed to come to an agreement. The corporatist literature is unable to account for the actual fiscal preferences of social partners and their evolution. Only *interest group politics* approaches and their focus on *preferences* have the potential to reveal the micro-foundations of fiscal adjustment, and probably even the emergence (or not) of corporatist arrangements (Table 2).

Table 2.A synopsis of different theoretical interpretations

<table>
<tr><th></th><th>INTERNATIONAL</th><th>DOMESTIC</th></tr>
<tr><td>TOP-DOWN</td><td>Legal constraint
Vincolo esterno</td><td>State administrations
Political/fiscal institutions</td></tr>
<tr><td></td><td colspan="2">Tying one's hands</td></tr>
<tr><td>BOTTOM-UP</td><td></td><td>Partisanship
New politics of welfare
Neo-Corporatism
Preferences</td></tr>
</table>

2. The Limits of Top-Down Explanations

I have argued above that one simplistic, but probably at the same time quite effective, way of putting some order on the vast literature on macroeconomic adjustment is by distinguishing between top-down and bottom-up explanations of fiscal reform. The following paragraphs go through existing top-down theories – i.e. external pressures, state administrations, political and fiscal institutions- with the objective of describing their specific contents and analytical leverage. I contend that, for one reason or another, they are not fully satisfactory, either in accounting for fiscal consolidation at large or, more specifically, in providing clarification for Italy's and Germany's awkward experiences with budgetary adjustment in the 1990s. A theme that cuts across most of the criticisms moved against top-down interpretations is that these fall short of demonstrating the micro-foundations of the political economy of budget consolidation as they do not account for the distributional implications of fiscal discipline.

2.1. The role of external constraints

Amongst top-down interpretations of the EMU convergence process are those that look at the role of external pressures. There exist variations of the argument that differ from one another in accordance with their relative conceptualisation of the term "external pressure". First, in a straightforward and rather uncontroversial manner, some argue that the presence of an international binding commitment should explain why so many European countries managed to reduce their deficit and debt levels after successive failed attempts in the preceding two decades, and also why this happened in a relatively similar time frame (Rotte and Zimmermann 1998). With the sole exception of Greece, all Euro-zone candidates had in fact managed to meet the 3 percent public deficit target by 1997, the reference year against which the EU was to decide EMU qualification. By setting a deadline common to all candidates, the Maastricht Treaty was also responsible for the timing of fiscal consolidation across the EU, with 1992 and 1996 representing in fact two European-wide structural breaks in the conduct of fiscal policies (European Commission 2000).

The argument is uncontroversial, at least at the aggregate level, and thus to some extent unproblematic. However, when considered through stricter analytical lenses, it shall provoke two criticisms, one empirical and the other theoretical. As to the former, nominal convergence around the 3 percent deficit did not coincide with real convergence, as is often acknowledged in this thesis. Real fiscal convergence was not there neither in the run-up to EMU nor thereafter. For example, cyclically adjusted fiscal positions continued to differ from one country to the other. Second, EU governments implemented different qualitative strategies to reduce their deficits with inevitable consequences for both the persistence of fiscal discipline and fiscal aggregates' short- and medium-term sensitivity to the economic cycle[1]. From a theoretical perspective, rule-based explanations of fiscal performance tend to be positivist and often fail to

[1] This would potentially lead to even greater divergence in national sensitivities to the cycle. The reference here is to the impact of welfare and tax reform on the extent and quality of a national economy's sensitivity to the business cycle.

acknowledge that the same rule can be interpreted differently[2]. There might be also a gap between the actual and the declared perception of the rule, with the latter being an important input to the whole process of preference formation if it is true, as constructivists argue, that ideas play a definite independent role in policy formulation.

Ambiguities between the reality and the rhetoric of the Maastricht commitment were particularly evident in the cases of Italy and Germany. Italian actors initially advocated a flexible interpretation of the Treaty provisions. Once this option faded away, the following step was to present fiscal discipline to the public as a EU imposition. The truth is that the Maastricht commitment exercised a greater pressure on Italy than it did on Germany, considering the former's less favourable starting position and the greater costs the country would incur into, were it be excluded from EMU. On the other hand, German authorities insisted on the rigorous respect of the "dreikommanull" deficit target and sold financial stability as a public good rather than an imposition from the outside. In factual terms, it is to be acknowledged that Germany felt certainly less pressure to qualify for EMU than Italy.

The above considerations take us to the second interpretation of "external constraint" available in the literature, one that is slightly more sophisticated than the former. Theories on the so-called "*vincolo esterno*" are predicated on a narrow and a broad definition of the external constraint (Featherstone 2001). In more general terms and borrowing from constructivism, the argument is that the idea of EMU reached national policy-makers and became for them a positive constraint (McNamara 1999). My contention is that this explanation is unsatisfactory in that it sees EMU and, by extension, fiscal consolidation as elite-driven phenomena. Fiscal policy has such far-reaching distributional implications that they can be hardly overstated. An argument related to the former is at the heart of the tying one's hands theory, which focuses on the economic rationale behind international agreements. It is argued that international commitments are

[2] There is in addition a strand of literature discussing the effectiveness of fiscal rules in general. Most agree that fiscal rules are needed only there where reputation is lacking (e.g. Italy); by the same token, they would be unnecessary in the case of countries with a strong reputation of fiscal prudence (e.g. Germany), see (Kopits 2001).

often self-imposed and used as means to acquire credibility. Needless to say, they are valuable policy tools for low-credibility countries. Along these lines, one could say that Italy's interest in EMU membership links back to its desire to import Germany's low-inflation reputation. Still, first, such a strategy is not necessarily successful. Giavazzi and Pagano show that Italy's membership of the EMS since 1979 was not sufficient to preserve exchange rate stability, and thus low inflation (Giavazzi and Pagano 1988). Secondly, the argument falls short of explaining Germany's support of EMU, and this is so also because EMU results in a much more complicated international arrangement than the EMS, one in which both positive and negative externalities play a greater role. Most importantly, the theory underestimates distributive conflicts, as well explained in Walsh:

> "The tying hand analysis focuses on the preferences of some policy makers for adjustment, but does not specify the domestic political conditions under which these preferences can be implemented. Measuring the aggregate consequences of divergent macroeconomic policies fails to consider how such policies affect groups whose specific interests may differ from the national interest" (Walsh 1999, 76).

Putting greater emphasis upon the interaction between *elites* and societal forces, the narrow definition of the "*vincolo esterno*" suggests that policy-makers may have used EMU to strengthen their positions at home (Dyson and Featherstone 1996; Dyson and Featherstone 1999; Grande 1995; Heritier and Knill 2000). Set against the tradition of rational-choice institutionalism, these interpretations indicate that EMU provides policy makers with strategic advantages, especially where there the State is traditionally weak. In other words, it is often used as an excuse to proceed with unpopular reforms. The availability of such an option would thus depend critically on the level of public support for EMU. The EU is an effective justification for reform only where the public opinion is supportive of the principles inspiring European integration. In this respect, the narrow definition of the *vincolo esterno* is probably illuminating in explaining the Italian experience with fiscal adjustment. According to Eurobarometer, Italy enjoyed levels of EU public support that were substantially higher than in other member states (*Eurobarometer,* various issues). No surprise then that successive governments in the 1990s presented deficit reduction as the condition that would save the country from exclusion from the European project Nevertheless, this interpretative perspective says little about the choice over the composition of fiscal reform. In addition, while it is true that the Germans continued to be strongly attached to their national currency and were generally sceptical of the Euro, this does not explain why the Kohl Government failed to provide the degree of fiscal discipline everyone one was striving for, considering that financial stability was, as much as the DM, a national value embedded in formal and informal institutions.

2.2. The position of state administrations

In the previous section, I have suggested that external pressures may account for nominal fiscal convergence and for the timing of reform across the EU. Still, the Maastricht commitment meant different things for different people, which is by itself indication of the fact that fiscal consolidation cannot be explained by exclusive reference to outside events. And indeed the Maastricht Treaty is unable to provide an explanation for persistently different real fiscal positions, be they the degree of fiscal discipline or the content of budgetary adjustment, aspects which neither tying one's hand theories nor the literature on the "*vincolo esterno*" nor arguments about the threat of exclusion from European monetary unification can satisfactorily account for. Against this context, there is no doubt that domestic factors are paramount. Even domestically, one should distinguish between top-down and bottom-up dynamics, though the borders here are much more in flux.

Political *elites* and state administrations can be regarded as domestic forces capable of imposing pressures for change from above. Inaugurated with the publication of the pioneering research "*Bringing the State Back In*", an important strand of literature has contended that dramatic policy reform can only come on the initiative of a powerful state administration (Skocpol and Evans 1985). This and other state-centred explanations of reform are predicated on three main assumptions. First, communities of experts are important inputs to the decision-making process. They induce preference formation and allow for policy learning

(Heclo 1974; Hall 1989; Radaelli 1999). In this sense, it is to be expected that policy reform is undertaken following optimal recipes, or at least those perceived as such. In the case of fiscal policy, one would expect the application of the tax-smoothing principle, just to name an example. Second, any reform is conditioned by policy legacies, either success or failure stories, and state administrations figure as the guardians of these legacies (Hall 1989; Skocpol 1992). Third, it is assumed that the State acts autonomously from society. This implies by extension that only strong States are capable of initiating and then realising policy change.

Undoubtedly, state administrations are central to the budgetary process. Officials play a pivotal role in the drafting of budget laws before these are passed through to parliament and, even more so, in the implementation phase. Still, even at first sight, state-centred explanations appear to entail some limits when it comes to explain fiscal policy outcomes. It is unclear how state administrations could affect medium- and long-term aspects of deficit reduction such as the persistence of discretionary fiscal discipline or what role they could play in the definition of the content of fiscal reform, where it is clear at the outset that this does not follow the principle of optimality. Often researchers have supported the view that state administrations and experts play a greater role in the case of complex policy areas whose distributional implications are either unclear or unpredictable (McNamara 1998). My belief is that fiscal policy does not fall under this category. Because the distributional impact of fiscal policy decisions tends to be both far-reaching and visible, it is extremely difficult to allow policy formulation to take place behind closed doors. In the following paragraphs, I shall test the validity of state-centred approaches to macroeconomic adjustment by discussing the relative explanatory power of the three assumptions mentioned above.

As to the first, bureaucrats can either be experts themselves or they can establish strong ties with communities of experts whose comparative advantage over policy-makers relates to their access and understanding of the relevant information. Game-theorists would talk of the existence of informational asymmetries between experts and politicians (Krehbiel 1991). However, it is not always true that state administrators are neutral to the content of the decisions they take and that optimality shall prevail. For one, bureaucrats can be affiliated more or less explicitly to political parties, through which they embrace views about desirable fiscal policy targets. Moreover, they can have a vested interest in the policies they design. There is an important strand of literature, which developed mostly in the 1970s, arguing that officials support public sector expansion, hence fiscal profligacy rather than discipline, as any public expenditure cut has the potential of threatening their own position (Tullock 1975; Niskanen 1975; Buchanan 1978; Przeworski 1990; Finlay 1990; Olson 1982). But even imagining that bureaucrats are the neutral and efficient decision makers the literature is attempting to portray, the process of fiscal convergence in the run-up to EMU entails a few characteristics that are hardly reconcilable with this view. First, and most importantly, EU governments had to take budget decisions within a relative short-time horizon. Probably, this did not allow them to opt for efficiency. There is extensive evidence of fiscal policy makers having implemented one-off fiscal measures simply with the immediate objective of cutting the net borrowing requirement the following year in mind. Secondly, the existence of a specific numerical target for the public deficit implied that all governments were deprived of the choice over the most appropriate deficit level; which by itself constrained the full exploitation of their economic expertise[3].

According to the second assumption, state administrations are in the privileged position to guard policy legacies from which they can draw lessons. Already in 1935, Schattschneider noted that "policies create politics" meaning that past policies produce resources, incentives and learning effects on governmental *elites*. More recently, it has been similarly explained that past policies exert feed back effects, possibly even expanding state capacities, and eventually having a clear bearing on future decisions (Hall 1989; Skocpol 1992, 58; Pierson 2000). This interpretation has been applied quite extensively to explain Italy's experience with budget consolidation in the 1990s. It has been suggested, for example, that a long history of policy failures in the area of fiscal policy led to institutional

[3] It is well documented that many economists across the EU expressed doubts over the soundness of the 3 percent target, often even those in the role of government advisers. Some commentators give a political explanation for the choice of that specific deficit level, arguing that it coincided with the German net borrowing requirement at the time in which the Maastricht Treaty provisions were being designed (see Walsh 2000, 97-104).

reform of the budgetary process in the late 1980s. This represented an essential precondition to the conquest of fiscal discipline during the 1990s (Radaelli 2000). Nevertheless, policy learning is incapable of accounting for other aspects of fiscal reform. In the case of Italy, for example, deficit reduction continued being undertaken on the revenue side of the budget, a strategy applied in the past, but one that economists had never failed to criticise. Thus, there is no clear-cut evidence of policy learning effects when it comes to giving reasons for the content of macroeconomic adjustment. If one interprets the feed-back metaphor more mechanically, then it is also not necessarily true that EMU candidates' choice for a revenue-based consolidation stemmed from the fact that revenue budget items are notably more flexible than spending items (De Haan, de Kam and Sterks 1992, 7), which would confirm past public policies and in particular the financing structure of government programme-directed policy change in the 1990s. As a matter of fact, still sticking to the Italian case, successive governments did implement a few expenditure cuts. Also, other EMU candidates opted for largely expenditure-based adjustments, which also indicates that the relative flexibility of budget items was not always present and was not necessarily a constraint on future policy decisions. I contend that past policies are not relevant because of the impact they exercise on governmental actors and structures, but rather because of feed-back effects on domestic interest groups and the public at large (see Pierson 1994; Myles and Quadagno 1997; Immergut 1992). The crucial point is that the financing structure of public programmes establishes beneficiaries. Fiscal reform proposals have the potential of altering their position - the most notable example being pension reform - and are thus more than likely to attract the opposition of vested interests (see Anderson 2001). To sum up, past policies matter in fiscal adjustment only to the extent that they have induced the formation of specific vested interests.

Third and linked to the considerations above, it seems highly unrealistic to assume state autonomy in fiscal policy-making. Decisions about the scope and distribution of public money touch on a multiplicity of socio-economic interests. In addition, when it comes to retrenchment, these interests are normally concentrated, thus functioning as powerful veto points (Pierson 2001). Having succeeded in mobilising large part of society in favour of welfare expansion in the post-war period (Korpi 1983), European labour unions now prove to be crucial actors in any decision concerning welfare retrenchment, mostly opposing it, even if to different extents and for different reasons across the EU (Brugiavini et al. 2000). By the same token, where welfare reform did in fact take place, this was feasible only thanks to the explicit support of social partners (Visser and Hemerijck 1997). Moreover, most case studies indicate that the involvement of labour unions and employers' associations in the framing of fiscal policy decisions had little to do with the strength of the state, a trait the literature mentioned often insists upon. The evidence is in fact mixed. States have proved able to lead negotiations with the social partners thanks to their indisputable strength, as was the case for Germany in the 1980s (Gualmini 1997). But, social partners can be directly and effectively involved where weak states are looking for a social legitimisation of their actions – the Italian experience in the 1990s is a case in point. This suggests that the relative power of the state is not independent from society; it is actually defined by the society it speaks to. To conclude, technocratic politics, policy legacies and the assumption of state autonomy find weak support in the real world and vacillate in front of the need to account for the emergence of social consensus (or lack of it) in favour of fiscal discipline and of the ways to achieve it. Wildavsky is probably right in saying: "if politics is regarded as conflict over whose preferences shall prevail in the determination of national policy, then the budget records the outcome of this struggle" (Wildavsky 1979, 4). In this sense, other elements should be incorporated in the analysis that takes account of bottom-up inputs to fiscal policy-making.

2.3. Political and fiscal institutionalism

I have shown above that state-centred explanations have little explanatory power when it comes to accounting for the run-up to EMU. In so doing, I have worked from an actor-based analysis showing that state officials, while being constituent parts of fiscal policy-making and of the budgetary process in particular, cannot "go it alone". This is not to say that state structures do not matter at all. Somewhere between top-down and bottom-up approaches, institutionalism suggests that national fiscal performances are strongly dependent upon the institutional setting in which budget decisions are taken, and more precisely upon party structures and budget institutions. From there and with some degree of simplification, one can identify two strands in the literature: political and fiscal institutionalism (Poterba and von Hagen 1999). According to these interpretations, fiscal discipline emerges where the government in power faces a limited number of veto points, as in the case of single-party governments, and where the budgetary process is efficiently designed, namely it is transparent and largely insulated from parliamentary amendments.

Originated in the US, institutionalist accounts of fiscal consolidation have become popular also in Europe in more recent years once the Maastricht Treaty had institutionalised the principle of sound public finances. Political institutionalists argued that any form of political instability, whatever the source, discourages fiscal prudence. As they give rise to coalitional governments, proportional representation systems (PR) are generally associated with poor fiscal performances. The underlying argument is that, against a high number of parties, fiscal discipline is more difficult to achieve because no one party would accept to bear the burden of adjustment; each one will then exercise its veto power (Alesina and Tabellini 1987; Roubini and Sachs 1989; Grilli, Masciandaro and Tabellini 1991). Economists have also gone as far as to evaluate the effect of political institutions on the composition of budgetary adjustment. In a panel data analysis looking at 20 OECD countries in the period 1960-1992, Alesina and Perotti have demonstrated that coalitional governments, when successful in budget consolidation, rely almost exclusively on interventions on the revenue side of the budget (Alesina and Perotti 1995, 21). Again the argument is modelled around the collective action problem by which, in the presence of multiple actors, it is easier to impose the diffuse costs from higher fiscal pressure than the concentrated costs that welfare retrenchment tends to produce. By the same token, single-party governments are seen as more efficient fiscal reformers and better capable at imposing discipline on the expenditure side of the budget. In addition, besides party structures, the length of government tenure - actual or expected (Grilli, Masciandaro and Tabellini 1991) - should also bear an impact on fiscal policy outcomes as, for example, governments not expecting to be re-elected would not embark on unpopular fiscal retrenchment.

As opposed to political institutionalism, which is in fact quite generic, fiscal institutionalism focuses more specifically on the formal institutional setting in which decisions take place. The budgetary process has been often defined as a "locus of conflict resolution" (European Commission 1994). The circumstances under which the conflict is solved depend upon the rules and norms characterising the budget process itself. There is an extensive literature demonstrating that budget procedural rules at all stages, during the governmental, parliamentary and the implementation phase, affect fiscal policy outcomes (von Hagen and Harden 1994; European Commission 2000). Amongst the most comprehensive cross-country investigations of budget rules is the European Commission Report "Budgeting Procedures and Fiscal Performance in the European Communities" (von Hagen 1992). By looking at the particular shape of budget institutions, von Hagen constructed a "structural budget index", which he showed to be correlated with countries' relative fiscal prudence. The composite index addresses five dimensions of the budgetary process: 1) the structure of budget negotiations within government; 2) the structure of the parliamentary stage; 3) the transparency of the initial budget draft; 4) the flexibility of budget execution; 5) the presence (or not) of some form of long-term financial planning procedure. He came to the conclusion that: "budget procedures lead to greater fiscal discipline if they give strong prerogative to the Prime or Finance Minister, limit universalism, reciprocity and parliamentary amendments, and facilitate strict execution of the budget" (von Hagen 1992). Hallerberg provides a more recent estimate of the degree of efficiency in the budgetary process by looking at most of von Hagen's variables and capturing them in a composite index. Interestingly enough, he compares the situation in the early 1990s with that at the end of the decade (Hallerberg 2004).

It remains to be seen if institutionalist explanations can satisfactorily account for the unexpected fiscal performances of Germany and Italy in the 1990s (Chapter III and V address the issue). Still, at a theoretical level, it should be noted that this literature is more interested in the transmission mechanism from fiscal inputs to outputs rather than in the nature of the input, which is instead the focus of the present thesis. Most importantly and linked to the previous point, both political and fiscal institutions do not operate in a vacuum. Fiscal contractions tend to have so far-reaching implications for domestic socio-economic interests that it is unrealistic to expect that the interests that are often represented within institutions do not become suddenly visible, and possibly active in a way that may well be contrary to the traditional operation of that particular institution. This is not to say that state structures play no role, yet they only matter to the extent that they channel societal claims by defining, for example, interest groups' access to policy-making. In this thesis, I intend to focus on this latter aspect, i.e. the relationship between state structures and society rather than on the technical transmission mechanism through which inputs turn into outputs.

3. The Leverage of Bottom-Up Explanations

In the previous paragraphs, I have suggested that top-down explanations are not always persuasive when it comes to accounting for deficit reduction, and especially not if applied to the Italian and German experiences with budgetary consolidation in the run-up to EMU; though the latter will emerge more clearly in the empirical chapters (Chapters III, IV, V, VI). The following section focuses on bottom-up interpretations –i.e. partisanship, new politics of the welfare state, corporatism, and interest group politics. As has been insisted upon earlier, fiscal policy has such significant distributional implications that it is hard to believe that structures matter more than preferences or, and similarly, that decisions are not entrenched in socio-economic interests. I will explore here the relevance of partisanship to assess if and to what extent, according to existing literature, the ideological orientation of the party in power would affect fiscal policy outcomes. Secondly, with a more institutionalist flavour, the new politics of the welfare state literature supports the view that fiscal austerity runs against multiple veto points consisting both of voters and minority vested interests, in most cases labour unions. This theoretical approach can be seen as a sort of institutionalism from below, as it focuses on the existence of formal opposition at the micro-foundations of fiscal policy formulation. This links nicely to neo-corporatist studies exploring the contribution of social partners to policy-making. The latter is certainly an attractive perspective that ties appropriately with the two cases analysed here, with Italian governments, on the one hand, successfully concluding agreements with the social partners and the Kohl government, on the other hand, failing to put in place a comprehensive political exchange with national peak associations. Nevertheless, I argue that, while crucial to the understanding of fiscal consolidation episodes, the (institutionalist) literature on corporatism falls short of taking actual interest groups' preferences into account. I shall then conclude by recalling contributions from the literature that look specifically at the role of socio-economic interests and at the ways in which these can inform policy outcomes; this refers to interest group politics and preference-based approaches.

3.1. The fate of ideology under permanent austerity

There is hardly a more contentious and debated issue in comparative political economy than the role of partisanship. Starting with Hibbs, left-wing governments have been always associated with fiscal profligacy, whereas right-wing parties adopted restrictive fiscal policies, largely in the expectation that these keep inflationary pressures at bay (Hibbs 1977; Hibbs and Masden 1981; Cameron 1984). There is however an extensive successive literature arguing that, in the era of globalisation and with the prevailing of a neo-liberal consensus in favour of fiscal rectitude, budget preferences between Left and Right have in fact faded away. On the one hand, national governments are said to be unable to manage their own economies at all. In Europe, fiscal policy would be constrained by full capital mobility after 1990 and by the need to stick to fixed exchange rates; even if only until the ERM crisis in September 1992 for some EU member states. On the other hand, imagining that they still retain some room for manoeuvre, the same external economic conditions highlighted above do not allow leftist governments to pursue their traditional constituents' interests. Large public budgets stop being an option; the little fiscal stimulus that they can inject into the economy is nothing different from that which conservatives can do.

Indeed, most of the research focusing on the role of partisanship under austerity is unconvincing. It is so because results are mixed, hence largely inconclusive. Besides the two extreme views of partisanship - one where it is believed to affect fiscal policy choices and the other ascribing no role to it at all - there are subtler conceptualisations of the *new* role of ideology in an internationalised economy. Global markets do not necessarily lead to left-wing parties behaving like right-wing ones. True, they may have abandoned demand management but not necessarily reduced their level of intervention in the economy. The Left will continue supporting the goal of full employment by spending, for example, on human capital formation, hence mainly relying on supply-side reforms (Boix 1997; Boix 1998). More paradoxically, other researchers even argue that leftist governments are better able to implement unpopular reform such as welfare cuts because the party's reputation sends a reassuring message to voters and organised socio-economic interests alike (Ross 1998; Armigeon et al. 2001). Going against the current conventional wisdom, Garrett argues that under capital mobility social democratic governments prove to be more generous fiscal spenders as they need to compensate losers from globalisation (Garrett and Lange 1991). Throwing a bridge across to neo-corporatist literature, Korpi argued that ideology continues to be an important determinant of fiscal policy outcomes and that it is more important where there are strong encompassing unions support the government in power (Korpi and Palme 2001).

The ambiguity of the research results is probably to be ascribed to the fact that there is no common definition of austerity and that most researchers tend to associate it with a change in the level of social expenditures as a proportion of GDP. This is not necessarily the best measure of welfare retrenchment as it misses the qualitative dimension of the problem. Responding to this methodological concern, Korpi focused on social rights curtailment (Korpi and Palme 2001). Pierson looked simultaneously at social spending levels and changes to benefit entitlements (Pierson 1996). Here, where the focus is fiscal discipline in general rather than how it is achieved, I intend to look at interventions both on the revenue and on the expenditure side of the budget introduced with the primary goal of cutting the public deficit. Once the priority is balancing the budget, then any fiscal decision consists of a trade-off choice. Even in the 1970s, welfare expansion was to come with greater fiscal pressure. Similarly, in the 1990s, where leftist governments refuse to cut welfare programmes, they are forced by default to accept greater fiscal pressure[4]. Against this background, this thesis attempts to test if ideological preferences affected fiscal authorities' positioning on the indifference curve that pictures the trade-off between lower expenditures and greater public incomes, once balanced budgets are accepted as primary aim.

There is only a limited number of studies that focused on the impact of partisanship on the composition of fiscal consolidation. In particular, Alesina and Perotti have demonstrated that leftist parties are more likely to adjust fiscal imbalances by intervening on the revenue side of the budget. Instead, conservative parties tend to opt for spending restraints (Alesina and Perotti 1995; Alesina and Perotti 1996). The underlying assumption is that revenue maximization consists *de facto* in an enlargement of the role of the state, and is therefore preferred by the Left (Fatas and Mihov 2003). By the same token, right-wing parties would choose cuts to social security programmes and to public wages as a means to minimise public interference with the markets as well as to please state-unfriendly financial markets (Krugman 2001).[5]

In reality, there is not only a problem with the definition of austerity. The very distinction between Left and Right is somehow simplistic and falls short of providing a realistic picture of parties' positioning in front of different issues. Similarly to the concept of the median voter, the Manichean distinction between two extreme ideological poles does not capture the fact that political beliefs are multidimensional. In turn, the present research looks not only at political parties' ideological heritage but also digs into their expressed preferences vis-à-vis single issues. From a methodological perspective, the latter is certainly a much more challenging task but is well supported by recent content analyses of electoral manifestoes (see Budge et al. 2001). And indeed, the distinction between actual

[4] See for a similar conceptualization of fiscal policy decisions, see (Korpi and Palme 2001)
[5] Still, not all agree with the proposition that market participants approve of spending cuts, while punishing tax increases. Through a series of interviews, Mosley argues that it is the size of deficit reduction that matters at the end of the day (Mosley 2004, 749).

and declared fiscal preferences is significant, as the two should not necessarily coincide[6].

3.2. The new politics of the welfare state and beyond

EMU candidate countries were to face difficult choices, having to strike a compromise between three not easily reconcilable pressures: the Maastricht commitment and its severe fiscal prescriptions, their own ideological preferences and, thirdly, the views of their electorate and/or affiliated interest groups. For once, partisanship is significant only to the extent that it does shed light on the relationship between governments and society. In this respect, any investigation on the political economy of fiscal adjustment should also look at the second reference object, namely society. The latter can impose severe constraints on public authorities' ability to pursue preferred or optimal fiscal policy recipes. First, electorates can feel that they have different priorities from their own governments. Second, labour unions, especially where well organised, can certainly obstruct undesired government decisions. They will do so by depriving the elected of their specific support, financial in addition to political, or more generally of the underlying social consensus. The latter tends to happen in those cases where unions are also political actors, in the wider sense.

The achievement of fiscal discipline is an unpopular exercise. Even if it is true that diverse strategies are available to cut the public deficit, there is wider consensus on the fact that, in the back of de-industrialization and of the ageing of the European population, welfare reform should be the way to go or at least where to start from, would sustainable fiscal stability be in governments' intention. Pierson explains that any attempt at reducing citizens' welfare will incur high electoral as well as socio-political costs. Following from arguments on path dependency and socio-political inertia (Visser and Hemerijck 1997), the new politics of the welfare state literature suggests that welfare states are in general highly resistant to change. Secondly, if governments do reform welfare states, they will opt for blame-avoidance strategies, so as to minimise the

[6] In a similar vein, Cusack has made a distinction between government partisanship and demand-side partisanship (Cusack 1997).

unavoidable political costs (Weaver 1986). This type of literature implies by extension that the position of the median voter is more relevant than the partisan complexion of government[7], where the latter are seen primarily as rent-seeking actors. Third and finally, welfare beneficiaries not necessarily coinciding with labour unions' membership *tout court* will oppose retrenchment (Pierson 2001).

The empirical evidence on fiscal adjustment in the run-up to EMU is not completely supportive of all the tenets behind the new politics of the welfare state literature. In most EU member states, welfare reforms were implemented (e.g. Italy: 1995 pension reform), even if in completely different contexts. Blame-avoidance probably did take place but is nonetheless a soft component; one that research on fiscal policy outcomes should not necessarily look at. There is more convincing evidence about the role of welfare beneficiaries, and in particular of labour unions. Having said this, large cross-country differences concerning the degree and type of social partners' involvement in fiscal policy decisions suggest that the argument about beneficiaries' unconditional veto is probably too naïve. Indeed, because most decisions require an evaluation of costs and benefits, preferences are far from unconditional. Instead, they would appear to be very much dependent on contingencies, such as incentives and/or compensation mechanisms. The trade-off arises because, when fiscal discipline is an accepted target, failure to tackle expensive welfare programmes will translate into either lower public investment or greater fiscal pressure. In this respect, the new politics of the welfare state suffers also from a theoretical flaw to the extent that it does not recognise that the resilience of some public programmes may lead, for example, to even higher, real or perceived, costs than their actual reform. To account for these aspects, this thesis attempts in turn to visualise the structure of such trade-off choices by looking at Italian and German interest groups.

Again from a rather theoretical perspective, this literature is possibly too dramatic in the relaxation of the Right/Left paradigm. Partisanship may not function in the way it has traditionally done, as highlighted above, but this does not mean necessarily that it is irrelevant. Parties can use partisanship strategically

[7] According to Downs' democratic theory (Downs 1957).

(Scharpf 1991). Finally and most importantly for the present research agenda, as Hemerijck and Visser note, "there is not much room in these accounts for negotiated reform, for compromises between political reformers and the representatives of organised interest groups" (Visser and Hemerijck 1997, 52) an argument that is certainly related to criticisms concerning the naïve conceptualisation of socio-economic interests. The possibility of a political exchange between politicians, as rent seeking as they could be, and well organised entrenched intermediate organizations is just not taken into account.

3.3. The contribution of neo-corporatism

Intermediate organizations dispose of diverse means through which they can inform fiscal policy-making processes and try to affect or alter outcomes. The neo-corporatist literature does not always distinguish clearly between their contribution to the actual process (Schmitter 1974; Schmidt 1982; Katzenstein 1985; Alvarez et al. 1991) and to the outcome, where the latter would require in most cases a sophisticated evaluation of unions' and employers' economic behaviour and of their internalisation, for example, of the trade-off between low inflation and employment along the lines of the Phillips-Curve model. The three most common channels through which organised interest groups participate to policy are lobbying, informal and formal consultation. Lobbying activities are an integral part of today's affluent democracies, widespread phenomena that are probably not necessarily relevant in this research context. As a matter of fact, lobbying does not automatically imply that these groups affect actual outcomes, which are instead the focus of this research. Informal consultation arises when governments consciously seek advice and support from the social partners, an example being Chancellor Kohl's so-called *Kanzlerrunde*. Only a case-by-case evaluation can tell if these arrangements bear an impact on outcomes. Finally, formal consultation would require instead a recognisable institutional setting against which decisions are taken according to commonly agreed rules and norms, as in corporatist realities. And here because the agreements are usually structured on a political exchange (Pizzorno 1978), it is extremely troublesome to differentiate between the participation of social partners in the process and their contribution to the outcome. The ambiguity is ingrained in Cawson's definition of corporatism:

> Corporatism is a specific socio-political process in which a limited number of monopolistic organizations representing fundamental interests engage in bargaining with state agencies over public policy outputs. In exchange for favourable policies, leaders of interest organizations agree to undertake the implementation of policy through determining the co-operation of their members" (Cawson 1987, 105).

This thesis looks at formal consultation with particular attention to tripartite agreements between government, employers and unions (so-called social pacts) and in so doing it shall simultaneously consider social partners' contribution both to the process and the outcome. As to the first, under austerity, governments resorted to organised interests mostly with the aim of legitimising their fiscal policy decisions. Often retrenchment took place with unions' consent (Fajertag and Pochet 2000; Baccaro 2000; Anderson 2001) and certainly, as Bordogna and Cella note: "they would have fiercely opposed similar measures if they had been introduced by the State" (Bordogna and Cella 1999). As to outcomes, many authors have established a clear-cut link between the conclusion of social pacts and successful fiscal consolidation (Sestito 2002; Hancke and Rhodes 2004). To the extent that these always revolve around voluntary wage restraint (Hassel 2003), corporatist arrangements clearly overlap with wage bargaining, thereby making visible the link between models of corporatism and macroeconomic performance[8]. Looking at fiscal performance, pay restraint bears an impact via multiple channels. When it improves the employment rate, public spending on the unemployed diminishes and revenues from social security contributions increase. Second, wage moderation in the public sector has a direct beneficial impact on public employee compensations. Third, voluntary wage restraint should keep inflation at bay, thereby reducing or preserving the real value of interest payments.

[8] Somehow merging their contribution to both the process and the outcomes, Rhodes talks of "competitive corporatism" (Rhodes 1997). While aiming to provide a name for this new constellation of preferences and strategies, he *de facto* acknowledges that they exercise an impact on countries' competitive performance by means of reducing unit labour costs.

And there is an extensive literature on the impact of corporatist arrangements on economic indicators and performance. In general, it has been argued that they are valuable because they prove capable of simultaneously performing allocative and distributive policy tasks (Katzenstein 1985; Hicks and Kenworthy 1998). According to Cameron, corporatism in the 1970s allowed governments to achieve two, often irreconcilable, policy goals: high levels of employment and low inflation (Cameron 1978). Borrowing from Scharpf (1991), Hassel points to the fact, with the new social pacts of the 1980s and 1990s, governments can partially offset the negative effects from monetary adjustment (Hassel 2003). Looking at wage bargaining systems and thus only directly at varieties of corporatism, Calmfors and Driffil explained that employment does not always improve where social partners have the power to shape wage policy. It depends more specifically on the structure of wage bargaining. In a nutshell, centralised and decentralised systems tend to do better than moderately centralised ones (Calmfors and Driffil 1988; Streeck 1994). Others enriched the argument by incorporating monetary policy into the model and arguing that central bank independence adds to centralised collective bargaining to the extent that, being a credible threat in the eyes of wage bargainers, it minimises *de facto* the trade-off between growth and low inflation, with bargainers conscious of the fact that aggregate price effects will not be accommodated (Hall and Franzese 1998; Soskice and Iversen 1998; Iversen 1999).

More specifically to the budgetary process, Rubin adopts an institutionalist approach to show that openness of the budget process to socio-economic groups has just the effect of amplifying the number of claims and requests, inevitably exercising upward pressures on public expenditures (Rubin 1997). By contrast, Perotti suggested that openness to few monopoly organizations might indeed be beneficial as it channels clearly defined socio-economic interests (Perotti, Strauch and von Hagen 1998). The underlying argument is indebted to Olson's collective action model. Animated by the same inspiring principles and more distinctively to the link between fiscal and wage policies, Summers at al. demonstrated that, in corporatist regimes, labour taxation tends to be both higher and less distortionary. Because peak associations internalise the effects from augmented SSC in exchange for greater social expenditures, higher labour taxation does not have the effect of dampening labour supply (Summer et al. 1993). Still, compensations in the form of more generous spending programmes are not always available. Acocella et al. suggested however that this does not necessarily alter the nature of the exchange between government and unions. Even under austerity, monopoly unions internalise negative macroeconomic externalities arising from the exchange between wage moderation and lower public expenditures (Acocella, Di Bartolomeo and Tirelli 2004). Indeed, there are degrees by which welfare programmes can be cut back.

While the degree of centralization and other institutional characteristics of the bargaining process are fundamental when it comes to account for the feasibility, for example, of collective decisions, i.e. the possibility of actually implementing collectively agreed wage moderation, they shed little light on the actual preferences of social partners. The same criticism was directed to the new politics of the welfare state literature said to underestimate the concrete and contingent interests of organised groups and the fact that they constantly face trade-off rather than linear choices. If it is true that institutions might coincide with the interests they represent –as seems to be the case for corporatist institutions, then it may well be that a specific distribution of socio-economic preferences is what explains the emergence (or not) of social pacts. In this respect, this research also contributes to neo-corporatist literature in determining whether "the institutional bias in neo-corporatist theory meant that all of these explanations underplayed actors' rational calculation of their interests and objectives in creating corporatist institutions" (Rhodes and Molina 2002, 314).

4. Bringing Socio-Economic Preferences Back In

This thesis revolves around the assumption that interests matter more than institutions or, at least, that it is not necessarily easy to distinguish between the two, considering that normally institutions are modelled around the socio-economic interests they represent and that any separation of the two is somehow artificial. In Chapter I, I have insisted upon the fact that budget consolidation is a multidimensional exercise. As its dimensions vary, so should the preferences confronting them. Where should one go to identify preferences when faced with fiscal consolidation? What is the most appropriate level of analysis and of aggregation? Around what cleavages are these preferences organised? The following sections look, first, at existing literature that has analysed the role of vested interests, or raw preferences, in economic policy-making. Secondly, I will go through the patchy current wisdom on interests and fiscal consolidation, trying to order preferences in front of the different dimensions of fiscal reform, and in particular of composition. This shall be just a tentative scheme, one that only the empirical research can definitely validate or invalidate, as is done in Chapter VII.

4.1. Vested interests and economic policy

As highlighted above, the bulk of the literature on neo-corporatism is institutional in essence. The underlying argument is that socio-economic interests affect policy outcomes because they are granted access to the policy-making process. The corporatist literature falls short of constructing hypotheses about the actual preferences of social partners. In general, there is no doubt that they promote the cause of their members and try to improve their political status. However, it is not always clear what the fiscal interests of employers and workers are. Not only are their preferences likely to be affected by factors other than class (e.g. economic sector, size of the group, outsiders *vs.* insiders), but also general macroeconomic conditions might have a bearing on the shaping of these preferences and, more so, on their evolution.

In recent years, preferences have somehow returned to the centre of political economists' attention. Moravcsik referred to preferences when describing national governments' behaviour at the EU negotiating table (Moravcsik 1998). Verdun resorted to this conceptual category to explain different approaches to, and implementations of, EMU in some EU member states (Verdun 2000). More often, researchers have looked to preferences to account for different policy outcomes across countries exposed to the same external constraint or over time in the same country (Gourevitch 1986; Milner 19881; Frieden 1991; Milner 1997; Hall 1989, 1997; Frieden 1999). When focusing on preferences, two fundamental issues should be addressed. Firstly, one has to establish a strategy to identify and aggregate such a complex and heterogeneous variable. Secondly, one needs to explain how preferences influence policy. While the neo-corporatist studies and institutionalism more generally provide a good answer to the second question[9], the former is probably under-researched, especially in relation to the exercise of fiscal adjustment[10].

There is a substantial number of studies considering functional coalitions of interests and their impact on government economic policies; in most cases, the reference is to trade policies. Most of these studies aggregate preferences around actors' market position. Rogowski suggested that trade policy outcomes are affected by countries' relative factor endowment in capital, labour and land (Rogowsky 1989). Gourevitch, Milner and Henning have all identified differences between export-oriented and domestic-market-oriented business sectors (Gourevitch 1986; Milner 1988; Henning 1994). Working from a similar aggregation of interests, Frieden demonstrated that export-oriented business is keener to partake of monetary integration than more insulated actors (Frieden 1991). Looking beyond producers, Swenson argued that employers in key export sectors ally with workers against employers and workers in sheltered sectors to preserve wage rates or promote skill differentials vis-à-vis the other group (Swenson 1991). With an eye on types of product, Rodrik showed that the preferences of producers of tradable goods vary from non-tradable producers (Rodrik 1994). All these works share common traits, i.e. they are quite static assigning preferences *a priori* in addition to deriving them merely from market

[9] It is fair to say that the distinction is not necessarily so clear-cut, as in Milner's words: "the preferences of different interest groups are weighted by their access to policy-making institutions" (Milner 1992, 494). Another example of studies that fail to distinguish between the identification of raw preferences and of the instruments to transform them into policy outcomes is the so-called power-resource literature. Exponents of this approach studied the preferences of those in power looking at Left and Right and their respective alliances with labour and capital (Stephens 1979; Korpi 1983; Castles 1982, 1998; Esping-Andersen 1985; Baldwin 1990). The crucial argument is that the governing party would implement policies that please her natural constituents grouped around classes.

[10] Instead, Garrett and Lange provide a valuable account of the role of preferences and institutions that simultaneously addresses both questions (Garrett and Lange in Keohane et al. 1996, 48-75).

position. These assumptions are unconvincing. Preferences are likely to evolve in response to changing external conditions and, as Kindstone notes, "the market leaves preferences underdetermined" (Kingstone 2001, 988). Therefore, there is probably more to preferences than market position.

4.2. Vested interests in fiscal adjustment

It was suggested above that most of the political economy of reform can be explained in terms of prevailing preferences and that, in turn, accounting for preferences is probably one the central challenges facing political economy (Hall in Lichbach and Zuckerman 1997, 174-207). While the previous part generally dealt with vested interests in economy policy-making and outcomes, this section discusses specifically fiscal preferences by focusing on the socio-economic categories, other than governmental actors, that seemed to have played a central role in EMU-induced macroeconomic adjustment, namely national social partners. Here I will lay out the conventional wisdom on the fiscal/budget preferences of social partners by relying on available literature. This *a priori* classificatory scheme is only intended to provide some guidelines to the empirical research that follows, and is thus likely to be altered when tested in specific real-world conditions (see Chapter VII).

Independently of how it is pursued, fiscal consolidation involves some social costs. Governments find it difficult to distribute them evenly; hence most stabilization policies are about the choice over what socio-economic category shall prevail. In turn, debt management should be interpreted as a redistributive struggle between competing economic interests, both intra-generational and between current and future generations. It goes without saying that societal conditions matter in explaining budgetary adjustment. This has not gone unnoticed, even by economists. There is an extensive literature on the implicit social contract that needs to underlie deficit reduction. More to the point, Boltho argued that stabilization policies are successful only in the back of vast social consensus (Boltho in Einaudi 1992)[11]. Fiscal discipline is feasible only there where society agrees with the goal, independently of the structure and functioning of formal institutions. However, albeit with a few exceptions, economists have failed to provide a definition of social consensus or to identify the conditions under which this is more likely to emerge.

A notable exception is that of Alesina and Drazen, who suggested that stabilization is achieved without delay once the "war of attrition" between competing interests over the distribution of the burden from higher taxes or expenditure cuts is resolved (Alesina and Drazen 1991; Drazen 2000). Indirectly, they provide for a conceptualisation of social consensus to the extent that they talk about the solution of a conflict. Their model is predicated on a number of assumptions. First, it is given that fiscal discipline is desirable as delay in adjustment entails costs in terms of distortionary taxation or inflation, a possibility not taken into account by the new politics of the welfare state literature or by path-dependency approaches with their focus on a *status-quo* bias. The same can be said for EMU-induced national experiences with budgetary consolidations, where general support of monetary unification, as well as the evidence of large public deficits having led in the 1970s to unfavourable price developments did not leave doubts as to desirability of fiscal discipline. Second, in their model, society consists of rational heterogeneous agents. This research looks at a much smaller number of actors – and the link with the corporatist literature becomes necessary here - but departs from a similar assumption assigning to business and labour's divergent interests, at least to some extent. Finally, the authors do not have the instruments to assess qualitatively the preferences of the confronting groups and, for the very same reason, do not take environmental changes into account when describing the dynamic evolution of the war of attrition. I attempt here to fill in the gaps by measuring preferences on the field and by relaxing the second unrealistic assumption to show how the changing macroeconomic environment could in fact induce different preference formation.

[11] This strand of literature is indebted to previous studies of capitalism looking at the role of the class compromise for the normal functioning of capitalist economies (see Przeworski 1985).

One good starting point might be Alesina's attempt in 1988 to construct a political theory of the debt. He hypothesised a specific distribution of fiscal preferences identifying three categories of stakeholders: renters, business and wage earners. At the same time, he contemplated three possible solutions to the debt problem: default, inflation and tax increases. Bondholders would oppose both default and inflation, privileging instead a revenue-based adjustment, but not progressive taxation. Holders of physical capital would support default and inflation, the latter in particular allowing for a reduction of real wages and the stimulation of exports where conducive to exchange rate depreciation. Their position vis-à-vis tax increases is less straightforward; they would however almost certainly oppose taxes on wealth and physical capital. Wage earners would be in favour of debt default, progressive income taxation as well as taxes on wealth and on capital. On the other side, they would oppose inflation if real wages were to fall (Alesina in Giavazzi and Spaventa 1988, 34-89). While this is possibly the clearest scheme on preference distribution that is available in the economics literature, it cannot be taken in full to account for EMU-induced stabilization. First, debt default was definitely not an option. Secondly, the policy of inflating away the debt was also not on hand as the Maastricht criteria also targeted inflation levels. In this respect, the available strategies for deficit reduction were at the same time narrower and wider. Governments would have to intervene either on the revenue or on the expenditure side of the budget; this meant however that, provided for the relative flexibility of each budget item, each of them could have been subject to reform. Bearing this in mind, the following paragraph derives *a priori* preferences for fiscal adjustment strategies from the existing economics and welfare literature.

Public employees and welfare beneficiaries are due to suffer from public spending cuts. On the contrary, most industrialists will appreciate smaller government in the belief that this allows for a more efficient allocation of resources. However, when national industrialists are also employers, then their preferences are less linear. There is abundant empirical evidence indicating that in fact business organizations support public welfare programmes (Thelen in Iversen et al. 2000; Swank and Martin 2001; Mares in Hall and Soskice 2001; Mares 2003). Not even interventions on the revenue side of the budget are without redistributive effects. Higher direct taxation is socially neutral only if completely progressive. In general, where it has the effect of slowing growth down, it will first of all be to the detriment of wage earners and only affect producers in the medium-term. On the other hand, indirect tax hikes are against the interests of wage earners, whose purchasing power will decrease overnight. Less straightforward is an evaluation of the distributional implications of increased SSC. The latter tend to reduce both demand for and supply of labour. Most importantly, they induce an internal redistribution of the adjustment burden between employees and employers.

At the same time, however, one should account for the fact that fiscal profligacy and/or exclusion from EMU following the failure to meet the Maastricht fiscal criteria could be even more costly than any budget consolidation episode, being it on the revenue or on the expenditure side of the budget. It is uncontroversial that most European business actors supported monetary unification, even if to different degrees (Moravcsik 1998), and mostly in accordance with their degree of external exposure (Frieden 1991). There is also convincing empirical evidence suggesting that most European labour unions themselves were supportive of EMU (Verdun 1999; Talani 2000) and, in turn, of the conditions for entry including fiscal discipline. In particular, besides the fear of loosing out from the growth effects expected from monetary unification, workers supported direct fiscal discipline as a means of keeping inflation at bay, especially in small countries for which a strong currency signified cheap imports (Jones 2005). Still, it is probably worth distinguishing between preferences faced with different dimensions of fiscal adjustment, as the latter is far from a monolithic exercise.

As far as the timing is concerned, there is no doubt that both industrialists and labour unions were keen on their respective governments' capacity to cut the deficit in time for EMU. This is to say that they shared a common goal and the interaction between them results into a cooperative game more than a war-of-attrition in Alesina's and Drazen's terms. The threat of exclusion also shaped their preference for the extent of deficit reduction considering that there was a specific numerical target they had to aim for. Nevertheless, labour unions are probably less sophisticated in the evaluation of the pros and cons from a large *vs* small retrenchment. Business actors strongly believe in the fact that extensive fiscal consolidation sends a credibility message to financial markets thereby allowing for lower long-term interest rates. Supported by a series of interviews with market participants, Mosley comes in fact to the conclusion that it is mostly the size of deficit reduction than induces positive reactions from financial markets (Mosley 2003). While not underestimating the role of financial markets, labour is probably more interested in the implications of credibility on inflation levels. A statistical evaluation of household surveys shows that consensus on exchange rate stability in the framework of the European Monetary System (EMS) was favoured by a general decrease in tolerance for inflation relative to unemployment (Collins and Giavazzi 1991)[12]. But wage earners are also concerned about the fact that large deficit reduction cannot be socially neutral, as it would require inevitably some form of retrenchment. Still, by and large, there is no reason to doubt that even when it comes to the size of consolidation, consensus and cooperation will prevail.

Much more controversial is instead the issue of composition. Following on from the conventional wisdom on the preferences of labour and capital, it may be hypothesised that business actors privilege expenditure-based adjustment, whereas pro-welfare coalitions such as unions opt for revenue-based deficit reduction, albeit by default. Here, conflict is likely to arise, so that the recalled war of attrition would revolve around the composition of adjustment and the strategy eventually chosen by the result of a non-cooperative game between players (i.e. government, unions and employers) with conflicting interests (Table 3). Along similar lines, Alesina and Drazen note: "in the political debate over stabilization, this distributional question is crucial" (Alesina and Drazen 1991, 1172). This confirms composition as the most challenging aspect of deficit reduction, at least for political economists.

[12] It is interesting to note that, according to this research, this shift in preferences concerned almost all EU countries with the notable exception of Germany where the contrary was true, namely households showed lower tolerance for unemployment relative to inflation (Collins/Giavazzi 1992).

Table 3.Social partners and dimensions of fiscal adjustment

	Timing	Extent	↓ Spending	↑ Taxation
Labour	Support	Neutral	Opposition	Support
Capital	Support	Support	Support	Opposition
GAME	Cooperative	Cooperative	Conflict	Conflict

The following chapters treat the two empirical cases. With the examples of Italy and Germany, I intend to test the relative importance of state administrations, political and budget institutions, partisanship, corporatist agreements and socio-economic preferences in affecting decisions over EMU-induced macroeconomic adjustment. Because anecdotal and empirical evidence already points to the central role of social partners, special attention is devoted to their preferences and contribution to budget policy formulation from 1991 to 1998 in both countries. The next chapter focuses specifically on the Italian case, exploring the characteristics of the country's successful budgetary consolidation in the 1990s and the overall institutional and social context against which this was achieved.

CHAPTER III

Timing, Size, Composition and Persistence of Italy's Fiscal Consolidation (1991-98): Preferences *versus* Institutions

1. Italy's Fiscal Consolidation: Stylised Facts

This chapter describes the main features of Italy's fiscal consolidation in the 1990s. The focus is on the timing, size, composition and persistence of fiscal adjustment in 1991-98. In this research project, I proceed from the assumption that all four dimensions should be taken into account in order to come to an objective evaluation of adjustment episodes. To be sure, in some cases, they are reciprocally related, with the result that it may well be that one dimension is endogenous to the other. To take just one example, large consolidation episodes tend to be revenue-based. When governments aim at extensive and rapid deficit reduction, then they may think of interventions on the revenue side of the budget as more appropriate because (1) public incomes are by definition flexible budget items; being far more regulated, spending commitments need more time to be reversed; (2) taxpayers are not as organized as welfare beneficiaries, which implies that tax increases are politically more feasible than welfare cutbacks. Also, both size and composition could relate to the persistence of fiscal adjustment. After governments have obtained extensive deficit reduction in T_1, it is more likely that they will succeed in keeping public budgets under control also in T_2 and T_3, ceteribus paribus. More technically, having a direct impact on economic growth, composition can either favour or hinder persistence. For all these reasons, the following section takes all four dimensions equally into consideration.

The timing refers simply to the relative adherence to the Maastricht timetable, and should be thus treated in conjunction with the size of adjustment. The latter is normally measured as the cyclically adjusted change in the value of primary surplus as a percentage of GDP. Needless to say, this has been extensive in the case of Italy considering that the country began with high deficit and debt levels in 1991. In this respect, absolute figures are not as illuminating as relative data may be. Bearing this in mind, I will juxtapose the Italian fiscal experience with that of other EMU candidates that started from a similar fiscal position (e.g. Belgium). In addition, the evolution of the country's public deficit is analysed in historical perspective to test if the fiscal performance in the 1990s would in fact represent a case of policy or regime change. At the micro-level, yearly changes in the extent of deficit reduction convey important information about the government's eagerness to stick to fiscal discipline and/or about the presence of a social context in which this is feasible.

Secondly, I analyse the composition of fiscal adjustment. The parsimonious argument that cut across this thesis is that budget consolidation is only viable where there is a large socio-political consensus around the distribution of the adjustment burden, especially around its content. True, the choice over fiscal strategies is often influenced by principles of optimality. However, in Italy, the composition of budget adjustment changed, in some cases remarkably, after consultation with the social partners (see 3.1), thereby losing any resemblance to the initial government proposal. Thus, while most socio-economic actors agreed to the principle of balanced budgets, they differed widely over their composition. The content of budgetary interventions is likely to reflect the preferences of the most powerful domestic interest groups rather than being a technical decision weighted within experts' circles.

Persistence itself conveys significant information about the nature of fiscal adjustment in one country. In the presence of a trend of uninterrupted deficit reduction, one could say that the government is committed to fiscal discipline and/or the existence of a socio-political context in which fiscal austerity can be perpetuated without leading to excessive social and/or electoral costs (e.g. strikes, street demonstrations, electoral punishment, etc).

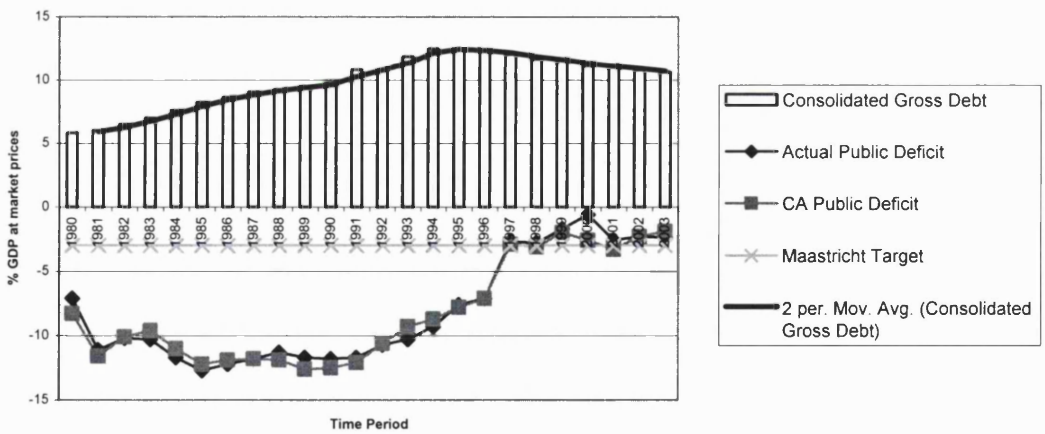
1.1.The timing and size of fiscal consolidation

Italy has experienced severe fiscal imbalances since the 1970s. With current expenditures growing exponentially (e.g. transfers to households and compensations to public employees), and revenues unable to keep the pace, deficit and debt levels grew rapidly (Stagni in D'Adda 2001). In the 1980s, Italy suffered from the highest public deficit in Europe with values above 10 percent of GDP (European Commission 2003a). The politically dependent Banca d'Italia responded to deficit spending by augmenting short-term interest rates. This caused strong inflationary pressures on top of everything else (Grilli, Masciandaro and Tabellini 1991). The country's financial instability was further aggravated by the specific structure of wage bargaining and by the operation of an automatic wage indexation system known as *scala mobile*, which produced inflation-wage spirals. Yet only with Italy's membership of the European Monetary System (EMS) in 1979 did inflation differentials vis-à-vis the trading partners become a more urgent problem. At this stage, fiscal consolidation was advocated only as a means to curb Italy's above-average inflation down.

Fiscal discipline became a policy objective in its own right in 1983-84 once inflation rates started to fall, albeit still modestly (Graziani 1988; Camera dei Deputati, October 1992, 17-24; Verzichelli 1999). With the divorce of the Italian Treasury and the *Banca d'Italia* in 1981, the monetization of public debt had stopped being an option (Epstein and Schor in Lange, Regini and al. 1989,147-164). In turn, the public debate revolved around the identification of the most appropriate debt stabilization strategy. It was soon clear that the best approach to Italy's fiscal problems would be a large and as rapid as possible improvement of the primary surplus (Morcaldo in Graziani 1988; Giavazzi and Spaventa 1989; Camera dei Deputati, Servizio Studi 1992). According to observers, the commitment to austerity remained superficial in those years. The country's high political instability and the numerous inefficiencies in the budgetary process neutralised any attempt at correcting fiscal imbalances (Salvati 1984; Giavazzi and Spaventa 1989; Verzichelli 1999, 98-142; Monorchio and Tivelli 1999, 22-27). Failure to consolidate was even more disappointing if one considers that, in the late 1980s, high growth rates should have soften the recessive bias of fiscal austerity (Sartor 1998; Degni and al. 2001).

After a few failed attempts at fiscal adjustment in the mid-1980s, Italy succeeded in cutting her deficit down in the 1990s under the pressure to participate in European monetary integration in the first wave. Needless to say, the timing of Italy's macroeconomic reform is significantly conditioned by the "Maastricht effect". Between 1989 and 1997, the cyclically adjusted net borrowing requirement improved by 9.2 percent of GDP (Caselli and Rinaldi 1998, 60). In the same period, Belgium managed to cut its deficit by 5.9 percent of GDP. Even in the shorter time span 1993-97, Italy continued to enjoy the best fiscal performance across the EU spectrum with a 6.4 percent improvement of CA net borrowing. The second best outcome was that of Belgium with a deficit decline of 4.6 percent of GDP (Caselli and Rinaldi 1998, 61). More specifically, the country's actual deficit continued decreasing until 1997 without major interruptions. Lower interest payments contributed importantly to deficit reduction. Italy stands out even when the development of the structural primary surplus is considered. In 1992-97, this improved by 6.3 percent of GDP (OECD various issues). The large surplus the government managed to create was also important to the extent that, functioning as a buffer against the continuous growth of the public debt until 1993, it further supported deficit reduction (Graph 2).

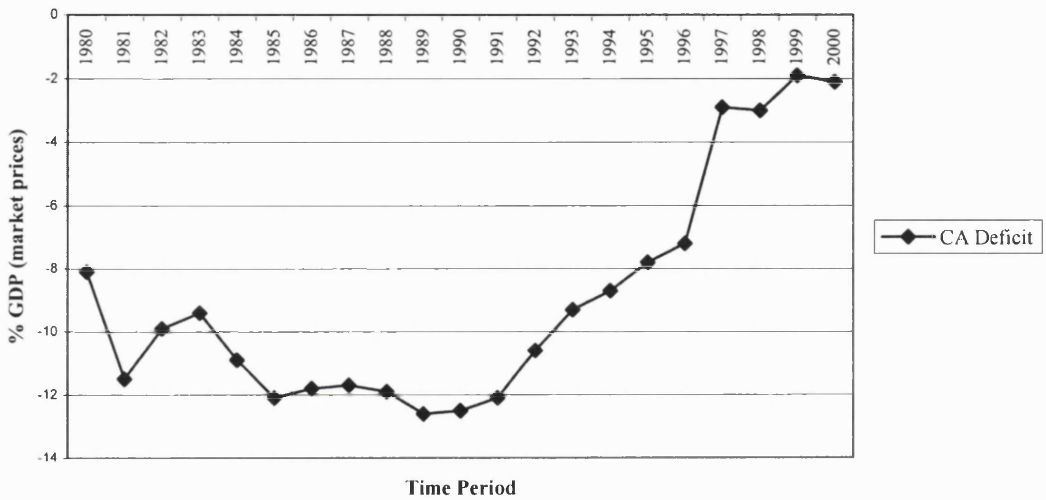
Graph 2. Italy: Evolution of Actual Public Deficit, CA Public Deficit and General Government Gross Debt (1980-2003)



Source: European Commission, *European Economy Statistical Annex,* 2004.

As pointed out above, Italy's fiscal performance stands out if set against parallel experiences in other EMU candidates. It is extraordinary also by "Italian standards". It is certainly true that, in the 1990s, the country experienced a proper regime change. Never had the country benefited from so low a deficit level. In truth, the CA net borrowing started to fall already in 1990, before the country officially committed to sound public finances through the signing of the Maastricht Treaty. In 1991, for the first time, the primary balance turned into a surplus; it continued to improve until 1997, the reference year the EU had chosen to evaluate EMU candidates' readiness to join monetary union. At the time when Prime Minister Giuliano Amato made fiscal consolidation a top priority in 1992 (Tesoro 1992), Italy's fiscal convergence process seemed already set on the right footing (Graph 3).

Graph 3. Italy: Evolution of the CA Deficit (1980-2000)



Source: European Commission, *General Government Data* 2003.

It could be that the economic situation made deficit reduction easier, as would be the case for example in the presence of high growth rates. However, this was certainly not the case for Italy. Graph 2 shows that EMU-induced fiscal consolidation took place in bad times: with the actual deficit lower than CA deficit from 1992 to 1996 it was clear that the business cycle was running against fiscal adjustment. Nevertheless, this did not jeopardise the continuous improvement of the deficit. This is a striking aspect of Italy's fiscal performance in the 1990s. Not only was consolidation initiated in bad times, but also the depression that followed the first adjustment episodes was not such that fiscal authorities decided to give up their goal. On the contrary, they were asked a greater discretionary effort to counterbalance a deteriorating economic environment, by strengthening for example consumer and business confidence. This is indication of the fact that successful adjustment was a political process, one in which not even recession was sufficient to dissuade policy-makers of their aim.

It is interesting to note that the pace of adjustment was not even from one year to the other. Table 4 provides a good picture of the different magnitudes of fiscal correction in the 1990s –expressed in trillions Lira and as a proportion of GDP. Interestingly enough, the two smallest (nominal and real) corrections were implemented in 1993 and 1995 respectively, under two technocratic cabinets -the Ciampi and Dini Governments. By the same token, the three largest deficit reductions took place under elected, and hence more legitimate, governments. External pressures should by no means be underestimated. Prime Minister Amato had to respond, in 1992, to a dramatic financial crisis. In 1996, Prodi aimed to secure Italy's accession to EMU. Still, the regular juxtaposition of small interventions and non-elected governments is indication of the fact that the lack of an electoral base and support functioned as a constraint on the severity of fiscal policy. Extensive anecdotal evidence shows that to be able to impose discipline domestically, non-elected governments in the 1990s made a great effort to compensate the lack of vast parliamentary support with an intense dialogue with the social partners (e.g. Ciampi and Dini Governments).

Table 4. Italy: Size of Budget Manoeuvres 1991-98 (+ contraction; - expansion)

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Projected	40.6	84.1	30.3	48	32.5	56.2	25
Actual*a*	60	75	25	53	38	60	25
Actual*b*	1.5	1.3	0.6	1	0.6	4.2	-0.2
Actual*c*	2.4	1.7	-1	1	0.5	2	-1.5

Key: Projected (extent) = size of correction as laid down in official budgetary documents (trillion Lira). Actual*a* (extent) = real size of retrenchment at the end of the consolidation episodes; here, data tend to be overall larger than projected figures because they do not refer only to Finance Bills but include also the impact of emergency budgets (trillion Lira). Actual*b*= change in cyclically adjusted net borrowing (% GDP). Actual*c*= change in primary surplus adjusted on potential GDP (% GDP).

Source: Degni et al., Il Riequilibrio della Finanza Pubblica 2001; European Commission 2003a.

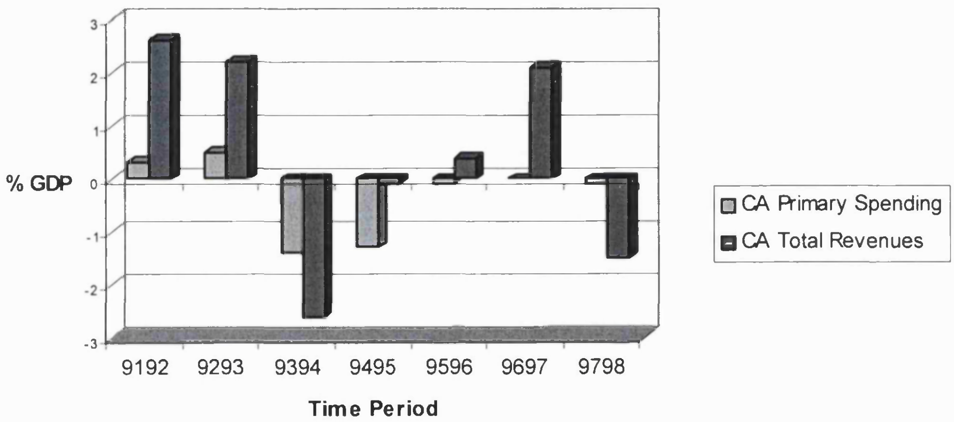
1.2.The composition of fiscal consolidation

The issue of the composition of deficit reduction entails great significance both in economic and political terms. As to the first, economists largely agree on the fact that expenditure-based fiscal consolidations are more likely to generate non-Keynesian growth effects (Alesina and Perotti 1995). This implies that that they would lead to more successful fiscal outcomes to the extent that relatively high growth rates reduce the debt ratio to GDP. As to the second point, if interest groups and citizens agree to unpopular expenditure restraints, then social consensus in favour of fiscal discipline is likely to be high. In addition, cuts to spending programmes are certain, as opposed to measures on the revenue side of the budget, whose impact are highly dependant on business cycles. From a political perspective, the content of fiscal adjustment is indicative of the specific constellation of domestic preferences regarding fiscal discipline.

In 1989-97, greater current revenues contributed to the improvement of the structural primary surplus by 60 percent, with the second largest contribution coming from lower capital spending, which decreased by 23 percent. When considering the shorter time span from 1993 to 1997, structural consolidation stemmed mainly from lower interest payments. Second came primary expenditure restraints with revenues contributing only to 7 percent of the total correction (Caselli and Rinaldi 1998, 60-1). Overall, and in comparison with other EMU candidates, the European Commission regarded Italy's fiscal adjustment as largely revenue-based (European Commission 2000).

Graph 4 shows the changes to CA primary expenditures and total revenues in 1991-98. In 1990-93, deficit reduction came from rising public incomes. The latter were so significant that they helped cover the costs from increased public spending. In the following year, from 1993 to 1994, CA public revenues started decreasing. This resulted not much from an actual lowering of Italy's fiscal pressure but from the fact that the Ciampi Government declined to renew one-off revenue measures introduced in the preceding two years (Tesoro 1993, 10-14). With the public debt ratio set on a downward trend since 1993, primary expenditures started slowly to decrease thanks to lower interest payments. In 1994-95, CA expenditure restraints were sufficient to offset revenue shortfalls, thereby not affecting the positive trend of deficit reduction. In the period 1995-97, under the Dini and Prodi Governments, interventions on the revenue side of the budget surged again to become the most important contribution to fiscal discipline. Amounting to a value of 3 percent of GDP, Italy's largest fiscal correction in 1996 was the result of greater public revenues, which increased over one year by 2.7 percent of GDP (Banca d'Italia, February 1998).

Graph 4. Italy: Change in CA Primary Spending and Total Revenues 1991-98



Source: European Commission, *Statistical Annex* 2003.

1.3.The persistence of fiscal consolidation

The persistence of deficit reduction in Italy is quite striking, as will be further discussed below. In 1991-97, the country went through politico-institutional turbulences, not to mention yearly government changeovers. Still, in spite of such an unstable institutional background, budget consolidation seemed largely undisturbed. This is taken as indication of the fact that the domestic consensus in favour of fiscal discipline and EMU membership was sufficiently large to overcome any institutional constraint, including electoral cycles.

2. The Role of Fiscal and Political Institutions

The most recent literature on fiscal adjustment focuses on the economic role of budget and political institutions (see North 1990) where the argument is that financial policy outcomes depend strongly on the institutional framework in which decisions are taken. And in line with this interpretative approach, many have argued that Italy's disappointing fiscal performance since the 1970s was determined by an unstable politico-institutional setting, one in which government changeovers were too frequent and political coalitions were too weak to allow courageous fiscal interventions. Collective action and coordination problems would be at the base of ill-thought-out and inefficient macroeconomic management. With the improvement of the budgetary process and the transformation of the national party system in the 1990s, observers have been naturally induced to look for institutional explanations to Italy's successful fiscal consolidation. Against this interpretation, this section indicates that some budget and political institutions did indeed become more efficient, but at the hand of actors whose preferences were already set in favour of fiscal discipline. In a nutshell, preferences came before institutional change[1].

It is true that the analysis of fiscal policy outcomes is affected by significant methodological limitations, of which the most significant is that a country's fiscal performance is typically over-determined. Bureaucrats cooperate with policy-makers in the drafting of budget proposals; members of parliament can often exercise significant amendment powers. In addition, domestic interest groups have access to fiscal policy-making either directly through roundtable talks or indirectly when represented by parliamentarians. With the aim of putting some order into this complex web of actors and institutional contexts, this section focuses mainly on the budgetary process. Electoral systems and the ensuing political fragmentation come into the picture to the extent that they shape budget actors' preferences and relative power.

[1] For details on the debate about the relationship between preferences and institutions, (see North 1990; Immergut 1998).

Since the late 1980s, i.e. well before the signing of the Maastricht Treaty, Italy started to embark on a macroeconomic regime change consisting of a relatively rapid though long awaited institutional adaptation to the culture of stability. With the 1988 Budget Reform, long-term financial planning became one of the cornerstones of fiscal policy-making in imitation of successful experiences elsewhere (e.g. Germany). In addition, the budgetary process was subject to minor adjustments. Of particular note among them was the Parliament's obligation to preserve the size of the budgetary correction as planned by the Finance Ministry. On the monetary front, the divorce between the Treasury and the Bank of Italy in 1981 represented the first step in the direction of central bank independence, which was only officially established in 1993. The strong domestic preference in favour of greater stability was reflected also in the conduct of exchange rate policy. After 1988, thanks to *Bankitalia*'s restrictive monetary stance, the Lira remained within the ERM bands, thus making any realignment unnecessary (Giovannini 1990).

For some, while it is true that progress had been made already in the pre-Maastricht period, fiscal adjustment became possible only under the EMU constraint. Not only was the threat of exclusion from monetary integration an effective incentive for all to put public finances in order, but it also triggered institutional adaptation both directly and indirectly. As to the first, Italian authorities were under the obligation of institutionalising the independence of *Banca d'Italia* by January 1, 1993. Indirectly, the threat of non-participation to the Euro-area catalysed domestic forces towards the common goal of balanced budgets, so that everyone accepted the centralization of the budgetary process around the figure of the Prime Minister and the ensuing downsizing of the role of Parliament (Verzichelli 1999; Radaelli 2000). Against this perspective, this thesis offers an interpretation of the facts that privileges preferences over institutions. The argument is that the striking of a compromise between competing socio-economic interests was *conditio sine qua non* for successful deficit reduction. The country's improved institutional configuration in the 1990s allowed for these preferences to translate into policy outcomes without the disturbing mediation of poorly functioning institutions. In other words, while necessary, better budget institutions would have not been sufficient to guarantee such a remarkable result.

The following section describes in detail the evolution and character of fiscal institutions in Italy.

2.1.The Italian budgetary process

Currently, the Italian budgetary process relies on a long series of documents and pieces of legislation. In February, the Treasury sends out technical notes for budget drafting to all ministries. Around May or June, the Council of Ministers approves the *Documento di Programmazione Economica e Finanziaria* (DPEF), a long-term financial planning document sketching out fiscal objectives for the following 3 to 5 years. This is then passed on to Parliament for approval. In September, the government presents its own budget proposal known as *Relazione Previsionale e Programmatica* (RPP). The latter sets out in detail the content of the commitments made in the DPEF. This document becomes the object of parliamentary debates, which develop over a few months in the so-called budget session. Before the end of December, Parliament has to translate the RPP into the final Finance Bill (Verzichelli 1999).

Until the late 1970s, Italy's budget process consisted of the mere elaboration of a "formal law", the so-called *Legge di Bilancio* (budget bill). It was termed formal because neither the government nor parliament had the power to prescribe new expenditures and/or taxes. Their task was limited to acknowledging the financial impact of previous legislative decisions. In 1978, the government engaged in a significant restructuring of the country's public finance legislation (Law n. 468 1978). The two successive oil shocks played an important role because they lead public authorities to desire greater control capacity over public resources (Verzichelli 1999, 104; Petricone 2000, 23-4). The 1978 Financial Law established the mandatory estimate of the net borrowing requirement within the newly created *Legge Finanziaria* (finance bill). In contrast to the budget bill, the financial bill created room for concrete fiscal interventions. Observers suggestively describe the first as the "budget of bureaucracy" and the *Legge Finanziaria* as the "budget of politics" (Camera dei Deputati, 19 September 1996). The present work focuses on this latter document.

The 1978 legislation was not sufficient to guarantee fiscal discipline. Poorly designed institutional arrangements continued to compromise Italy's fiscal performance. First, the Finance Minister did not play a strong supervising role. Second, the Parliament enjoyed extensive amendment powers over government proposals. In addition, at this stage of the process, the high number of political parties created huge coordination problems. Third, budget documents lacked transparency; this implied that efficient financial planning was compromised in spite of the earlier introduction of the finance bill. Fiscal decisions ended up being taken on an incremental basis (Morcaldo 1993; Camera dei Deputati, 6 December 1993, 21055-68; Alesina and Perotti 1995; Monorchio 1996; Giavazzi, Penati and Tabellini 1998; Poterba and von Hagen 1999; Monorchio and Tivelli 1999). Fourth, and most importantly for the purpose the present research, the process was wide open to pluralist interest groups (Cotta in Cotta and Isernia 1996, 43). Under the pressure of numerous and diverse government clienteles, public spending continued to grow after the late 1970s (Morcaldo 1993) with public authorities forced into a perverse practice of distributing public resources in areas far from budgets' traditional redistributive tasks (Ferrera 1992). In light of all these factors, Italy's fiscal institutions were traditionally regarded as the most inefficient in the EU.

As a result, at the end of the 1980s, a widespread consensus had formed around the need to improve further the institutional foundations of fiscal policy-making (Pisauro in Bernardi 1990, 61). In 1988, a new reform improved long-term financial planning with the introduction of a new budget document known as DPEF (Law n. 362, 1988). There, the government was expected to work out the main contents of its financial policy for the following 3 to 5 years. The same reform established the so-called *provvedimenti collegati* (accompanying provisions). Being part of the finance bill, these addressed specific policy areas. They allowed for micro-reforms to bypass Parliament, thereby speeding up the parliamentary passage of the budget and delegating additional powers to the executive. In addition to this, on 8 August 1988, the government issued a directive imposing limits on spending by the individual ministries. For the first time, spending centres were subject directly to a legal constraint. In the past, limits were imposed on expenditure items rather than on decision-makers (Pisauro in Bernardi 1990). At first, institutional reform failed to deliver, if we are to follow Vincenzo Visco's, Finance Minister in 1996-98, view of the 1980s:

> "Italy appeared to be, and indeed was, a country without economic discipline, characterised by a low level of social cohesion, mal-governed by a ruling class that was incapable of making brave choices, that yielded in to the requests and pressures exercised by interest groups, and which increasingly and openly corrupt and therefore less authoritative. In such a situation, it not at all surprising that the adjustments introduced gradually starting from the end of the 1980s, involving all the revenue side, were not deemed to be sufficient and were ignored by the markets that continued to penalise Italian public debt" (Visco 2002).

2.2.The economic role of fiscal institutions

One has to wait until the early 1990s to see institutional reforms having a concrete impact on Italy's fiscal policy-making. On the one hand, the 1988 budget reform started to deliver. On the other, fiscal authorities continued a piecemeal process of institutional adaptation. It was only after 1992 that the Italian government required the strict application of one of the provisions in the 1988 Budget Law under which parliamentarians submitting an amendment to the government budget proposal had to indicate the corresponding financial coverage for the entire period of application and not just for the following year (Degni and al. 2001). A leftover of the 1988 Reform, governments in the 1990s exploited the option of making use of the accompanying provisions (or delegation laws) with the purpose of ringfencing entire sections of the budget from parliamentary amendments. The Head of the Accounting Department at the Treasury, Andrea Monorchio, stated on this note: "it would have not been possible to govern the country without the accompanying provisions" (Monorchio and Tivelli 1999, 148). All these measures shared the objective of strengthening the budgetary role of government over parliament.

It is indisputable that there exists a correlation between reformed budget institutions and stricter fiscal discipline. For example, large early corrections were associated with greater government strength over parliament[2]. In July 1992, the Amato Government approved by decree a correction for a total value of 30 trillion Lira (15.5 billion euro), being at the time in the position to circumvent potential parliamentary opposition (Corriere della Sera 3/8/1992). Under the Ciampi Government, the fiscal intervention for the following year amounted to only 12.7 trillion Lira (7 billion euro). Yet, there is something extraordinary about this intervention that reminds the reader of the importance of the content of reform. Most of the adjustment was to come from the expenditure side of the budget. To reach this result, Prime Minister Ciampi took fiscal decisions in close consultation with his economic cluster but left out spending ministers and social partners (Tesoro 1993; Corriere della Sera 21/5/1993). In addition, both the Amato and Ciampi Governments relegated indications about cuts to areas as sensitive as health care, pensions and public employment to the accompanying provisions, thereby avoiding an inevitably troublesome parliamentary passage (Camera dei Deputati, 16 September 1992, 3250-3282; Corriere della Sera 24/7/1992, 29/7/1992; Pesole 2001).

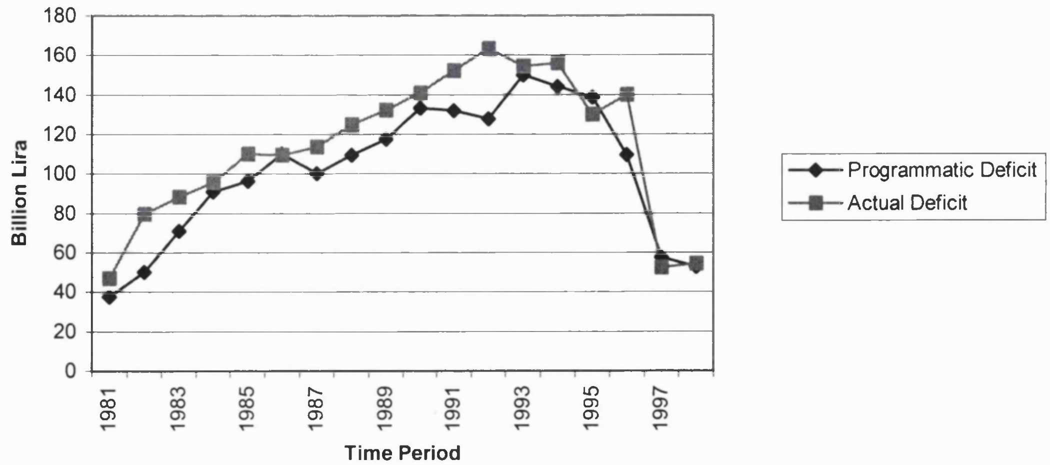
Better functioning fiscal institutions not only affected the extent and, at times, the quality of deficit reduction, they also improved government planning capacity, a crucial point, if it is true that good planning capacity improves fiscal results (Wildavsky 1979). Graph 5 sketches the gap between programmatic and actual budget deficits in billion Lira over the period 1981-1998. It is manifest that the early 1990s represent a breakthrough with planning capacity improving remarkably, with the exception of 1996.

While budget institutions have been clearly improving with notable consequences for fiscal policy outcomes, this does not mean that under a better functioning institutional setting Italian governments were finally able to take decisions independently of society, be it parliament or the social partners. Extensive anecdotal evidence indicates that budget proposals were being constantly reshaped under pressure from labour unions as well as during

[2] The results come from a linear correlation, where I have juxtaposed the early size of fiscal corrections to a multidimensional index of government strength relative to parliament computed by Verzichelli (Verzichelli 1999). The correlation produced a positively inclined slope.

parliamentary passage. Moreover, even quantitative data suggest the process was not fully isolated from societal pressures. If this were the case, then one should expect a dramatic change also in the quality of fiscal interventions, with the executive proving capable of tackling uncontrolled spending growth, something that did not really happen with the notable exception of the Ciampi Government. Graph 6 contains data on the ratio of revenue increases to the total nominal value of the fiscal correction, as planned by government authorities. It is interesting to note that the revenue content of budgets started heading below average from 1987 onwards, i.e. before the implementation of the ambitious 1988 Budget Reform. That was a time in which the preferences of most political actors were converging in favour of fiscal discipline, not least because of the parallel conduct of a disciplined exchange rate policy, for which Italy had given up the option of realignments within the EMS. This seems to suggest that part of the explanation to Italy's changing fiscal strategies lies in external macroeconomic constraints and the ways in which these might have altered the constellation of domestic preferences. In other words, budget reform arose first and foremost from shifting preferences.

Graph 5. Italy: Programmatic and Actual Public Deficits -billion lira (1981-98)



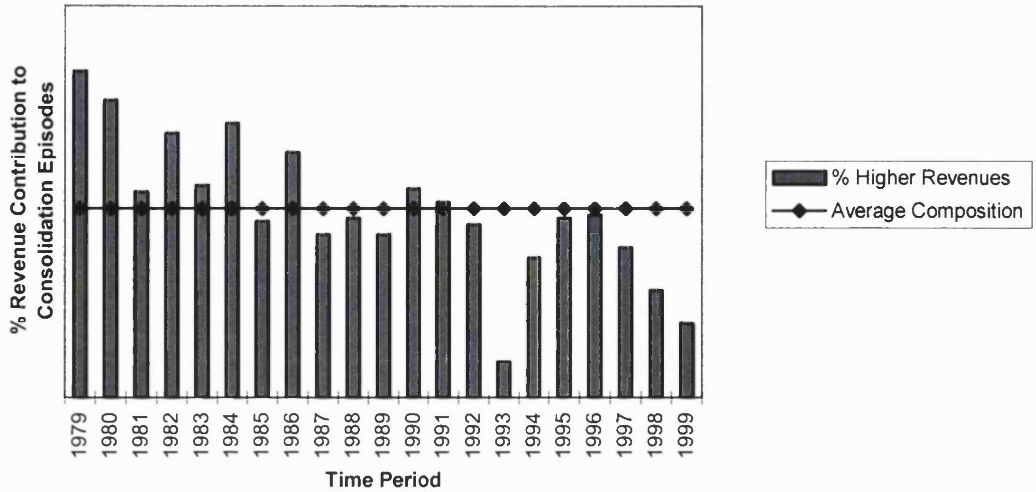
Source: Own Elaboration. Data from Cappugi 2000.

While the reliance on revenue maximising measures seemed to diminish after 1987, a comparison between the Maastricht years and the preceding decade does not reveal macro-differences. By way of example, the average revenue component of budget correction in 1992-98 does not differ dramatically from that in 1981-92. In the first period, programmatic revenue increases represented 46 percent of the cumulative fiscal correction whereas, in the second, they averaged 56.5 percent (Graph 6). There is instead a visible difference when it comes to assessing actual rather than projected budget outcomes. Planned budget measures in 1981-1992 consisted by more than half of greater public incomes, but the latter actually ended up contributing to 73 percent of the total correction at the end of the financial year (*read* after passing through Parliament). In 1992-98, the gap between projected and actual totals amounted instead to just 2 percent[3]. In conclusion, by improving government planning capacity, budget reform guaranteed only the matching between initial preferences and outcomes rather than forcing political elites into unpopular decisions on welfare reform.

At a micro-level, some of the assumptions in the institutionalist literature appear to be confirmed. For example, there seems to be a positive correlation between parliament strength (or government weakness)[4] and revenue-based consolidation, thereby confirming the hypothesis according to which common pool resource problems within multi-actor institutions (i.e. parliament) lead to the introduction of revenue-maximising measures by default. However, these results should be interpreted with caution. First, the Amato and Ciampi Cabinets consisted of the same number of parties but the macro-content of their respective interventions differed quite substantially. Second, members of parliament also represent specific socio-economic interests and, in this respect, evidence is not sufficient to show that the composition of fiscal packages was affected by the coalitional character of government rather than by the actual policy preferences of parliamentarians.

[3] Own elaboration from data in: Cappuggi (2000).
[4] Indexes on parliamentary strength derive from Verzichelli's computation (1999).

Graph 6. Italy: The Revenue Component of Budgets, percentage contribution (1979-2000)



Source: Own elaboration. Data from: L. Verzichelli, *La Politica di Bilancio*, Bologna 2000, CNEL; *I Dpef negli anni Novanta,* Roma 2000; Tesoro, Dpef 2000-2003, 1999.

Other points can be raised that confirm the argument according to which improved budget institutions are not a sufficient explanation of successful fiscal adjustment. First, better budget rules did not translate into greater control over expenditures, as the institutionalist literature might have anticipated. Even in the following years, observers continued to protest at the lack of appropriate tools to control spending growth (Pisauro in Bernardi 1990; von Hagen 1992; Alesina and Perotti 1996; Poterba and von Hagen 1999). As indicated above, fiscal institutional change only had the effect of improving financial planning. Second, as anticipated, the 1988 reform was not perceived as capable of addressing completely the inefficiency of Italian budget institutions. The theme of a necessary revision of the budgetary process continued to be central throughout the decade (Camera dei Deputati 29/6/1996, 1703). In 1991, government authorities denounced the still difficult exercise of expenditure growth control (Tesoro 1991, 23). In addition, once the EMU convergence process was concluded, two additional reform initiatives were taken, in 1996 and 1999.

2.3.The economic role of political institutions

Intertwined with the budget process are also political institutions. The latter exercise an indirect impact on fiscal institutions, as in the case of a variable such as parliament polarization. In the theoretical debate, government instability and political fragmentation of the party system have been associated with larger public deficits and debts. This is particularly true in the case of Italy. In the post-war period, the country experienced the most numerous government changeovers of all OECD countries (Lijphart 1984, 71). Weak short-sighted executives proved unable and/or unwilling to adjust public finances (Morcaldo 1993; Verzichelli 1999). More precisely, fiscal imbalances were strategically employed in a war of attrition between alternating governing party coalitions, where the incumbent would purposely leave large debts to its successors (Alesina and Drazen 1991).

The 1990s are no exception to Italy's instability record. In the wake of a vast institutional crisis after most politicians had been accused of corruption in the 1992 "Mani Pulite" scandals, Italy's political parties found it difficult to forge long-lasting parliamentary coalitions. Between 1992 and 1998, five different governments undertook the troublesome task of leading the country towards the ambitious goal of fiscal consolidation. To some extent, the presence of the Ciampi and Dini technocratic governments reduced the scope for inter-party electoral competition. However, two elections still took place in 1994 and 1996, which could have potentially kick-started the vicious game between alternating coalitions described above.

By creating significant coordination problems, the high number of political parties was likely to lead to greater fiscal imbalances. In 1994, Finance Minister Giulio Tremonti noted: "public debt and the proportional electoral system are nothing but two sides of the same coin" (Regonini in Cotta and Isernia 1996, 87). Minister Tremonti's was the first establishment to be elected under the new semi-majoritarian electoral law passed in 1993. While the reform's objective was to reduce Italy's political fragmentation, numerous political formations continued to hide under new umbrella names. In this respect, the 1990s represent no particular break with the past. It is therefore difficult to defend the argument according to which more stable political institutions would explain public authorities' firmer macroeconomic management.

With the political system proving not sufficiently sound to support difficult budget balancing, budget reforms seemed to serve the primary function of minimising and counterbalancing the weakness of political institutions. They did so by centralising the budgetary process around pivotal institutions. In a sense, renewed fiscal institutions compensated for structural deficiencies elsewhere without necessarily nullifying the political nature of the process nor centripetal forces from below.

Amongst a country's institutional characteristics is corporatism. The literature on the relationship between models of corporatism and fiscal performance is divided into two strands. An older research agenda is concerned with the effects of institutional openness on fiscal results. Italy's budgetary process has been commonly characterised as an open one, where interest groups have enjoyed full access to macroeconomic policy-making, although largely through the intercession of parliament (Rubin 1997). In the 1990s, their involvement in budget policy-making underwent a significant institutional transformation. In two successive income policy agreements, signed in 1992 and 1993 respectively, social partners were granted the status of budget actors with the government obliged to consult them prior to the presentation of yearly DPEFs, as well as before the submission of the RPP. As a result, the political arena fell in importance to the advantage of the social arena with labour unions even substituting political parties in the task of creating social consensus around budget proposals (Cella and Treu 1998). To illustrate this state of affair, some have used the expression of "consensual stabilization" (Salvati in Rossi 2002). A second more recent strand of literature studies the trade-offs between government fiscal policy and wage moderation suggesting that highly centralised union confederations have in fact improving equilibrium outcomes (see Chapter II). I will tackle these issues in practice in Chapters IV and VII.

3. Partisan and Median Voter Preferences

In the previous sections, I have attempted to demonstrate that institutions *per se* are not responsible for Italy's successful fiscal consolidation in the 1990s. Or rather that, it is inappropriate to treat institutions independently of the preferences of the actors operating within them. Bearing this observation in mind, I intend to assess here the role of partisan, strategic and self-interested preferences in the Italian process of fiscal convergence from 1991 to 1998. My argument is that successful adjustment was not the result of isolated technocrats taking harsh but necessary fiscal decisions on the basis of principles of optimality. Instead, governments were constrained partly by their ideological preferences, which under specific circumstances exercised some impact on the content of budget consolidation, and partly by electoral considerations, though only in 1994 and 1996. Yet, the greatest input came from self-interested socio-economic groups, whose support for fiscal discipline was considered a public good by all governments, independently of partisan orientation.

There is hardly any evidence of a "politics of expertise" in Italy's financial history (Radaelli 1999). On the contrary, the country's fiscal problems have been explained by the fact that politics traditionally obfuscated bureaucrats and experts (Franco in Einaudi 1992). On a similar note, the Head of the Accounting Department at the Italian Treasury, Andrea Monorchio, claimed with reference to the pre-Maastricht period: "technical considerations on the appropriate management of public finances were systematically ignored" (Monorchio and Tivelli 1999, 25). To prove this point is for example the fact that there is no empirical support for the tax-smoothing theory according to which governments acting as social planners would increase spending during recessions and decrease it when growth is sustained (Giarda 1989, 7). In spite of the extraordinary size of fiscal adjustment, the 1990s represent no break with the past to the extent that budget policy decisions were not necessarily inspired by efficiency concerns (interview with Andrea Monorchio). Is there any evidence of this? In a nutshell, fiscal strategies in the 1990s were not optimal to the extent that (1) they did not follow a consistent and gradual course; (2) they differed from one budget document to the other; (3) they did not address directly the very source of the problem (e.g. the expensive welfare state); and (4) they were not necessarily consistent with the nature of international pressures (e.g. financial integration).

Absence of gradual consistent fiscal course

Different fiscal adjustment magnitudes from 1991 to 1998 suggest that deficit reduction was not gradual. Some governments were more virtuous than others. Table 4 sets out the projected and actual extent of budgetary corrections in trillion Lira. Figures show that, in 1993 and 1995 respectively, the technocratic Ciampi and Dini Governments were less fiscally ambitious than the other governments, and the 1996 elected Prodi Government in particular. Not even the macroeconomic scenario against which budget decisions were set justifies these differences in magnitude. It is not true, for example, that large consolidations correlated with optimistic growth projections. The tax smoothing theory I referred to above does not hold true either for the 1990s. This seems to suggest that the degree of fiscal discipline depended more on the government's electoral and societal support – naturally greater in the case of elected governments - than on the technical opportunity to implement an extensive fiscal adjustment.

Variation from one budget document to the other

Most interestingly, both the extent and composition of budgetary interventions changed from one budget document to the next – and not necessarily in response to an altered macroeconomic environment - thus supporting the view according to which fiscal discipline was still the result of a socio-political compromise between competing socio-economic interests. The size of the manoeuvre in the final Finance Bill often differed from provisions in the DPEF by more than 20 percent. At the end of the process, its content was also different from initial projections. This is to say that pressures exerted on political actors at different stages of the budgetary process undermined initial and potentially optimal government decisions over the most appropriate size and quality of fiscal consolidation.

No adjustment at the source of the problem

Experts in the Italian Treasury believed in the desirability of expenditure-based consolidation if only because, when based on the revenue side of the budget, stabilization would push prices up thereby inducing in turn greater nominal outlays (Morcaldo in Einaudi 1992, 176; interview with Andrea Monorchio). Because Italy's fiscal imbalances stemmed mainly from excessive pension and health care spending Franco in (Einaudi 1992), the natural adjustment strategy was one that would tackle these programmes and possibly involve a radical re-thinking of the role of the State in the national economy (Morcaldo in Graziani 1988, 130). However, in 1991-97, two-thirds of fiscal discipline was guaranteed by interventions on the revenue side of the budget. There is no indication of austerity having entailed welfare retrenchment. True, in 1995, a radical pension reform was approved. However, its short-term financial impact was modest, at best (Padoa-Schioppa Kostoris 1996).

Inconsistency with international developments

Italy's choice of fiscal strategies seems also to run against parallel economic developments at the international level. In 1990, capital movements were liberalised. By 1992, the SEM was completed. In addition, the prospect of EMU increased expectations of a fully integrated European market. Against this background, most EU countries were concerned with competitiveness and started looking into strategies to boost their competitive position without resorting to exchange rate policies. The challenge was particularly pressing for a country such as Italy, which for two decades had taken advantage of competitive devaluation. Still, to achieve fiscal adjustment, the country paid the price of greater fiscal pressure. By 1997, total revenues had increased by 4.2 percent of GDP and were above the EU average by more than 1 percent of GDP (European 2003). Nor do initial tax levels justify this choice considering that, at the beginning of the 1990s, Italy did not belong to the group of low-fiscal-pressure countries (e.g. Portugal, Ireland).

3.1. Demand-side partisan politics

In the previous section, I have attempted to demonstrate that pure optimal policy considerations failed to drive Italy's fiscal adjustment. I investigate here if ideology played any role in the process. Even a superficial look is sufficient to indicate that the desirability of fiscal discipline was not a prerogative of liberal parties. The culture of financial stability together with the desire to qualify for EMU pervaded most political agendas from the right to the left of the political spectrum. Partisanship might instead play a role on two fronts. First, the ideological orientation of government is likely to impact on financial markets. Conservative governments tend to be more credible than social democratic ones. Secondly, leftist coalitions would possibly be less prone to cut the welfare state. With the aim to identify the contribution of ideology to the Italian process of fiscal convergence, I employ both anecdotal and empirical evidence.

There is sufficient anecdotal evidence showing that politics did in fact continue to matter. Fiscal policy decisions were driven by the political beliefs of fiscal actors. This is evident even under formally technocratic governments. The 1992 Amato Government is normally considered a technocratic establishment. I argue instead that this did not translate into political neutrality. First, while the Italian party system had already collapsed by 1992, Amato came to power under the rules of the old so-called "party government" (Cotta and Isernia 1996). Second, Amato himself explained that technical considerations about the most appropriate fiscal adjustment strategy were mediated by ideological concerns and accompanied by an evaluation of the social feasibility of any budget policy decision:

> "I remember when I was Prime Minister and had to increase taxation. Some of my advisers insisted for an across-the-board surcharge on incomes so as to collect as much as possible from medium-low income groups. And I thought that this was something they could have asked Margaret Thatcher to do, not me. My instinct, as a socialist, was to render an inevitably large fiscal adjustment socially acceptable" (Amato/Giddens 25/2/2002, www.policynetwork.org).

Partisan politics were even more visible under the Berlusconi Government. Elected at the end of March 1994, the new government coalition consisted of a rightist segment including Berlusconi's *Forza Italia* (FI) with the largest share of votes, *Alleanza Nazionale* (AN) and the *Lega Nord* (LN) and two minor centrist parties. All three major parties were more ardent supporters of welfare retrenchment than Italy's other political formations, even if AN was much less liberal than the other two coalition partners (Budge et al. 2001). In spite of a few differences in the conception of social policies, FI-AN-LN delivered a relatively consistent public image of outspoken liberalism. Unsurprisingly, much of the fiscal effort in 1994 came from primary spending restraints.

After the transitional left-supported Dini Government, on 21 April 1996 a new coalition under Prime Minister Prodi came to power. It was the first centre-left government guiding the country since the post-war period. It was composed of members from the PDS and relied on the votes of the extra-governmental RC without whose support it would not have enjoyed absolute majority in the Lower House. In his first appearance in front of Parliament, Prodi acknowledged that fiscal austerity had to go hand in hand with social justice and equity (Camera 22/5/96; www.parlamento.it, July 2002). Hence, all governing parties were keen on preserving Italy's welfare state and amongst the hardest opponents of welfare retrenchment (Budge et al. 2001). Overall, the Prodi Government attempted to deliver the image of a virtuous (social democratic) establishment making the best out of a financial situation of emergency (Levy 1999).

To sum up, Governments in the 1990s differed substantially in their respective declared (and actual) ideological orientations and, when discussing the most appropriate fiscal strategies, partisan arguments were often put forward. Yet, to what extent did partisan preferences affect the actual content of fiscal reform? A closer look at the composition of budget corrections under the Amato, Ciampi, Berlusconi, Dini and Prodi Governments reveals that partisanship is generally well reflected in fiscal policy outcomes. Ciampi, Dini and Prodi did not tackle social expenditures and the latter two put in place revenue-based consolidations. Instead, the Berlusconi Government announced a typically rightist fiscal policy agenda with more than half of the budget correction stemming from spending restraints, in which social outlays played an important role. Table 5 elucidates the main characteristics of budget interventions in the 1990s. Transfers were significantly curtailed only in 1994 under the Berlusconi Government, where they diminished by 0.7 percent of GDP in CA terms.

However, rather than Government partisanship, it seems that it was the partisan complexion of Parliament, which is the closest approximation to the preferences of society, that exerted the greatest impact on reform contents. As the budget proposal moved from the governmental to the parliamentary stage, the contribution of revenues to deficit reduction tends to increase but it did so more when the leftist component of Parliament is strongest (under the Amato, Dini and Prodi Governments). The Amato Government, for example, was a relatively moderate formation; this is at least what emerges from an analysis of electoral manifestos and programmes of its different partisan components[5]. Yet, here, the centralization of the budget process around the executive induced the latter to introduce significant social expenditure restraints which, it was acknowledged, were highly unpopular but necessary to set Italy's fiscal adjustment on the right footing. Yet, not surprisingly, the contribution of spending cuts to deficit reduction diminished as the budget process moved from the governmental to the parliamentary stage. In the DPEF, which tends to be a technical note in which considerations of optimal policy are dominant, 74 percent of the total intervention was to address public spending; the share diminished, moving to 61 percent in the government budget proposal (RPP) delivered in September and more so in the final Finance Bill, where expenditure restraints represented only half of the total adjustment.

[5] Budge at al. constructed indexes measuring parties' policy preferences using electoral manifestos and programmes (2001). One particular index measures the party's positioning on the Left-Right spectrum where negative values indicate an extremely leftist policy agenda. As contents of official documents reflect more moderate and rightist agendas, the value of the index increases progressively. The Amato Government scored a value of 8.24 against the most leftist configuration, the RC, which had a negative score of –26.7 and the most rightist position, that of the Italian Republican Party (PRI), with a positive value of 36.73.

As has already been argued in the literature, demand side partisan politics may at times be more relevant that supply-side (Government) partisanship and, in this particular research context, this is indicative of the overwhelming importance of society as opposed to state structures. Certainly factors other than pure ideological preferences should be taken into account –e.g. relationship with organised interests.

Table 5. Italy: Revenue Contribution to Total Adjustment (1992-97)

	Dpef 1	(2)-(1)	Rpp 2	(3)-(2)	FB 3	ΔTransfers
Amato	26	50%	39	35%	63	0.3
Ciampi	9.7	23%	12	25%	15	-0.1
Berlusconi	41	2.5%	42	17%	49	-0.7
Dini	51	8%	55	27%	70	0.1
Prodi	35	43%	50	34%	67	0.4

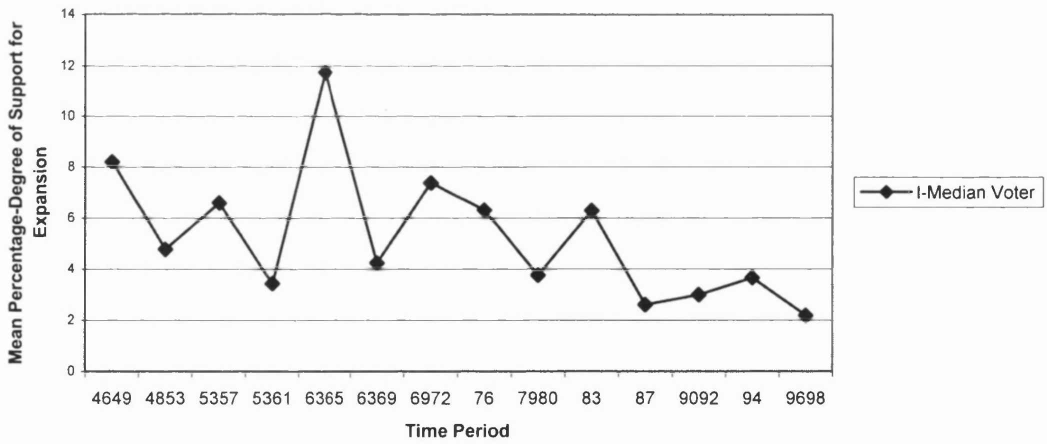
Key: Bold = leftist governments or with leftist component; Dpef = contribution of revenues to the total fiscal correction as indicated in the Dpef; (2)-(1) = percentage increase of revenue contribution from the Dpef to the Rpp; Rpp = contribution of revenues to the total fiscal correction as indicated in the Dpef; (3)-(2) = percentage increase of revenue contribution from the Rpp to the FB; FB = contribution of revenues to the total fiscal correction as indicated in the Finance Bill; ΔTransfers = actual cyclically adjusted change in social transfers (yearly).

3.2.The Italian median voter

Electoral politics have important implications for retrenchment. The original literature on austerity indicates that expenditure restraints are put in place only where governments have designed an effective strategy of blame-shifting onto other domestic or, more commonly, international actors/factors (Ross 1997; Pierson 2001). The natural assumption behind this literature is that welfare retrenchment is against the preferences of the median voter. In this section, I attempt to indicate the extent to which electoral politics played a role in Italy's fiscal adjustment. It is about identifying the relative importance of strategic preferences.

I have already demonstrated above how it is not true that technocratic governments were more courageous than elected ones, as some of the literature has suggested. This is interpreted as a sign of the societal embeddedness of economic reform in the 1990s. In turn, societal support is a variable that fiscal authorities would take into account when forming decisions on debt stabilization. Graph 7 illustrates the median voter support for welfare expansion for each electoral year[6]. A falling mean percentage signals that the electorate is more prone to accept welfare retrenchment. In the 1990s, the average support for the welfare state was historically low. It started decreasing from 1983, at a time in which the need to put social security budgets in order was strongly felt, without anything tangible being achieved. The median voter theory finds no support at the micro-level either. Support increases from 1992 to 1994 as the Berlusconi Government takes power. This is in contradiction with the empirical quantitative evidence showing cyclically adjusted transfers down by 0.7 percent of GDP in 1994-95. Moreover, under the successive two governments, social transfers actually increased, even if the median voter was less keen on the welfare state.

Graph 7. Italy: Median Voter Position on Welfare (Degree of Support for Expansion), 1946-1998



Source: Budge et al., "Mapping Policy Preferences", 2001, CD-ROM.

In conclusion, electoral politics did not prove relevant to the story of Italy's macroeconomic adjustment. To be sure, the view taken here is that the notion of a median voter is one-sided and does not allow for a representation of relative preferences and trade-offs. These are instead, as mentioned earlier, crucial to understanding the political economy of fiscal consolidation. As a confirmation of

[6] The percentage is taken from Budge et al. 2001.

the limits of median positions come detailed survey-based data, which provide a rather different view of citizens' preferences. Conducted in the 1990s, the surveys testify of the existence in Italy of an overwhelming preference for the preservation of the status quo in welfare state reform. This preference is stronger in the case of poor, older and labour market insiders. However, it is interesting to note that there is a strong status quo bias in the case of union members that goes beyond individual attributes (Boeri, Boersch-Supan and Tabellini 2001). This trait is of extreme relevance in this research context. First, it supports the decision to focus on powerful interest groups as a special category of actors. In the case of Italy, these also had significant access to budget policy-making. Second, it confirms the assumption behind the *new politics of the welfare state* literature, in which minority vested interests are rather more conservative than the general population. Because the finding remains general, it makes more sense at this point to focus on the actual fiscal micro-preferences of social partners.

There is no doubt then that social partners played an important role in budget policy-making. The argument that cuts across this thesis is that a full understanding of their role and contribution to deficit reduction is possible only once their micro preferences have been unveiled. In the next chapter, I describe in detail budget policy-making in the 1990s focusing on the input and preferences of social partners.

CHAPTER IV

Social Pacts and the Fiscal Role of Italian Social Partners

1. Macroeconomics and the Italian Variety of Corporatism

Besides rigorous institutionalist analyses of macroeconomic policy change there are studies that focus on the role of social partners. It is not to be ignored that, by illustrating a policy-making mode, models of corporatism represent themselves institutional variables (see Chapter II). However, it is reasonable to expect that corporatist institutions differ from budget and electoral institutions to the extent that, socio-economic preferences are more likely to play a role and possibly even to forge consensus in favour of a corporatist compromise at the very outset. I depart from the strong assumption that corporatism does not exist independently of the macro- and microeconomic preferences of the actors involved (see Rhodes and Molina 2002)[7].

What formal corporatist channels did Italian social partners have available to them in the 1990s that allowed them to exert an impact on budget outcomes? First, and most importantly, representatives of organized labour and capital enjoyed institutional access to public finance decisions starting from 1992. The 1992 Income Policy Agreements bound the government to consult them in May before the presentation of the DPEF to Parliament and again in September when the executive was due to submit its official budget proposal (*Protocollo sulla Politica dei Redditi*, July 1992; Cella and Treu 1998, 397). While the agreement was formally extending consultation rights to a wide range of socio-economic associations, it is indisputable that the government's actual reference partners were just *Confindustria* and the three labour confederations CGIL-CISL-UIL (Amato 1994). Mandatory consultation on public finance ran parallel to the signing of four successive social pacts, in 1992, 1993, 1996 and 1998. These represent typical examples of explicit corporatist agreements. To the extent that

[7] On the contrary, budget processes are either efficient or inefficient and tend to shape preferences rather than being shaped by preferences, in the short-term at least. The reference is to the debate revolving around endogenous institutions.

they revolved around income but also tax and welfare policies, they were deemed to have a great impact on the country's fiscal performance[8].

More informally, namely outside more or less explicit corporatist arrangements, domestic interest groups continued to access the policy-making process by lobbying members of government and parliament (CGIL, *Nuova Rassegna Sindacale* 35, 5/10/1992). Finally, social partners play a significant macroeconomic role in the context of collective wage bargaining. In the 1990s, collective bargaining was subject to extensive restructuring. While committing unions to wage restraint, the 1993 Income Policy Agreements also included a re-organization of bargaining on two levels, the national and the plant level. This reform resulted in a strengthening of centralization, which probably created the institutional conditions against which labour unions could accept and, most significantly, implement wage moderation (Olson 1982; Calmfors and Driffil 1988). The section that follows sketches the profile of Italian interest groups looking at membership; relative importance in the national economy; centralization of wage bargaining and macroeconomic role. This description may offer some leverage to better interpret their fiscal preferences in the 1990s. I also review Italy's previous experiences with social concertation.

1.1.A profile of Italian interest groups

For two decades after WWII, the Confederation of Italian Industry – *Confindustria*- enjoyed representation status (see Offe 1981, 137), namely a monopoly over interest intermediation. It was so not only because, at the time, the labour movement remained extremely divided and weak but, more positively, because the organization's public image benefited from the fact that it was associated with the post-war reconstruction of the national economy and with Italy's economic miracle in 1959-1963 (Salvati 1984). The balance of power between labour and capital started to change from the late 1960s. As elsewhere across Europe, Italy witnessed the outbreak of worker discontent and a strong

[8] An additional form of corporatism would be the joint or self-administration of welfare programmes on the part of labour unions. However, this is a rather sectoral type of policy-making and does not necessarily follow the same trend as the wider macroeconomic picture.

political mobilization never experienced before. During this period, the country's largest union confederations – CGIL, CISL, UIL - gained enormously in organizational and political power. Not only did union density increase across the board, but also Italian governments soon became aware of the fact that the labour movement had turned to a powerful political actor (Regini 1981). The empowerment of unions culminated in 1970 with the introduction of the *Statuto dei Lavoratori* (Worker Statute). Thereafter, the first attempts at social concertation took place.

Differently from other European countries (e.g. Germany), the relationship between Italian social partners and political parties has always been extremely close, with large flows of union officials joining the political arena. Hence, ideological cleavages divide Italy's three largest labour confederations. The *Confederazione Generale Italiana del Lavoro* (CGIL) has been affiliated with the Italian Communist Party (PCI) and, after 1989, with the Party of the Democratic Left (PDS)[9]. The *Confederazione Italiana Sociale del Lavoro* (CISL) has instead been traditionally associated with the Christian Democratic Party (DC) and after 1992, when corruption scandals caused the disintegration of DC, with minor political formations that remained but inspired by the social catholic ideology. While created with the mandate of serving workers at large, independently of their ideological orientation, the *Unione Italiana del Lavoro* (UIL) did not refrain from striking deals with the Socialist Party (PSI) and other liberal formations (Kemeny in Urbani 1992, 68-9; www.uil.com, October 2002).

On the other side of the spectrum, *Confindustria* has attempted to present a politically neutral self-image (www.confindustria.com, November 2004). The organization has shown interest in government as such, namely in the concessions that public actors could grant to its members (Mattina 1992), with the result that it tended to support moderate political coalitions, independently from whether they were gravitating to the right or the left of the political spectrum. To be sure, at least until the 1960s, *Confindustria* had established a

[9] With the fall of the Soviet bloc, the more leftist CGIL segments abandoned the union to form a new political configuration under the name of *Rifondazione Comunista* (RC) led by former union leader Fausto Bertinotti.

cooperative relationship with the Christian Democrats in power, even if their respective ideological backgrounds were quite different. Where the cultural heritage of the DC was deeply rooted in the catholic social tradition, organised capital converged on a more liberal platform. This indicates how *Confindustria* was committed to strategic alliances.

What is today's organizational profile of Italian social partners? *Confindustria* represents about 208 affiliates from all sectors: industry, agriculture and, since 1991, services. Multiple cleavages cut across this heterogeneous organization, such as that between protected and export-oriented sectors, between producers of tradable and of non-tradable goods and between large and small and medium enterprises (SMEs) (Cella and Treu 1998, 150; Traxler, Blaschke and Kittle 2001, 48). *Confindustria* is the confederation of industry and the association of employers as well, thereby combining two roles that in other socio-economic systems tend to stay separate (e.g. Germany). This institutional trait is significant for at least two reasons. First, it explains why the confederation always adopted an "interdisciplinary approach" during roundtable talks, showing willing to discuss issues as diverse as wage moderation and welfare reform at the same negotiating table. Second, it accounts for the relative flexibility of the organization's bargaining behaviour to the extent that the representation of multiple interests increases the number of equilibrium outcomes. Internalising negative externalities is in fact easier when the actor in question is the same one. So, for example, it becomes easier to trade wage restraint with higher fiscal pressure.

In addition to intense ideological competition, CGIL-CISL-UIL have also been characterised by slightly different organizational profiles, even if they have shown a tendency towards convergence in the last decade. The largest of the three, CGIL continues to preserve to this day its original associational monopoly. In 1990, 46.4 percent of all union members were affiliated to CGIL, 34.5 to CISL and 19.1 to UIL (Ebbinghaus and Hassel 2000, 384). The high number of non-active members is also an important trait of CGIL. In 1990, 45.8 percent of all members consisted of pensioners against the 38.2 and 18.7 percent of CISL and UIL respectively. Still, it is interesting to note that the other two confederations witnessed a rapid increase in the number of affiliated pensioners from 1990 to 1995 (Table 6). This is to say that the CGIL-CISL-UIL coalition sitting at the negotiating table in the era of the successful social pacts was principally representing the interests of pensioners. Sectoral concentration changes too from one confederation to the other. CGIL members are concentrated in the export-oriented manufacturing sector (Frieden 2002). CISL has privileged access to public sector employees. UIL aims to represent the self-employed (CNEL 2000b, 322).

Table 6. Percentage of Non-Active Members (CGIL-CISL-UIL)

	1990 Non-active (%)	**1985-90** Increase of non-active	**1990-95** Increase of non-active	**1995-97** Increase of non-active
CGIL	45.8	+ 30%	+ 17%	+ 3%
CISL	38.2	+ 44%	+ 24%	+ 8%
UIL	18.7	+ 60%	+ 37%	+ 6%

Source: Ebbinghaus and Hassel, *Trade Unions in Western Europe,* 2000 (Ebbinghaus and Visser 2000, 424).

1.2.The historical relevance of macro-concertation

Italy's variety of corporatism is an awkward one. Experts like to talk of a hybrid case of neo-corporatism (Regini 1981; Bull 1988). Until the 1990s, Italy lacked the institutional preconditions which neo-corporatist theory had identified as being *conditio sine qua non* for the emergence of corporatist arrangements; these being the high centralization of collective bargaining and the institutionalisation of dialogue between government and social partners (Lehmbruch and Schmitter 1979). In spite of these deficiencies, the country has experienced forms of social concertation before the 1990s. More specifically, one can identify different historical phases. The first experiment of tripartite social partnership goes back to the late 1970s when unions gave their consent to a severe austerity programme. In the early 1980s, social concertation took the form of a traditional political exchange between wage restraint and government fiscal concessions. In the successive years, bilateralism prevailed with the State playing a marginal, if even that, role in negotiations between labour and capital. The social pacts of the

1990s marked the return of tripartism with social partners enjoying a very powerful position (Regini 1981; Salvati 1992).

This section describes in detail the first three phases with particular attention to the incentives behind them and to the content of the agreements. My ultimate aim is to appreciate differences between older corporatist experiments and recent social pacts. Corporatism emerged in Italy for the first time in the wake of a dramatic economic crisis (1976-79). As a result of the two successive oil shocks, the country was burdened with extraordinary inflationary pressures and severe fiscal imbalances. In 1976, once the PCI had joined the coalition under the new Solidarity Government, organised interests agreed to the implementation of an austerity programme. Union support came also from the fact that it was the General Secretary of the PCI, Enrico Berlinguer, who advocated greater discipline (Golden 1988). In this context, it is interesting to note that the call for fiscal austerity is not necessarily a prerogative of conservative parties, but more probably a function of the distributional impact of an economic crisis and/or emergency.

At the time, Italian labour unions appreciated the need for a concerted response to economic emergency. A different behaviour would produce in fact "unintended macroeconomic consequences" (Regini 1987). Their readiness to strike a deal with the Solidarity Government is explained only partially by the partisan argument. Strategic considerations mattered too. In particular, with the State playing an important role in the alliance, labour unions expected fiscal compensations in exchange for wage restraint. These took the form of additional social transfers, which in the long-term produced the rapid uncontrolled growth of social security spending (Salvati 1992; Treu in Dore, Boyer and Mars 1994). After three years, tripartite consultation started to stumble when confronted with a divided labour movement. On the one hand, the three confederations were competing ideologically against each other. On the other, and because of this partisan confrontation, CGIL, CISL, and UIL had different conceptions of the social viability of the austerity package (Golden 1988).

In the early 1980s, Italy was still suffering from high inflation. There was widespread awareness that at the basis of the country's excessive price levels was the wage indexation system that unions and employers had introduced in a consensual fashion in 1975. In 1983, government and the social partners came to an agreement on incomes policies. Workers committed to controlling wage growth so as to keep it in line with programmatic inflation as much as possible. The government was expected to guarantee that direct taxes and SSC were not augmented. Also, the government decided on a decrease of health contributions, the elimination of the fiscal drag, the exemption from SSC for employment contracts in the South and on additional benefits to families (CNEL, *Accordi Governo e Parti Sociali*, www.cnel.org). It was again a political exchange but one where the government was compensating wage earners with tax alleviation. In 1984, a similar compromise failed after the opposition of CGIL. Observers started to talk of the end of consensual politics.

The mid- and late 1980s marked a manifest decline in corporatism. Firstly, the State stayed out of talks between labour and capital. In this sense, there was a move from tri- to bipartism. Secondly, social partners themselves were losing political and organizational power as elsewhere in Europe (Golden et al. 1999). With collective bargaining moving towards decentralization in most European countries, observers forecasted the "end of corporatism" (see Schmitter 1974). Thirdly, cooperative relations between CGIL-CISL-UIL were rapidly deteriorating. One has to wait the early 1990s to see the re-emergence of social concertation in Italy in response to the 1992 financial crisis and under pressure to qualify for EMU. In section IV of this chapter, I will describe in detail the contents of the social pacts emerged in the 1990s and, in Chapter VII, I will attempt to identify their determinants.

2. Fiscal Policy Responses to the Financial Crisis

This chapter focuses on fiscal policy-making in 1992-94. This was an exceptionally turbulent time marked by the collapse of Italy's traditional party system after a series of corruption scandals, by the 1992 financial crisis culminated in the Lira's abandonment of the ERM and by the dramatic economic recession spread across Europe in 1993. It was but also the period in which serious fiscal consolidation was put in place under the Amato and Ciampi Governments, importantly with the crucial support of labour unions. The elimination of wage indexation in the 1992 social pact controlled the potential inflationary impact of the Lira's significant depreciation. In the successive 1993 agreement, the government reiterated its commitment to fiscal discipline should labour unions continue to support it indirectly by means of voluntary wage restraint. The terms were set for a sort of political exchange to some extent similar to those flourishing in Europe during the 1970s. The following sections describe this period.

2.1.The U-turn under the Amato Government (1992-93)

When, in May 1992, Giuliano Amato became Prime Minister, Italy was in political and financial turmoil. The recent corruption scandals known as *Tangentopoli* (Bribe city) had undermined the country's politico-institutional foundations. In addition, the economic situation was far from comforting. Growth projections were modest both in comparison with the previous five years and with parallel developments in other European countries (Tesoro 1992, 4). Inflation continued to be high and interest rate differentials with Germany grew as a result of financial markets lending little credibility to the troubled country. Against this background, the Amato Government soon realised that an extensive fiscal intervention was urgently needed. Deficit reduction was necessary to fight inflation and to improve the current account deficit[10] (Tesoro 1992, 6; Camera dei Deputati 16/9/1992, 3250-3282). It is interesting to note that fiscal adjustment was means both to keep inflation under control and, more obviously, to preserve the sustainability of public finances.

[10] While macroeconomics literature has not confirmed the existence of a systematic general relationship between high deficit and debt ratios to GDP and inflation, this seems but to be the case for Italy. Certainly, public authorities were firmly persuaded that the two were associated. In addition, by weakening internal demand conditions, fiscal adjustment would put a halt on imports, thereby correcting current account imbalances and, eventually, preserving the Lira's stability.

In the face of a rapid deterioration of Italy's financial situation, the new government was obliged to realise an extraordinary budget intervention in July. Passing it by decree so as to circumvent potential parliamentary opposition, Prime Minister Amato approved a corrective measure of about 30 trillion Lira (15.5 billion Euro) consisting mainly (75 percent) of revenue increases stemming from tax hikes on real estate and on bank deposits, and from greater pension contributions (Corriere della Sera 3/8/1992). It was also planned that, having obtained delegation from Parliament, fiscal authorities would design a structural reform in the areas of pension, health services, local finance and public employment (Camera dei Deputati 16/9/1992, 3250-3282; Corriere della Sera 24/7/1992) to allow expenditure restraints for 6.8 trillion Lira (Banca d'Italia 1993). The significant fiscal restriction was not sufficient to avert fears about skyrocketing inflation. In the same month, Governor of the Bank of Italy Ciampi raised the discount rate by 1.75 points (Tesoro 1992, 18). Italy's high public indebtedness made a restrictive monetary stance often necessary. Anti-inflationary measures would in fact allow also to contain the cost of servicing the debt (Pesole 2001; interview with Andrea Monorchio). It is interesting to note that Italy was the only EU country to pursue fiscal adjustment against rather restrictive monetary conditions (European Commission 2000, 12).

CGIL-CISL-UIL did not welcome Amato's emergency fiscal correction. A CISL official explained that, while unions were giving their green light to the size of the planned budget correction, they were doubtful about the specific distribution of the sacrifices (CISL, *CdL* 25/9/92). They expressed concerns about pension restraints and about the planned freeze on public employment contracts envisaged in the delegation law, on which they had not been even consulted (CGIL, *NRS* 34, 28/9/1992, 8-9). Unions were also critical about the suggested 0.8 percent increase in pension contributions and campaigned against housing tax, finally obtaining an exemption on first houses (Corriere della Sera 29/7/1992)[11]. CGIL indicated that, while having tackled the appropriate side of

[11] There was not unanimity in the labour movement on the question of the housing tax. CGIL was extremely critical of the measure and welcomed the granted exemption as a victory. Instead,

the budget, government authorities were targeting the wrong items. They should instead tax capital gains as well as reform the national tax system to eliminate widespread fiscal elusion and evasion (CGIL, *NRS* 29, 27/7/1992, 8-9).

On the other side of the spectrum, *Confindustria* was supportive of such extensive fiscal correction. Yet, as budget negotiations between government authorities and social partners were evolving, President Luigi Abete remarked upon the potential failure of a measure whose composition was being rapidly reshaped under labour unions' pressure. This was believed to be detrimental to the external credibility of the Italian economy, showing the government's incapacity to resist bottom-up pressures (Corriere della Sera 23/7/1992; 5/10/1992). Content analysis of official documents and media reports released in September shows that business actors were at the time primarily concerned with fiscal discipline as such. For most of the 1990s, they showed great concern for the reaction of financial markets, a trait that would be quite important to the political economy of fiscal adjustment. Second came their preference over its very composition; they favoured expenditure restraints but were equally firm in opposing greater fiscal pressure. The fact that the Lira had not yet abandoned the ERM explains their sensitivity to the tax burden to the extent that this, if significant, would endanger competitiveness (see Chapter VII).

With the supplementary budget came the first agreement between government and social partners. The Lira continued being subject to intensive speculative pressures and large amounts of currency reserves were employed to preserve its external value. On top of that, Italy's large inflation differential *vis-à-vis* other EU countries was further weakening the national currency. While the commitment to fiscal discipline aimed to calm financial markets down, domestically only across-the-board wage moderation would help the country out of mounting inflationary pressures. The pact signed in July 1992 revolved around the elimination of the *scala mobile* (wage indexation), substituted it with a system where only productivity growth was rewarded. The ensuing reduction of unit labour costs would support the too weak domestic investment ratio. In

CISL supported it because it enlarged the tax base, once excessively concentrated on employment and pension (CISL, *CdL* 25/9/1992).

addition, the agreement prescribed that government consult social partners before the presentation of the financial planning document (DPEF) and budget proposal to Parliament (*Protocollo sulla Politica dei Redditi*, July 1992).

In September 1992, the government resumed consultation rounds with the social partners. The Lira had further weakened making the preservation of fixed exchange rates extremely difficult. The Italian Confederation for Industry was sceptical of the possibility of devaluating officially. Since the late 1980s, organised capital was showing hostility to the use of competitive devaluations. In the autumn of 1992, the organization's primary interest resided in the size of the fiscal correction. The latter would convince financial markets of Italy's serious commitment to fiscal discipline, thereby allowing a reduction of interest rates. The Bank of Italy supported a similar view (Banca d'Italia 1993)[12]. At the root of *Confindustria*'s strong preference for rapid and significant budget consolidation was also a concern for the excessive cost of money that was strangling the Italian industry (Corriere della Sera 5/10/1992). Secondly, business actors indicated that deficit reduction had to be achieved by means of expenditure restraints and privatisation proceeds and not through tax increases (Corriere della Sera 9/9/1992).

The final devaluation of the Lira at the end of the month created alarm amongst workers after all three confederations had signed up to the elimination of the wage indexation system in July (CGIL, *NRS* 34, 28/9/1992). Fears for the inflationary impact of a flexible exchange rate in the absence of wage indexation strengthened unions' support for speedy and extensive deficit reduction, thereby clearly aligning their preferences with those of *Confindustria* (CGIL, *NRS* 36, 12/10/1992). This did not stop them from pressing government for further adjustment to the content of the budget. In the DPEF, the Amato Government had in fact envisaged a rather expenditure-based manoeuvre with cuts to primary spending of 36 trillion Lira (18.5 billion euro) and revenue increases of 16

[12] Nor was the government less concerned with the reaction of financial markets. In consultation with the unions, Amato declared: "I acknowledge you are risking screws, but I have to confront the markets every day" (author's own translation). There is extensive empirical evidence showing improvement in the value of the Lira in perfect correspondence with the approval of various budget documents, especially there where this approval came by decree (Corriere della Sera 15/10/1992).

trillion Lira (8.3 billion euro) (DPEF 1993-95, 11). As revealed by some content analysis of documents dating back to September 1992, labour unions were equally committed to fighting against cuts and to promoting revenue-maximising measures, having deficit reduction as their priority (see Chapter VII). CISL leader Sergio D'Antoni acknowledged his support for the austerity package, but asked for a fairer distribution of the fiscal adjustment burden (CISL, *CdL* 19-20/9/1992). CGIL-CISL-UIL put forward a common proposal, which envisaged a revenue-based consolidation constructed around the elimination of the too numerous tax benefits, the imposition of a minimum tax on firms and on the self-employed (CISL, *CdL* 15/9/1992).

At the end of roundtable talks with social partners, the Amato Government presented its official budget proposal for 1993. The fiscal package, worth 93 trillion Lira (48 billion Euro), embodied the greatest budget correction in Italy's economic history, amounting to 6 percent of GDP (OECD, *Country Survey: Italy*, 1994)[13]. More than half of the effort was concentrated on the revenue side of the budget. Measures included a revision of tax breaks, a new municipal tax on buildings, a new tax on companies' net assets, a tax amnesty, VAT harmonization and tighter rules in the computation of income from self-employment. The remainder was to come from spending cuts spelt out in the accompanying provisions of the budget law, of which pension cuts constituted the greatest part (Pesole 2001; CGIL, *NRS* 35, 5/10/1992, 10-12).

While *Confindustria* was satisfied with the government's fiscal strategy, expecting that the extraordinary size of adjustment would bring about a fall of interest rates (Corriere della Sera 11/9/1992), CGIL-CISL-UIL were much more critical. True, they would also welcome a more relaxed monetary stance expected in response to successful deficit reduction, but insisted that its composition be revised on more equitable terms (CISL, *CdL* 25/9/1992). The three union confederations unanimously rejected measures taken in the areas of pension and health care (CISL, *CdL* 18/9/1992), the freeze on seniority pensions and the one-year freeze on public employment contracts. They suggested that government

[13] Over the period 1971-91, the average size of budget corrections amounted to 18 trillion Lira (9.3 billion Euro) (see Verzichelli 1999).

substitute planned spending restraints with additional revenue-maximising measures (CGIL, *NRS* 35, 5/10/1992, 10), such as a surcharge on capital gains, the suspension of tax returns and the introduction of special measures to fight fiscal evasion (CISL, *CdL* 22/9/1992; CGIL, *NRS* 35, 5/10/1992, 10-12). Their position was as follows:

> "We have to intervene on the public debt, we must and we can; we should do it now because tomorrow could be too late or, anyway, much more expensive; but we have to do it keeping always equity in mind; this is a fundamental prerequisite for any fiscal manoeuvre to be successful. We are aware that this will have to be translated into additional taxes, but the burden of adjustment should not be based on the most numerous but less wealthy social categories" –author's own translation (CISL, *CdL* 25/9/1992).

Their discontent took the form of a massive mobilization on 13 October. Against the threat of a second general strike (CGIL, *NRS* 38, 26/10/1992, 7), the Amato Government declared itself willing to strike a deal with the unions over the content of the budgetary correction as long as its extent was preserved (CGIL, *NRS* 35, 5/10/1992, 10-15; CISL, *CdL* 23/9/1992). Cutbacks to pension and health care were reduced and the ensuing loss compensated by restraints on development policies; the fiscal burden was shifted onto the self-employed away from wage earners; tax increases on utilities and on the personal income tax (IRPEF) postponed; and the surcharge on firms incorporated in a decree law to guarantee immediate application (Corriere 29/9/1992: CGIL, *NRS* 36, 12/10/1992; *NRS* 38, 26/10/1992; CISL, *CdL* 16-25/10/1992). In the end, CGIL-CISL-UIL acknowledged that all their requests had been accepted. Approved by Parliament at the end of December, the 1993 Finance Bill consisted of expenditure restraints of 41.9 trillion Lira and of revenue increases of 44.4 trillion (Degni and al. 2001). In terms of final outcomes, the intervention led to a cyclically adjusted deficit reduction of 1.3 percent of GDP with the primary surplus improved by 1.7 percent of GDP. Total revenues increased 4.3 percent of GDP. In spite of the budget's planned nominal spending cuts, CA total expenditures actually increased by 3.1 percent of GDP (European Commission 2003).

Existing literature explained the Amato Government's success in imposing such an extensive budget consolidation on two grounds. First, the commitment to the Maastricht Treaty and the impending financial crisis left authorities with no choice (Dyson and Featherstone 1999). Secondly, deficit reduction was allowed by stronger political and budget institutions. More specifically, Della Sala argued that, with the collapse of the Italian party system, the executive was *de facto* granted greater room for manoeuvre and independence from Parliament with the result that ambitious fiscal plans had little chance to get lost during the parliamentary passage (Della Sala 1997). On a similar note, Verzichelli suggests that, from an institutionalist perspective, the most visible change in the early 1990s was the government's enhancement of direct responsibility in economic matters (Verzichelli in Cotta and Isernia 1996, 223-4). To take one example, Amato was the first prime minister to threaten resigning, should the size of the budget correction not be preserved after the parliamentary stage. In a nutshell, stronger institutions accounted for the conquered fiscal rigour.

My contention is that, while significant, the centralization of the budgetary process around the figure of the prime minister is not a sufficient explanation of fiscal stabilisation. Anecdotal evidence is clear about the fact that Amato was be no means a "free rider" but required constant support from labour unions. With the traditional party system having lost legitimacy, trade unions inherited significant political power. At that time, they also enjoyed great mobilization potential. Their direct involvement in budget policy-making allowed for the creation of a broad social consensus around fiscal discipline (interview Giuliano Amato). CGIL-CISL-UIL ended up substituting Parliament in the function of transmission channels between the State and society (Amato 1994). However, before their consent could be obtained, fiscal authorities would need to design an acceptable reform package. This explains why the dimension of composition is of such relevance and why it also accounts for the size of budgetary consolidation, when the latter is a good proxy for successful deficit reduction. In brief, the progressive convergence of budget actors' fiscal preferences from one consultation round to the other is on the basis of policy change. By the same token, the 1992 financial crisis was not an abstract external threat, as suggested by some literature, but had the specific effect of altering the preferences of socio-economic interests, allowing for labour and capital to converge on a similar position in favour of fiscal discipline, even if for different reasons. Again, the explanation lies in the newly emerged constellation of domestic preferences rather than in institutions.

2.2.Technocrats, social partners and markets (1993-94)

In May 1993, the technocrat Carlo Azeglio Ciampi was appointed Prime Minister. He was immediately confronted with two challenges, namely the state of public finances and the relationship with the unions. Fiscal consolidation continued to be an absolute priority. The latter was even more urgent now in light of the fact that the Lira had abandoned the ERM and was more vulnerable to financial markets' perception of Italy's progress towards financial stability. Ciampi had been a firm advocate of stability for the past two decades. When governor of the national central bank, he insisted that balanced budgets were essential, both for keeping inflation under control and for freeing up the resources necessary to sustain growth and employment creation (Banca d'Italia 1979-1986). Also, with wage moderation having offered a great contribution to adjustment in the previous year, it was felt that the new government should put its effort into maintaining the support of labour unions.

At the beginning of the year, the macroeconomic scenario seemed to offer better opportunities than it had been the case in 1992. First, while the devaluation of the Lira had the potential to undermine Italy's credibility on international markets, it had also offered a pressure valve for domestic exports and could so contribute to growth, had other variables being controlled for. Second, the income policy agreements signed in July 1992 guaranteed greater control over inflationary spirals (Tesoro 1993,10-14). With the inflation rate appearing to be under control in the first months of 1993, domestic groups pushed for a more relaxed monetary stance. The reduction of interest rates was expected to minimise the cost of the country's high public debt, guaranteeing greater sustainability of public finances in a situation in which overall growth was alarmingly slowing down. Impending recession was perceived as a severe problem to the extent that it undermined the possibility to contain fiscal imbalances through the growth channel, without major sacrifices (CGIL, *NRS* 6, 22/2/1993).

It was fundamental that the new Prime Minister succeeded in preserving an environment in which unions' commitment to wage restraint could be sustained. Not only was the cooperation of the social partners necessary to the success of the government plan for economic adjustment, but also politically desirable considering that the new technocratic establishment lacked electoral legitimacy. The difficulty arose from the fact that the Prime Minister had to create as wide a socio-political consensus as possible in a situation in which there was no real alternative to retrenchment (Corriere della Sera 7/5/1993; Pesole 2001, 122-130). Faced with this tricky situation, Ciampi declared his commitment to maintaining an open dialogue with the unions, acknowledging that their support was essential to successful economic reform. Wage restraint and the ensuing control over inflation would help keep interest rates low, thereby benefiting both investment and debt sustainability (Tesoro 1993, 19). It was fortunate that unions had full trust of the Prime Minister (Tesoro 1993, 12-14; Corriere della Sera 5/5/1993; interview Andrea Monorchio).

Still, the government's first fiscal act came under strong criticism to the extent that decisions were taken at closed doors without consultation with the social partners (Corriere della Sera 22/5/1993). Faced with a rapid deterioration of public finance aggregates at the end of May, the executive had been induced to deliver a supplementary budget worth 12.7 trillion Lira. More than half of the burden of adjustment was placed on the revenue side of the budget, where a new ecological tax was introduced and indirect taxation increased. The rest came from cuts to central government consumption and from reduced transfers to local administrations (Tesoro 1993; Corriere della Sera 21/5/1993). Domestic groups were not satisfied mainly because they had not been consulted. UIL leader Larizza indicated that the government should have taken concrete measures to fight fiscal evasion and implemented more generous investment policies (Corriere della Sera 3/5/1993). The Confederation of Italian Industry criticised the excessive reliance on tax hikes. In response, Prime Minister Ciampi was keen to acknowledge that his was an emergency measure and that decisions over the official budget proposal would be taken in close consultation with the social partners (Corriere della Sera 27/5/1993).

Delivered on 13 July 1993, the government's long-term financial document reflected the technocratic character of the new establishment. Ciampi's fiscal objective was threefold. First, he was committed to a gradual but firm debt stabilization, in contrast with previous governments' fiscal policy prescriptions where deficit reduction had represented the one and only target, with debt reduction believed to follow en suite. Second, it was acknowledged that Italy's non-tradable sector was excessively protected (e.g. services) and that resources had to be redistributed towards tradable sectors (e.g. manufacturing). Thirdly, it was recognised that the welfare state was deemed to face significant strains as a result of the ageing population. According to government plans, about 80 percent of the total (nominal) value of the fiscal correction would stem from expenditure restraints in public administration; these would come without compromising the quality of public services (DPEF 1994-96, 14-36). The remaining would come from additional revenues created by the rationalization of the tax system. The Government had no reason or inclination to further increase Italy's fiscal pressure, not least because of mounting socio-political pressure upon the executive (Bernardi 1994, 22).

Under the Ciampi Government, social partners agreed to the signing of a second social pact. This was meant to complete the 1992 agreement. From the way in which they had been conceived, the 1993 Income Policy Agreements immediately became a manifesto in favour of fiscal discipline. It was acknowledged that wage moderation was an essential part of inflation control and of successful budget consolidation. Among other effects, lower price levels would induce financial markets to believe that Italy was setting itself on sounder feet with positive implications for the country's alarming risk premium. Not only did this pact reiterate labour unions' voluntary wage restraint, but it also envisaged a complete restructuring of wage bargaining on two levels of negotiation, the national and the plant level (*Protocollo sulla Politica dei Redditi*, July 1993). Considering collective bargaining had been previously quite fragmented, this innovation was significant in that it made the national level more visible, thereby enhancing centralization and coordination across regions and sectors.

On 9 September, the Council of Ministers presented the official budget proposal for 1994. It envisaged a 31 trillion Lira intervention (15.5 billion Euro), of which only 3.8 trillion came from greater incomes and 27.2 trillion from spending restraints, thereby largely confirming data laid down in the DPEF. Already in the design, Prime Minister Ciampi's budget policy did not share common traits with either previous or subsequent fiscal interventions. It was both the smallest and the most expenditure-based manoeuvre. Content analysis of official documents and declarations to the press reveals how *Confindustria*, while appreciating the significant expenditure component of the budget correction, nevertheless expressed concerns about the fact that the limited size of the intervention would not induce a sufficiently rapid deceleration of interest rate levels (Corriere della Sera 3/9/1993; CISL, *CdL* 10/9/1993). At the same time, Italian trade unions - *Confcommercio*, *Confartiginato* and *Confesercenti*- appreciated the fact that the Government had abolished the minimum tax, a transitory measure introduced by Amato in the previous year which, consisting of a minimum flat-rate contribution, was conceived with the aim of correcting for self-employed workers' tendency to evade (Corriere della Sera 4/9/1993).

In spite of Ciampi's effort to gain the support of CGIL-CISL-UIL, labour unions were extremely disappointed and called for a general strike to take place on 28 October. Content analysis of official documents identifies three peculiarities about 1993. First, the fiscal preferences of labour unions were much more volatile than they had been the year before. Second, the opinions of the three confederations tended to diverge more often than not. Third, fiscal discipline was not always perceived as their most intensive preference; only greater interventions on the revenue side of budget were (see Appendix 1a). With recession looming in the background, organised labour was more cautious in calling for a restrictive fiscal stance and, instead, went so far as to ask the government to launch new programmes in favour of employment.

Under particular criticism was Ciampi's decision to abolish the minimum tax, which labour representatives felt had the advantage of correcting for the unequal distribution of the adjustment burden between dependent and self-employed labour (Corriere della Sera 21/9/1993). Most importantly, the tax was one of the items the government had exchanged for wage moderation. In that respect, its abolition was perceived as a violation of the 1992 and 1993 Income Policy Agreements (CISL, *CdL* 5/10/1993; Corriere della Sera 13/10/1993). Also, CISL criticised interventions on pensions and health care, showing particularly concern over the ungenerous public employment provisions (CISL, *CdL* 7/9/1993, 13/10/1993; Corriere della Sera 14/9/1993), not least because of the unions' significant penetration in the public sector. CGIL talked more vehemently of an equal distribution of the adjustment burden, mainly as a result of the introduction of indiscriminate spending cuts (CGIL, *NRS* 32, 27/9/1993, 4-7). In agreement with CISL, CGIL expected signs of commitment to greater public investment in research and vocational training (CGIL, *NRS* 32, 27/9/1993; CISL, *CdL* 24/11/1993). Their position is well reflected here:

> "Unions were asking for a larger intervention on the revenue side of the budget. Certainly, they are not asking for greater fiscal pressure, which has reached unbearable levels. Yet, they are asking for less fiscal benefits and for the devolution of the ensuing additional revenues to employment-boosting initiatives...Since the government has to proceed in the adjustment of public finances, it would have to do so by guaranteeing fiscal equity and by intervening more significantly on fiscal benefits so as to free resources to be devoted to investment and to active labour market policies" –author's own translation (*CdL* 12/9/1993, 6/10/1993).

Approved at the end of December, the 1994 Finance Bill confirmed the size of the adjustment as indicated in the September RPP, but its composition was slightly revised on the revenue side of the budget, with revenues increasing from 3.8 to 5 trillion Lira. Public incomes would be inflated thanks to indirect tax hikes, which were intended to cover for the approval, during the parliamentary session, of an amendment to Ciampi's severe provisions on minimum pensions (Corriere della Sera 16/10/1993). Large savings derived from the vast reform of public administration designed by Civil Service Minister Sabino Cassese (4.6 trillion Lira), but also from cuts to pensions, health care and public investment (OECD various issues). In terms of actual fiscal outcomes, the CA deficit fell 0.6

percent of GDP; results came from both sides of the budget with total CA expenditures and revenues both diminishing by 2.5 percent of GDP (European Commission 2003). Yet, the adjusted primary surplus deteriorated by 1 percent of GDP showing in fact that interest payments had contributed significantly to deficit reduction, as in authorities' expectations.

3. The Creation of Consensus in the Final Run-Up to EMU

With 1994, a new elected government came into power, a development that had important implications for fiscal policy. Budget policy-making certainly becomes more politicised. The neo-liberal Berlusconi Government was relatively successful in putting in place some expenditure restraints. However, its attempt to achieve a pension reform without unions' support in fact into a failure, forcing the establishment to resign. Financial markets showed particular sensitivity to the instability caused by this, as well as being not much impressed by the Prime Minister's repeated calls for an expenditure-based consolidation. After the transitional Dini Government, under which a significant pension reform was successfully negotiated with the unions, the ball rolled to another elected government. The Prodi Government in power from 1996 to 1998 was able to successfully manage Italy's final rush into EMU, with a deficit reduction in 1996 of 4 percent of GDP. In the following sections, I describe in detail fiscal policy-making during this period.

3.1.The neo-liberal agenda of Berlusconi (1994)

Elected in 1994 under the new semi-majoritarian law, the centre-right Berlusconi Government did not linger to express its full support for an expenditure-based fiscal adjustment. The electoral campaign itself had centred on economic issues, much against Italy's politico-institutional heritage (Bernardi 1995; Bellucci 1999). In official budget documents, the government attacked Italy's expensive pension and health care system and excessive public wages (Tesoro 1994, 1-5). Only structural cuts, as opposed to mere deficit reduction, would keep inflation under control, thereby accelerating debt stabilization (Pesole 2001, 130-1). Ideological reasons explain the government's fiscal stance. Welfare expenditure cuts together with the parallel project for significant tax alleviation aimed *de facto* at reducing the role of the state in the national economy (Verzichelli 1999), as was explicitly suggested in the DPEF:

> "The excessive role of the State in the production of goods and services generates, on one side, inefficiencies in the allocation and redistribution of resources and, on the other, creates and protects monopolies hindering the emergence of the degree of competition that is necessary to produce wealth. Budget consolidation cannot be successful if not associated with the retreat of the State from economic activities that are, by nature, better performed by the market" –author's own translation (Tesoro 1994, 2 & 9).

In their first budget act, fiscal authorities envisaged a moderately large fiscal intervention worth 35 trillion Lira, 27.8 trillion of which came from expenditure restraints, mostly in the area of pensions and health care. The September budget proposal largely confirmed these figures. It contained savings for total 50 trillion Lira (25.9 billion Euro), with more than half coming from adjustments to the pension system and to the health service, from a halt to public employment contracts and from reduced transfers to local administrations –this done with the intention to prepare for fiscal federalism. On the revenue side of the budget, the government had planned to gain from an improvement of fiscal administration and from one-off measures, e.g. an amnesty on building infractions (OECD various issues).

In spite of the apparent match between the government's fiscal proposals and the requests that *Confindustria* had put forward over the previous couple of years, the Confederation was sceptic of the new establishment. The country's credibility on financial markets continued to be their major concern. Government authorities actually expressed the same view and explained that courageous cuts to the welfare state were aimed, among other things, at proving to markets that the government was able to oppose labour unions' pressures (Tesoro 1994, 24; CISL, *CdL* 13/10/1994). However, this did not materialise. On the contrary, when Foreign Minister Martino criticised the EMU project and expressed doubts about Italy's chances of meeting the Maastricht criteria, interest rate differentials with Germany started to grow again after having narrowed in the two previous years. *Confindustria*'s initial disappointment was inevitable. In its view, budget consolidation had to be, above all, credible.

However, the real challenge came from labour unions. These opposed Berlusconi's fiscal plan, not least for ideological reasons. CGIL-CISL-UIL criticised the budget for being "unbalanced and socially dangerous" (CISL, *CdL* 30/9/1994) in light of the overwhelming predominance of spending cuts and the insufficient reliance on revenue-maximising measures. It was suggested that privatisation programmes be accelerated and measures taken to scrap fiscal benefits that worked only to the advantage of a few socio-economic categories (CISL, *CdL* 28/9/1994):

> "Not a penny has to be taken from the pensions fund so as to rescue a fiscal manoeuvre, which is saving powerful people and tax evaders…we ask for fiscal consolidation and equity. The government budget is too biased in favour of spending cuts, in spite of the recent efforts to increase revenues…the government has to take out requests into account, namely consider a reform of taxation able to generate additional incomes from tax evasion and elusion" –author's own translation (*CdL* 28/9/1994).

With this backdrop, budget negotiations between government and unions proved extremely troublesome. Unions complained about the fact that fiscal policy was not really constrained by the international economic environment, as suggested by government authorities, but that it was rather, and more disappointingly, the result of specific political considerations, at the root of which were the electoral promise to reduce fiscal pressure and the belief that public spending always determines a distorted allocation of resources (CISL, *CdL* 13/10/1994). Having let divisions through under the previous government, the front of CGIL-CISL-UIL was again highly united as reflected in the perfect convergence of their preferences. Again, content analysis suggests that fiscal discipline figured as their priority; second came opposition to welfare cuts; third the support for revenue-maximising measures (see Chapter VII).

In the first round of talks, the Prime Minster seemed to grant a few concessions. The revenue side of the budget was subject to some fine-tuning so that, in the new proposal, the contribution of revenues to adjustment was raised from 33 to 43 percent of the total value of the fiscal intervention (CISL, *CdL* 13/10/1994). Still, CGIL-CISL-UIL did not consider the changes satisfactory. In parallel, unions explained that spending restraints were not acceptable because they were an exercise in cost containment that lacked the logic of reform (CISL, *CdL* 30/9/1994). With negotiations coming to a halt, CISL leader D'Antoni noted:

> "The government did not take into account our requests to balance spending cuts with revenue increases by about the same amount. Still, unions do not object to fiscal austerity. The government has privileged short-term cuts over a general and equal reform to be negotiated with the social partners" –author's own translation (*CdL* 13-20/10/1994).

The conflictual relationship with the unions entered also into Parliament. In a parliamentary hearing, CGIL-CISL-UIL reiterated their unconditional support to the size of the fiscal intervention but declared firm opposition to its composition (CISL, *CdL* 19/10/1994). The Prime Minister was in a difficult position considering that he did not enjoy an absolute majority in the Upper House and risked facing obstruction from the pro-labour opposition. It was soon clear that Berlusconi had no alternative but to strike a deal with the unions. In early December, government and social partners came together to sign an agreement. Labour unions obtained an amnesty over pension contributions, additional spending in favour of the South and more modest cuts to health services (CGIL, *NRS* 44, 12/12/1994, 4).

The most visible change was the decision to treat pension reform separately from the finance bill so as not to jeopardise the punctual conclusion of the budget session (Corriere della Sera 25/11/1994). In this separate document, the increase of the retirement age was postponed to July 1995. Second, it was planned that pensions be adjusted to inflation much earlier than anticipated. These provisions were to be financed through higher indirect taxes and pension contributions (Corriere della Sera 9-22/12/1994). At the end of the negotiations, all three union leaders appreciated the considerable adjustment made from the original budget proposal; which had been possible without altering the size of the correction (CISL, *CdL* 2-7/12/1994; CGIL, *NRS* 44, 12/12/1994, 5). The agreement allowed the last-minute approval of the budget manoeuvre, but did not save the government, which was forced to resign soon after. The following government would inherit the sensitive issue of pension reform. As to actual fiscal outcomes, at the end of the financial year, Berlusconi's manoeuvre had brought to a 1 percent of GDP deficit reduction, with expenditures and revenues falling 1.7 and 0.7 percent of GDP, respectively (European Commission 2003).

3.2.The Dini and Prodi Governments (1995-98)

On 13 January 1995, in the midst of the political crisis provoked by the resignation of Prime Minister Berlusconi, former Treasury Minister Lamberto Dini was designated to lead the country through the transition period before new political elections. The domestic atmosphere was tense, with deteriorating economic variables. In the previous year, the country had suffered from a considerable loss of credibility on financial markets with the result that the floating Lira had lost too much value. Since its exit from the ERM, the national currency had depreciated by more than 40 percent vis-à-vis the DM. Having reached such low level, the exchange rate was starting to also affect the sustainability of public finances, even if only a limited portion of public debt was denominated in foreign currencies. Simultaneously, inflationary pressures were building up (Modigliani and Padoa-Schioppa Kostoris 1998). Yet, for most observers, currency depreciation was not the cause of higher inflation. Rather, the latter was determined by domestic producers deliberately pushing prices upwards to recoup profits eroded by recession (FT 21/2/1995; Pesole 2001, 137-146). Against this climate, in February, the *Banca d'Italia* raise the discount rate from 7.5 to 8.24 percent, thereby provoking *Confindustria*'s fierce protests (FT 22/2/1995).

Soon after, the Dini Government had to introduce an emergency budget intervention to correct for newly emerged fiscal imbalances and at the same time to restore the credibility of the Lira on financial markets (Sole24Ore 12/2/1995). Confronted with strong criticism within Parliament, the extraordinary fiscal package was finally approved thanks to the last-minute support from a section of the Partito Popolare Italiano (PPI) and from the extra-governmental Rifondazione Comunista (CGIL, *NRS* 11, 27/3/1995, 7-8). While the new government expressed on various occasions its technocratic origin and agenda (www.parlamento.it, July 2002; CGIL, *NRS* 4, 6/2/1995, 4), it is a fact that its appointment was possible only thanks to the parliamentary support of the left-wing Party of the Democratic Left (PDS). Against this background, Forza Italia's vote against the budget rested on ideological grounds too. After being subject to multiple parliamentary amendments (CGIL, *NRS* 11, 27/3/1995, 8), the approved fiscal correction consisted of 3.6 trillion Lira in spending cuts and 16 trillion in revenue increases from VAT, greater direct taxation and contributions to the health system (Bernardi and Parlato 2000, 8; Pesole 2001, 139).

CGIL-CISL-UIL privileged fiscal rigour above all, as was apparent in official documents, but did not abandon their push for greater spending in favour of employment as a means to allow rapid recovery from the recent recession (see Chapter VIII). Unions were generally quite supportive of the plan, with the exception of the government's decision to increase VAT. Workers' sensitivity to inflation developments had increased since 1992, when labour unions had signed up to the elimination of the wage indexation system. Greater indirect taxation was thus undesirable because it was likely to exert pressure on price levels (FT 17/3/1995; CGIL, *NRS* various issues). To be sure, *Confindustria* expressed a similar concern. Their argument was that the shrinking of disposable income as a result of inflation would dampen already modest domestic consumption (Sole24Ore 12/2/1995; FT 22/3/1995). On the whole, CGIL-CISL-UIL did appreciate Dini's first fiscal act to the extent that it appeared relatively balanced in its composition, as in the words of CGIL representatives:

> "Finally, the government has acknowledged what we were trying to argue last autumn during budget negotiations; in our conditions, promising and implementing a policy of fiscal pressure reduction (as Berlusconi suggested) is irresponsible and represents a swindle against citizens. The idea of asking for a contribution from firms and self-employed through higher direct taxation and social security contributions is inspired by a principle of equity" –author's own translation (*NRS* 8, 6/3/1995, 4).

On 2 June, the government presented its DPEF, in which it reaffirmed the commitment to fiscal consolidation but also gave renewed emphasis to the fight against inflation and the strengthening of public investment policies in most disadvantaged regions (Tesoro 1995, 15-36). Amounting to 32.5 trillion Lira (16.8 billion Euro), the proposed fiscal correction was modest even compared with previous budgets but fairly balanced between spending restraints and revenue increases. For the first, government authorities suggested a freeze on public contracts and wages and a rationalization of the system of central government consumption and of transfers to local authorities. On the revenue side of the budget, the government increased VAT and enhanced control over fiscal evasion with a commitment to at least maintain fiscal pressure to 1995 levels (Tesoro 1995, 24).

At the same time, Dini initiated his pension reform process in close consultation with the unions. The plan envisaged a shift from Italy's wage-based to a contribution-based pension system. While the reform's short-term financial impact remained uncertain and offered no immediate guarantee for deficit and debt reduction (Padoa-Schioppa Kostoris 1996; Sole24Ore 5/8/1995), its contents were certainly revolutionary. The direct involvement of CGIL-CISL-UIL in the reform process was vital to its very success. Labour unions accepted welfare reform only because they were allowed to contribute to the relevant decisions exercising an impact on the shape of the new system (Ebbinghaus and Hassel 2000; Baccaro 2000; Ferrera and Gualmini 1999, 107-10; interview Beniamino Lapadula; Andrea Monorchio). For the same reason, organised capital regarded the reform as overly modest and refused to sign it. It lamented the fact that it failed to address the problem of expensive seniority pensions (Sole24Ore 15/6/1995).

At the end of September, the Dini Government unveiled its budget proposal. If the size of the intervention confirmed figures laid down in the DPEF, its composition had been significantly shaped by union pressure with the result that spending cuts were withdrawn and greater weight placed on revenue increases in the name of equity (CGIL, *NRS* 31, 11/9/1995, 6-7; CISL, *CdL* 28/9/1995). In particular, the government accepted that public employees recovered part of the inflation-induced loss in real earnings, a measure pushed through also by the parliamentary centre-left coalition supporting Dini (FT 28/9/1995; CGIL, *NRS* 35, 9/10/1995, 4-5). In addition, it withdrew cuts to health services, in line with union requests (CISL, *CdL* 21/9/1995), and laid down provisions for a greater rationalization of public administration. It was believed that these measures were unavoidable in order to preserve social expenditure levels (CGIL, *NRS* 31, 11/9/1995; CISL, *CdL* 28/9/1995). In the end, CGIL-CISL-UIL were very satisfied with the outcome and went as far as to argue that Dini's represented the most equitable of all recent fiscal corrections (CISL, *CdL* 28/9/1995).

Needless to say, unions' enthusiasm was matched by the disappointment of the Confederation of Italian Industry. The latter lamented the fact that the budget's underlying rationale consisted of "fulfilling social aims rather than being instrumental to stability and growth" (FT 28/9/1995). *Confindustria* opposed the government's decision to adjust public wages to inflation (CISL, *CdL* 20/10/1995; CGIL, *NRS* 37, 23/10/1995, 30). The disagreement with VAT increases also reflected a concern with inflation. Again, business actors feared a restrictive monetary stance in reaction to mounting price levels. Most importantly, the confederation criticised the cabinet's declared intention to withdraw some of the tax breaks firms had obtained from the previous Berlusconi Government and warned against the absence of initiatives on the spending side of the budget. Interestingly enough, Governor of the Bank of Italy Antonio Fazio voiced similar concerns (FT 3/11/1995).

There is no doubt that Dini's use of concertation guaranteed large socio-political consensus around fiscal adjustment (CISL, *CdL* 30-31/12/1995). Extensive anecdotal evidence shows that unions and leftist political parties managed to alter the composition of the budgetary intervention for 1996, making it more revenue-based. Unions showed appreciation for the fact that planned expenditure restraints were withdrawn, that the level of social spending was left untouched and that public revenues were to be enhanced through greater control over fiscal evasion. On the other hand, the relationship between this establishment and *Confindustria* was more tense. The Dini Government had repeatedly accused the business community of causing inflation by expanding margin profits. Still, in spite of the Confederation's general disapproval of the chosen fiscal strategy, the emphasis on fiscal consolidation was appreciated, as was Prime Minister Dini's decision to allow currency depreciation in spite of its pushing of inflationary pressures (Walsh 1999, 79).

At the end of the parliamentary phase, the resulting finance bill appeared clearly biased in favour of greater public incomes (Pesole 2001, 44). The impact of the provisions on central government accounts was calculated at 22.6 trillion Lira from revenue increases and around 10 trillion from spending cuts (Degni and al. 2001). Just before the end of the financial year, the rightist opposition succeeded in passing an additional intervention worth 5.25 trillion Lira which, thanks to the government coalition's veto power, did not incorporate social spending cuts (FT 30/12/1995). In terms of actual outcomes, the resultant end-of-year correction proved quite modest amounting to 0.6 percent of GDP. CA incomes and expenditures grew 0.3 and 0.5 percent of GDP, respectively (European Commission 2003).

The year 1996 represents an *annus mirabilis* for Italy's EMU convergence process. With the implementation of one of the country's largest deficit reductions, the new Prodi Government succeeded in bringing Italy into EMU. Between 1996 and 1997, the actual public deficit moved from 4.2 down to 2.7 percent, below the target value imposed by the Maastricht Treaty. Multiple factors account for the successful fulfilment of the Maastricht fiscal criteria. First, and most obviously, the EMU project was at its final stage. Failure to fulfil the criteria would have meant Italy's exclusion from European monetary integration. Second, it became easier to take courageous fiscal decisions against a more stable politico-institutional environment at home. In April 1996, political elections had given birth to a legitimate centre-left government after a long succession of technocratic executives. Third, in that period, the Bank of Italy was highly supportive of fiscal austerity and responded by relaxing monetary policy twice. In July, the new Governor Antonio Fazio lowered the discount rate from 9 to 8.25 percent and then, in October, down to 7.5 percent (FT 21/6/1996; 24/10/1996). It is not to be excluded that the support of monetary authorities was the natural consequence of the fact that the Budget Ministry was taken over by former governor Carlo Azeglio Ciampi (Monorchio and Tivelli 1999, 97 & 170; Pesole 2001; Visco 2002).

With the Euro-clock ticking, government authorities were keen to insist on their serious commitment to budget consolidation. Economic rhetoric consisted of an important component of the government's strategy. The number of official statements rose massively, as a means for communicating with financial markets. Embracing a rather critical attitude, business actors argued that the presence of a leftist coalition was itself a message to international markets and were afraid of the possibility that fiscal discipline could come under threat. As in 1992, *Confindustria* strongly believed in the need to put in place extensive deficit reduction. Fiat CEO Cesare Romiti explained that this was the only possible recipe to allow interest rates to decrease (Corriere della Sera 8/5/1996). In truth, the government had no reason to think differently. The presence of Ciampi in the government meant that this strategy, which he had already pursued as a prime minister in 1993, was given absolute priority. In his own words:

> "If inflation is reduced and government as well as the whole country gain greater credibility, then we can expect a lowering of nominal and real interest rates. The long awaited reduction of interest rates is key to the relative success of Italy's economic policy. Without a considerable fall in interest rate levels, it will not be possible to trim the debt burden, to open up the way for private investment and, more generally for production process" –author's own translation (Senato 10/7/1996).

However, while the new establishment would not dare question austerity, it adopted a different approach to its composition. During the presentation of his government programme, on 22 May, Prime Minister Prodi indicated that revenue increases were no longer feasible and that sufficient room existed to restructure the welfare state without necessarily jeopardising social justice and equity (Camera dei Deputati 22/5/1996). He attempted to deliver the image of a progressive establishment concerned with social rights but at the same time aware of the need to respond to globalisation pressures. As progressive as it might have been, when in office, the new coalition expressed the intention to intervene on pensions, health and education.

Prodi's eagerness to reform the welfare state was not well perceived by labour unions. In particular, if it is true that CISL and UIL were aware of the fact that pensions and the health sector needed some restructuring – mostly against the position of CGIL, which was rather supportive of the *status quo* - they were more inclined to qualitative adjustments, so that would not necessarily result in deficit reduction, at least in the short-term (Corriere della Sera 10/5/1996). In other words, it was not accepted that welfare retrenchment becomes a means to balance the public budget. UIL leader Larizza noted: "the welfare state can be reformed towards greater efficiency and cost-minimization, but this should not compromise the State's duty to provide social insurance" (Corriere della Sera 8/5/1996). In spite of the government-union confrontation in front of the content of budget consolidation, CGIL-CISL-UIL expressed their full support to extensive deficit cuts (Reuters 4/6/1996).

On 20 June, a few months after its election, the Prodi Government announced an extraordinary intervention. As lower-than-expected growth had depressed public incomes, the establishment's first task was to guarantee that fiscal outcomes for the previous year would be met (Bernardi and Parlato 2000, 14). Worth 17 trillion Lira (8.8 billion euro), the intervention consisted in two thirds of expenditure cuts affecting transfers to railways and road authorities and, for the remaining third, of revenue increases expected to come from a review of taxation on bank deposits. In spite of the overwhelming predominance of measures on the spending side of the budget, these were such that the preferences of *Confindustria* were not met. In particular, employers were critical of the 0.6 percent reduction of tax allowance for employee welfare payments (FT 21/6/1996; OECD 1998-99). The Confederation of Industry accused the government of deliberately shifting the burden onto the business sector.

The subsequent DPEF envisaged, for 1997, an intervention of 32.4 trillion Lira (16.7 billion euro). The Treasury was proudly announcing that this last proposal was a significant break with the past, to the extent that expenditure restraints were at the heart of the new fiscal strategy. According to public authorities, it was possible to achieve a threefold objective, namely to defend discipline, alleviate fiscal pressure as well as guarantee at the same time the preservation of the Italian welfare state (Tesoro 1996; Senato 10/7/1996; The Economist 13/7/1996; CNEL 2000a). However, after consultation with the social partners in September, the budget proposal looked very different from provisions contained in the long-term financial planning document. In terms of its layout, it consisted now of two distinct financial acts. On the one hand, the government profiled an ordinary intervention worth 37.5 trillion Lira which, being largely based on spending cuts, respected the original plan in the DPEF (Senato 7/10/1996). On the other hand, fiscal authorities foresaw an extraordinary measure known as "Intervention for Europe" consisting of Treasury operations and of the contentious introduction of a Euro-tax, a surcharge on all types of incomes (nota di Aggiornamento Tesoro 1996).

The new government's first fiscal act had been then altered both in terms of extent and composition. The size of the correction was doubled. This decision was taken against the growing certainty that Italy would be able to fulfil the deficit criteria by 1997 (Chiorazzo and Spaventa 2000). Instead, functional needs and political pressures explain the choice over the content of this extensive adjustment. The new document gave absolute priority to revenue increases, in spite of Prodi's initial commitment not to increase fiscal pressure. Functionally, measures on public incomes could be realised in a shorter time frame. From a political perspective, with labour unions and the Party of the Reconstructed Communists vetoing interventions on pensions and health care, revenue-maximising measures remained the only option left (Il Mondo 12/10/1996). Treasury Minister Vincenzo Visco explained the reasons behind this last minute change to the budget:

> "The decision to make an all-out attempt was taken in September...Having cast aside any chance of radical cut in spending for political and time-related reasons, and with the promise of intervening with Treasury measures, the sole means that remained was tax increases" (Visco 2002).

The decision to extend the size of deficit reduction taken in September was very well perceived by *Confindustria*. Giorgio Fossa, chairman of the organization, had earlier warned that strong action was necessary to allow Italy into EMU in the first wave (FT 12/9/1996). The Bank of Italy was criticised for not having relaxed monetary policy to a sufficient degree. It turn, it was believed that only markets could reward Italy's serious fiscal consolidation policy by allowing interest rates to decrease (Il Mondo 23/11/1996). A wide consensus had formed more generally among political *elites* on the fact that efforts had to be directed to designing a credible adjustment, one that would bring Italy's risk premium down. There was in fact a conscious political exercise towards this goal (Il Mondo 1/6/1996; CNEL 1996; interview Andrea Monorchio). The Prodi Government seemed to have succeeded when, after the September announcement of the ambitious deficit reduction, long-term interest rates started to fall (Camera dei Deputati 3/10/1996).

Despite this, *Confindustria* was less persuaded of the content of budget adjustment. The rise of direct taxes would have a recessive bias, further aggravating the country's capacity to generate growth (CISL, *CdL* 26/9/1996; Il Mondo 21/12/1996)[14]. Possibly, it would be necessary to tackle social spending to allow such an extensive cut to the net borrowing requirement (CISL, *CdL* 12/6/1996). Not only that, but while they would be desirable because of their expected growth-generating effects, structural spending cuts would also maximise the credibility of fiscal reform in front of financial markets (Il Mondo 1/6/1996; FT 30/9/1996; Sole24Ore 1/10/1996). As revealed by content analysis, expenditure restraint had moved to the forefront of business interests (see Chapter VII).

The centre-left establishment was keen to preserve relations with unions even if they seemed more interested in reducing the political power of unions in the framework of social concertation (Mania and Sateriale 2002). Despite the fact that CGIL-CISL-UIL shared with members of the coalition a common ideological background, agreement on fiscal policy issues was neither immediate nor easy. Unions rejected Prodi's initial reform proposals on

[14] In addition, while some interventions on the revenue side of the budget were purely of an accounting nature, they would still be disliked by the Confederation of Industry. One of them, in particular, consisted of advance payment of taxes on leave-of-service contributions from medium-large firms with more than 15 employees. It was obvious why *Confindustria* would be against it.

pensions and health care and threaten to respond strongly (CISL, *CdL* 24-26/9/1996). The government was open to compromise. Soon after, the two partners came to an agreement with labour unions expressing satisfaction for the budget proposal's appropriate balance between spending cuts and revenue increases (CGIL, *NRS* 8/10/1996; and 15/10/1996). First, the government accepted lowering the inflation target down to 2.5 from 3 percent (Reuters 3/7/1996). Second, the Euro-tax was made progressive, as the unions had requested (FT 18/11/1996; CGIL, *NRS* various issues; CISL, *CdL* various issues). In addition, in spite of fierce opposition from the Treasury, it was agreed that the tax would be returned in the form of repayments (Corriere della Sera 19/11/1996; FT 28/11/1996).

Not only was the composition of the budget proposal continuously altered under unions' pressures but also passage through parliament led to important changes with the result that the revenue component of the fiscal manoeuvre moved from 50 percent up to a consensus figure of 67 percent of the total volume (see table 3)[15]. End-of-year fiscal results confirm the exceptionality of Prodi's intervention. The CA deficit went down 4.2 percent of GDP. Public incomes grew 2.4 percent and total expenditure fell 2.1 percent of GDP (European Commission 2003).

As public finance figures deteriorated in the first months of 1997, the debate over alternative adjustment strategies re-emerged. CGIL-CISL-UIL proceeded in their refusal to accept any welfare retrenchment (Sole24Ore 5/1/1997). In more critical terms, *Confindustria* acknowledged that fiscal pressure had reached unsustainable levels and criticised the government's inability to tackle primary expenditures, and welfare spending in particular (Sole24Ore 10/1/1997; OECD 1998-99; www.eiro.eurofound.ie), while subject to socio-political constraints and still naively relying solely on the financial gains from lower interest rates (Sole24Ore 23/5/1997). Fiat CEO Cesare Romiti commented with disappointment:

[15] The use of different accounting principles explains why there is no consensus on the relative contribution of spending and taxing items to deficit reduction. With reference to fiscal manoeuvres in 1996, the Bank of Italy calculates that 60 percent of the total volume of the intervention came from revenue increases (Banca d'Italia 1997, 159). By contrast, according to *Confindustria*, the revenue component reached 70 percent (Camera and Senato 9/7/1999; www.univa.it/Studi.nfs, October 2002).

> "The government action is rather puzzling; public deficit reduction is obtained through an increase in fiscal pressure damaging the production system, hence growth and employment. Without welfare state reform and the reduction of interest rates, a larger adjustment will be necessary" –author's own translation (Sole24Ore 25/4/1997)

With the fiscal manoeuvre for 1997, Italy secured access into EMU. Not surprisingly, in the following year, the Prodi government embarked on a much more modest budget adjustment. Worth 25 trillion Lira, the fiscal package described in the DPEF was fairly balanced between revenue increases and spending cuts. Resources were to come from the rationalization of tax administration, the harmonization of VAT to European standards and the fight against fiscal evasion. Amongst the restraints were lower transfers to local authorities and pension funds and a curtailment of public employment. At the same time, fiscal authorities expressed their interest in promoting employment with a package of measures worth 1.5 trillion Lira (Tesoro 1997).

Later on in the summer, the public debate happened to be dominated by discussions on welfare state reform after the appointment made by Prodi of a technical commission to study and submit a report on the issue. *Confindustria* insisted that any piece of reform should be included in the budget proposal for 1998 so as to send a strong message to markets (Sole24Ore 30/7/1997). On the other side, CGIL-CISL-UIL opposed welfare retrenchment (Sole24Ore 29/5/1997) as well as the idea that welfare reform became a sub-section of finance. Also, they read the appointment of the Onofri Commission as Prodi's attempt to take economic policy-making out of their direct control and requested that any reforms be negotiated with them (Sole24Ore 21/8/1997). To be sure, once EMU membership had been secured, unity of intent among Italy's three largest union confederations started to crumble. Divisions arose with regards to welfare reform. Whereas UIL was against any type of intervention on social spending, CGIL and CISL were more reform-oriented, for example remaining open to a possible revision of the Dini pension reform.

The September budget proposal confirmed figures contained in the DPEF. Business actors continued to criticise the lack of ambition in deficit reduction, whereas labour unions showed appreciation for the fact that interventions on health care were kept to a minimum and the Onofri's proposal left out of the budget (CISL, *CdL* 11/9/1997; 23/10/1997). The battle over the budget during the parliamentary session was even tenser than that on the streets. After unions had broken up the common front with the loss of the EMU constraint, political parties followed suit. Suddenly, Italy's politico-institutional fragility became visible again. This fact confirms the general argument set forth in this dissertation. Socio-political consensus over fiscal adjustment from 1992 to 1998 rested on a fragile equilibrium and did not depend upon a radical transformation of Italy's political and fiscal institutions, as other have argued. Contingent socio-economic interests and their specific constellation retain greater explanatory power, as Chapter VII will indicate in greater detail. In this context, social pacts epitomise the solution to the distributional conflict between all these diverse socio-economic interests. In the next section, I will look at the content and financial impact of social pacts signed in Italy during the 1990s.

4. Social Pacts: Their Content and Financial Impact

This thesis has suggested that social concertation can contribute to successful fiscal adjustment. However, it is not social dialogue *per se* that is supportive of fiscal discipline. To be sure, public choice theories on collective action problems would suggest that the greater the number of the actors involved in a decision-making process, the less likely it is to reach a final compromise. This theoretical line seems in contradiction with authoritative political economy literature demonstrating that the involvement of social partners in policy-making leads, for example, to better economic performances. These latter studies are only in apparent contradiction with public choice explanations since they specify that such an outcome is likely only where labour unions are centralised, which functionally is equivalent to saying that unions become a single actor. Hence, in the end, there is no large multiplicity of actors taking part in the process of policy formulation. In this respect, it is certainly noteworthy that, after the 1993 reform of bargaining levels, Italy moved to a more centralised industrial relations system. It is to be expected that Italian labour unions were in the 1990s more inclined to internalise negative externalities inherent to wage moderation, while also being better able to implement it.

However, the analysis would not be complete if another aspect was not taken into consideration, i.e. the content of social pacts. It is one of the central contentions of this research work that institutional features are not sufficient to explain policy change or its failure. A look at the preferences of the actors involved is deemed necessary. More precisely, an ordering of preferences would allow identifying the situations in which centralised labour unions could in fact accept a particular trade-off. Centralization explains only the fact that they can come up with fairly clear-cut preferences without that differences between sectors, for example, worked against the formulation of a common position. A focus on contents would also allow the researcher to determine if social pacts are corrective (or not) of existing fiscal imbalances. The part that follows analyses the content of Italy's social pacts.

4.1.The content of Italian social pacts

Just as in the late 1970s, it was an economic emergency that triggered social concertation in the 1990s. Inflation continued to be high by comparative standards and the Lira was subject to increasing speculative attacks that put into question the government's ability to preserve parity within the ERM. At the core of the first agreement between the Amato Government and the social partners was inflation control. As it was generally recognised that Italy's longstanding problem with inflation levels had been driven by excessive wage increases in the form of a continuous automatic adjustment to actual inflation, the consensual elimination of the *scala mobile* was believed to serve the primary purpose of softening inflationary pressures. Not without internal conflict, especially within CGIL (Corriere della Sera 7/5/1992; 5/6/1992), the three labour confederations accepted the deal in the anticipation that this move would prevent devaluation.

There was widespread recognition that competitive devaluation did not represent a recipe for growth. By importing inflation, it would immediately affect workers' purchasing power (CISL, *CdL* 15 and 24/9/1992). In addition, lower inflation would allow also a reduction of interest rates (CGIL, *NRS* 34, 28/9/1992). With unions seriously committed to wage moderation, government authorities would on their part exercise a more stringent control over prices and tariffs (*Protocollo sulla Politica dei Redditi,* July 1992).

At the same time, inflation control would positively contribute to the government's desperate attempt to reduce the public deficit. Firstly, when concerning the public sector, slower wage growth translated into savings with an immediate positive impact on the state budget. Secondly, lower inflation would reduce the burden of government consumption, and particularly the real burden of interest payments on the country's high public debt. The Amato Government played an active role in convincing the unions of the need for wage moderation (interview Giuliano Amato; interview Beniamino Lapadula; DPEF various issues). However, as at this time public resources were lacking, Italian authorities could not act as generous providers of side-payments but had to simply assume the role of defenders of the public interest. This state of affairs does not go against the traditional interpretation of social pacts being based on a political exchange. A closer look at the negative preferences of unions suggests that there was still some room for compensation to the extent that their strong opposition to welfare retrenchment was taken into account and deficit reduction concentrated, by default, on the revenue side of the budget. On a similar note, Treu acknowledges:

> "A second area covered by the (1992) agreement had more popular appeal and has long been a preoccupation of the unions; measures to reduce tax evasion among artisans, small shopkeepers and those in the liberal professions. The subsequent directives produced strong reactions from these groups and the political lobbies which support them, but if the public administration is strong enough to implement them they promise the most redistributive effect of all efforts at concerted action –a clear case of the unions acting as representatives of the public interest to achieve a more equitable income distribution and raise fiscal revenues, partially counter-balancing pressures to cut social expenditures" (Treu in Dore, Boyer and Mars 1994).

The commitment to deficit reduction and debt stabilization became explicit only in the 1993 Income Policy Agreements signed under the subsequent Ciampi Government. If, earlier, inflation control was believed to serve the purpose of correcting fiscal imbalances, in this latter agreement unions were asked to accept fiscal austerity as the price for lower inflation (*Protocollo Politica dei Redditi* July 1993). The direction of causality was somehow reversed. Now, the government was compensating unions' wage discipline with the promise to put in place credible and effective budgetary corrections. The definition, in the same pact, of a new structure for wage bargaining that moved in the direction of further centralising the process had the effect of making social partners' involvement in fiscal policy-making more visible through the collective bargaining channel.

Meant to re-establish peaceful relations between the two, even the bilateral agreement between the Berlusconi Government and the unions in 1994 contained quite detailed provisions on strategies to guarantee successful fiscal consolidation. In the 1996 Employment Pact signed under the Prodi Government, besides a description of expensive measures to support employment creation were detailed suggestions with regards to financing methods (*Patto per l'Occupazione* 1996). To sum up, in Italy, the pact's bits and pieces never overlooked the need to preserve fiscal discipline. Italy's financial instability well as the commitment to the Maastricht Treaty provisions functioned as an important catalyst of socio-economic forces towards the goal of deficit reduction and, eventually, of debt stabilization. It was not about the abstract notion of an external threat. By shaping socio-economic preferences, the crisis mobilised domestic interest groups, allowing for a constellation of interests that was eventually conducive to successful fiscal adjustment.

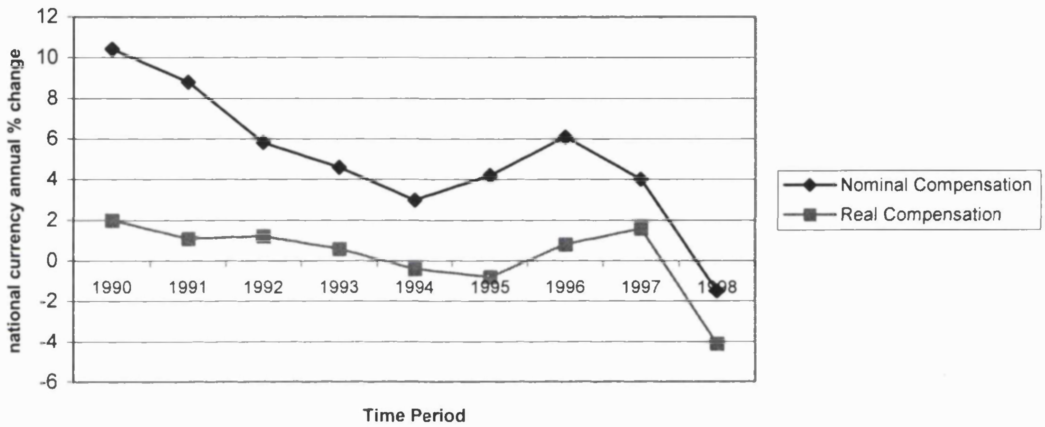
4.2.The financial impact of social pacts

Experts and policy-makers have repeatedly recognised that the income policy agreements signed in 1992 and 1993 have represented a major determinant of Italy's fiscal adjustment (Tesoro 1993; Sestito 2002, 32-41). But why were social pacts of this kind so beneficial to the country's fiscal performance? The 1992 agreement abolished the wage indexation system, which was universally believed to be the main cause of inflationary spirals in the last two decades. As a result, inflation levels started to decrease remarkably. According to the Bank of Italy, in the absence of income policies, Italy' inflation rates would have been 3-5 points higher than they actually were in 1997 (Fabiani et al. 1998). Graph 8 shows how the gap between nominal and real compensations narrowed progressively in the decade from 1990 to 1998. While securing the fulfilment of the Maastricht inflation and interest criteria, lower inflation had also the effect of minimising the country's debt service, therewith addressing fiscal imbalances (Corriere della Sera 5/5/1993). In addition, the public budget benefited also directly from wage moderation as public employee compensations, which amounted in 1991 to almost 15 percent of GDP (European Commission 2003b), started then to follow a downward trend.

This pattern is not peculiar to Italy. Most of the countries that resorted to social pacts in the 1990s benefited from an improved fiscal performance as well. In the Netherlands, within the new social pacts agreed in 1982 and 1993 respectively, not only was wage moderation guaranteed but these also formed a forum in which more far-reaching and spending-minimising labour market reforms were successfully agreed (Visser and Hemerijck 1997). The country's CA primary surplus increased by 3.6 percent from 1989 to 1997, the fourth best performance in the EU (Caselli and Rinaldi 1998). Similarly, Spain and Portugal improved considerably their fiscal position in the framework of social pacts. By the same token, in Greece, where social concertation was attempted but failed to take off because of the lack of a sufficient degree of coordination between unions and employers, fiscal adjustment was relatively unsuccessful, at least until 1997.

Nor it is the first time that social concertation has proved particularly beneficial to Italian public finances. Italy's first corporatist experiment, in 1976-79, was motivated by a similar desire to curb inflation down. It was after the formation of a large governing coalition including, for the first time, the Communist Party (PCI) that an austerity programme was being promoted. There, wage restraints were sold as a means to control inflation, which prior to fiscal consolidation had reached 16.4 percent points, and preserve workers' purchasing power (OECD various issues). In 1976-77, Italy's structural balance improved by 3.3 percent of GDP. Similarly, when in the very early 1980s, after a setback in 1979-81, social concertation experienced a brief revival; the CA public deficit improved by 1.6 and 0.5 percent of GDP at the end of 1982 and 1983, respectively (European Commission 2003a).

Graph 8. Italy: Gap between Nominal and Real Compensations per Employee Total Economy, 1990-98



Source: European Commission, European Economy, Statistical Annex 2003.

This is but not to say fiscal consolidations accompanied by voluntary wage restraint are always successful. Rather, my contention is that Italy's macroeconomic environment in the 1990s and the fiscal preferences that domestic groups formed in response to it were such that simultaneous trade-offs between different policy areas existed, with the result that compromised solutions were at hand allowing for an efficient coordination of fiscal, monetary and wage policies. As it will be indicated in the next chapters, this was not the case for Germany.

CHAPTER V

Timing, Size, Composition and Persistence of Germany's Fiscal Adjustment (1991-98): Preferences *versus* Institutions

1. Germany's Fiscal Adjustment: Stylised Facts

The following section describes the characteristics of Germany's fiscal consolidation during the 1990s. As for the case of Italy, special attention is devoted to four dimensions of fiscal adjustment, i.e. the timing, its actual size measured in cyclically adjusted terms, its composition, and its persistence over the period under investigation (1991-98). All four convey a significant message about the nature of the process and allow the reader to form a relatively complete picture of the case study and of its peculiarity, if any, in the 1990s.

Relatively unproblematic, the timing of fiscal reform is but indicative of the domestic perception of the Maastricht constraint. Indeed, this was never pressing in the case of Germany with fiscal authorities treating sound public finances as a collective good rather than an externally imposed constraint. EMU was called into question at a much later stage, around 1996. This issue will be treated in conjunction with the size of the adjustment. Taken at face value, the actual extent of deficit reduction would not be such a revealing variable in the German case. Indeed in 1991, when the EMU convergence process was inaugurated, the country's public deficit was already amongst the lowest in the EU. In comparison to other EMU candidates, and in spite of the pressure from the recent unification, the size of the necessary adjustment to the Euro was modest to start with. Accordingly, I will analyse Germany's fiscal effort in comparative perspective by looking at similar countries' experience over the same period (1991-98) and at the German historical record since the late 1970s. This seems to be a more meaningful way of looking at the extent of budget consolidation. At the micro-level, a weakening of the federal government's discretionary fiscal rigour from one year to the other may reflect either a more moderate commitment to sound public finances on the part of public authorities –for whatever reasons (e.g. views about the most appropriate policy mix, partisan considerations, electoral concerns) or a deteriorating institutional framework or, rather, a more difficult and less compromise-prone social context, one in which the government was unwilling and/or unable to impose sacrifices on its citizens. The size of the German fiscal adjustment in the 1990s is read according to these basic indications.

I will then discuss the specific composition of budget consolidation. From a political economy perspective, the decision to either cut public spending or increase taxation is of uttermost importance. At the basis of this choice might be issues of policy optimality. Just as an example, fiscal policy-makers could think of abrupt tax increases as undesirable because most taxes tend to have distortionary effects (Balaam 1961). However, it could well be that, once the federal government had guaranteed the necessary transfers to East Germany, the "rest of the pie" was allocated on the basis of socio-economic actors' preferences. In this respect, the content of macroeconomic adjustment would reflect the fiscal preferences of the most powerful domestic groups whether they act independently (*interest group politics*) or are represented by the political party in power (*partisan politics*).

Finally, in the sense of uninterrupted deficit reduction, persistence measures the country's degree of commitment to fiscal discipline and the existence - or not - of a domestic context in which retrenchment can be perpetuated in spite of other possibly disturbing factors, such as the presence of multiple veto players at different stages of the budgetary process (*political and fiscal institutionalism*) or an upcoming national election (*political business cycles*).

1.1.The timing and size of fiscal adjustment

Germany enjoys a tradition of fiscal discipline that goes back to the late 1960s when, with the 1967 Stability and Growth Law, the federal government committed itself to the threefold objective of low inflation, full employment and balance of payment equilibrium. Since then and thanks to the introduction of important reforms to the budget process, sound public finances have been at the top of successive governments' economic policy agendas, irrespective of their ideological orientation. Moreover, the *Bundesbank*'s switch to monetarism after 1975 imposed a concrete constraint on fiscal policy-makers to the extent that any attempt at deficit spending would be punished by a restrictive monetary stance with unwanted consequences for national growth. In sum, the late 1970s marked Germany's embracing of economic orthodoxy. It was not only an issue for economic elites. Even German public opinion strongly believed in the desirability of balanced public budgets, a preference that would become more and more intense with the actual progressive deterioration of public finances from 1979 to 1982 (Noelle-Neumann 1983, 1997). Voters tended to punish undisciplined governments. Some have argued that the SPD-FDP government's loss of power in the early 1980s was due to the Social Democrats' inability to keep public expenditures under control (Giersch and al. 1995, 193).

Notwithstanding this deeply rooted austerity tradition, during the 1990s the German government demonstrated a relatively uncertain hand over the management of public finances, and not only as a result of the re-unification shock. Some literature states that the prospect of joining the monetary union did not exert the same degree of pressure on Germany as it did on other more vulnerable EMU candidates (e.g. Italy, Belgium, Ireland). This shall be evident even from the timing of reform, with EMU surfacing in the public debate as late as 1996 (Hassel 2001). While this is certainly true, it must be acknowledged that the financial impact of unification represented for many - elites as well as public opinion - a source of great preoccupation. In this respect, the pressure to adjust, while domestically generated, was not necessarily less strong than in the case of Italy (interview with officials at the Finance Ministry). Still the country's fiscal performance was rather poor. In the short time span between 1991 and 1997, the actual value of the public deficit deteriorated in 1992-93 and again in 1994-95 – as a consequence of a deterioration of the primary surplus (Graph 9), remaining as a result above the Maastricht reference value for two consecutive years, in 1995 and 1996 (European Commission, 2002). In cyclically adjusted terms, the net borrowing requirement deteriorated by 2.5 percent of GDP in 1989-97, of which 1.5 percent came from a fall of the primary surplus and 1 from higher interest payments. In the same period, countries like Austria and France, which like Germany started from quite low deficit levels in the early 1990s, performed significantly better, registering improvements in their primary surpluses of 1.1 and 1 percent of GDP respectively (Caselli and Rinaldi 1998, 60).

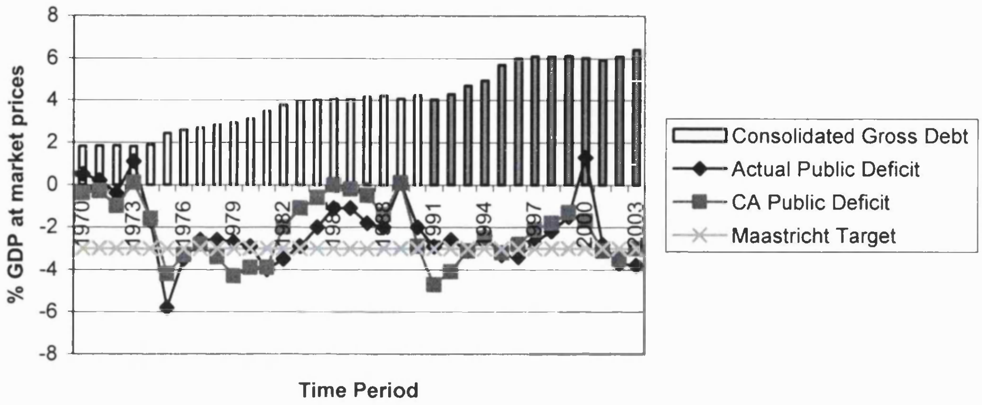
More specifically with reference to the every-year management of fiscal policy, it may be worthwhile considering business cycles. True, the use of CA figures should control for them but, as stressed in Chapter I, the measure is far from unproblematic so that one could draw some insights from the juxtaposition of actual and adjusted data. It has been an exploited argument to say that cyclical conditions affected Germany's fiscal policy outcomes in the 1990s. Slow growth has the effect of reducing incomes from direct and indirect taxation and, when creating greater unemployment, of putting upwards pressures on social budgets. In the first years after re-unification and until 1995, the conjuncture seemed to play quite an important role – as exemplified by the large gap between actual and cyclically adjusted figures. Yet, it did so by improving rather than worsening the country's fiscal performance with actual figures below CA data[1] (Graph 9). Only in 1995-99 were cyclical conditions responsible for a lower-than-expected deficit reduction. Still, these were also the years when the government had put in place a much more visible fiscal consolidation effort. In a nutshell, the cycle accounts only for a deviation from the fiscal plan rather than for its overall direction, i.e. increasing or decreasing deficit trends. It follows that slow growth cannot be the only reason behind weak fiscal discipline. Nor are financial markets responsible for it. As indicated in Chapter I, the deficit trend is perfectly in line with the primary surplus, revealing thus that interest rate developments have not been so important in determining Germany's budget performance. Fiscal results must depend upon government decisions on spending and taxing.

Needless to say, German re-unification put the federal budget under strong pressure. When, in July 1990, the Federal and the Democratic Republics of Germany were unified, substantial financial transfers started pouring from the West to the East. Net transfers grew from 106 billions DM, in 1991, to 140 billions in 1995, and stabilised around that level thereafter (OECD various issues). In this light, the financial implications of unification should by no means be underestimated. Still, it is plausible to believe that the necessary financial support to unification is only one of the factors that contributed to Germany's disappointing fiscal performance in the 1990s. This thesis proceeds from the assumption that the formation of a united Germany represented instead an intervening variable, to the extent that its implications undermined the social

[1] Especially in 1991 and 1992, unification exerted significant growth effects.

consensus from which federal governments had benefited until then. This meant that fiscal policy became a much less insulated and government-controlled policy area than it had been in the past.

Graph 9. Germany: Evolution of Actual and CA Public Deficit, and General Government Consolidation Gross Debt 1970-2003



Source: EU Commission, AMECO Database (last reviewed May 2005).

Even from a purely economic perspective, the argument according to which re-unification is the one and only cause of Germany's more relaxed fiscal stance is not completely convincing. Bibow calculated that only one third of the country's deficit deterioration resulted from the financial effort imposed by re-unification (Bibow 2001). Moreover, it is worth including some other observations at the margin. First, deterioration had already started in 1989-90 when unification had not yet taken place. Some observed that the deficit had risen as a consequence of lower-than-expected revenues after the 1990 income tax reform (Lindlar and Scheremet 1998, 38). Second, the CA deficit started to grow again from 2000 onwards, at a time in which one would expect the financial impact from re-unification to be largely absorbed. Third, the incorporation of East Germany into the political and economic structure of the West had a more direct impact on the public debt than on deficit levels. In the early 1990s, the financing of transition in the former DDR was managed by means of the *Treuhand* (Public Trustee Office). After having accumulated a substantial debt, the *Treuhand* ceased to exist in 1995 and the debt was officially incorporated into the federal budget

(Flockton in Smith, Paterson and Padgett 1996,211-32), thereby inducing the general government gross consolidated debt to increase from 49.3 in 1994 to 57 percent of GDP in 1995 (European Commission, 2003b, 180).

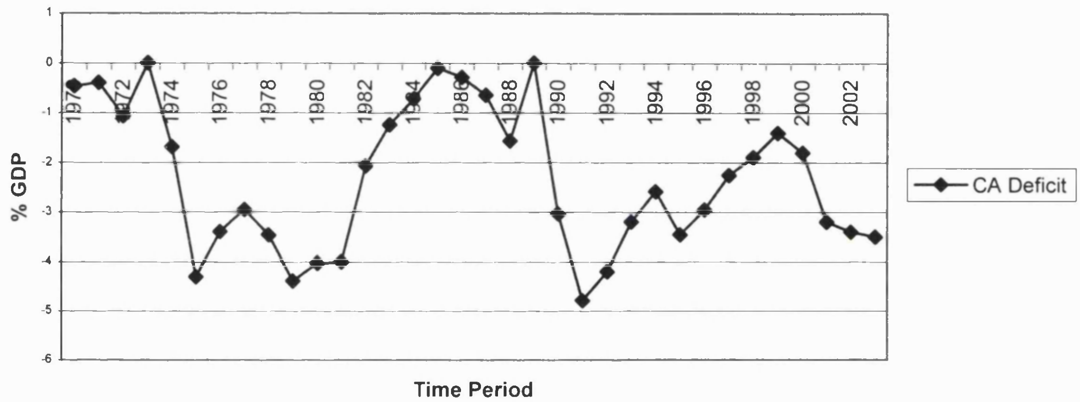
Were the 1990s really an extraordinary period in German fiscal history? It was certainly not the first time that Germany had encountered serious fiscal imbalances. After 1973, both the international macroeconomic environment and political factors had contributed to the deterioration of the public deficit. While it is true that the German economy was doing well in comparative terms – at a time when most European countries were experiencing severe imbalances following an unfavourable combination of slow growth and high inflation - domestically, public budgets had never been in such bad shape. In the wake of the two successive oil shocks in 1973-74 and 1978-79, the SPD-FDP government did little to keep public expenditures under control. On this occasion, the Social Democrats were accused of being undisciplined spenders and the small Liberal partner started to distance itself from the SPD with the launching of a unilateral fiscal consolidation plan. The Finance Ministry tried to react to this, but the planned budgetary interventions proved insufficient to reverse fiscal trends in a substantial way (Giersch and al. 1995, 193). Partly due to centrifugal forces within the coalition, partly as a result of the Christian Democrats' ability to exploit the situation, new elections brought the CDU-CSU to power in alliance with the FDP. The two coalition partners shared a similar understanding of fiscal policy goals. Chancellor Kohl's first move was to express strong commitment to the restoration of fiscal discipline. With 1982, Germany's budget policy underwent a U-turn (Walz 1985)[2]. In a few years, from 1982 to 1989, the net borrowing requirement moved from a deficit to a small surplus (Graph 10).

It may be interesting to highlight possible differences between the country's two most important fiscal consolidation plans, the one implemented in the 1980s by the newly appointed Kohl Government and the one induced by EMU. Again

[2] Not all observers agree with this interpretation, although it remains overall only a question of *nuances*. Borchert notes how, after the collapse of the SPD-FDP Government coalition, economic policy-making in Germany did undergo a U-turn, but with an impression of continuity. True, the new establishment was keen to express his commitment to restore fiscal discipline, but the Finance Ministry remained in the hands of the FDP, as in the previous Government (Borchert 1995, 117).

here, even from a historical perspective, the size of the fiscal effort in the 1990s was much more modest than it had been in the 1980s. From 1981 to 1985, the actual deficit had dropped from 4 to 1.1 percent of GDP. It continued to decrease thereafter, albeit at a slower pace, moving from 1.1, in 1985, to a 0.1 percent of GDP surplus in 1989. In contrast, from 1991 to 1997, the size of actual deficit reduction amounted to only 0.2 percent of GDP (European Commission, 2003b, 176); where but the CA result was visibly better, consisting of a 2.5 percent of GDP improvement (European Commission, 2002) or 1.1 percent if calculated over the period 1993-97 (Caselli and Rinaldi 1998, 61).

Graph 10. Cyclically Adjusted Public Deficit:
West Germany (1970-90), Unified Germany (1991-2003)



Source: EU Commission, AMECO Database (last reviewed May 2005)

As earlier anticipated, I place special attention in the size of yearly CA budget corrections in the belief that changes in the fiscal adjustment effort reflect day-to-day difficulties in dealing with the dramatic transformation of the politico-administrative landscape and probably reproduce more closely the reasoning behind the various allocative and redistributive decisions the federal government had to take on a yearly basis. Table 7 shows the extent of the yearly deficit reductions measured in cyclically adjusted terms. It is manifest how proper fiscal rigour emerged only in 1992 when the CA deficit decreased by 1 percent of GDP –or by even 1.1 percent if one looks just at the adjusted primary surplus- and, to a lesser extent, in 1993 and 1996 when the net borrowing requirement improved by

0.7 and 0.6 percent of GDP respectively; the latter arguably under pressure from EMU as the country needed to meet the Maastricht reference value by 1997.

How can one explain the variation in the intensity of fiscal corrections? In the introduction to this chapter, I suggested that a relaxation of fiscal policy would reflect a weakening of the political commitment to austerity and/or a more difficult socio-economic context in which to impose it. Already here, arguments about the importance of the institutional framework appear to be not fully satisfactory. Sticky institutions would not explain yearly changes in the extent of adjustment. To support this interpretative stance it is useful to look at the government's actual fiscal effort in trillions DM as laid down in official documents. Figures in Table 7 include supplementary budgets. Fiscal inactivity prevailed in 1994-95, arguably out of the concern that excessive austerity could undermine the chances of the governing coalition to be re-elected in the 1994 national vote. That the CA deficit registered in turn such a considerable deterioration shows how the government's choice of the fiscal strategy was not driven primarily by technical considerations. The significant effort in the following year is to be understood again through the lenses of political business cycle theory and read as the government pursuit of the (conservative) fiscal preference of its constituents. Instead, budget consolidation was intense in 1992-93. In a sense, this shows that the re-unification unfolding in those years did not necessarily prevent the Federal government from pursuing deficit reduction. As will be extensively demonstrated in this thesis, the large deficit reduction in 1992-93 is to be explained with reference to the peculiar macroeconomic conditions of the time. More precisely, the looming of the world recession in 1992 shifted the attention to the domestic cost of money. Fiscal discipline was necessary to prevent the *Bundesbank* from increasing short-term interest rates. The fear was that lower domestic investment would add to the weakening external demand[3].

[3] From 1992 to 1993, German exports decreased by 5.5 and investment by 4.4 percent of GDP (European Commission, 2004).

Table 7.Germany: Extent of Budget Manoeuvres 1991-98 (+ contraction; expansion)

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Actual	-13.4	27.56	-16.16	0	28.3	-14.6	-21.8
Actual*a*	0.7	1.0	0.7	-0.9	0.5	0.6	0.3
Actual*b*	1.1	1.1	0.7	-0.4	0.4	0.7	0.3

Key: actual (extent) = real size of retrenchment at the end of the consolidation episodes (trillion DM); here, data tend to be overall larger than projected figures because they do not refer only to Finance Bills but include also the impact of emergency budgets. *a* = change in cyclically adjusted net borrowing –adjustment based on potential GDP (% GDP); *b* = change in cyclically adjusted primary surplus –adjustment based on potential GDP (% GDP).

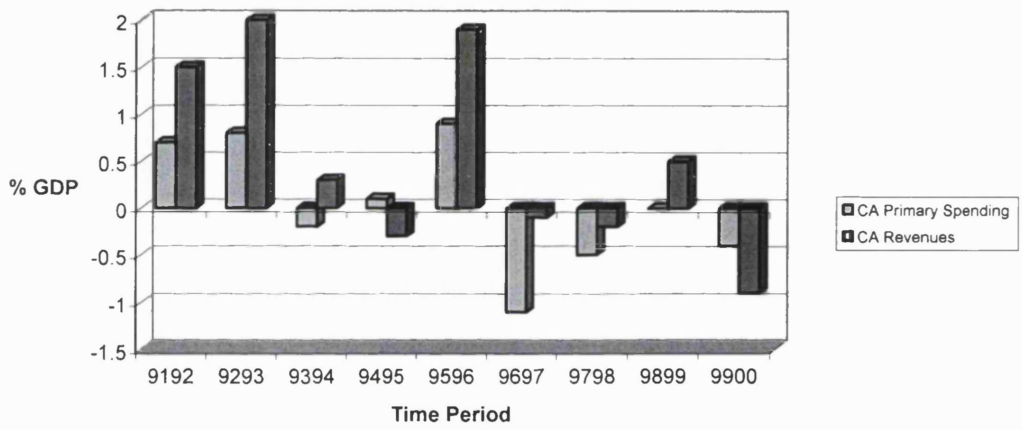
Source: European Commission, AMECO Database (last reviewed May 2005); Bundesfinanzministerium, Finanzberichte from 1991 to 1998.

1.2.The composition of fiscal adjustment

If one is particularly concerned with the political economy of fiscal reform, then the composition of fiscal adjustment does appear to be the most intriguing variable. During the run-up to EMU, Germany resorted to a fiscal path which the European Commission labelled a "switching strategy" to indicate that, after a considerable increase of public incomes, the Finance Ministry opted for a more expenditure-based fiscal strategy trying to tackle spending programmes (European Commission 2000).

In 1991-92 and 1992-93, deficit reduction was achieved merely on the revenue side of the budget. In 1991, a 7.5 surcharge on personal and corporate income was introduced with immediate effect. The federal government also opted for an increase of the tax rate on mineral oil and other excise duties (von Hagen, Hallett and Strauch 2001). Social security contributions were also augmented growing from 35.65, in 1990, to 36.7 percent of GDP, in 1992 (European Commission, 2003b). At the same time, unification pushed the level of public expenditures upwards. This state of affair lasted until 1993 when, faced with emerging signs of a fiscal revolt above all from part of the business community, the Kohl Government took steps in the direction of primary expenditure restraints. For the first time, CA public expenditures decreased as a result of cutbacks. The social security budget inclusive of unemployment insurance went down by 5 percent from the previous year (Bundesministerium 2003, 222). Overall, in 1993, the expenditure impulse of the public sector was negative for total DM 49 billions, with public consumption contributing for DM 24 billions (Lindlar and Scheremet 1998, 39)[4]. The establishment continued to pursue a rather expenditure-based strategy until 1998, with the only exception of the year 1995 when the re-introduction of the solidarity charge in 1995 had a visible effect on revenue levels (Graph 11). Mostly controversial were the measures introduced in 1996, which included a fall in unemployment benefits, a reduction of sick pay, the postponement of rise in child benefits, and less state-subsidised cures (The Economist 4/5/1996).

Graph 11. Germany: Change in CA Primary Expenditures and CA Total Revenues (1991-2000)



Source: European Commission, AMECO Database (last reviewed May 2005)

1.3.The persistence of fiscal adjustment

Finally, this section looks at the relative persistence of Germany's fiscal adjustment. By this, I mean the presence of a continuous effort in the period under investigation (1991-98), but also thereafter until 2003. Continuity is a dimension full of political meaning; where present, it indicates a government's capacity to pre-empt potential impediments to successful deficit reduction, those

[4] The expenditure impulse is measured as the "deviation of the actual level from the trend level, as extrapolated from the level of the previous year by potential production at current prices" (Lindlar/Scheremet 1998, 39).

being institutional (e.g. veto players in the budgetary process), politico-strategic (e.g. electoral considerations) or socio-political (e.g. opposition from domestic interest groups)[5]. CA figures show deficit deterioration in 1994 and again after 1999. In actual terms, fiscal policy relaxed in 1992-93 and 1994-95 (Graph 9). In sum, the country's fiscal effort was only moderately persistent. This shall come as confirmation of the fact that, when the necessary size of adjustment is limited to start with, then the room for free-riding improves and so the tensions between competing interests, with the result that the discretionary fiscal trend reveals uncertain.

2. The Role of Fiscal and Political Institutions

As suggested in Chapter II, in recent years, there has been a resurgence of institutionalist approaches to economic policy-making and outcomes. This has been particularly evident in the case of fiscal adjustment. With this policy area deeply embedded in national budgetary processes, there is no doubt that institutional constraints and opportunities play a role. The following sections look specifically at the nature of the German budgetary process as well as at the political system at large in order to find support for the argument that Germany's recent fiscal difficulties should be ascribed to unification-induced institutional deterioration and to the system's general incapacity to initiate policy change against a high number of veto points. According to Scharpf, the system is entrapped in joint decision-making where the constant search for compromised solutions with social partners or between different government levels (i.e. federalism) impedes proper reform (Scharpf 1988). I come to the conclusion that institutions remain empty shells if one does not look at the specific socio-economic interests within institutions themselves. The institutional deterioration

[5] It is not the purpose of the present study to elaborate considerations on the sustainability of sound public finances. This would be more of an economic exercise that requires an in-depth analysis of the composition and age of the country's public debt as well as a forecast of future welfare spending. Less ambitiously, I intend to read a persistence of deficit reduction as proof of governments' capacity to overcome any institutional and/or socio-political impediment to successful consolidation.

that arose in the 1990s derived from government authorities' incapacity and/or uncertainty in dealing with the distributional consequences of re-unification.

2.1.The German budgetary process

Of all variables intervening in fiscal policy-making, budget institutions are probably the most obvious ones. The institutionalist literature uses fiscal institutions to explain cross-country variation in macroeconomic performances. Along these lines, observers have argued that Germany's most recent difficulties in keeping public budgets under control have been the result of a pronounced institutional deterioration, marked by a decline in the management capacity of the Finance Ministry; by the multiplication of special funds created to finance transition of former DDR; and by reduced government planning capacity following the frequent and often inconsistent tax reforms introduced in the 1990s (von Hagen and Strauch 1999; Hallerberg 2004).

Instead, I argue that Germany's indisputable institutional weakness in that period is just epiphenomenonal of more profound problems, and above all of the Kohl Government's uneasiness with the socio-political consequences of retrenchment in the aftermath of re-unification. Confirming this bottom-up explanation of institutional change is the fact that no official budget reform was implemented in this period. National fiscal rules remained unaltered; hence it is the interpretation of these rules that changed. In addition, the permanence of the Kohl administration over the whole period under investigation leaves little room for explanations that hint at changing constraints on the budgetary process during its governmental phase[6]. The overall conclusive argument is that Germany's fiscal adjustment was less affected by institutional constraints than otherwise believed. Or rather, at its origin is the contingent evolution of socio-political preferences, which may have in turn lead to a different interpretation of institutional

[6] Nonetheless, as it will be explained below, institutional constraints changed in the parliamentary phase once, in 1991, the government coalition lost absolute majority in the *Bundesrat*. Still, because the national Parliament has generally only limited influence in the budgetary process, the impact on budget policy outcomes is expected to be weaker than it would otherwise be, had the institutional set-up of the governmental stage changed.

constraints. The section below describes the main features of the German budgetary process.

Even if formally shared with the Chancellor Office, in practice the Finance Ministry has full responsibility for the drafting of annual budgets. At the beginning of the financial year, individual ministries send out their desiderata. The Finance Minister takes them into consideration, while also having the power to alter them (Horst 1995). In July, the government produces a long-term financial planning document, the *Finanzplan*, and the actual budget proposal, the *Bundeshaushaltsentwurf*. This marks the end of the budget process's governmental phase. A month later, both documents are then submitted simultaneously to the Upper (*Bundesrat*) and the Lower House of Parliament (*Bundestag*). After the Finance Minister has officially presented the budget's contents and aims in the first reading, the fiscal documents are referred to the respective budgetary committees, whose amendments are usually accepted in full by the other members of Parliament (Horst 1995). After approval by the *Bundestag*, the budget law goes back to the Upper House for final endorsement of the *Bundeshaushaltsgesetz* (Bundesministerium 2001; European Commission 1994).

Until the late 1960s, decisions on spending and taxing were taken in the framework of the 1922 Budget Code according to which German governments only had to guarantee that on a yearly basis sufficient revenues were generated to cover public expenditures (Bundesfinanzministerium 2001, 4). The first piece of mature public finance legislation was introduced in June 1967. The 1967 Stability and Growth Pact was the product of a time in which, after a rapid deterioration of the international economic environment, public authorities had realised that existing budget policy tools were inappropriate (Walz 1985). Most interestingly, the law foresaw the adoption of the *Finanzplan* that, by imposing a long-term perspective on fiscal policy, became one of the cornerstones of the German system. The act also paved the way for a more comprehensive reform of budget policy that resulted in the introduction, in 1969, of the Law on Budgetary Principles and the Federal Budget Code. The latter is also important because it regulates financial relations between government and regions. These rules have not been altered since and still inform today's process (Knott 1981, 20; Bundesfinanzministerium 2001).

Until the 1990s, the German budget process was unanimously described as one of the most efficient in Europe, against which the less virtuous Italian one was often juxtaposed. For a long time, Germany and Italy epitomised the best and worst cases of public finance management respectively (De Haan, de Kam and Sterks 1992; Poterba and von Hagen 1999). In the early 1990s, when important budget reforms were introduced in Italy, government authorities repeatedly explained that the spirit of these reforms laid in the imitation of Germany's 1967 Stability Law (Camera dei Deputati, September 1992). These are the characteristics that make up for the effectiveness of the German process: (1) the system of delegation to the Finance Minister; (2) the transparency of budget documents; and (3) the Parliament's limited amendment powers. The natural implication for the latter is that the relationship between the executive and the legislative is mostly a cooperative one from the very beginning. Government budget proposals tend to reflect the will of the parliamentary majority (Horst 1995, 287). This is confirmed by the fact that figures emerging out of the parliamentary process do not differ from initial government projections. From 1982 to 1990, the German parliament did not altered government spending figures by more than 0.9 percent (Table 8). Not only does the Parliament lack the legislative power to overrule government decisions, it is also lacks sufficient human resources and technical expertise to play such a role (Horst 1995, 330). In 1992, in a detailed review of fiscal institutions in Europe, von Hagen explained clearly why German budget policy was amongst the most rigorous in Europe. It consisted of a political and bureaucratic exercise under the strict control of the Finance Minister with the support of experts from the Ministry; it was largely insulated from Parliament's pressures as well as completely immune to the claims of organised interests (von Hagen 1992). All of this was seen as a guarantee of the fact that fiscal policy outcomes would in the end reflect government plans.

These features make the process in principle more efficient than the Italian one. This does not however exclude that contingent domestic factors condition the relative efficiency of German budget policy-making. Hallerberg explains that the actual power of the Finance Minister for example is very much dependent upon external circumstances. It is constrained under coalition governments or if the *Bundesrat* decides to exercise its veto power; the Constitutional Court takes advantage of its authority; or, finally, the *Bundesbank* threatens to punish fiscal profligacy with a restrictive monetary stance (Hallerberg 2004). As to the particular situation of the 1990s, there is a relative large consensus around the argument that budget policy-making was not functioning well. Still, researchers disagree over the reasons for this. Supporters of the superiority of German fiscal institutions blame unification. Others argue instead that the worsening of government fiscal management capacity started much earlier, constrained by the lack of serious reforms after 1969 and happened to be only exacerbated by the financial implications of re-unification (Sturm 1998).

What are the tangible signs of this institutional deterioration? The argument presented here is that institutional deterioration is a multifaceted phenomenon, which implies that it is neither possible nor wise to isolate a single category of causes as with different aspects of deterioration come different causes. For instance, when analysing institutional changes in the 1990s, it seems reasonable to distinguish between institutional mechanisms and outputs[7]. The first sheds light on emerging decision-making practices and represent a powerful analytical tool to identify new constraints and opportunities in the budgetary process. Thus, first and most importantly is the fact that the Finance Minister started losing control of the budget to the advantage of the Chancellor, who was keen to reserve for himself the greatest possible visibility in the wake of German unification (Der Spiegel 44, 1992; von Hagen and Sturm 1999; Hallerberg 2004). Needless to say, in comparison to the Finance Minister, the Chancellor is generally more sensitive to politics. Second, labour market interventions in the East were negotiated between party representatives, social partners and bureaucrats from the Chancellor Office in the framework of special roundtable talks. Thus, at least one budget item was not as insulated from external socio-economic pressures as it used to be. Kohl's responsiveness to societal claims was

[7] Instead, most of the existing literature is not particularly sensitive to this distinction (von Hagen/Sturm 1999).

so evident and unexpected that the national press attached to him the name of "Chancellor Billion" (Czada 1994 cited in von Hagen/Sturm 1999).

On the other hand, institutional outputs are descriptive in nature. They are indicative of a situation of institutional deterioration but are not necessarily correlated with disappointing fiscal outcomes. Already outputs themselves, they could easily coexist with efficient macroeconomic management. To name just a few examples: special funds were created to finance the transition of East Germany that remained outside official fiscal documents. This practice had the effect of undermining the comprehensiveness and transparency of budgetary documents. Second, the government's loss of control over the public budget was apparent also in the large reliance on supplementary budgets. While in 1952-80 German governments only resorted to four emergency interventions, in 1990-97, the Kohl Government introduced seven supplementary financial bills. Third, successive tax reforms jeopardised the fiscal authorities' capacity to foresee revenue levels, as these were often overestimated, e.g. in 1995-97 (Horst 1995; Sturm 1998; SVR 1995, 138-9)[8].

2.2.The economic role of fiscal institutions

While altered institutional practices and outputs are a fact, it is less obvious that they are responsible for budget outcomes. I argue that institutional deterioration is only a reflection of the Kohl Government's incapacity to deal with the socio-political consequences of a firmer fiscal policy. True, social partners did not have formal access to budget policy-making, at least not under the terms Italian social partners had. However, their claims were still taken into consideration to the extent that the elected federal government was concerned with the socio-political feasibility of reform and threatened with the prospect of social unrest and/or with a possible electoral punishment. The resulting relaxation of fiscal policy in the early 1990s was not determined by formal institutional constraints, as some

[8] Interestingly enough, when Germany registered a disappointing fiscal performance, it was so not because of excessive spending, as in Italy, but because public incomes were not as high as the government had predicted. In other words, while Italy's problem resided more on the expenditure side of the budget, in Germany, public revenues appeared to be much more troublesome items.

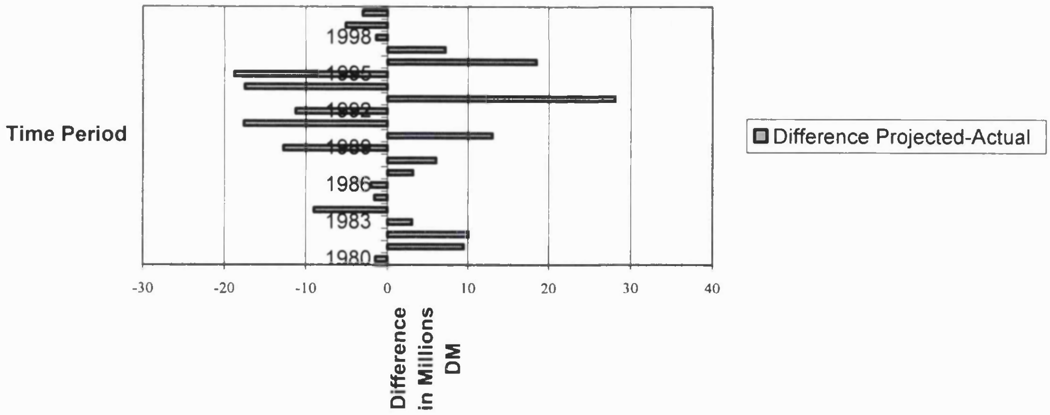
literature has attempted to suggest (von Hagen and Strauch 1999), but was dependent upon societal factors. Under the latter's pressure, fiscal authorities might have been induced to "manipulate" budget institutions to accommodate different socio-economic interests. This interpretative approach is confirmed by the fact that qualitative structural indexes measuring the effectiveness of the German budgetary process do not change in the time span from 1991 to 2001 (Hallerberg 2003). This is to say that, formally, nothing changed for the worst in the country's institutional set-up.

Interestingly, some of the data usually used to prove the argument of the emergence of institutional deterioration offer alternative interpretations. Graph 12 shows that government planning capacity indeed deteriorated in the 1990s, with an expanding gap between government deficit projections and actual outcomes. Still, in most cases, government authorities had foreseen a much larger deficit than it actually turned out to be –especially in 1992, 1994 and 1996. While diminished planning capacity in the 1990s is a fact, its impact on actual fiscal discipline is debatable.

As for the role of Parliament, figures confirm that members of parliament intruded more visibly on the budgetary process. In 1991, 1994, 1996 and 1997, parliamentary changes to total spending were, in comparative perspective, quite remarkable[9]. Yet, it was not always the case that Parliament's intrusion translated into greater fiscal profligacy. There has been an instance when the interventions of the Upper and Lower House were even made in the name of greater fiscal discipline (Table 8). In 1996, two members of Parliament, Wolfgang Weng (FPD) and Adolf Roth (CDU), threatened not to pass the government budget proposal if deficit projections were not made more realistic (Der Spiegel 38, 1996).

[9] It should be noted that these figures are to some extent problematic. It is hard to discern where parliamentary changes stem from parliamentarians' intention to alter government fiscal plans and where they are simply the result of changes to the macroeconomic scenario against which budget decisions are taken. To be sure, the Parliament's modest average contribution to spending decisions is not necessarily a sign of institutional weakness but possibly an indication that the executive took account of Parliament's wishes at an early stage, while drafting its proposals (Horst 1995, 363-4).

Graph 12. Germany: Difference Projected and Actual Net Borrowing Requirement (- overestimated) 1980-2000



Source: Bundesfinanzministerium, *Finanzberichte* 1980-2000.

True, the Finance Minister lost his monopoly over budget policy-making but, from an institutionalist point of view, this should have not affected the efficiency of budget institutions to the extent that the process continued to be centralised. However, the fact that the Office of the Chancellor became the new decision-making body meant that the only thing that changed was the responsiveness to societal claims of the new fiscal authority. Deficit spending in the first year after re-unification was not merely result of a loosening budgetary process. Chancellor Kohl was consciously responding to the largest possible range of claims made upon him. On a similar note, Kitterer argued that fiscal profligacy aimed at preventing strong distributional conflicts at such a delicate time (Kitterer 1999).

Table 8.Germany: changes decided by parliament over total spending

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Change	-0.2	-0.9	0	+0.7	-0.4	+2.7	-0.1	0	+ 7.6	n.a.	-2.7	+ 2.7

Source: Horst 1995, 363; Bundesfinanzministerium, *Finanzberichte* 1986-1997.

Finally, a budgetary process can be defined as open or closed in relation to the degree of access social partners enjoy. Corporatism falls under the category of domestic institutions and is believed to have important implications for economic policy-making. The traditional argument is that governments' excessive responsiveness to societal claims tends to lead to larger public deficits. Instead, the example of Italy has demonstrated that the involvement of social partners in budget policy-making allowed for the creation of a stable consensus around fiscal austerity by providing legitimacy to the government's austerity plan; at the same time, unions were offered the opportunity to decide over the content of fiscal adjustment.

In Germany, forms of cooperation flourished between labour and capital leading to an institutional bias in favour of compromised solutions simultaneously meeting the preferences of workers and employers. Interest groups have historically played a semi-public role by taking part into various stages of the economic policy-making process (see Chapter VI). Still, in the 1990s, there was no formal role for interest groups in the budgetary process. The Kohl Government attempted to involve domestic socio-economic actors in the framework of specific projects or policy areas, the most visible examples being the institution of a technological council at the federal level (*Technologierat*) and of concerted action in the health sector (*Konzentrierte Aktion im Gesundheitswesen*), which aimed to induce interested parties to achieve voluntary cost control (Sturm in Smith et al. 1996, 127). Against these two clear examples of sectoral corporatism, the tripartite roundtables created to discuss the transfer of West German labour market institutions to the East were certainly more extensive in scope (Strauch and von Hagen 1999; Sturm in Smith, Paterson and Padgett 1996, 126), if only because they were deemed to exercise a greater impact on the public budget. In addition to these, in the 1990s, the Office of the Chancellor would hold periodic round-talks with interest groups to discuss various pieces of reform (*Kanzlergespräche*). In this context, the role of social partners was one of mere consultation. The Kohl Government did not seek their advice on general issues such as the role of the State in the national economy and the future of social security. In power since 1982, the Christian Democrats proved in fact reluctant to extend political power to the unions. More importantly, the small Liberal coalition partner was strongly against any form of social concertation and criticised any timid attempt towards it. Only the Social Democrats in opposition continued to support the idea that socio-economic policy decisions should be taken with the consent and support of the social partners, in the old corporatist tradition.

2.3.The economic role of political institutions

No doubt, political institutions –a government's life expectancy and type- exercise an impact on fiscal policy-making and outcomes. Time frames direct governments' strategic choices. In addition, the number of potential veto players, larger in the case of coalition governments and/or federalist states, conditions the political room for manoeuvre. Following this reasoning, a widespread argument was that Germany's successful preservation of fiscal discipline until the 1990s was possible thanks to the country's strong political stability where government changeovers were infrequent, and to low political fragmentation, as exemplified by the small number of parties and in the formation of large parliamentary majorities (Glaeßner in Smith, Paterson and Padgett 1996, 33). In fact, in spite of the presence of a hybrid electoral system comprising both majoritarian and proportional features, Germany has been functioning as a *de facto* majoritarian democracy since the post-war period (Poterba and von Hagen 1999).

If these arguments are acceptable, then a troublesome budget consolidation in the 1990s should have derived from changing institutional constraints in the German political system. However, in that period, the federal government was no less stable than it had been in the past. The same liberal-conservative coalition led the country through the EMU convergence process[10]. Only electoral cycles might have exercised some form of constraint. It is manifest that upcoming elections in 1990, 1994 and 1998 exerted some impact on government behaviour. CA fiscal data reveal a relaxation of discretionary fiscal policy in the years before and after general elections, in 1989 and 1991, and in 1993 and 1995. Electoral concerns mobilised the governing coalition and, for the very same reasons, the opposition with inevitable implications for fiscal policy-making. This interpretation is confirmed by the fact that, especially before the 1994 federal election, the

[10] Still, it is to be noted that, while the overarching political institutions remained unaltered after re-unification, the micro-politics changed instead with evident effects on the national party system and voting behaviour. Yet, again, it was more about preferences within institutions rather than institutions themselves (Glaeßner in Smith et al. 1996, 33).

partisan polarization between the CDU and the SPD intensified, revealing two different ideologically charged fiscal visions, with the Christian Democrats supporting small government and cutbacks and the opposition Social Democrats recognising the role of the State in social security provision (Budge et al. 2001).

As for the notion of political fragmentation, the CDU/CSU-FDP government was to a large extent a coalition not dissimilar to previous ones in German political history. The same configuration proved able, in the 1980s, to put in place an extremely successful budgetary adjustment. In the 1990s, the government continued to enjoy a large majority in the *Bundestag*. There is no particular reason to believe that the SPD opposition could count on greater veto power than it had in the previous decade, at the least in the Lower House. However, an important limit to government's room for manoeuvre came from federalism. From 1991 onwards, the governing coalition had lost absolute majority in the *Bundesrat* to the advantage of the Social Democrats. While lacking veto power on spending decisions, the Upper House co-decides on tax laws (Horst 1995; Braun, Bullinger and Waelti 2002). The regions lobbied successfully to get a larger share of incomes from VAT (Sally and Webber 1994; Horst 1995, 384; Bach and Vesper 2000), but were unable to control their own spending levels. Official documents indicate that the accounts of regions and municipalities were performing much worse than the federal budget. The Council of Economic Experts requested on several occasions that regional actors both in the West and in the East strengthen their commitment to fiscal consolidation (SVR various years). In vain the government attempted to impose spending limits on regional budgets[11]. Nevertheless, the indisputable importance of federalism does not necessarily contradict the argument that preferences were more relevant than institutions. Significant pressures from above conditioned fiscal policy-making in the 1990s. Federalism does say that these were not only socio-economic but also territorial in nature.

[11] Even at a later stage, there was no success for the proposal to implement an internal stability pact so as to subject regions to the same deficit limits the federal government had committed to with the signing of the Stability Pact.

There is another, more institutionalist argument about federalism, which is often called into question. Federalist states are affected by substantial coordination problems. Any anti-cyclical fiscal policy is aggravated by the fact that authorities need to coordinate responses between numerous units; this leads either to no result or to a considerable delay, and in turn to inefficient outcomes. Re-unification should have exacerbated this problem as it brought about an increase in the number of Länder. Empirical data do not seem to support this account. Figure 1 illustrates the evolution of both actual and cyclically adjusted deficits. A large gap between the two figures would indicate weakness in the German fiscal reaction function. Interestingly, the federal government's capacity to put in place anti-cyclical fiscal policy was remarkably modest during the 1980s, at a time when an extensive deficit reduction was achieved. On the contrary, in the 1990s, in spite of the fact that the number of regional authorities increased, as did administrative cultures, fiscal authorities seemed better able to pursue stabilization policies, as indicated by the fact that the gap between actual and CA figures narrowed substantially. Therefore, other factors should account for a poor fiscal performance.

3. Partisan and Median Voter Preferences

In the previous sections, I have attempted to demonstrate that pure institutionalist arguments have limitations when it comes to accounting for Germany's fiscal consolidation in the 1990s. More precisely, it was suggested that at the basis of changing institutional constraints and opportunities were shifts in preferences. Budget consolidation appeared like a difficult exercise also because governing authorities were torn between ideological and electoral considerations. The pursuit of partisan policies and the quest for public support made the federal government deviate from principles of optimal fiscal management.

That fiscal efficiency was not at the top of government priorities is evident from the gap existing between actual government policies and recommendations coming from the Council of Economic Experts. In spite of a political rhetoric in which fiscal discipline figured as the ultimate goal, the Kohl Government found it difficult to keep public expenditures under control. In 1991-93, a large part of the re-unification process was financed through deficit spending and by means of revenue maximising measures. According to Heilemann and Jochimsen, the federal government had taken the conscious decision to subordinate economic considerations to the political imperative of unification (Heilemann and Jochimsen 1993, 49). The Council of Economic Experts was extremely critical of the fiscal stance[12]. It accused the government of lacking a coherent communication policy about its long-term fiscal objectives, something that had undermined consumer and investor confidence (SVR 1992, 2). In addition, and contrary to Kohl's decision to augment direct and indirect taxation, the Council suggested that deficit reduction be achieved on the expenditure side of the budget, possibly by means of a dramatic restructuring of spending priorities (SVR 1992, 139). On the other hand, if revenue increases were the only possible way to balanced budgets, then indirect taxes other than VAT should be increased (SVR 1991,15). Not even Kohl's strategy switch after 1993 seemed to be informed by principles of optimality. True, in apparent accordance with recommendations coming from the Council, the Finance Ministry decided to cut expenditures and reduce fiscal pressure. However, this did not prove sufficient in the eyes of experts, with the Council continuing to lament the lack of structural reforms on the spending side of the budget (SVR 1996, 12).

Thus, notwithstanding a genuine belief in the desirability of fiscal discipline, the Kohl Government was constrained in its capacity to stick to such a commitment. In the following sections, I assess the extent to which fiscal decisions were taken on the basis of ideological preferences and electoral considerations (i.e. adaptation to the median voter). I will also hint at pressures stemming from self-interested domestic socio-economic groups; this topic shall be further developed in the next chapter. It should be noted at the outset that the high variation in fiscal outcomes in the 1990s does not reflect the fact that the same CDU/CSU-FDP government had been in power over the entire period under investigation.

[12] The Council's 1991 Annual Report stated: "where the State has the power to reject unjustifiable economic claims, it should not hesitate to do so. Old privileges should not be perpetuated and new ones should be denied...if the Government induced ministers to do so, it would also become easier to limit requests coming from socio-economic actors" (SVR 1991, 15).

This suggests that the government's declared partisan preferences are more important than actual ideological heritages. In other words, pure ideology did not play a role and issues of partisanship were always intertwined with opportunistic evaluation of government's chances of political survival.

3.1.Demand-side partisan politics

Even a superficial look reveals that pure partisanship is not a convincing explanation for the German experience with fiscal adjustment. Size and composition of budget consolidation varied from one year to the other discrediting any hypothesis of links between the ideological orientation of the (same!) governing party and fiscal policy decisions. Partisan arguments in the tradition of Hibbs' work (Hibbs 1977) are not a satisfactory explanation in this particular case. Declared rather than real ideological preferences leave greater room for an interpretation of the German experience. And, in fact, in the wake of re-unification with the federal government running an electoral campaign, the CDU-FDP coalition displayed a much more welfare-friendly rhetoric than the Social Democratic opposition (Budge et al. 2001). In an attempt to use the historical event of unification as a resource in the electoral competition, the Kohl Government publicly insisted on the need to extend the West German generous welfare state to the East. In this sense, electoral concerns proved more powerful than the government's attachment to its ideological heritage.

Once the pressure of re-unification seemed overcome, the Kohl Government resorted to a more traditionally partisan policy stance. The shift from a revenue to an expenditure-based adjustment in 1993 is to be understood in this light. The cost of the united Germany had been borne by private and corporate taxpayers whose voice soon reached the Chancellor. In addition, fiscal laxity had induced the *Bundesbank* to reduce the money supply. Higher interest rates ran against the preferences of private investment. The fear of losing support from his natural constituencies in the run-up to the 1994 federal election induced Kohl to reshape the government fiscal strategy. Again, electoral manifestos are quite revealing of the coalition's stance in that period. After having supported welfare expansion in the early 1990s, the CDU-FDP coalition argued for welfare retrenchment in 1994 (Budge et al. 2001).

In the parliamentary debate, there was certainly an element of partisanship as competing political groups juxtaposed very different views of appropriate economic policy-making, with the CDU/CSU and the FDP putting forward the case for supply-side reforms and the SPD supporting Keynesian demand management (Friedrichs and Weishaupt in Andersen 1998, 76). In the end, actual fiscal policy outcomes appeared to be affected more by the Kohl Government's openness to socio-economic interests in a period of unprecedented crisis rather than by pure partisanship.

3.2.The German median voter

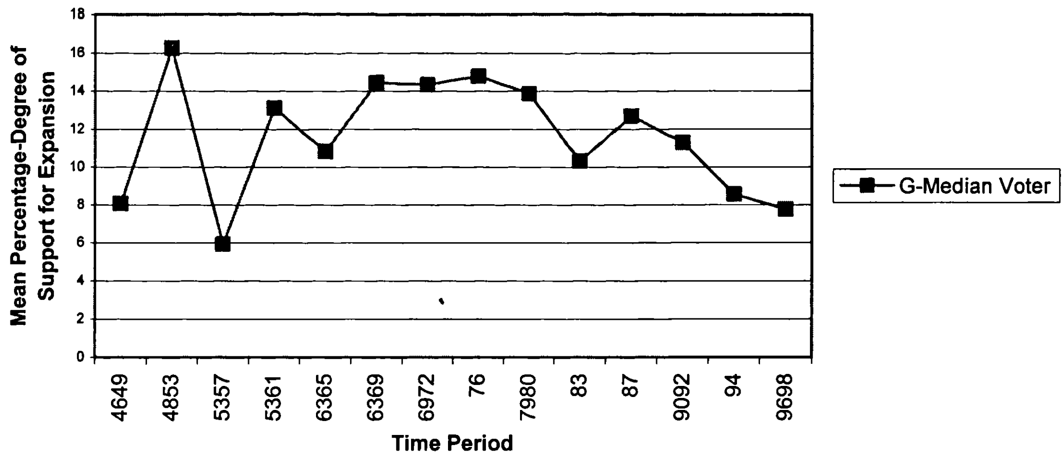
I have shown above that electoral considerations are a convincing explanation for German fiscal policy-making, and in particular for its relaxation, in the aftermath of re-unification. Most electoral politics arguments revolve around the notion of a median voter whose preferences then become governments' reference point in the phase of policy formulation. Still, the median voter theory does not necessarily coincide with the tenets behind the electoral politics literature. The latter is a pluralist account of policy-making and describes a relatively open process in which voters at large, or rather self-contained interest groups play a role. Median voter accounts focus instead on a representative voter but possibly fail to shed light on the fact that voters have multiple preferences, at times in contradiction with one another and often structured in the form of trade-off[13].

Graph 13 illustrates the position of the German median voter with reference to welfare expansion (Budge et al. 2001). Firstly, Germany is one of the strongest supporters of the welfare state in Europe. Second, and most importantly, the trend is set downward from 1987 onwards. This is possibly the result of the Kohl Government's successful management of the economy in the 1980s, which led voters to support rather orthodox economic policy recipes. This might explain

[13] For a similar comment, see Besley, British Academy Annual Conference, 2004.

why Chancellor Kohl dared to propose a few welfare retrenchment measures in 1994 and 1996. Even if CA social transfers continued to increase until 1997 in response to the increasing number of unemployed in the united Germany, they did so at much slower pace from 1993 to 1997, stabilising thereafter (European Commission 2003b). Yet, as was noted for the Italian case, the median voter theory does not capture the fact that preferences are normally multidimensional. In this respect, survey-based data might be more revealing of societal preferences. In Germany, a larger majority than in Italy is in favour of the preservation of the status quo. Interestingly enough, there is no trade union bias in this case. Namely, members of trade unions and non-members shared this preference to the same degree (Boeri, Boersch-Supan and Tabellini 2001). In this respect, unions' veto of the welfare cuts proposed in 1996 was not the reaction of minority vested interests but reflected a wider social feeling[14].

Graph 13. Germamy: the Position of the Median Voter on Welfare, Germany 1946-1998



Source: Budge et al., "Mapping Policy Preferences", 2001, CD-ROM

This leads us to consider the role of more specific actors, namely social partners. While it is true that they were not formally involved in the budgetary process as in Italy, it is nonetheless evident that they enjoyed some form of access to fiscal

[14] As a matter of fact, opinion polls show that 72 percent of the population was against the social spending restraints Chancellor Kohl pushed through parliament in April 1996 (FT 2/5/1996).

policy-making. Still, their preferences were distributed in such a way that there was no scope for a comprehensive agreement over fiscal policy issues. In the end, any "policy output represent(ed) the lowest common denominator between those corporate actors that command the potential to crush the initiative completely" (Webber 1992, 174). The Kohl Government's incapacity to satisfy both capital and labour explains half-hearted fiscal consolidation as well as the crumbling itself of social partnership. Their incremental *ad hoc* intervention in the German budgetary process during the 1990s together with the government's failure to provide them with any official recognition as budget actors explain why their uncoordinated contributions to taxing and spending decisions might have been responsible for the country's loss of its traditional fiscal rigour.

The next chapter should then look at the contribution of social partners to German fiscal policy-making during the 1990s.

CHAPTER VI

The Fiscal Role of German Social Partners: The Failure of the Social Pact

1. Macroeconomics and the German Variety of Corporatism

Fiscal policy does not take place in a vacuum. It is reasonable to expect that the federal government felt particularly sensitive towards the socio-political impact of fiscal policy decisions in the aftermath of re-unification when citizens in the West and in the East were already asked to adapt to a dramatically different national landscape. In Germany, social partners do not enjoy formal access to budget policy-making, at least not in the same way as Italian social partners during the 1990s. Still, there are specific areas in which they play a pivotal role which spill-over onto public finances. In this respect, they can be said to be implicit budget actors.

This is evident in the case of wage bargaining. Collective agreements affect the standing of public budgets via two main channels. First, social partners have the power to set wages in the public sector. Compensations for public employees represent quite an important expenditure item amounting, in Germany, to an average of 10 percent of GDP in the period 1991-2000 (European Commission 2005). Second, by setting wages, social partners affect national inflation levels. For example, wage restraints have two positive implications for public finances. On the one hand, the resulting low inflation controls the growth of nominal public consumption expenditures. On the other, wage moderation impedes that the *Bundesbank* intervenes by raising interest rates, which would expand the interest payment bill and, at the same time, exercise a downward pressure on public incomes because of lower growth. In addition, German social partners play a role in social policy implementation, and hence on the financial aspects of it as they administer social security budgets.

Indirectly, to the extent that they are important economic actors on the national scene, social partners would in one way or another exert an impact on fiscal performances. Even if budget policy is a matter of government control, the parties in power are sensitive to their natural constituencies, and thus to either capital or labour respective of partisan preferences. But also, the federal government tends to consult social partners on various issues. In the early 1990s, most of the economic and social details of re-unification were negotiated in the framework of special roundtables comprising government authorities, opposition leaders and social partners. What do social partners do in Germany? What are their preferences? The following section offers a snapshot of German organised interests and of the country's corporatist tradition. For the national labour and business confederations, I describe membership; relative importance in the national economy; centralization of wage bargaining; and macroeconomic role. Finally, I review the country's variety of corporatism, i.e. the way in which social partners have in the past been involved in macroeconomic policy-making as well as the nature of their role in the 1990s.

1.1.A profile of German interest groups

As in most continental European states, social partners have contributed significantly to the formation of the post-war German welfare state. With the end of WWII, national social partners took up responsibility for reorganising German society. Gathered under the umbrella of the *Bundesverband der Deutschen Industrie* (BDI), business actors played a central role in the material reconstruction of the post-war economy. Through them, it became soon clear that capitalism was the only possible socio-economic model for Germany. In 1949, almost all existing labour unions with the only exception of white-collar workers joined one labour confederation, the *Deutscher Gewerkschaftsbund* (DGB) under the presidency of Hans Böckler (Markovits 1986)[15]. While initially uneasy with the political establishment's rapid embracing of the capitalist model, soon thereafter the DGB directed its efforts to finding a "compromise with reality" (Schneider 1991), as the economic miracle was creating room for an improvement of living standards for all citizens. A favourable economic environment allowed business and labour actors to agree on multiple forms of cooperation under the ultimate common goal of creating a strong and stable national economy. Largely dissimilar cultural and ideological heritages did not in fact prevent them from finding some common ground.

[15] White-collar workers founded an autonomous confederation, the *Deutsche Angestellten Gewerkschaft* (DAG); however by 1986 this accounted for only 20 percent of all German white-collar workers (Markovits 1986).

Together with its sister organization representing national employers, the *Bundes-vereinigung der Deutschen Arbeitgeberverbände* (BDA), the BDI embraced liberalism from the early days. Similarly to other industry associations, the confederation has been generally supportive of "small government" and opposed to an excessive intrusion of the State in the management of the national economy. For this reason, fiscal discipline has always been at the top of its agenda. First, balanced budgets hint at the fact that public expenditures are not excessive; this is to say that the allocation of resources is efficient because induced by the market's invisible hand rather than being imposed from above. Second, and linked to the latter, where government spending is not too high, then fiscal pressure is also likely to be contained. Third, financial stability in the form of low inflation is desirable because it pre-empts potential for conflict on the wage bargaining arena[16]. Together with the appreciation of fiscal austerity is a belief in the desirability of supply-side reforms. Still, within the organization, differences existed between the preferences of large and of small-medium enterprises. The former were mostly concerned with macroeconomic policies and their potential impact on the external value of the DM. The latter were more interested in issues of industrial organization (e.g. training schemes, tax incentives, etc.). Since the late 1980s, their positions have come more and more irreconcilable, a state of affairs that has compromised the unity and power of the BDI confederation as such (Streeck and Hassel 2004).

On the other side of the spectrum, the DGB realised soon that Keynesianism represented the best approximation to labour representatives' way of conceiving of any advanced capitalist society. At the core of the agenda was an "expansive wage policy", for which real wages had to be high enough to boost consumption and, therewith, national economic growth. No surprise then that the confederation supported the introduction of the 1967 Stability Law with its strong commitment to financial stability and full employment. Sluggish growth was often perceived as a serious problem because of its negative impact on labour market developments. In recession, the labour confederation would hence

[16] For obvious reasons, this is an issue that mobilises in particular the BDA.

ask the government to support the economy by means of expansionary fiscal policies, as happened in the 1970s (Markovists 1986). Such a position was perpetuated even in the post-unification period when the DGB insisted that the federal government expand spending programmes in the East and that growth promotion be privileged over inflation control.

What is the organizational profile of German social partners today? The BDI, the voice of the industry, consists of 36 industrial associations organised by product group. Almost all German firms are members of the organization. The BDI is a lobbying organization and benefits from strong ties with the Christian Democrats. The BDA, the confederation of national employers, gathers 56 associations representing about 80 percent of all national enterprises in 1985 (Soskice 2000). Employers in the metalworking sector are organised in a single organization, *Gesamtmetall,* which is the bargaining partner of the corresponding labour union, *IG Metall*. In the public sector, by contrast, it is the Ministry of Interior that takes part in the collective bargaining process in the role of employer (Fuerstenberg 1998).

With a membership of 7.6 million (2002), the DGB is comprised of 16 unions representing an equivalent number of economic sectors. Amongst them, the metalworking union *IG Metall* figures as one of the largest across Europe with 2.6 million members (2002) (www.dgb.de). German trade unionism is organised across sectoral lines. True, there is a partisan element to it, as historically the DGB leadership has been close to the SPD[17]. This affinity was particularly evident in the 1970s under Chancellor Helmut Schmidt, when the BDI and BDA went so far as to argue that the risk of the emerging of a "state union" was present and that this signified a serious threat to democracy (Markovits 1986). In spite of the traditional closeness with social democracy, German labour unions have overall taken quite a pragmatic and moderate stance over most issues (Trade Unions of the World, 2001). Independently of the ideological orientation of the governing party, the DGB has notoriously been an important reference partner for most post-war federal governments.

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[17] It is to be noted that few management positions in the DGB are reserved to CDU representatives (Trade Unions of the World, 2001).

With the division into sectors comes collective bargaining at the sector level. However, the wage leadership of the export-oriented *IG Metall* provides a good functional equivalent to an encompassing confederation. Indeed, all other sectors use wage agreements negotiated in the metalworking as a benchmark (Streeck 1994). In this area, social partners enjoy full autonomy where the State has no right to intervene. Still, bargainers were subject to an important institutional constraint, the *Bundesbank*. With the national central bank having built up a strong reputation for inflation control since the mid-1970s, unions had an incentive to keep wage increases in line with the evolution of the inflation rate to the extent that excessive wage settlements would prompt the *Bundesbank* to raise interest rates, thereby punishing unions with greater unemployment (Ebbinghaus and Hassel 2000) or employees in export-oriented manufacturing sector with an appreciated exchange rate (Soskice 2000).

1.2.The historical relevance of macro-concertation

In the debates around the different varieties of capitalism, Germany has been always presented as the role model for a coordinated market economy (CME) in which labour and capital cooperate actively and peacefully to shaping the domestic political economy (Hall and Soskice 2001). For most of the post-war period, German social partnership has thus been bipartite in nature. In the area of wage bargaining, where the parts agreed to the principle of wage autonomy (*Tarifautonomie*), their collaboration is clearly free of external interference. But, even in the realm of labour market and social policies, the role of the state has been limited to the provision of "overarching legal frameworks" (Katzenstein 1985) and to the performance of a largely "enabling function" (Streeck 1984)[18]. In this respect, Germany's tradition revolves around a form of diffuse

[18] Streeck describes this particular form of "managed capitalism" as follows: "the state in the Federal Republic acts in a variety of ways as a supporting, facilitating, encouraging force in the formation and preservation of broad encompassing, internally heterogeneous interest organizations. Ironically, but hardly unintended, the interventionist policy of the German State on the organizational forms of social interests enables it in many cases to abstain from direct economic intervention since it provides interest groups with a capacity to find viable solutions within and for themselves" (Streeck 1984, 145).

corporatism quite different from the tripartite macro-concertation that is at the basis of recent so-called social pacts.

To find a similar form of consultation between government, employers and unions one has to go back to the late 1960s, when in 1967 the Grand Coalition initiated the experiment of the *Konzertierte Aktion* (KA). The 1966 recession had lead to growing private sector unemployment. In the framework of this new forum, labour unions agreed to wage moderation in the belief that the latter would favour the re-entry of the unemployed into the labour market. *Real* economic problems were at the basis of unions' acceptance of wage restraint. In exchange, the federal government promised additional social expenditures (Carlin 1996). The terms of an explicit political exchange were set. The experiment with tripartism was short-lived. It failed due to increasing tensions between government and labour. Labour representatives had accepted government interference into collective bargaining with reluctance and, in the late 1970s, the DGB found it increasingly difficult to block the spreading of unauthorised strikes (Markovits 1986). Also, the monetarist stance of the *Bundesbank,* which translated into the central bank's readiness to punish any potentially inflationary wage agreement, was twisting the arm of unions into accepting wage moderation, thereby making an explicit compromise with the government at best unnecessary (Streeck in Dore 1994). In 1978, KA ceased to exist.

Even if explicit social pacts are not common in German economic history, the practice of taking decisions on the basis of a large socio-political consensus is undoubtedly a constituent part of the domestic political economy. Germany's comparatively low number of strikes and street demonstrations until the 1990s is result of this entrenched consensual policy-making style (ILO Database). In the early 1990s, however, German consensus politics started to crumble. Some researchers blamed re-unification. I believe that re-unification *per se* has no direct responsibility. Anecdotal evidence suggests that this was indeed the only area around which government and social partners could reach an agreement in the form, for example, of an unconditional transfer of West German labour market institutions to the former DDR (Manow and Seils 2000). The Kohl

Government needed social support, borne out of a concern about possible electoral punishment, should the process prove too costly. With this aim, special roundtables involving social partners were created to discuss the technicalities of re-unification (Strauch and von Hagen 1999) and, in September 1992, a larger Solidarity Pact was launched to engage also the opposition and regional representatives.

Using a more sophisticated institutionalist argument, Manow and Seils explain the crumbling of German social partnership on the grounds that, once reforms were truly necessary as a consequence of unification and of the EMU challenge, Germany's comparative advantage (i.e. its adaptive capacity to changing external circumstances) proved self-defeating (Manow and Seils 2000). Others explain that macro-concertation ran against the institutional constraints induced by a highly developed sectoral corporatism (Siegel 2003). My contention is that such explanations are deficient to the extent it does not explain what happens at the micro-level when, for example, one socio-economic group is seriously committed to radical policy change. From this follow legitimate questions: how intensive should one group's support in favour of drastic adjustment be in order to exert a disturbing impact on German highly adaptive system? How intensive should a competing group's resistance be? Partially offering an answer to these queries, Streeck suggested that organised interests lost all incentives to negotiate, i.e. to come up with compromised piecemeal solutions, as a result of shifting macroeconomic conditions, slow growth and high unemployment. The new macroeconomic environment in the 1990s is then responsible for the abandonment of corporatist practices (Streeck 1997). The following sections discuss budget policy-making in the 1990s with an explicit eye on the role of social partners where the attempt is to verify if a correlation did in fact exist between the macroeconomic preferences of German organised interests and weakening social consensus, where the latter is manifest in the striking failure of the 1996 Social Pact.

2. Fiscal Policy-Making in the Aftermath of Unification

This section aims to unveil the main traits of the political economy of fiscal discipline in the aftermath of re-unification, with particular attention devoted to the preferences of social partners. Quite understandably, at the core of the debate were unification and its financial implications. So, in 1991-92, fiscal policy was largely constrained by the need to rebuild former DDR. Yet, a year later, the government proved able to act with a firmer hand, stressing the need to control spending growth and to abandon revenue-maximising measures. The looming recession played no marginal role in persuading fiscal authorities that higher fiscal pressure would have just further slowed output growth down. From the outset, divergences emerged between the government and business actors, on the one hand, and the opposition together with the unions, on the other, regarding the ways in which the public good of fiscal discipline was to be achieved. This dilemma would characterise the entire decade. While in Italy interest groups' concerns shifted from the size to the quality of budgetary adjustment, in accordance with changes to the external macroeconomic environment, here the composition of fiscal reform had been the crucial variable since the very beginning. Labour and capital showed a common interest in balanced budgets, but it was only in 1991-92, facing with the government's not always sound public finance management, that capital come in with a comparatively stronger claim for austerity.

2.1.First budget response to unification (1991-92)

In 1989, Germany was facing an unprecedented political and financial challenge. German unification came after forty years of diplomatic and, most importantly, cultural division with, on the one hand, West Germany incarnating the perfect model of a well functioning social market economy and, on the other, the former DDR organised into a planned economy and for decades largely isolated from world markets. The task of the Kohl Government was first to manage the transition of East Germany into a modern market economy and, second, to facilitate its integration with the West. Faced with an upcoming federal election in the winter of 1990, the Chancellor soon realised that his strong commitment to a smooth re-unification process would represent the best possible electoral programme. From the outset, German unification became a political matter (Giersch et al. 1993). The rapidity with which highly significant socio-economic decisions were taken at that stage - often against prescriptions coming from experts in the different ministries and professional economists - supports the view according to which the process was, more than anything else, politically driven (Heilemann and Jochimsen 1993)[19].

The establishment did its best to spread an optimistic view of the possible financial impact of unification. Spending increases in the form of transfers were necessary to support transition; nevertheless, it was anticipated that the growth hikes expected from the enlargement of the national market would in turn finance initial expenditures. The prospect was that re-unification was self-financing. In this respect, the Finance Ministry insisted that there was no need to think of fiscal discipline as being under serious threat. While the necessary financial transfers to the East put pressure on nominal public expenditures, real spending would be under control. However, when in February 1991 the German Finance Ministry submitted its first *Finanzplan* and budget draft for the united Germany, the figures appeared much less comforting than the government's repeated declarations of rigour. The volume of the intervention for the same year amounted to 37 billion DM, of which 20.2 billion consisted of additional expenditures and 17.6 billion of new revenues (Bundesministerium 1991). Despite repeated public announcements, the budget draft actually envisaged some deficit spending. In addition, the largest part of the new spending commitments was financed through augmented fiscal pressure, in spite of the Kohl Government's electoral promise not to increase taxation. The adopted fiscal stance divided the government coalition. The liberal FPD attacked Finance Minister Waigel's excessive generosity and called for greater austerity as well as

[19] A typical example is the decision for a 1:1 conversion of the exchange rate between East and West.

for cuts to taxes on companies and high-earners (Der Spiegel 24, 29 and 37, 1991; FT 23/4/1991)[20].

There is no surprise that organised interests showed concern over the macro-changes their country was going through. Content analysis of official documents and declarations reveals how, in early 1991, the BDI was above all worried of the prospect that fiscal policy relaxed to such a degree that a restrictive monetary intervention from part of the *Bundesbank* would be finally unavoidable. After short-term interest rates had grew rapidly since 1988, domestic business actors were indeed particularly mobilised against any further restriction. Second came their opposition to augmented taxation. The completion of the SEM had created greater concern around competitiveness, and more so at a time in which higher domestic interest rates had induced a slight appreciation of the DM[21]. In turn, the BDI insisted that the road to deficit reduction should instead go through a rationalization of public administration costs (BDI, *Bericht 1990-92,* 176).

The German labour union confederation was less critical of the government's fiscal stance. Overall, it was appreciated that deficit reduction was to come from the revenue side of the budget. While not criticizing the practice of trying to maximise public revenues, the DGB showed more concern about the choice over what taxes to augment (DGB, *Die Steuerbeschluesse der Bundesregierung*, Informationen zur Wirtschafts- und Strukturpolitik IWS 18/3/1991). Labour unions contested the government's decision to increase unemployment insurance contributions. However, their opposition was not as intense as that of employers. First, the latter were facing at the same time a restrictive monetary environment. Second, wage bargainers benefited from the option of transferring the additional costs onto wages; as a matter of fact West German wages increased over the period 1990-92[22]. In addition, unions opposed VAT increases. By affecting

[20] The decision to eliminate the trade and wealth tax after the signing of the coalition agreement on 16 January 1991 resulted almost certainly from the pressures of the FDP (DGB 18/3/1991).
[21] In the immediate aftermath of unification, a pressing concern had been the rapid depreciation of the DM against the US Dollar in the back of increasing uncertainty amongst international investors around the financial implications of re-unification. In the first months of 1991, the German currency depreciated by 23.5 percent against the US Dollar (Der Spiegel 29, 1991). Yet, the reaction of the *Bundesbank* was so prompt that, just a few months later, the DM moved from being a depreciated currency to a highly appreciated one.
[22] This strategy was viable only until unemployment started to bite.

consumption, they would be more punitive of low-income groups (DGB, *Die Quelle* 1 and 4, 1991). This came from their conviction that the federal government could not withdraw from public investment programmes. To be sure, it was necessary to boost infrastructure investment in the new Eastern regions. True, fiscal discipline was a priority but additional expenditures were not necessarily detrimental to public finances as they were meant to control for the rapid increase of unemployment and therewith pre-empt its potentially disastrous impact on social security budgets (DGB, *Wirtschafts- und beschaeftigungspolitisches Sofortprogramm fuer die neuen Bundeslaender* IWS 6/2/1991; *Ein oeffentliches Infrastrukturprogramm fuer Ostdeutschland* IWS 11/3/1991). It was possibly the first time that social partners had come up with their own well-defined recipes for macroeconomic management. This was also a period of unprecedented socio-political unrest. Against this difficult scenario, on 7 June, the national Parliament approved the financial plan and the budget law for 1991 (Heilemann and Jochimsen 1993).

Soon after the Kohl Government had to take decisions on the 1992 Budget. The Finance Ministry put forward its long-term financial planning document and draft budget in July. The documents envisaged an extensive intervention for a total value of 41 billion DM of which 12 billion was in higher spending and 30 billion was in additional incomes. In nominal terms, the actual expected reduction in the general government borrowing requirement amounted to 16.5 billion DM (Bundesministerium 1991). Considering the circumstances, the size of the correction was quite extraordinary. At the end of the year, Germany's actual deficit improved by 0.3-percent of GDP. In cyclically adjusted terms, this amounted to a deficit reduction of 0.4 percent of GDP. Needless to say, with expenditure increasing, the contribution had to come from public revenues with all components rising for a total CA increase of 1.5 percent of GDP (European Commission, 2003s).

Still, the extent of the correction was not sufficient to avert the perception that price stability was at risk. On 15 August, with inflation at a rate of 7 percent, the *Bundesbank* increased the discount rate by 1 percent (Bundesbank 1991; FT 24/9/1991). Here and throughout the 1990s, differently from Italy - where monetary authorities were sensitive mostly to the extent of the budgetary correction - the German central bank showed more concerned with its quality. Greater fiscal pressure was by no means desirable; in particular, VAT increases were likely to exert an unwanted inflationary impact on the national economy. In its 1991 monthly report, the *Bundesbank* noted: "...restraint in public spending should have priority over tax increases that would be problematic from a growth and stability standpoint" (FT 24/9/1991). The interplay between fiscal and monetary authorities as well as domestic interest groups should not be underestimated. In Germany, business actors and labour unions formed their fiscal preferences by also taking the reaction of the national central bank into account. This aspect was certainly more pronounced here than it was in Italy, for example.

In front of the new budget proposal, socio-economic actors displayed divergent reactions. The BDI was critical of the numerous revenue-maximising measures the government had been introducing since 1990. The organization's standpoint was that fiscal pressure was slowing down growth and damaging Germany's image as a favourable business location. On the same note, German industry welcomed tax relief and allowances, especially on investment initiatives in the new federal regions (BDI, *Bericht 1990-92,* 176-7). Again, it was believed that only the quality of the interventions allowed an improvement of the economic environment. Tax alleviation would increase business confidence both domestically and internationally. They insisted less on fiscal rigour, considering that, in light of the circumstances, the government was proving sufficiently disciplined. Hence, in mid 1991, the most intensive preference of the BDI was a negative one translating into the strong opposition to greater fiscal pressure, and this came in conjunction with the marked appreciation of the national currency. Fiscal consolidation was necessary, but it could only be truly achieved on the expenditure side of both the federal and the regional budget. The BDI thus appreciated the planned cuts to state subsidies (BDI, *BDI zu den Haushaltsbeschluessen,* Pressemitteilung 10/7/1991).

The government budget proposal for 1992 also left the DGB largely unsatisfied. The organization explained that the intervention "...was not designed to meet the country's needs and was unfairly financed" (DGB, *Die Regierungsbeschluesse zum Bundeshaushalt 1992, zur Finanzplanung des Bundes bis 1995 und zum Subventionsabbau* IWS 5/8/1991). First, projected expenditures in East Germany would not be sufficient to sustain transition; hence additional spending commitments were urged. The government had rightly concentrated consolidation efforts on the revenue side of the budget but the choice of the tax base was not appropriate. The DGB opposed VAT increases to the extent that, by targeting consumption, they affected low-income groups in a disproportionate fashion. Labour unions suggested that the so-called solidarity charge, a supplementary tax on incomes, be preserved, albeit with a revision of tax breaks (DGB, *Die Quelle* 11, 1991). At the same time, they labelled tax relief for entrepreneurs as "anti-social", proposing that it be withdrawn (DGB, *Dokumentation einer unsozialen Steuer- und Abgabenpolitik* IWS 13/11/1991). In response to the government's decision to cut subsidies, the DGB argued that only half of it would contribute to fiscal discipline; the rest (especially cuts on employment creation measures) were not only unjustifiable forms of welfare retrenchment, but would also not have any significant short-term impact on the budget (DGB 5/8/1991).

Not only had Finance Minister Waigel encountered difficulties in justifying his fiscal decisions in front of organised interests, he was also put under heavy parliamentary pressure. The Social Democratic opposition expressed dissatisfaction with the financial law and put forward an alternative plan where it was suggested, among other things, that defence spending be reduced; the cabinet apparatus slimmed down and state subsidies cut back. In the end, various adjustments were made during the parliamentary stage and the final document contained a slightly more stringent intervention. Expenditure growth was more modest than in the government proposal and tax increases slightly greater (Bundesministerium 1991). As suggested in the previous chapter, there were occasions during the 1990s when the intervention of the national Parliament was oriented towards greater discipline. Still, the political commitment to budget consolidation was not sufficiently credible when, on 19 December 1991, the *Bundesbank* raised once more the discount rate by a further 0.5 percent (Bundesministerium 1991).

2.1.Pro-active budgetary interventions (1992-93)

The year 1992 had not started under the best auspices. Germany's economic situation was rapidly deteriorating and so did in turn the domestic socio-political climate. Unification had not proved as smooth as the government had expected. Growth continued to by sluggish and, in May 1992, the Kohl Government was forced to introduce a supplementary budget (SVR 1992). In parallel, business actors and large segments of public opinion started showing signs of a fiscal revolt after the introduction of several new taxes to finance spending in the East (Der Spiegel 9, 1992). Moreover, the large number of bargaining rounds scheduled for 1992 created concerns among political elites over the inflationary impact of wage policy. In manifest disregard of the principle of *Tarifautonomie*, the federal government intervened in the debate by asking that unions commit more firmly to wage moderation. This did not come without the strong criticism of *IG Metall* (DGB, *Die Quelle* 1, 1992; Handelsblatt 22/1/1992). Under increasing uncertainty about unions' bargaining behaviour, the *Bundesbank* replied with a dramatic increase in the discount rate, which at that point reached a historically high value of 8 percent.

The scenario was set for confrontation between the monetarist domestic alliance, on one side, comprising the government coalition, the BDI and the *Bundesbank* and the (neo)-Keynesian front, on the other side, represented by the DGB for whom such restrictive monetary interventions were constraining independent wage policy formation (Der Spiegel 9, 1992; DGB, *Die Quelle* 3, 1992). Amongst the most extensive bargaining rounds was that involving public sector and engineering workers, who were asking for a 6-percent wage increase. After a long strike, the conclusive agreement in May 1992 set the increase at 5.4 percent. The government welcomed the settlement as a sign of self-restraint, but the President of the German Chamber of Commerce and Industry (DHIT) Hans Peter Stihl still regarded it as excessive (FT 19/5/1992). Wage policy was not the only area over which the Kohl Government and the unions had come to some disagreement. The government's latest fiscal intervention consisting of a retrenchment programme to the value of 11.5 billion DM in the health sector came under equally strong criticism. DGB representative Ursula Engelen-Kefer labelled it as "socially unacceptable" (DGB, *Die Quelle* 7-8, 1992).

On 1 July, the federal government submitted its financial plan and budget proposal for 1993. Public expenditures and revenues were expected to grow by 10 and 17 billion DM respectively. In nominal terms, the reduction of the net borrowing requirement was relatively contained, amounting to 2.5 billion DM from the previous year. Unemployment-induced spending continued to grow and so did the cost of servicing the public debt. However, defence expenditures were set to decrease by 2.5, family and pension spending by 0.5 and regional subsidies by 4.8 percent (Bundesministerium 1991). At the core of the intervention was a fiscal strategy slightly different from one adopted in the previous year. No scope for deficit spending was allowed; in addition, the government put greater emphasis on real expenditure control. Still, in spite of Finance Minister Waigel's constant reassurance that taxes would not increase (FT 8/9/1992), public revenues continued to be the main source of finance. The Council of Economic Experts strongly criticised such an approach, arguing that real deficit reduction would come only from the spending side of the budget and that it would have to target simultaneously the regional and communal level (SVR 1992). At the end of the financial year, the intervention had led to CA primary surplus rise of 1.1 percent of GDP thanks to a rise in revenues of 1.5 where spending had increased by 1 percent of GDP (European Commission 2003a).

The BDI welcomed the government's firmer commitment to fiscal discipline. With the deterioration of public finance aggregates in the very early 1990s and the ensuing restrictive monetary response from part of the *Bundesbank*, German business actors were concerned with the sign of fiscal policy. At the same time, the BDI indicated that tax increases by no means represented a viable budget consolidation option especially in view of the looming recession; instead, considerable savings could derive only from a rationalization of German public administration. For the same reasons, the confederation appreciated the government's decision to keep expenditure growth under control and to postpone the introduction, in the East, of wealth and capital taxes (BDI, *Bericht 1990-92*, 175-7).

The DGB did not show appreciation for the budget proposal. It was noted that, because of the strong inflationary pressures that the national economy was subject to, the government projection of nominal expenditure growth was unrealistic. In real terms, it translated into significant spending cuts (TAZ 2/7/1992). The labour confederation criticised in particular the decision to decrease allowances in favour of the Employment Ministry, a measure believed to exert undesirable socio-economic consequences in the new regions (DGB, *Brennpunkte der finanzpolitischen Diskussion: Kurzinformationen und kritischen Anmerkungen* IWS 24/6/1992). The argument was that transition in the East could not be financed by means of welfare retrenchment, as the latter would slow the reconstruction process down and the results would be counterproductive. Instead, further public investment in the East was to be supported through the introduction of a supplementary tax on incomes (DGB, Nachrichtendienst 17/11/1992).

Faced with a deterioration of public finance aggregates, the government was forced to adopt a supplementary budget soon after the presentation of its proposal for 1993. The emergency intervention aimed at reducing the net borrowing requirement by 5 billion DM against actual trends and foresaw additional expenditures for 7.8 billion and revenues for 3 billion DM (Bundesfinanzministerium, *Finanzbericht* 1992; TAZ 25/11/1992). In the same period, the *Bundesbank* started to revise its stance, showing clear signs of relaxation. This change of attitude resulted from two facts. First, the government's return to fiscal discipline reassured monetary authorities. The German macro-economic policy framework consisted in fact of a monetary policy-oriented system in which monetary authorities were internalising variations occurring in the fiscal arena. Even more so, the government's commitment to expenditure control and partial retreat from revenue maximising measures conferred greater credibility on its fiscal adjustment plans. Second, the central bank started believing that recession was as serious a problem as inflation. On 16 July 1992, after the executive had approved the budget draft, the *Bundesbank* lowered the discount rate by 0.5 percent (Bundesbank 1992)[23].

Not only were labour unions sceptical of the government's fiscal strategy, but also the opposition SPD and large sections of public opinion judged it hopelessly unrealistic (FT 8/9/1992). The shock from re-unification as well as the Kohl Government's reaction to it contributed to destabilising the domestic consensus. In the 1990s, Germany suffered from an unprecedented high number of strikes and street demonstrations (ILO Database). With the 1994 federal election approaching, the Chancellor came to believe that a return to corporatist practices might help him out of the impasse. In this climate, the idea of a social pact rapidly took shape with the Social Democrats offering their full support to revisiting consensual politics. Still, the conclusion of the pact soon proved a difficult task. First, Kohl had to deal with the FDP's resistance to any kind of social concertation. Second, and most importantly, the federal government had little to offer in exchange for wage restraint. Quite paradoxically, it introduced instead a severe austerity package consisting of a freeze on social security payment, a cut in allowance to asylum seekers and, on the revenue side of the budget, of a rise in unemployment contributions. The impact of the fiscal interventions on the fate of the pact was immediately felt. Voicing the concerns of the DGB, Ursula Engelen-Kefer declared that the measures risked postponing the pact "into a distant future" (FT 2/11/1992). In turn, negotiations between government and unions were suspended.

The parliamentary budget session in the autumn of 1992 proved particularly confrontational. Fiscal policy issues surged to a central theme in the pre-electoral competition between the CDU-FDP coalition and the SPD. In May, the Social Democrats submitted an alternative fiscal consolidation plan. Echoing most of the proposals put forward by the DGB, the project envisaged the introduction of supplementary revenue maximising measures to support transition in East Germany (TAZ 14/5/1992; FT 26/11/1992). Certainly more in line with claims coming from the BDI, the government's fiscal vision was diametrically different

[23] It is to be noted here that relaxation was piecemal as the Bundesbank had to regain control and credibility in front of wage bargainers (Lindlar/Scheremet 1998).

as it began with the assumption that greater fiscal pressure was undesirable in the back of the recession (FT 26/11/1992) and would undermine national competitiveness in the SEM, having thus the potential to exacerbate the trend of slower growth (TAZ 5/6/1992; Der Spiegel 20, 1992). The bill approved by Parliament was less fiscally stringent than the one put forward by Finance Minister Waigel at the beginning of the budget session (Bundesfinanzministerium, *Finanzbericht* 1993). At the root of this slight relaxation of fiscal discipline was the decision to transfer additional 12 billions DM to the new regions (TAZ 25/11/1992). Nevertheless, in cyclically adjusted terms, the consolidation effort was significant with the primary surplus improving by 1 percent of GDP thanks to CA revenues and expenditures growing by 2.1 and 1 percent of GDP respectively (European Commission 2003a).

3. Reconciling Fiscal Austerity and Electoral Politics

With the fading of the unification shock in 1993, fiscal authorities seemed to have greater room for manoeuvre to implement their preferred policy options. In 1991-92, business actors (producers but also financial agents) together with the central bank had been complaining about the lack of fiscal consolidation. Largely in response to these calls, Chancellor Kohl was keen to re-affirm his commitment to sound public finances and introduced, in 1993, a special consolidation programme to which both the opposition and the social partners had to contribute. That was a clear indication of Kohl's confidence in social concertation and its support in overcoming the unfolding socio-economic crisis. After the state budget had appeared more or less under control in 1993 and 1994, the attention of budget actors shifted more visibly to the composition of adjustment. The year 1995 represents a structural break in the domestic fiscal debate, with employers and producers lamenting first the temporary rise in wage demands, and, then, more vehemently, Germany's excessive non-wage labour costs (interview with DGB). Because also the DM had been slightly moving on the upside, industry was more and more affirmative in its opposition to higher fiscal pressure. The government fiscal strategy after 1995 was in fact one that combined expenditure restraints with tax alleviation in the belief that lower taxes would have produced sufficient growth to offset the deterioration of state budgets. In the first section, I analyse fiscal events in the period 1993-95, focusing in particular on the input that came from social partners. The second is a description of the debate after 1995, when employers and employees found themselves agreeing on the need to reduce unit labour costs, but with unions blaming the government for an excessively restrictive fiscal stance in the back of the recession.

3.1.U-turn in German fiscal policy (1993-95)

Germany's macroeconomic situation was not showing any sign of improvement from the previous year. Quite on the contrary, it was finally manifest that expectations about the impact of re-unification had been overoptimistic. Growth rates in former DDR had not reached the level originally foreseen. Not only that, but after initial overheating, the West German economy was also facing impending recession. This had detrimental implications for the federal budget. Slower growth would both reduce incomes from taxation and put greater pressure on social security budgets, where the deficit in fact doubled from 1993 to 1994 (SVR 1993).

Set under pressure in the face of the spreading of *real* economic problems (e.g. slow growth and unemployment), the federal government felt reaffirmed in its belief that social concertation might be the only way out of the crisis. After a difficult phase at the end of the preceding year, negotiations resumed in January 1993. Chancellor Kohl was ready to involve not only the social partners but also the opposition (TAZ 21/1/1993). At the core of the proposed social pact was an austerity package, which – consisting of a mixture of spending cuts and tax increases - was clearly a compromise between the preferences of the DGB and of the SPD, on the one hand, and those of the BDI and of the most liberal wing of the CDU-FDP coalition, on the other. Labour unions appreciated Kohl's promise to continue supporting not yet privatised enterprises in East Germany, his assurance that investment subsidies be increased, tax allowances abolished and his proposal to augment oil taxes with the purpose of financing the highly indebted national railway system. In exchange, the DGB offered its support to a few cutbacks[24]. On the other side of the spectrum, the BDI welcomed some of the planned expenditure restraints but criticised measures taken on the revenue side of the budget (FT 21/1/1993).

The general dispositions contained in this Solidarity Pact were then incorporated in the so-called "Federal Consolidation Programme" delivered on 13 March 1993. The government plan marked a visible shift in German fiscal policy setting the pace for a rapid return to austerity. Amongst its declared priorities was the reduction of the country's structural deficit to show financial markets that German unification had been handled properly. With this purpose in mind, the re-introduction of the solidarity charge was expected to bring around 60 millions DM to the federal budget in 1995-96 (Table 9). Needless to say, while welcomed by the DGB, the measure attracted strong opposition from the BDI concerned with the country's continuously growing fiscal pressure (BDI, *Bericht* 1993, 44). In an effort to accommodate the preferences of business actors, the government declared that, since workers had borne the greatest adjustment burden in the first years after unification, sacrifices were now expected from transfer recipients. The call on welfare retrenchment was explicit, albeit modest in size. Still, the move was not sufficient to leave the BDI satisfied; the organization lamented the fact that the government had not implemented structural spending restraints and that the input of unions had translated into an excessive reliance on revenue-maximising measures. The second priority the government was thereby attempting to tackle was the design of appropriate fiscal responses in the face of recession. There was an awareness that an excessively restrictive fiscal policy would exert a pro-cyclical effect, further slowing growth down. The DGB often expressed a concern about pro-cyclical policies. All in all, the search for social consensus over fiscal adjustment led to a rather union-friendly agreement[25].

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[24] Interestingly enough, the DGB was then more compromise-prone than the allied Social Democratic opposition. On the left, some party representatives were suggesting that the Pact was nothing but a strategy to extend the costs of reunification to new socio-economic categories (TAZ 3/6/1993).

[25] Besides supporting quantitative measures on the spending and revenue side of the budget, the DGB welcomed provisions adopted to regulate financial relations between the federal government and the new regions (DGB, *Finanzpolitik Ost im Zahlenspiegel* IWS 24/1/1994).

The renewed commitment to fiscal consolidation was not sufficient to avert the rapid deterioration of public finance. Soon after, the Finance Ministry was obliged to adopt another supplementary budget (Bundesministerium 1992). There was no surprise when, in July 1993, the Kohl Government responded with the even stricter "Savings, Consolidation and Growth Programme". The plan consisted of a combination of spending restraints and revenue increases (Table 9). For the latter, these would not derive from the introduction of new items but from an improvement of tax administration without consequences for the country's fiscal pressure. Moreover, for the first time, the government envisaged a significant curtailment of social security spending for a total of 16 billion DM. Not only were public consumption and investment deemed to decrease, but also labour market policies would suffer from some restraints. It is the content of this fiscal adjustment plan that led observers to identify the year 1993 as a turning point in German fiscal policy-making (Bundesministerium 1993).

The indications contained in the two consolidation programmes were then incorporated in the government budget draft for 1994. The total value of the intervention amounted to 40.5 billion DM of which 20.26 billion were in spending increases and 21.77 billion in greater incomes (Bundesministerium 1993). On the expenditure side of the budget, the government intended to cut unemployment and social assistance benefits and to put a freeze on public sector wages. Commenting with satisfaction on the budget proposal, Finance Minister Waigel noted: "we have laid the foundations for improving the ability of the *Bundesbank* to cut interest rates" (FT 14/7/1993). And, there is no doubt that the shift to an expenditure-based consolidation was strongly influenced by pressures coming from the national central bank and from the business community (TAZ 3/6/1993). At the end of the year, the manoeuvre had contributed to a 0.3 percent of GDP reduction of CA total expenditures. It was the first time after unification that total adjusted spending had in fact decreased (European Commission, 2003a).

The DGB was highly critical of the plan. It was indicated that the welfare retrenchment measures contained therein would have extremely negative social consequences (DGB, *Die Quelle* 2, 1993). The Social Democratic opposition went so far as to argue that the new budget law consisted of a severe rollback of the German welfare state and proposed instead the introduction of ecological taxes as well as a new employment pact that would help Germany out of the recession (FAZ 13/10/1993). Interestingly enough, even the small Liberal coalition partner expressed concern for some of the measures adopted, in particular for the abolition of bad weather payments to construction workers. However, Finance Minister Waigel detained a powerful position. While enjoying a majority in the *Bundesrat*, the SPD could in fact alter only 10 percent of the entire package (FT 12/8/1993). The federal government insisted that the cutbacks represented only 1.6 percent of the social security budget (FAZ 23/10/1993), but they were unavoidable (FR 25/9/1993).

Table 9. Fiscal Consolidation Programmes (Mio. DM)

FCP	1993	1994	1995	1996
Expenditures	-310	-1019	-1110	-1124
Taxes	-285	821	31057	36857
Of which Solidarity Tax	-	-	28000	31600
SCGP	**1993**	**1994**	**1995**	**1996**
Expenditures	-	-5789	-9469	-10074
Taxes	-	7900	8700	8800
TOTAL	**1993**	**1994**	**1995**	**1996**
Expenditures	-953	-11914	-17375	-19564
Taxes	-1550	7580	39390	47705

Legend: FCP = Federal Consolidation Programme (federal level); SCGP = Savings, Consolidation and Growth Programme (federal level); TOTAL = refers to the sum of FCP and SCGP for all levels of government.

Source: Sachverständigenrat, *Jahresgutachten 1993/94*, 15/11/1993.

The *Bundesbank* gave further support to fiscal authorities. On 2 December, against the consensus forecast, the bank again decreased interest rates, justifying the move as a response to excessive slow growth (TAZ 3/12/1993). The parliamentary passage of the budget proposal had a greater impact on revenues than it did on spending. The former were set to diminish by 3 billion DM (Bundesministerium 1992). In spite of harsh internal confrontation and of widespread societal criticism, on 20 December, the Parliament finally delivered the budget law for 1994. The fiscal correction resulted at the end of the financial year into a 0.7 percent of GDP improvement in the CA primary surplus with expenditures decreasing for the first time by 0.3 percent of GDP (European Commission 2003a).

Fiscal policy issues continued to be at the heart of the public debate at the beginning of the year. For once, public finance outcomes in the previous year had been disappointing. The resultant net borrowing requirement almost doubled from initial projections, reaching a value of 66 billion DM at the end of 1993 as a result of fiscal decisions taken in 1992 (Bundesfinanzministerium, *Finanzbericht* 1994; SZ 5/1/1994); besides being the highest in German economic history, the deficit value also overshot the public investment share, in full breach of Germany's constitutionally entrenched golden rule. Newly emerged fiscal imbalances created alarm among the business community. The German Chamber of Commerce and Industry (DHIT) asked for a prompt return to fiscal discipline. Most interestingly, the BDI insisted now more than ever on rapid deficit reduction but argued also that this could come only from expenditures. At stake was not the size of fiscal adjustment but its content. The government was asked to cut primary spending, without affecting the level of public investment (FT 1/3/1994).

In spite of an only moderately successful fiscal adjustment, the government had succeeded in passing disputed expenditure restraints. There was the strong belief that this path was to be further pursued. In January, the Finance Ministry submitted a report with the title "Perspectives on Public Spending Policy". Here, officials suggested that housing, carbon policy and pension systems be subject to extensive retrenchment (SVR 1994; SZ 15/1/1994). It was the occasion for Chancellor Kohl to restate his commitment to fiscal discipline and, in particular, to "small government" in the face of the approaching 1994 federal vote. His primary objective was to regain the trust of his natural constituents. Fiscal imbalances were not the only national emergency. The unemployment rate was still on the rise. In the same month, the government delivered the "Action Plan for Greater Growth and Employment", which contained a recipe to improve the country's employment performance. At its heart was tax alleviation, in perfect accordance with requests the BDI had put forward (SZ 19/1/1994). The proposal soon catalysed public attention, becoming one of the central items in the electoral competition between the CDU-FDP and the SPD. The latter rejected tax relief as a means to boost employment creation (SZ 4/2/1994); later on, it would find it difficult to combat the image of a tax-friendly party (SZ 16/5/1994).

On 15 July, the government submitted its annual budget documents. The nominal volume of the intervention was modest, amounting to 9.75 billion DM, of which 4.75 billion were in additional spending and 5 billion in greater public incomes. Electoral concerns may explain the relaxation of fiscal policy. Inevitably, the *real* result at the end of the financial year appeared disappointing, with a 1 percent of GDP increase of the CA public deficit. The outcome was remarkably negative considering the pressures stemming from EMU and the rapid approaching of Stage III. In terms of composition, at the end of the financial year, CA expenditures had increased. On the other hand, revenues decreased by 0.4 percent of GDP, on an adjusted basis (European Commission, 2003a).

If the Kohl Government was probably targeting the median voter, domestic interest groups had remained unsatisfied with the budget proposal. The German business community called the government's plan "half-hearted". The BDI insisted that it was necessary to dramatically revise the role of the state in the national economy (BDI, *Bericht* 1994, 41). The BDA would more explicitly call the costs of Germany's welfare state into question (SZ 18/10/1994). The president of the confederation, Klaus Murmann, stated: "the burden of the welfare state will crush us if we fail to act" (FT 19/10/1994). The stronger the attacks on national social security, the more explicit were the unions' proposals for adjustment. True, the country was subject to a dramatic socio-economic transformation but the actual response to it should take the form of an expansion, possibly in the framework of a reformed welfare state, and not in the curtailment of public spending[26]. Unions asked that the government implement an anti-cyclical fiscal policy (FA 14/1/1994; 17/6/1994). New social expenditures were to be financed through general taxation. Also, an improvement of fiscal

[26] Most surprisingly, the DWI, a government-friendly economic research institute, indicated that lower spending levels would not help Germany out of the competitiveness problem; rather a postponement of fiscal consolidation and a more explicit expansionary monetary stance were needed (SZ 7/1/1994).

administration could serve the purpose of preserving fiscal discipline (DGB, *Der Entwurf des Bundeshaltes 1995 und die Finanzplanung bis 1998* IWS 5/9/1994; SZ 5/10/1994).

In its electoral manifesto, the government coalition reiterated its commitment to fiscal discipline and to a reduction of the role of the state in the national economy (SZ 15/11/1994). The *Bundesbank* seemed to be in support of government action and appreciated in particular tax alleviation measures contained in the long-term financial planning document (SZ 20/10/1994). Still, in spite of the firm opposition of the FDP, it was agreed that the solidarity charge be preserved as this would allow deficit reduction in the short-term (FT 16/11/1994; DGB, *Die Quelle* 11, 1994). The results at the polls reconfirmed the CDU-FDP coalition, yet with a more modest majority than in the previous legislation, with the government having a majority of only 10 seats. In addition, the opposition had further stabilised its clear majority in the Upper House (FT 19/10/1994). The difficult parliamentary passage of the budget law confirmed the political weakness of the re-elected establishment. Again, the pressure was mostly felt on the revenue side of the budget, where tax incomes were set to increase by 5 billion DM from the original plan (Bundesministerium 1993). Business actors were reassured when the *Bundesbank* announced its intention to keep an eye on price stability, but in a way that was not detrimental to output growth (SZ 23/12/1994).

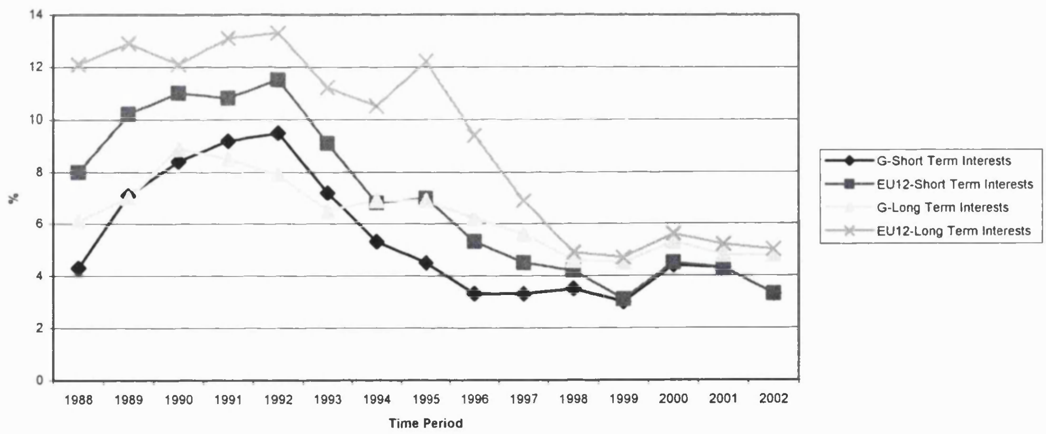
3.2.Fiscal solutions to unemployment (1995-98)

At the beginning of 1995, there was still uncertainty about the future of the German economy. True, the *Bundesbank* had succeeded in keeping inflation under control. In the first months of the previous year, the national central bank agreed to reduce short-term interest rates after a severe restriction in the two previous years. The decision came about because, in the end, fiscal profligacy had not endangered the external stability of the DM, which continued to be an international reserve currency (SZ 3/1/1994; FT 6/3/1995). In turn, monetary policy decisions spilled over to the national exchange rate with beneficial effects for the country's export performance (SVR 1994). In spite of the comforting improvement of exports, the unemployment rate continued to increase. In addition, the lack of a government clear-cut fiscal policy stance was making business actors particularly uneasy. Possibly to compensate its electorate for being reconfirmed in power, the federal government delivered a strategic paper on the future of German fiscal policy, which reflected to a large extent the vision of the BDI and of the BDA. In "Reduction of the Size of the State Up to 2000", the Finance Ministry suggested that, after being subject to considerable upwards pressures, the level of public expenditures be brought back to its pre-1989 level, when the ratio to GDP amounted to 45.5. Smaller government would create the conditions for greater stability and growth. Lower spending would actually allow deficit reduction, while also creating room for tax alleviation (Bundesministerium 1994; Der Spiegel 11, 1995).

In its financial plan and budget proposal for 1996, the Kohl Government projected cuts to nominal expenditures of 25 billion and revenues reduced by 21 billion DM. The shading of the re-unification emergency and the positive response of domestic investment and exports to the *Bundesbank*'s monetary relaxation put fiscal authorities at ease, inducing them to focus more on the quality than on the size of budgetary adjustments. There was widespread awareness that spending restraints represented the only possible road to deficit reduction. In particular, the government believed in the need to send a credible message to financial markets after long-term interest rates had started to grow far above the central bank's short-term rates since 1993 (Graph 14). It is to be noted that the Federal Consolidation Programme envisaged the re-introduction of the Solidarity Charge in 1995. In turn, cyclically adjusted figures at the end of 1996 reveal a situation in apparent contrast to the spirit of Kohl's clearly designed fiscal strategy. Real incomes increased by 1.2 percent and expenditures by 0.7 percent of GDP. The net impact on the federal borrowing requirement was equivalent to 0.5 percent of GDP (European Commission, 2003a).

Modest inflation, lower interest rates, the slight improvement of the German export performance, together with the government's firmer commitment to spending restraints, reassured the business community. The BDI appeared less concerned with fiscal discipline and more with the actual size of the public sector. The level of public expenditures was to go down to 45.8 percent of GDP. At the same time, it was necessary to decrease the country's fiscal pressure, especially at a time in which the DM had slightly re-appreciated (FT 6/3/1995). Both measures would contribute to greater growth and employment creation. Cuts to social security spending would reduce Germany's comparatively high labour costs, halting the recent wave of re-location of numerous production sites to Eastern Europe. Also, tax alleviation would stimulate domestic and foreign direct investment. Against these guidelines, it is no surprise that the Confederation of German Industry expressed appreciation of the government's latest budgetary interventions (BDI, *Bericht* 1995).

Graph 14 Short and Long Term Nominal Interest Rates, Germany and EU 12, 1988-2002



Source: European Commission, Statistical Annex, 2003.

By the same token, the DGB was negative about developments in German fiscal policy. The Finance Ministry was accused of stubbornly insisting on the preservation of fiscal discipline, even at a time in which Germany would need to implement anti-cyclical fiscal policies to offset the continuous growth of unemployment. To be sure, the government's austerity effort went even well beyond the Maastricht constraint itself (DGB, *Abbau der Staatsquote –ein finanzpolitisches Ziel* IWS 30/8/1995). Welfare retrenchment was by no means an acceptable strategy (DGB, *Die Quelle* June 1995). There was not sufficient empirical evidence to demonstrate that large government is always associated with lower growth rates, as the government was arguing in its policy papers. The Confederation expressed also concerns about the recent tax policy initiatives. Finance Minister Waigel's tax reform was targeting high-income groups, while leaving low and middle-income groups unaffected (DGB, *Die Quelle* April 1995). Instead, it was necessary to reduce SSC and the ensuing revenue loss would be offset by the introduction of an energy tax. True, the tax system needed to be reformed and possibly simplified, especially in the area of corporate taxation, but all these measures should have been financially neutral, meaning that more urgent tax relief would still be required (DGB, *Die Quelle* October 1995).

In the same months in which budget documents were being prepared, the Kohl Government intensified talks with the social partners. In the context of the *Kanzlerrunde*, public authorities, representatives of German industry and of labour unions confronted each other on the national unemployment emergency. The intensity of the consultation led the president of the BDA, Klaus Murmann, to talk about a revival of the German traditional social partnership (DGB, *Die Quelle* June 1995). In December 1995, *IG Metall* launched the idea of a social pact, in which unions were ready to exchange wage restraint for employment creation measures. Soon after, the DGB offered its support to the initiative. It was apparent at the outset how this pact differed from those concluded in other EMU candidates to the extent that instead of being aiming at inflation control and deficit reduction, the pact envisaged a possible partial relaxation of fiscal policy through the creation of new public jobs. In the following section, I expand on the details of the pact and reasons for its ultimate failure.

Budget negotiations were again characterised by strong confrontation between the CDU/CSU and the SPD. Social Democrats accused the government of proving incapable of keeping public finances. This left fiscal authorities with little room for manoeuvre. Not only this, but planned cuts to unemployment benefits were not a sign of an expenditure-based consolidation but a transfer of responsibility from the Federal government to regional authorities (FA 6/9/1995). The budget as finally approved differed in its composition from the initial one, with restraints increasing by 2.7 percent and revenue shortfalls by almost 50 percent.

EMU entered the public debate in 1996 for the first time. This is not surprising considering that EMU candidates were asked to meet the Maastricht criteria by 1997. German fiscal authorities were subject to increasing pressures since the country's public deficit had deteriorated in the previous year and was slightly above the reference value in the first half of 1996. Budget negotiations proved particularly troublesome. The Kohl Government restated its commitment to an expenditure-based fiscal consolidation. The DGB criticised the strategy for its potential counter-productive effects. Expenditure cuts would further harm job creation and, in so doing, impinge on social security budgets (Reuters 13/5/1996). Similarly, the Social Democratic opposition threatened to exercise its veto power in the *Bundesrat* (Die Presse 11/7/1996). Tensions arose also in the wage bargaining arena. In 1995, nominal compensations had been well above the average in the previous decade (European Commission, *Statistical Annex* 2003) and employers were suggesting that wage restraint became part of the budget law for 1997 (FT 13/5/1996).

On 10 July, the government coalition submitted its official budget documents for 1997. Net borrowing would diminish by 3.4 billion DM. Again, the fiscal strategy adopted was one that combined expenditure restraints of 11 billion DM with a tax alleviation of 6.8 billion DM (Bundesministerium 1996). With the budget law, the Finance Ministry submitted an extensive tax reform containing measures to reduce tax rates, extend the tax base and improve fiscal administration. Finance Minister Waigel expounded the view that lower fiscal pressure would improve the status of Germany as a privileged business location. The subsequent boost to growth would in turn ameliorate public finance aggregates (Waigel cited in Andersen 1998, 94-97). At the end of the financial year, cyclically adjusted expenditures were lower by 0.9 and public revenues by 0.1 percent of GDP (European Commission, 2003a).

Being to a large extent a reflection of appeals stemming from the German business community, the government financial plan was understandably opposed by labour unions. The DGB restated its belief in the need to relax fiscal policy, the better to face the unfolding severe recession. In the background was a flexible interpretation of the Maastricht fiscal criteria; they held to them only to the extent that they did not force governments into pro-cyclical fiscal policies. A rigorous pursuit of fiscal was likely to aggravate the situation on the labour market (DGB, *Der Entwurf des Bundeshaltes 1997 und die mittelfristige Finanzplanung bis zum Jahr 2000* IWS 10/9/1996; Reuters 31/1/1997; Josselin 2002). Alarm spread across many sectors of the economy. The leader of *IG Bau*, the construction workers labour union, blamed the Maastricht requirements for exacerbating the country's already disappointing employment record (FT 7/3/1997). For the Vice-President of *IG Metall*, EMU membership was not to come "at any price nor at any time" (The Observer 16/3/1997). In particular, the labour confederation was concerned with the socio-economic consequences of Kohl's numerous welfare retrenchment measures targeting the unemployed, families and public employees (The Times 7/3/1997).

The announcement of the Kohl Government's fiscal strategy was sufficient to put a halt to negotiations for a social pact between government, unions and the business community. The DGB withdrew from the project when faced with the Chancellor's firm intention to implement welfare retrenchment measures and to do so through traditional parliamentary channels rather than in consultation with the social partners. Hence, at the basis of the failure of the German social pact was clearly a confrontation over fiscal policy issues (DGB 1996; Pierson 2001). Against such a difficult social atmosphere, parliamentary negotiations over the budget proved also extremely troublesome. Chancellor Kohl was still able to secure for himself an absolute majority in the *Bundestag* and push his welfare cuts through. Finance Minister Waigel indicated it was a "signal for investors" (FT 14/9/1996; 27/9/1996; FA 30/11/1996).

Tax reform became a central theme of the politico-economic debate in 1997. There was large inter-party consensus around the fact that fiscal pressure in Germany had reached unbearable levels, but there was still strong disagreement over the means necessary to finance lower public incomes (Der Steuerzahler 1997 cited in Andersen 1998, 105). The government plan envisaged tax alleviation to a total value of 37.5 billion DM, which included a two-point reduction of the Solidarity Charge. According to the government coalition, lower fiscal pressure would be self-financing because of the expected growth effects. If greater growth were to prove to be insufficient to preserve fiscal discipline, then compensations were to come from the spending side of the budget. The smaller coalition partner FDP particularly perpetuated this latter strategy. Since just after the shock of unification, the Liberals had suggested a mixed strategy of tax reductions and expenditure restraints (Der Spiegel 27, 1997). While in favour of a tax reform of some kind, the SPD opposition rejected the proposal to alleviate fiscal pressure for the wealthy and pressed instead for lower SSC. German Social Democracy did not portray a macroeconomic vision different from Christian Democracy but emphasised the tax system as a valuable redistributive tool[27].

In July 1997, the federal government submitted its financial proposal for the following year, which contained also figures for the just agreed supplementary budget. Expenditures were expected to remain more or less stable and public nominal incomes to grow by 10 billion DM, mainly as a consequence of extremely positive growth projections. The overall planned fiscal effort amounted to 13.4 billion DM, the second largest budget consolidation effort after the one in 1991. The proposal contained also provisions for pension reform and other cutbacks to social spending (Bundesministerium 1997). At the end of the financial year, total CA expenditures had decreased by 0.5 and revenues by 0.2 percent of GDP (European Commission, 2003a).

The preferences of domestic interest groups continued to differ. The BDI complained about the fact that corporate tax rates were comparatively still too high. At the same time, public investment kept on diminishing. True, the federal government had committed itself to controlling social spending growth, and this was appreciated, but no provisions had been made for structural cutbacks (BDI, *Bericht* 1997). On the other side of the spectrum, the DGB criticised the establishment for failing to implement an anti-cyclical fiscal policy in the face of

[27] In a similar fashion, analysing the links between partisan politics and economic policy-making, Boix has indicated that, while unable to pursue deficit spending in the globalisation era, social democratic parties have but continued to favour redistribution and done so by means of alternative redistributive strategies such as tax systems, training, etc. (Boix 1998).

a deep recession. It was necessary to boost public investment and, at the same time, to avoid severe welfare retrenchment. The government's pursuit of unconditional fiscal discipline had exacerbated Germany's economic position, in particular the situation with the national labour market (DGB, *Bonner Finanzpolitik ohne beschäftigungspolitische Impulse* IWS 12/9/1997).

4. Social Pacts: Their Content and Financial Impact

There is an extensive literature arguing that social pacts emerged in the 1990s contributed to successful macroeconomic convergence in most EMU candidates (Ebbinghaus and Hassel 2000; Hancke and Rhodes 2004). The general argument is that wage moderation keeps inflation down, taking short-term interest rates down with it. Where this secures also a depreciation of the real exchange rate, significant growth effects are also expected. In addition, wage restraint is directly beneficial to public finance. Firstly, looking at public wages, nominal compensations per employee will diminish. Secondly, the ensuing low inflation dampens the public consumption bill. While generally convincing, this reasoning fails to address the institutional foundations of these relationships, which make also for the large cross-national variation. Wage moderation is not always sufficient for keeping inflation at bay. In addition, it does not necessarily lead to a relaxed monetary reaction. The ensuing expansion will be greater under floating than under fixed exchange rate regimes. Also, the nature of the monetary response will depend upon the degree of central bank independence. Generally, economists apply sophisticated econometric or, more generally, statistical methods to evaluate the interlocking between fiscal, monetary and wage institutions and policies. Inevitably, their modelling of actors' preferences and behaviour is constructed on an abstraction, being it workers' desire for higher wages or for preserving their jobs. While generally robust in their results, these models miss case-specific features. In the following sections, I will simply describe the specific content and ensuing financial impact, actual or expected, of German tripartite agreements with the aim of unveiling the peculiarities of the case study.

4.1.The content of German corporatist agreements

The initial stimulus to a revival of social concertation came from the need to create a vast social consensus in the face of the unification emergency. The latter represented a sufficiently extraordinary event to force the corporatism-averse CDU-FDP government coalition to come to terms with the unions. Over a couple of years, the bargaining partners concluded a long series of agreements. In the early months of 1991, social partners agreed on the progressive alignment of East and West German wages (Leaman 2002). Differently from social pacts being signed at the same time in other European countries, this accord did not consist of a traditional political exchange. At its heart was the extension of West German labour market institutions to the East. As this measure would not create losers but just beneficiaries, the role of the federal government was not to deliver side-payments but to merely facilitate the dialogue between social partners. The pact did not contain calls in favour of the preservation of fiscal discipline. Indeed, the impact of wage alignment on public finances was deemed to be detrimental. Employees in the East demanded wage increases well above labour productivity growth[28]. With this dynamic came an inflationary potential likely to escalate the public wage and consumption bill.

Similarly conceived to manage the transition of former DDR, the subsequent 1993 Solidarity Pact was open not only to organised labour and capital, but also to the Social Democratic opposition and the regional governments. Having fiscal discipline as one of its explicit objectives, the pact aimed at creating a vast political and social consensus around the need to defend Germany's fiscal virtue in front of the dramatic financial impact of re-unification. Interestingly enough, the most difficult part of the negotiations concerned the ways in which fiscal virtue should be achieved (FT 26/11/1992). The accord lost soon its multilateral character. The Chancellor chose to negotiate with the regions on a federal consolidation programme and dealt separately with labour and business representatives on more directly unification-related issues. At the core of the fiscal consolidation plan was the introduction of a Solidarity Charge of 7.5

[28] In 1992, the annual increase in average real earnings was of 5.5 percent against an annual increase in national labour productivity of 3.9 percent (Federal Statistical Office in EIROnline).

percent on incomes. Deficit reduction was to come from a short-term increase of public revenues. The German fiscal performance for the year figured as the best one over the period 1990-96 with a 0.7 percent of GDP improvement of net borrowing (European Commission, 2003a). On the other side, negotiations with the social partners did not prove an easy exercise, especially in the area of wage and investment policies as all parties involved were hardly inspired by principles of solidarity but by their own self-interest (Lehmbruch in Streeck 1994).

A reconciliation of the preferences of the government coalition and of socio-economic actors proved even more difficult with diverse policy areas at stake at the same time, from wage moderation to labour market and social policies. This was the case with the social pact attempted in 1996, which is the only one comparable to the tripartite agreements established in other EU countries. It was so because, like the latter, the agreement consisted of a traditional political exchange, according to which labour unions traded wage moderation for employment creation measures. After the initial proposal of *IG Metall*, the parties met again at the beginning of 1996 when they adopted a common document known as "Alliance for Jobs and to Preserve German Production Sites". The federal government took over social responsibility for employment, declaring its readiness to use public jobs for redistributive purposes. Also, private employers gathered under the umbrella of the BDA gave their support to job creation initiatives and committed themselves to augmenting vocational training opportunities in the private sector. In exchange, unions would agree to wage restraint and to some labour flexibility, e.g. working time reduction (DGB 5/12/1996 in DWP 1996 www.etuc.org).

Much more contentious were the pact's fiscal provisions. In the document, the Kohl Government restated its commitment to budget consolidation. It clearly indicated that public expenditures had reached an excessive level. It had to be cut back to allow a revival of private entrepreneurship. Unions would not support expenditure restraints. Indeed, they requested that the tightening of criteria to qualify for unemployment benefits were reversed and that statutory pensions, sickness and unemployment insurance would be funded out of general taxation. On the whole, the DGB was not satisfied with the scope of the pact, which the

Confederation was keen to extend. Its position paper reflects the disappointment with the pact's fiscal policy indications and, interestingly enough, identifies in those the reasons for the failure of the tripartite agreement:

> "Statements on the reduction of the public sector share in GNP and consolidation of public sector budgets were contentious. We wanted to link the path to consolidation with growth and jobs. We were successful in ensuring that the corporation tax reforms will be revenue neutral. No discussions were held on further steps aimed at restructuring the tax system with a view to promoting growth and employment. And herein lies the greatest potential for conflict because the German federal government and the employers are essentially relying on a reduction in the rate of government expenditure and on tax breaks for companies to be able to open up more leeway for investment and jobs" (cited in DWP 1996).

The social pact between government, unions and employers was doomed to fail. When in April 1996 the Kohl Government presented an austerity package to Parliament without first consulting the unions, it became clear that the prospect of an agreement with the latter risked vanishing. The proposal envisaged welfare retrenchment measures to a total value of 2 percent of GDP, including such measures as: a fall in unemployment benefits; a reduction of sick pay; less state-subsidised cures; a gradual increase of the retirement age; the postponement of arise in child benefits; and the removal of job protection guarantees for firms with less than 10 employees (The Economist 4/5/1996). It was a declaration of war against labour. The unions reacted by organising strikes and street demonstrations. It was a fatal blow to the country's social consensus. Herbert Mai, president of OETV, the public workers union, acknowledged the end of German social partnership (Der Spiegel 18, 1996). While the BDA would have been keen on an agreement, the BDI complained that Kohl's attempt at social concertation had been a waste of time (FT 25/4/1996). In the end, the DGB refused to sign the so-called "Alliance against Employment".

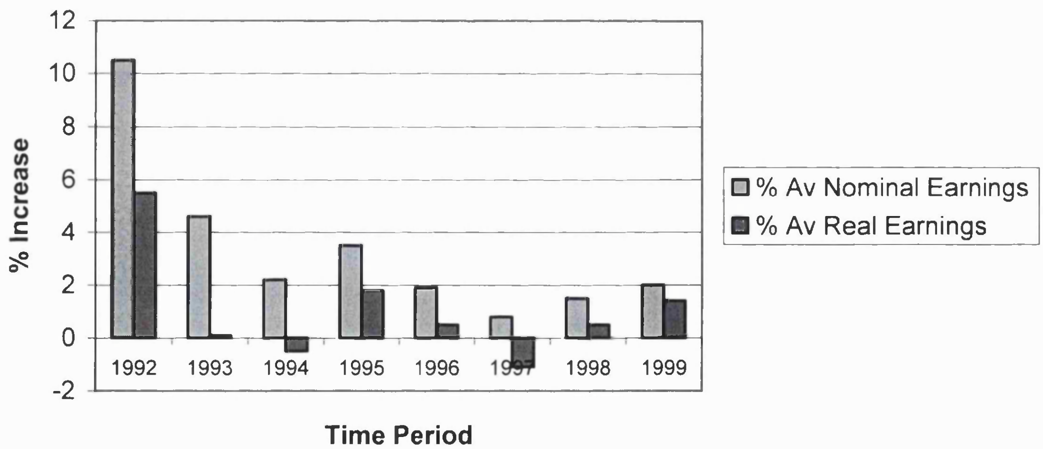
While capital and labour agreed on the need to preserve fiscal discipline, the pact collapsed over their inability to find a compromise over the composition of adjustment. A fundamental limit to the striking of the deal came from the fact that the parties involved had clearly different appreciations of the relationship between fiscal and macroeconomic policies at large. The Kohl administration, together with organised capital, and the BDI in particular, believed in the unconditional desirability of fiscal discipline. Fiscal imbalances had to be eliminated to start with. Growth and job creation could flourish only within a financially stable environment.

By contrast, the DGB supported the view that growth and employment creation were means to balance budgets. At the core of Germany's booming public indebtedness were in fact strains on social security budgets, caused by rapidly increasing unemployment. Fewer employed reduced the incomes from SSC; in addition, the unemployed would put forward their unemployment benefit applications, thereby exercising pressure on social expenditures. Unemployment was in this respect damaging public finances on both sides of the budget. In 1996, labour unions asked the government for a shift from "an ambitious to a moderate fiscal consolidation". The macroeconomic environment was sufficient reason to put in place some demand management. For its part, the DGB suggested working time reduction and wage restraint (DGB, *Alternativprogramm für Arbeit und soziale Gerechtigkeit* IWS 10/6/1996). In turn, the government had to improve public investment towards modernization and the *Bundesbank* to continue preserving an expansionary stance. This brief description of the politics of German corporatist arrangements should have shown that unions had no incentive to accept wage restraint in the framework of a political exchange with fiscal authorities. Along similar lines, the leader of the left wing of the SPD explained that wage moderation would have been acceptable only if accompanied by sensible budget, tax, and monetary policies, and Kohl's were not (FT 10/6/97 cited in (Ulman and Gerlach 2002, 28).

4.2.The financial impact of social pacts

The description of the content - or rather, would-be content - of the German corporatist agreements gives a good indication as to what the real or potential financial impact of the agreements was (or would have been). With the exception of the 1993 Solidarity Pact and the one that failed in 1996, the other agreements did not aim specifically at fiscal discipline. On the other side, it cannot be said that the absence of voluntary wage moderation in the framework of social pacts is responsible for an uncertain hand in the management of public finances. To be sure, Figure 1 shows that real wage increases, with the exception of 1992 and partially of 1995, were nonetheless quite modest overall (Graph 15). Unions accepted wage moderation out of fear that unemployment increased. Because the latter is perceived as an individual rather than a collective risk (Scharpf 1991), fiscal authorities had no need to offer immediate compensations in return. At the same time, the hard-line of the national central bank was credible enough to persuade unions that inflationary wage settlements would be punished with higher interest rate (Hassel 2003).

Graph 15 Germany: Annual Increase in Average Nominal and Real Earnings, 1992-1999



Source: EIRO, Questionnaire for Comparative Study on the Macroeconomic Meaning of Wage Policy in Germany 2000

So, really, it is not the absence of wage moderation, once a social pact has failed, what accounts for fiscal misbehaviour. Rather my contention is that fiscal consolidation was not successful in Germany because it was conducted in a disintegrated fashion, where long time lags existed between one measure and the other and between fiscal interventions, on one side, and monetary and wage policy adjustments, on the other side. This is because the particular macroeconomic environment and the fiscal preferences that domestic groups formed in response to this environment did not offer simultaneous trade-offs, so social partners could not come to an agreement that was satisfying for all. Tripartite social pacts emerged with the purpose of facilitating re-unification and contained by definition spending boosting measures. Only the 1996 social pact was likely to have a positive impact on fiscal discipline but the failure to agree on its content precipitated its collapse.

Having indulged on the details of the politics of fiscal adjustment in Italy and in Germany, the next chapter takes a comparative approach to assess the reasons behind the divergent distribution of fiscal preferences between Italy and Germany. I focus on the determinants of preference formation, which I have identified as being countries' level of public debt and currency regime.

CHAPTER VII

The Societal Base of Fiscal Adjustment: a Comparative Perspective

1. Strategic Configurations and Macroeconomic Contexts

In the previous chapters, I have focused on the possible determinants of Italian and German fiscal performance in the run-up to EMU. The analysis has brought up some interesting results. On a general note, it is manifest that domestic factors continue to be paramount over international ones. While the logic of EMU was inspired by the identification of a single economic policy model that was accepted as optimal and well adapted to the era of internationalised markets, national governments carried on shaping policy formulation and outcomes with the result that fiscal policy never stopped being highly politicised. More specifically, in this thesis, I have suggested that national institutions such as party systems, fiscal and political institutions, and traditions of corporatism are not as important as socio-economic interests in explaining different domestic responses to a common challenge. In this respect, the theoretical bulk of this piece of work consists of the re-appropriation of traditional political economy models.

But what are exactly socio-economic interests? When are they conducive to fiscal adjustment? What shapes them? Under what circumstances are they most likely to be relevant? I have organised this discussion into two large sections. The first deals with the concept of strategic configurations. Using data gathered on the fieldwork, I order the fiscal preferences of Italian and German interest groups, paying attention to their respective relative intensity. The underlying argument is that the particular configuration of preferences in Italy made deficit reduction possible, as there was sufficient room to strike a compromise between the competing interests of labour and capital. The same was not true for Germany, where unions' opposition to welfare retrenchment and business actors' strong refusal of higher taxation made any consensual agreement over deficit reduction highly unlikely. In a nutshell, the configuration of Italian socio-economic preferences was strategic to governments' capacity to consolidate the state budget; the same was not true for Germany. The argument developed here benefits from a game-theoretic interpretation of a set of empirically derived data.

The second section presents an explanation of preference formation. It explains that macroeconomic conditions and their evolution may affect the fiscal preferences of the most powerful domestic groups. More precisely, labour unions and business actors are influenced by debt-to-GDP ratios and currency regimes when taking decisions over their preferred fiscal policy strategy. Under the conditions of capital mobility created in 1990, business actors in high-debt countries across Europe have been generally supportive of budget consolidation, as this was believed to guarantee lower long-term interest rates. The preference in favour of easy monetary conditions is more intense where the exchange rate does not offer a valuable instrument to boost competitiveness, as is the case under fixed exchange rate regimes (e.g. Belgium). While fiscal discipline is accepted as optimal economic policy, politically, organised capital would have to confront labour over the composition of deficit reduction. With a temporarily weak currency capable of fuelling exports, yet at the same time not likely to import inflation once wage indexation is eliminated, business will not question unions' support of revenue-maximising measures (e.g. Italy).

In low-debt countries, distributional issues look completely different. Here, capital has not internalised an "inferiority complex" relative to financial markets. Risk premiums are already low and so are long-term interest rates. Organised capital will look at tools other than monetary policy to expand the level of activity. In the presence of a strong currency where devaluation is not an option, fiscal measures remain the only instrument available to trigger growth, even if only through supply-side reforms. In turn, capital and labour would compete fiercely against each other before any stabilization measure is implemented (e.g. Germany). Competition is only partially softened there were there is some scope for devaluation, yet this might not be sufficient to keep export-oriented sectors at bay, leaving the battle over the distribution of the adjustment burden unsolved (e.g. Portugal).

1.1.The distribution and intensity of fiscal preferences

The extensive empirical investigation at the basis of the previous chapters allows me to build hypotheses about the exact distribution of fiscal preferences in Italy and Germany. I have argued that the domestic constellation of socio-economic preferences is paramount in affecting the chances of reaching a compromise over fiscal adjustment between competing groups that is by and large satisfactory for all stakeholders. In Italy, labour and capital met under government supervision. The three parties signed up to a political exchange in which public authorities offered unions the opportunity to determine, to a large extent, the content of fiscal packages. Business actors accepted these terms because, first, they had already obtained wage moderation and, second, their priority was to get an extensive adjustment as a means to improve Italy's credibility on financial markets regardless of its specific composition. To better appreciate the relationship and ranking between different preferences, I have distinguished between high-, moderate- and low-intensity preferences. Only within specific configurations is the identification of a common denominator possible. This exercise was feasible in the case of Italy, but not so for Germany. Here, the absence of a common denominator hindered any political exchange. In Germany, the distribution of preferences and the distinction between high, moderate and intense preferences will shed light of this aspect. The following section analyses the Italian case.

Italy

The Confederation of Italian Industry was typically in favour of fiscal discipline as this was associated with small government. According to *Confindustria*, high public debts deprived producers of legitimate resources, thus hindering private investment and growth. In this sense, the Italian State was believed to be responsible for the country's modest competitiveness since the late 1970s. Historically, employers have covered on average 75 percent of Italy's high non-wage costs, which were driven by an overly generous and badly organised welfare state. In addition, public wages were comparatively high with consequent spillover effects into the private sector. The State proved also unable to provide proper infrastructures, and various administrative inefficiencies led to high compliance costs. Not only did these factors function as a straightjacket for domestic producers, but they also reduced Italy's attractiveness as a business location (www.confindustria.it, November 2004). This position reflects *Confindustria*'s strong neo-liberal orientation and generalised plea for small government. A balanced budget would be a sign of improvement in economic policy management allowing a more efficient allocation of resources.

In the 1990s, the Confederation's concern with competitiveness came to the forefront. The completion of the SEM was well under way. It implied the abolition of all barriers to trade and was increasing competitive pressures for everyone. Business across Europe was struggling to think of innovative ways to boost competitiveness. Competitive devaluations had been in use for two decades but seemed to have outlived their usefulness in the sense that Italian business was no longer fully convinced of their capacity to generate growth (FT 7/7/1992; Corriere della Sera 9/9/1992). In fact, devaluations had exacerbated the country's inflation problem. Price levels continued to grow in a spiral also because the operation, since 1975, of a wage indexation system amplified the negative consequences from imported inflation, leading eventually to greater wage costs. The rise of production costs in the medium-term was thus completely absorbing the gains from short-term export-led growth. Policy failure, together with the emergence of new reputable studies about the undesirability of devaluation, contributed to forging a general disbelief in the usefulness of the exchange rate for business purposes (De Grauwe 2003).

Very few alternatives remained to improve Italy's competitiveness. One was a more business-friendly fiscal policy. It was necessary to reduce primary public expenditures with the purpose of creating sufficient room to then lessen the fiscal pressure. Fiscal discipline was thus desirable in improving the economic and institutional environment in which producers operated. The second significant instrument was wage moderation in the form of the elimination of the *scala mobile*, responsible for the uncontrolled growth of nominal wages. *Confindustria* believed quite realistically that, as opposed to fiscal consolidation, wage restraint had the advantage of being immediately available once the parties had agreed on the elimination of indexation. By controlling inflation, wage moderation would simultaneously reduce interest rates, making money less costly. Not only would the availability of credit support investment initiatives; it would also exercise a positive impact on state budgets to the extent that it lessened the value of interest payments (Sole24Ore, various issues). In a nutshell, the support for slower wage growth was paramount but it went hand in hand with the need to adjust fiscal imbalances. The fact that *Confindustria* represented both national producers and employers explains why wage moderation was never put forward in a vacuum but always connected to major issues, such as fiscal pressure, welfare reform and public investment.

Against this background, the Confederation's support for extensive budget corrections in the early 1990s comes as no surprise. The official elimination of the *scala mobile* in 1992 had not been sufficient to convince the Bank of Italy to reduce interest rates. True, there were signs of a slowdown of inflation, but the national central bank was still not very receptive to wage and price developments because it was preoccupied with other overwhelming concerns and, above all, by the country's high public debt[1]. The latter made a policy of comparatively low interest rates not feasible, in the short-run at least. In turn, Italian monetary authorities were influenced and constrained by the perception that financial markets had of Italy's fiscal situation. *Confindustria*'s intensive preference in favour of large credible deficit reduction stems from the belief that successful budget consolidation would send a credibility message to markets allowing for an externally induced reduction of interest rates. This opinion was even more intense in 1992 and in 1994 when, in the wake of a vast political and financial crisis, markets turned pessimistic about the future of the Italian economy, as reflected in the rapid increase of long-term interest rates. The bottom-line is that the acknowledgement of Italy's lack of an independent monetary policy diverted business actors' attention to outside markets. This explains also why the Confederation was more concerned with political stability than with the actual colour of government, as well as why it was generally more inclined towards moderate party configurations (Il Mondo 7/1/1991; 5/8/1991; Mattina 1992).

[1] For example, Banca d'Italia became officially independent just in 1993.

Second was *Confindustria*'s support for welfare cuts. Capital representatives supported strongly the view that fiscal imbalances should be tackled on the side of the budget where they originated. They called for a reduction of primary expenditures on public employment, pension and health care (Pininfarina 1992, 478). Behind this plea was the aforementioned belief in the superior economic performance of small government. Moreover, it was believed that the structural reform of spending programmes would be perceived by financial markets as a sign of serious commitment to adjustment, and a guarantee of the sustainability of fiscal discipline for the years to come. Markets' appreciation of Italy's reform policies would initiate a virtuous circle, allowing the country's risk premium and hence its interest rates to decrease (Sole24Ore various issues). It was again the strong dependence on external markets that shaped *Confindustria*'s interests. Finally, had the government really succeeded in passing welfare cuts, tax increases would not be necessary for the purpose of budget consolidation, thus supporting also one of the organization's moderately strong preferences. Still, business actors were certainly aware of the powerful veto unions would exercise on welfare retrenchment. In this respect, their immediate interest was in seeing the public deficit fall and in negotiating as much as possible over any attempt to increase taxes. Only with revaluation of the Lira within the ERM bands in November 1996 did the opposition to higher fiscal pressure move into the first position, leaving fiscal discipline as the least intensive preference.

At the same time, the Confederation opposed greater fiscal pressure. Overall, in 1991-98, there is no clear-cut hierarchy between the opposition to tax increases and the support for welfare cuts. Especially when consisting of increased social security contributions or direct taxes, greater fiscal pressure had the effect of increasing production costs but also dampening private consumption so that the whole production process was negatively affected both on the supply and the demand side. In addition, the consequences would be immediately felt on the trade balance, as exports would diminish. With competitive pressures increasing as a result of the recent completion of single market, tax competition in Europe was more of an issue, although national sensitivities and the reactions to it varied extensively from country to country. The opposition to tax increases was only moderate since a depreciated Lira in 1992-96 offered a temporary solution to preserve the country's competitive performance. While it is true that, since the late 1980s, *Confindustria* had been conscious of the limits of competitive devaluations, the shift from fixed to *de facto* flexible exchange rates in September 1992 opened up new opportunities and was thus welcome[2]. Under flexible exchange rates, the need for rapid fiscal consolidation became in turn an absolute priority, to the extent that if interest rates continued to be relatively high, this would progressively minimise the depreciation of the Lira with more investors interested in taking advantage of high returns on currency investments (Walsh 2000). In this respect, business actors were well aware of the interlock between fiscal and exchange rate policies.

As in most European states, Italian labour unions had played a significant role in the formation of the national welfare state. Since the late 1960s, they had supported the implementation of numerous public spending programmes as well as the introduction of the Workers' Statute, which provided wage earners with additional guarantees and rights in front of employers (1970). In the periods of social concertation, labour unions accepted wage moderation in exchange for social benefits, thereby exercising an indirect pressure on social spending levels. Only at times of dramatic economic turbulence did Italy's three largest union confederations consciously consider the impact of their demands on the state budget (see Chapter III).

If, in the past, unions' opinion of fiscal discipline had been conditioned by the contingent macroeconomic situation, in the 1990s, CGIL-CISL-UIL were less ambivalently in favour of budget consolidation. It was generally recognised that Italy's high public indebtedness was responsible for high interest rates. By dampening private investment, the excessive cost of money had worked against employment creation. On this front, CGIL-CISL-UIL and *Confindustria* shared an identical position. Fiscal imbalances had also led to high inflation. Unions and employers had been negotiating over the abolition of the wage indexation system since 1983 when the employers' association obtained a few concessions. The approach of the expiration of the 1975 agreement on the *scala mobile* due in

[2] Even government authorities recognised that the devaluation, while not intentionally induced, ended up offering some leeway (Ciampi 1996).

December 1990 made unions realise that, in the absence of wages' automatic adaptation to actual inflation, other measures would be necessary to guarantee that in fact inflation did not rise. Budget consolidation could be one of the most effective means to keep interest rates and inflation under control.

In July 1992, after an intense internal confrontation, CGIL-CISL-UIL signed the agreement for the elimination of the wage indexation system. Mounting speculative pressure on the Lira created great alarm and convinced recalcitrant unions of the opportunity of wage restraint. Stefano Patriarca, head of the CGIL economic department, explained that his union's decision to sign the agreement, in spite of fierce opposition from the rank-and-file, had a strong economic rationale. It aimed at preventing the devaluation of the Lira (CGIL, *NRS* 8, 28/9/1992). It was believed that booming inflationary pressures would completely offset the gains from export growth. Of the three confederations, the CGIL was the most sensitive to inflation differentials since its membership was denser in export-oriented sectors. In addition, devaluation would increase the burden of foreign denominated debt and be particularly detrimental to budget consolidation. It is interesting to note that, with the elimination of wage indexation, Italy's labour unions were more strongly committed to the consolidation of public finances as a means to keep inflation under control. In this respect, they had no interest in jeopardising governments' attempt at fiscal adjustment.

While the support for extensive budget corrections was there, and was very intense for the reasons highlighted above, there was a moderately strong preference against welfare cuts. Having already had their arms twisted into wage moderation, CGIL-CISL-UIL had no intention of suffering in parallel from welfare retrenchment. True, all of them were going through a radical internal change coinciding with the embracing of new ideas for welfare reform. Having been for two decades the most ardent defenders of the *status quo*, union confederations started being concerned with the sustainability of the national welfare state. However, they advocated qualitative policy change. For example, they would support a rationalisation of public expenditures if this meant eliminating unjust and unfair practices locked in the system, securing greater equality. They could not accept unconditional bold expenditure restraints put in place with the purpose of balancing the state budgets or, worst, of deliberately retrenching the welfare state. Rather than stemming from the need to save public money, any adjustment to welfare programmes had to be implemented against a vision that took sustainability into consideration.

By default, CGIL-CISL-UIL supported a revenue-based fiscal consolidation. They insisted on the creation of a more equitable tax system where the self-employed would be subject to the same fiscal duties as dependent workers and where tax evasion and elusion were eradicated. While they did not oppose direct taxation if changes were progressive, they were less inclined to accept an increase in indirect taxation because of its inflationary potential.

Table 10 offers an overview of the distribution of fiscal preferences and of their relative ranking according to intensity. It is manifest how deficit reduction was possible because both capital and labour could have their first preferences satisfied. *Confindustria* obtained extensive yearly budget corrections. CGIL-CISL-UIL would be compensated with less welfare cuts than would otherwise be necessary. They gained a free hand in determining the content of fiscal adjustment, which in fact turned out to be largely revenue-based from 1992 to 1996.

Table 10. Italy: the ordering of fiscal preferences 1991-97

	Confindustria	**CGIL-CISL-UIL**
HIGH INTENSITY	Fiscal discipline	Fiscal discipline
MODERATE INTENSITY	Support for welfare cuts/ Opposition to ↑ tax	Support for ↑ tax/Opposition to welfare cuts
LOW INTENSITY	Opposition to ↑ tax	Opposition to welfare cuts

Source: Computed by author by means of content analysis and interviews (84 observations).

Germany

Like other business confederations in Europe, the BDI had a strong preference for fiscal discipline, as suggested in Table 11. As in the Italian case, it was perceived that balanced budgets signalled that the government's intrusion in the market was kept at its minimum. The marked independence of the central bank and its punitive behaviour in the face of excessive fiscal imbalances also meant that any deficit spending would be automatically followed by interest rate increases to the detriment of investment activities. It is therefore not surprising if, in the face of re-unification, business actors continued to strongly support the goal of sound public finances (interview with BDI). In particular they feared that a loss of fiscal rectitude would induce the national central bank to reduce the money supply, as initially happened. It is interesting to note however that, on this particular issue, the BDI and the BDA did not speak with one voice. The employers' association did not share the same obsession with interest rates that producers did. Their absolute priority was a stability-oriented policy that would keep the external value of the DM stable even at the cost of higher interest rates (BDA 1992).

Second came the opposition of organised capital to tax increases. As was the case for Italy, German business perceptions had been importantly reshaped by the completion of the internal market in 1992. Competitiveness was a national concern in a country that had been benefiting since the post-war period from export-led growth. Moreover, in the period 1989-93, profitability in manufacturing had declined to 22 percent of gross value-added from 24.2 in 1984-88 (Glyn 1996 cited in Carlin and Soskice 1997). This explains why producers were particularly sensitive to any fiscal intervention that would further undermine competitiveness. On top of that was the fact that the unavoidable monetary restriction following unification-induced deficit spending led to an undesirable appreciation of the DM. Besides a general criticism of greater taxation, organised capital and employers in particular vehemently condemned the continuous increase in non-wage labour costs, caused mainly by the transfer of West German labour market institutions to the East. Greater SSC meant greater tensions over wage bargaining for employers. Indeed, econometric calculations confirm that workers incorporated higher contributions into their wage demands (Tullio and al. 1996).

With a strong preference in favour of fiscal discipline and an almost equally intensive opposition to tax increases, the BDI and BDA were naturally supportive of an expenditure-based budgetary consolidation, believing in the need to trim back public administration as well as the excessively expensive welfare state. Welfare retrenchment would exert numerous positive effects. First, it would provide financial stability since a large part of the country's public deficit originated in social security budgets. Second, it opened up room for tax alleviation in a period in which both consumption and investment needed to be boosted. In addition, as regards labour costs, tax alleviation coincided with an improvement in the country's international competitiveness. The latter was a reason for serious concern throughout the 1990s, when Germany's share of world exports decreased from 11.5 percent in 1991 to 9.3 percent in 1997 (AMECO Database). Moreover, there was a general belief that only an expenditure-based consolidation would show to financial markets that unification had been handled properly.

On the other side of the spectrum, the preferences of German labour unions were conditioned by a genuine belief in the superiority of Keynesian economics (interview with DGB). By no means should the Federal state respond to the unification challenge with a fiscal restriction. On the contrary, authorities were called upon to make new spending commitments in order to support transition. This would pre-empt future strains on social security budgets, thereby guaranteeing financial stability in the long- rather than in the short term (*Die Quelle*, various issues). Moreover, especially during the 1993 slowdown, they insisted on the fact that it was the state's role to get the country out of the recession. Given the slowdown, consolidation should be postponed. Differently from Italy, economic agents did not expect that fiscal restriction would be immediately followed by looser monetary conditions. First, especially after 1993, the money supply was considered sufficient, hence monetary conditions were favourable to start with. Second, the country's hard currency regime excluded any significant monetary relaxation *a priori* as this would endanger the external value of the DM. Unions' support of fiscal discipline was then their less intensive preference. They were rather more concerned with anti-cyclical fiscal policies; and this was even more evident after 1995, once unemployment rates had reached historically highs, creating great alarm amongst labour representatives.

Linked to this is the fact that the trade union confederation opposed above all spending cuts, especially if imposed on the welfare state. Faced with the recession, expenditure restraints were first of all against traditional Keynesian policy recipes. Secondly, with unions having offered an important contribution to the creation of the German welfare state after WWII, its curtailment would also inflict a wound on their socio-political status. As in other European countries, the DGB was rather in favour of the preservation of the *status quo* (Brugiavini, 2000) and suspicious of any welfare reform pursued just with the aim of putting state coffers in order.

Table 11. Germany: the ordering of fiscal preferences 1991-97

	BDI-BDA	**DGB**
HIGH INTENSITY	Fiscal discipline/Opposition to ↑ tax	Opposition to welfare cuts
MODERATE INTENSITY	Opposition to ↑ tax	Support for ↑ direct tax
LOW INTENSITY	Support to welfare cuts	Fiscal discipline

Source: Computed by author by means of content analysis and interviews (78 observations).

Their second most intense preference was for a rise in general taxation that would allow all citizens to take part in the financing of unification after a substantial rise in labour taxes in 1990-92. They thus supported a revenue-based consolidation but made clear that this should be pursued by raising wealth taxes and income taxes in a progressive fashion. In fact, besides SSC they also opposed indirect taxes to the extent that they affected only low-income groups and were thus not equitable in their impact (DGB, *Die Quelle* April 1993). It is interesting to note that, in sharp contrast with their Italian counterparts, unions were less concerned with the potential inflationary impact of fiscal pressure. With the DM continuing to be a strong stable currency, export-oriented unions such as IG Metall were not concerned with inflation differentials (interview with DGB)[3].

1.2. Explaining preference formation: macroeconomic environments

This section focuses on the two most important cleavages around which domestic preferences aggregate. The first one is the divide between high- and low-debt countries. The fact that Italy and Germany carried different risk premiums on financial markets is relevant in that it affected governments' room for manoeuvre during fiscal adjustment. My underlying argument is that the less credible Italian economy had a potential for catching-up that the stronger well-established German system did not have. This point is corroborated by purely economic studies showing that, when embarking on the consolidation of public finances, high-debt countries are more successful than low-debt countries because of the pressures that derive from a weaker starting position. To be sure, it is not only a question of debt–to-GDP ratios. Inflation and interest rate differentials also exercise an impact on domestic preference formation to the extent that they affect the relative credibility of national economic systems and, in particular, competitiveness.

The second important cleavage here considered revolves around the distinction between soft- and hard-currency regimes (this links back to the argument on inflation and interest rates). Italy and Germany have favoured almost completely opposing currency regimes. Before 1996, the Lira was traditionally a weak currency, both because successive Italian governments did not refrain from using competitive devaluations to fuel exports, and because high debt burdens and two-digit inflation rates compromised its credibility on financial markets. On the contrary, Germany prioritised currency stability. This preference was enshrined in the statute of the *Bundesbank* and translated in the country's aspiration to

[3] The strength of the DM even in the midst of uncertainty provoked by unification was reassuring to unions, who associated a weak currency with the loss of wages' purchasing power. No surprise then that with the approach of EMU, public authorities insisted on the fact that the Euro would be at least as strong as the DM (Der Spiegel 47, 1996). This was seen as part of the contract between the government and rather sceptic public opinion.

become an anchor currency in Europe, as Chancellor Helmut Schmidt made clear during the negotiations for the EMS in 1979. As happened later on during EMU negotiations, the rationale for the request was the refusal to adapt to policies conducted in soft-currency countries (Kaltenthaler 1998).

The low/high-debt divide

I have come to the conclusion that high debt burdens represent a strategic advantage during fiscal adjustment and, particularly so, when this is imposed from the outside. Highly indebted countries have the option of obtaining curtailment to their public deficits through credibility gains on financial markets, whereby large budgetary corrections convince markets that the government is seriously committed to fiscal discipline[4]. In turn, market-generated lower interest rates allow savings on total interest payments. By way of example, Italy's nominal long-term interest rates fell by 8.6 points in the period 1991-99, and by only 4 points in Germany. This shows that markets supported deficit reduction in Italy. This is better visible in the evolution of implicit interest rates (ratio of interests to gross public debt)[5], which fell by 7.2 percent in Italy but by a more modest 2.7 percent in Germany during the EMU convergence process (AMECO Database). From a political economy perspective, the important implication is that high-debt countries dispose of ways to make fiscal consolidation less unpopular than it would otherwise be. Not only have financial gains in the form of lower interest payments almost non-existent distributional implications – being thus unproblematic - but they also release unanticipated resources for more urgent needs.

[4] The impact of fiscal policy on long-term interest rates has been subject of extensive investigation but research results have varied from those recognising the existence of important effects (Canzoneri et al 2002) to others suggesting that their quantitative significance is small (Mountford and Uhlig 2000; Perotti 2002). Overall, there seems to be agreement on the fact that, in high-debt countries, such effects are amplified; hence they would nonetheless be significant in one way or another. In a recent panel-data study, it has been suggested that the effects of deficit increases on interest rates are quite evident and that changes to the debt stock have a more-than-proportional impact on interest rates when the debt burden is large to start with (Ardagna et al 2004).

[5] This measure controls for the fact that the share of interest payments to GDP depends on the debt ratio to start with, hence for the fact that it is a slightly endogenous figure.

Moreover, in the new scenario opened up by the completion of the Single European Market (SEM), export-oriented interest groups - arguably both employers and employees (Swenson 1991) - will develop a strong resistance against excessive interest rate and inflation differentials because of their impact on international competitiveness. In high-debt countries, where debt burdens have accumulated over years or decades, export-oriented producers and employees will more firmly push for rapid fiscal adjustment as this lowers price levels and interest rates[6]. As will be further explained below, this preference will be more intense there where the currency regime does not allow the maintenance of a competitive edge. To sum up, there are three aspects common to high-debt countries that are at the basis of this paradoxical type of comparative advantage: risk premiums, inflation and interest rate differentials.

As to the first, the departing point is that high-debt countries suffer from a lack of credibility on financial markets with the consequence that their liabilities are overburdened with risk premiums. When judging on the likelihood of default, market participants tend to rely on a pretty concise set of macroeconomic indicators: deficit and debt levels, but also inflation and foreign exchange rates (Mosley 2003, 55). International investors have traditionally showed little trust in the potential of the Italian economy so that the country's risk premium was comparatively high, at least until the 1990s when the verbal commitment to EMU membership was sufficient to improve credibility (Gilbert 1994). The downward sloping yield curve in Graph 16 shows that this effect became visible after 1994. The financial market channel was extremely important for the Italian experience with fiscal adjustment. Even policy-makers admitted explicitly that they had been playing with the markets (Ciampi 1996; Bianchi in Bernardi 1995). On the contrary, in Germany, government authorities had little to expect

[6] Again, it is not necessarily true that unbalanced fiscal positions lead to above-average interest rates and inflation levels. Empirical studies explain that this has certainly been the case for countries with dependent central banks. First, where the national central bank is obliged to monetize the public debt, excessive money supply leads to inflation. Italy was victim of this until 1981 when the Bank of Italy "divorced" from the Treasury (Grilli et al. 1989; Fratianni and Spinelli 1997). Second, a poorly credible dependent central bank does not prevent unions from restraining wage demands to the extent that they will not believe in monetary authorities' ability to keep inflation under control. And indeed, Italy suffered historically from the fastest inflation in Europe. In 1971-80, the country's average annual price deflator amounted to 14.9 percent of GDP against Germany's 5.2 percent (European Commission 2004).

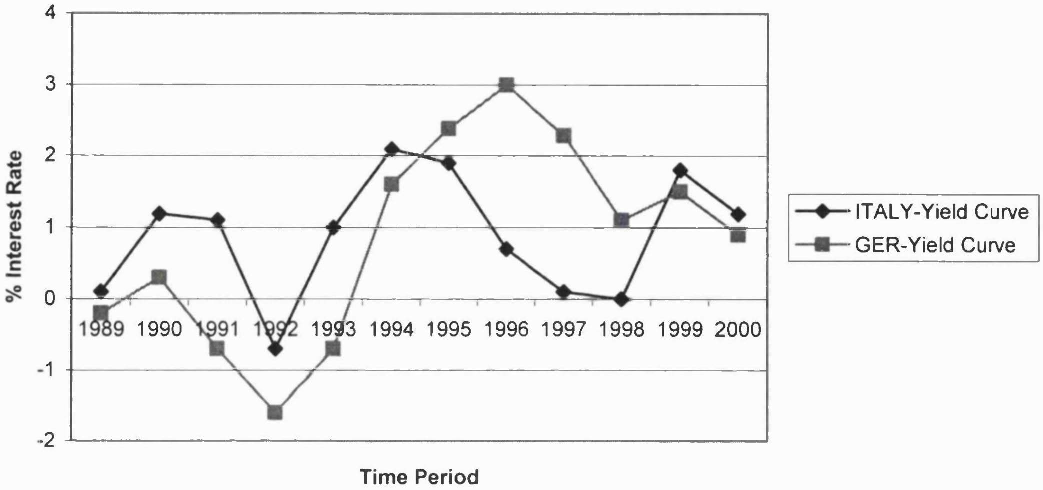
from financial markets. Not only was public indebtedness historically low, as were interest and inflation levels, but not even the shock of reunification had the effect of initially pushing the country's risk premium up. Quite on the contrary, the negative yield curve in 1991-93 is indicative of financial markers betting on the benefits of reunification (Graph 16).

What about interest rate differentials? With the completion of the Single Market, the fact that high-debt countries had significant interest rate differentials vis-à-vis other EU member states represented a potential constraint on competitiveness. As suggested throughout this piece of work, past policies exercised feedback effects on domestic socio-economic interests, and business actors as well as trade unions lobbied for less restrictive monetary policies there where interest rate differentials were high. Lower interest rates provided multiple advantages. First, they would improve competitive performance in a context in which devaluations were either unfeasible or undesirable. Second, they supported investment and employment. With central bank independence being adopted across Europe as the most desirable institutional setting, the only way to obtain a benign (*read* relaxed) response from national central banks was by lobbying fiscal authorities for severe fiscal adjustment. Thus, interest groups in high-debt countries have strong incentives to desire fiscal discipline in the back of deeper economic integration (e.g. SEM). And indeed the Italian *Confindustria* was firmly advocating a relaxation of monetary policy in the belief that this would narrow differentials. This preference became even more intense once the Lira abandoned the ERM and comparatively high interest rates risked provoking an appreciation of the currency, given also that capital controls had been eliminated[7]. On the other hand, with the DM being the anchor currency of the ERM, Germany was dictating interest rates in Europe rather than having to passively suffer from differentials vis-à-vis other EMS members. In that respect, monetary policy mattered only because of its implications for domestic investment decisions. In relation to the outside, the business community supported a monetary policy

[7] In the real world, this eventuality did not come to pass. Persistent inflationary pressures together with the country's considerable debt–to-GDP ratio continued to constrain the Lira's attractiveness in the face of international investors, thereby preventing excessive currency appreciation (Giorganni 1997).

geared towards a stable DM only if this did not compromise domestic price stability (Kaltenthaler 1998, 31).

Graph 16. Yield Curve, Germany and Italy (1989-2000)



Source: European Commission, AMECO Database (last reviewed May 2005)

Thirdly, as already suggested above, comparatively high interest rates lead to above-average inflation. Where a country has the chance to control inflation domestically, then it is also likely to obtain credibility gains on financial markets if it is true that the risk premium is driven by inflation rates as much as by deficit and debt levels (Mosley 2003). With the elimination of the wage indexation system in 1991/92, Italy was set on the right footing to adjust its inflation rate to the EU average. And here consensus-building practices in the framework of the 1992 and 1993 Income Policy Agreements can be hardly overstated. Consensual wage restraint gave a fundamental contribution to macroeconomic adjustment. Deficit reduction would accelerate this process; lower interest rates dragged inflation rates down. Because of their impact on international competitiveness, smaller inflation differentials after 1992 supported the cause of export-oriented producers within *Confindustria*[8]. Converging inflation at the EU level also

[8] Italy proved very successful when it came to converging to EU inflation levels. In 1971-80, the country's price deflator was clearly higher than the European average. Some adjustment took place already in the 1980s where the annual average GDP price deflator went down by 30 percent

offered an advantage when it came to perceptions. Real economic fundamentals were being unveiled at the same time that inflation differentials narrowed, with the result that actors started getting a clearer perception of the real links between fiscal, monetary and wage policies.

It is to be noted that aversion to inflation had not always been there and that changes to the macroeconomic environment in the 1990s had an important effect on preference formation. Since the 1970s, Italy had managed to maintain the proportion of exports to GDP relatively stable in spite of the large inflation differentials, the progressive decline of manufacturing and the weakness of technological innovation. Competitive devaluations – also in the form of the realignments within the EMS after 1979 - allowed for the preservation of short-term competitiveness. In the late 1980s, this favourable set-up began to crumble. In 1988, the Bank of Italy turned to a restrictive monetary stance. Moreover, in the same period, the project for the completion of the single market was going ahead. Deeper European economic integration would increase competition from outside producers.

The soft/hard-currency divide

The underlying argument made with respect to the role of currency regimes is that, in the presence of weak currencies, windows of opportunity open up that allow a reconciliation of the interests of capital and labour. Once the social partners have all recognised the need for (rapid) fiscal adjustment, business actors will be more inclined to accept unions' suggestions for a revenue-based consolidation as the costs of higher fiscal pressure are offset by the advantages that derive from currency depreciation. Panel data combining EU figures on fiscal adjustment episodes and exchange rates seem to confirm this point. In the 1990s, most soft-currency EMU candidates opted for revenue-based budget consolidations (e.g. Ireland, Italy, Portugal, Spain, Greece). In 1991-2000, exports of goods and services grew to a larger extent in weak-currency countries, even if they were at the same time intervening heavily on the revenue side of the budget. In Ireland, Italy and Greece, exports grew by an annual average of 15,

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from the previous period. Yet, in the decade from 1991 to 2000, the annual average deflator was lowered by 65 percent from the preceding decade (European Commission 2004).

9.4 and 8.1 percent of GDP respectively against an average of 6.8 percent in the EU 12 (European Commission 2004). Fiscal pressure was not perceived as detrimental to competitiveness given that a weak currency allowed the share of exports to GDP to remain constant or even to improve.

Qualitative analysis further corroborates this line of argument. My study of official documents and a set of interviews have revealed how Italian socio-economic actors acknowledged such a compensatory logic to be in place. After having supported exchange rate stability in 1988-91, *Confindustria* began to advocate the devaluation of the Lira. Considering Italy's ERM membership, this coincided with the request for a shift from fixed to flexible exchange rates. Under the pressure of strong speculative attacks, the Lira abandoned the ERM in September 1992. At the same time, the Government was asked to commit to fiscal discipline. Business actors were well aware of the interlocking between fiscal and exchange rate policies. They believed that a move to a flexible exchange rate regime would not damage Italy's competitiveness because lower interest rates as a consequence of fiscal consolidation would prevent an excessive appreciation of the Lira (see also Walsh 2000, 130-7).

While probably being able to alleviate distributive conflicts, currency depreciation can potentially undermine fiscal adjustment through two channels. First, when the debt is denominated in foreign currencies, depreciation amplifies the value of a country's debt service. However, the largest part of Italy's debt belonged to domestic investors. Less than 10 percent of the debt issued during the 1990s was denominated in foreign currencies (European Commission 1998). Second, depreciation can lead to imported inflation, in the short-term at least when domestic production profiles cannot be altered. As a consequence, government consumption can become more costly; in particular, public wage settlements may reflect the adjustment to higher inflation. After 1992, the elimination of the wage indexation system prevented a weak Lira from endangering the process of budget consolidation[9].

[9] Along similar lines, Lane and Perotti indicated that, when accompanied by a flexible currency regime or by devaluation, fiscal adjustments are associated with export growth; hence they have expansionary (non-Keynesian) effects (Lane and Perotti 1998). More recently, Lambertini and

A look at exchange rate developments also sheds light on the German experience where the situation was, in this regard, dramatically different. Since the early 1970s and until the advent of the Euro, the DM had been used as a trading, investment and reserve currency. Competitive devaluations were not a viable policy option nor had the *Bundesbank* the intention of endangering domestic price stability by means of beggar-your-neighbour exchange rate policies. First, the currency was extensively used in international trade so that most invoices and transactions were denominated in DM. Second, it played an important role on international financial markets. In the 1970s and 1980s, capital controls guaranteed that demand of DM did not cause excessive currency appreciation. Finally, the DM functioned as the second most important reserve currency after the US dollar (Gebhard 1998, 139-173). The hegemonic role of the German currency in international monetary relations prevented public authorities from using the exchange rate as an economic policy instrument and/or as an instrument for redistribution. Consequently, in spite of the unification shock and the uncertainty surrounding its medium-term impact, the hegemony of the DM remained unquestioned until 1999.

Currency regimes are also influential because they link back to the risk premium. Italy suffered from low credibility on financial markets also on the back of a widespread perception that the Lira was a weak currency. With risk premiums being also attributed on the basis of currency risks, long-term interest rates continued to be comparatively high even in the early 1990s, in particular in the months between 1991 and 1992, when it had become clear that Italy would not be able to support the ERM exchange rate any longer. That was a period in which the catching-up potential was still large. Financial markets supported successful fiscal consolidation only after 1994, once the more realistic prospect of Italy's

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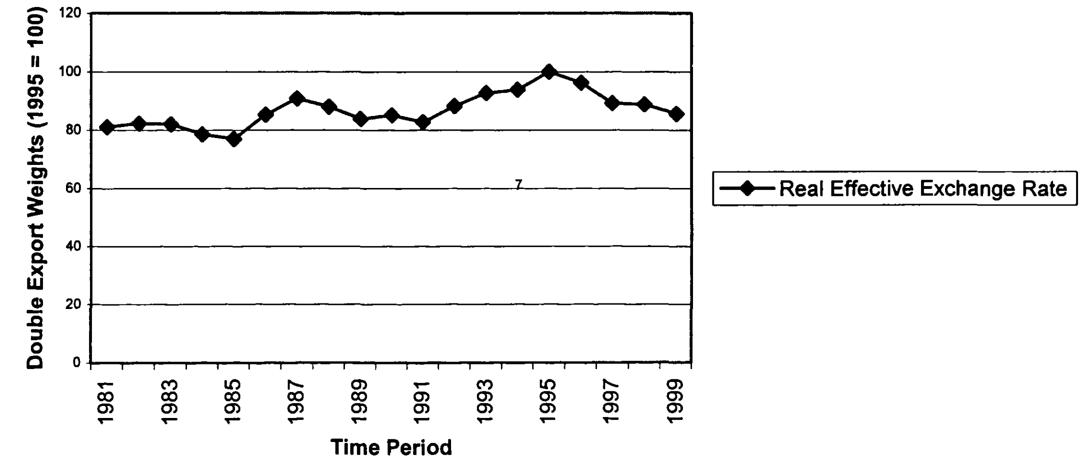
Tavares have argued that successful fiscal consolidations tend to be preceded by large nominal exchange rate depreciations –as in the Italian case. Instead, unsuccessful adjustments are anticipated by currency appreciation (Lambertini and Tavares 2003). These economic reports go in the direction of corroborating the argument presented in this research project. By pinpointing the positive correlation between a currency's weakness and fiscal discipline, they show that a trade-off may exist between fiscal and exchange rate policies and that this trade-off looks very much like the one hypothesised in this work.

EMU membership induced investors to bet on a rapid recovery of the Lira. The contrary can be said for Germany. The DM was a stable and strong currency, very attractive to both domestic and international investors. In this respect, there was no currency risk involved. Most interestingly in relation to the time frame analysed here, not even the unification shock endangered the stability of the DM. In parallel, this fact explains why German business has never enjoyed from a catching-up potential via the exchange-rate channel (Graph 17).

Graph 17. Real Effective Exchange Rate (performance relative to the other 23 industrial countries) 1981-99



Source: EU Commission, AMECO Database (last reviewed May 2005)

2. Further Supporting Evidence: Sequencing

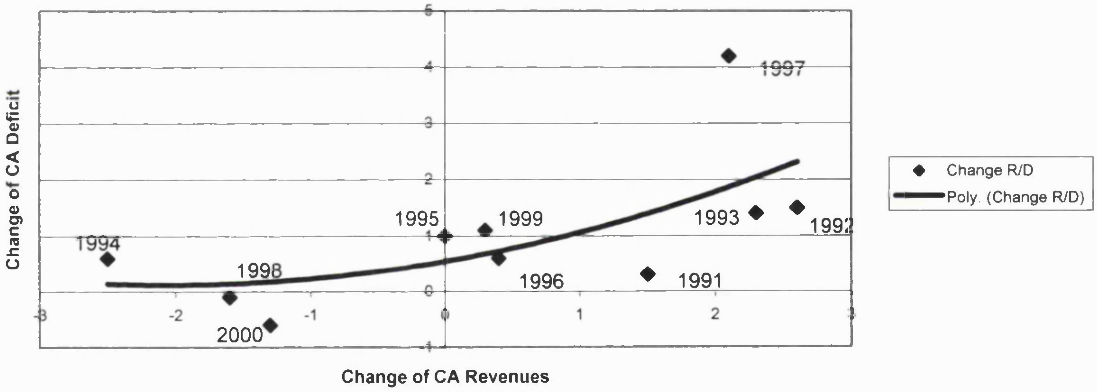
The strong argument behind the present thesis is that macroeconomic conditions, especially debt conditions and currency regimes, inform socio-economic preferences. In this respect, it would be interesting to test if changes to these conditions induce powerful domestic interests to alter their preferences accordingly. The next sections evaluate the relevance of sequencing in the examples of Italy and Germany. For the reasons highlighted above, there is more empirical evidence in support of the general argument in the case of Italy than there is for Germany. This is naturally so considering that it is only in Italy that social partners could compensate losses in one policy area with gains from another. In particular, while changes to the debt level had minimal impact as the debt service remained comparatively low throughout the 1990s, an alteration of the currency had a much more visible effect. After 1995 and the progressive appreciation of the Lira, business actors started expressing support for an expenditure-based consolidation since, in the absence of the exchange rate channel, this was the only instrument left to boost competitiveness. From a methodological perspective, the German case is more difficult to prove, as it would involve explaining why something has not occurred. Still, when abandoning the idea of a rigorous approach, it remains possible to identify correspondences between the changing macroeconomic environment and domestic fiscal preferences.

2.1.Italy: the short-term advantage of floating

I believe that a closer look at sequencing provides useful insights into the political economy of fiscal adjustment. In this section, I compare the evolution of macroeconomic variables in the 1990s with domestic groups' responses to them. I have earlier indicated that Italian interest groups managed somehow to distribute their influence over different aspects of fiscal reform with the result that budget adjustment was both extensive and revenue-based. Business actors influenced the size of deficit reduction, whereas organised labour had a free hand in shaping its content. Indeed, the support for fiscal discipline cut equally across all groups. All budget actors were aware of the fact that the country's weak financial reputation in fact offered a vast catching-up potential and that budget consolidation could in theory stem just from credibility gains. With this strategy having negligible distributional implications, the confrontation between capital and labour softened up. Labour unions would express their concern only in those cases when, the planned fiscal effort being extensive, social security programmes might come under serious threat. In general, while supportive of prompt fiscal adjustment, CGIL-CISL-UIL would by default recommend a revenue-based budget consolidation.

The bottom-line is that there existed some sort of implicit political exchange between organised capital and labour, according to which the former would obtain large fiscal corrections, yet only at the expense of higher fiscal pressure. *Prima facie* quantitative evidence seems to confirm that a positive correlation existed between the size of consolidation and its revenue component, in cyclically adjusted terms. Graph 18 indicates that the greater the extent of deficit reduction, the more significant the contribution of revenues to that result. If the limited number of observations makes this finding not particularly robust and largely indicative, it suggests nonetheless that some sort of trade-off existed between the size of fiscal adjustment and its specific content.

Graph 18. Italy: Correlation between CA deficit change and total CA revenues change, 1991-2000



Source: European Commission, General Government Data 2003

It was suggested above that at the basis of domestic actors' fiscal preferences was the level of public indebtedness. Therefore, one would expect that changes to the debt ratio to GDP during the 1990s would alter their perception of trade-offs between different policy areas. There are indeed a few signs of shifting preferences even if feeble, something that could be well explained by the fact that, while on the downside, the country's debt remained high by European standards. Italy's debt ratio to GDP started to decrease in 1995. Most importantly, this is when the interest rate differential with Germany began narrowing. The country continued to benefit from a catching up potential, but this was softening and bound to disappear with the launch of EMU in 1999. It is no surprise if, from then onwards, governments and social partners started to show greater concern for the quality rather than the size of deficit reduction. Survey-based data gathered in the framework of this research project show that *Confindustria* dropped its prioritisation of fiscal discipline in November 1996, coinciding with the Lira re-entering the ERM, to insist more vehemently on its opposition to revenue increases (Appendix 1a).

This is only one part of the story. I have also argued that exchange rate developments affected fiscal preference formation. Italy's export-oriented business community tolerated high fiscal pressure for a while precisely because a depreciated Lira allowed them to maintain a competitive edge. This "fortunate" macroeconomic constellation – comparatively high debt levels and a weak national currency - prevailed from 1991 to 1995, the period in which the fiscal effort was mostly concentrated. Not only did the debt-to-GDP ratio in fact continue to grow until 1995 but also, over the same time span, the nominal effective exchange rate depreciated by an annual average of 6.9 percent (European Commission 2003b)[10]. It was thereafter, in 1996, that the Lira regained a large part of its value in conjunction with its re-entering of the ERM, one of the conditions for access to EMU. The stronger Lira induced a different appraisal of the situation from some of the interest groups confirming their sensitivity to exchange rate issues. First, *Confindustria* openly criticised the excessively high exchange rate on which the government had agreed Italy's membership of ERM. Secondly, content analysis shows that the year 1996 represents a structural break with business actors shifting their attention from the size to the content of budget consolidation, as mentioned above (Appendix 1a). Their most intensive preference became the opposition to tax increases; second was their support for spending cuts. Thirdly, after 1998, under a fixed exchange rate regime, the correlation between the size of fiscal adjustment and its revenue

[10] This figure compares with an average depreciation of just 1.5 percent in 1988-1990 (European Commission 2003). It is interesting to note that this was a period in which, against a rather stable and moderately strong Lira, *Confindustria* started to push more aggressively for the elimination of the wage indexation system. Inflation and wage control allowed export-oriented firms to preserve competitiveness once the national currency started alarmingly appreciating.

component became looser. This should confirm that fiscal aggregates tend indeed to reflect societal preferences[11].

While it is manifest that *Confindustria* adopted this position, it is less obvious that this was eventually reflected in policy outcomes. If my overall argument is valid, once the macroeconomic environment changed in 1995/96, the very interaction between domestic interests should experience some changes. First, because there existed fewer options for a political bargain among social partners, tensions between labour and capital should rise. Second, deficit reduction would be less revenue-based, and more so where the government is sensitive to business actors' claims. As to the first point, it is believed here that it is in the realm of wage bargaining that one can best assess the evolution of the relationship between labour and capital. Actors' perceptions of constraints and opportunities in the national economy are expected to spill over onto labour markets, thereby affecting the relative level of conflict in wage rounds. For instance, employers will resist wage rises if they cannot compensate for them in other policy areas. They will be keener on wage moderation once the national currency has appreciated failing to be a boost to competitiveness. Following this reasoning, I should then detect a negative correlation between real wages and currency appreciation. And indeed, at the macro-level at least, such a link is discernible. As soon as the Lira appreciated, real compensations per employee descended. In 1994 and 1995, real wage changes became negative, for the first time since 1986, showing decreases of 0.4 and 0.8 percent respectively (European Commission 2004)[12].

The second hypothesis seems also largely to be confirmed. Empirical evidence shows that with the appreciation of the Lira came a shift in fiscal strategies. If between 1991 and 1995 the average annual increase of CA revenues amounted to

[11] The statement might sound arbitrary and will be better qualified in the following paragraph.
[12] The identification of this correlation is extremely significant. It is in fact counterintuitive. Conventional macroeconomics theory would suggest that, with currency appreciation controlling for domestic price levels, *ceteris paribus*, real wages would be destined to rise. At least, this is expected in the short-term before the stronger exchange rate bits into exports, inducing firms to slow production down and with it stop offering jobs with the result that real wages need to go down. Yet, this is likely to happen only against the medium-term and would not apply to the two-year perspective adopted here.

1 percent of GDP, then in 1995-98, it went down to a more modest 0.2 percent (own calculations). Again, the correlation is loose, as it does not account for other determinants of fiscal strategy choices (e.g. partisanship). And it is indisputable that also partisanship played a role. In 1994, under the liberal right-wing Berlusconi Government, total CA revenues decreased for the first time since 1987 by a considerable 2.5 percent of GDP[13]. Nevertheless, while the size of tax alleviation is a signal of the government's responsiveness to its natural electorate, the fact that the trend continued more or less in the same direction also thereafter indicates that strong partisan arguments can be discharged. In a nutshell, irrespective of their ideological orientation, Italian governments in the 1990s were all prone to compensate currency appreciation with lower fiscal pressure.

I demonstrated above that a diminishing debt and an appreciating currency somehow narrowed the common ground between labour and capital. On labour markets, unions' arms got more and more twisted into wage moderation. Moreover, after 1995, business actors proved less liable to accept high fiscal pressure. Yet, the analysis of official documents and press releases shows that, even amongst labour unions, revenue increases were perceived with less enthusiasm than in the years before. As a way of confirming the conceptual model herein presented, it might be interesting to relate also wage developments to the content of fiscal consolidation. Rudimental correlations between real wage and total CA income changes highlight a clearly positive relationship between the two variables (Graph 19). This confirms that a relationship between wage and fiscal policies existed. Namely, once real wages started decreasing at a time when EMU was approaching and employers showing greater concern for unit labour costs, then it is no surprise if unions' acceptance of tax-maximising measure became less unconditional than used to be.

[13] True, in 1994, the Lira was only starting to appreciate but that was sufficient to shift the attention of the business community away from exchange rate policy. In addition, further appreciation was expected in the very short-term with one of the Maastricht criteria being participation in normal ERM bands.

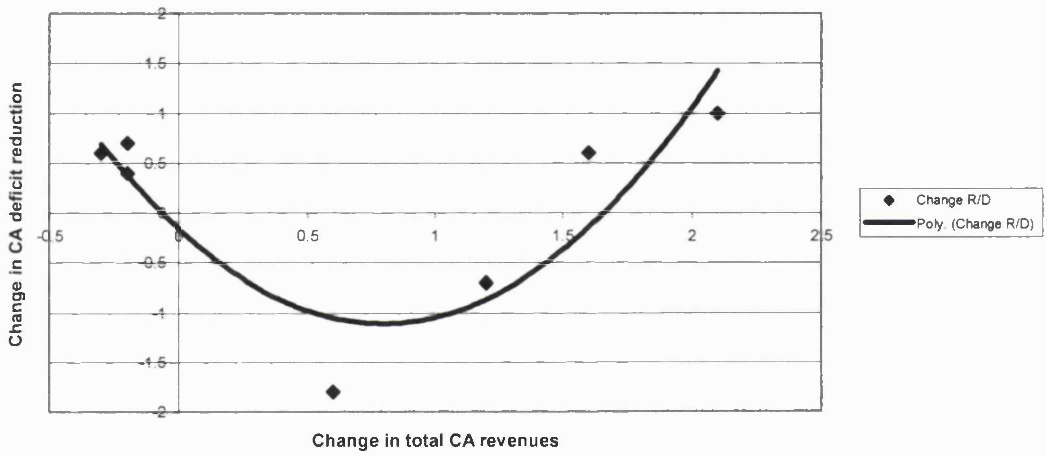
Graph 19. Italy: Correlation between CA Revenue Changes and Changes in Real Wages per Employee, 1991-1997

Source: European Commission, Statistical Annex 2004 and General Government Data 2003

2.2. Germany: the straightjacket of monetary hegemony

Earlier I indicated that the striking of a deal between German capital and labour over fiscal adjustment was made difficult by the unfavourable distribution of actors' preferences regarding deficit reduction and its financing. Low public indebtedness and a hard currency regime shut off the option of obtaining credibility gains on financial markets. Moreover, the unification shock was not sufficient to create uncertainty and/or to undermine the credibility of the German economic system. In a nutshell, Germany did not enjoy the catching up potential characteristic of weak systems. The confrontation between domestic competing interests dealt mainly with the composition of macroeconomic adjustment, with the social partners envisaging quite different deficit reduction strategies. And in fact, the correlation between deficit reduction and the change in total revenues is not linear, as one would expect in the presence of a symmetric trade-off, but U-shaped. While the limited number of observations hardly makes the result robust, a tentative interpretation can nonetheless be pursued. Where the government is able to implement rigorous fiscal consolidation (right-side of the quadrant), then society (i.e. business actors) is willing to accept greater tax levels. As the fiscal stance begins relaxing, there is less tolerance for fiscal pressure levels. It is instead more difficult to understand developments in the left-hand quadrant (Graph 20). Here, there is hardly any evidence of a political bargain between labour and capital. Instead, fiscal consolidation resolves in a confrontation between fiscal authorities and the only demand component (i.e. investment) that is believed capable of supporting indirectly fiscal discipline (i.e. driving output growth).

Graph 20. Germany: Correlation between change in CA total revenues and CA deficit reduction, 1991-98



Source: European Commission, General Government Data 2003

From 1989 to 1993, German fiscal authorities faced severe challenges. Re-unification had come about with shocking rapidity, and the need to support transition in the former DDR with major financial transfers translated into growing pressures on the federal budget. At the outset, in order to finance this extraordinary spending, the Kohl Government had no other choice but to increase public incomes and chose the form of augmented direct taxation with the so-called Solidarity Charge. This fiscal strategy proved highly unpopular amongst export-oriented business actors as it was combined with equally unfavourable developments on foreign exchange markets, i.e. the appreciation of the DM. The latter outcome was driven by the *Bundesbank*'s monetary policy. In the fear that unification-induced expenditures would push inflation up, in the very early 1990s, the German Central Bank increased official interest rates for twelve consecutive months. Higher domestic rates attracted capital from abroad, inducing a rapid appreciation of the exchange rate. In turn, during this period the fiscal effort was relatively modest as the government had to compensate business for the costs of greater fiscal pressure and currency appreciation. It did so by providing West German firms with investment opportunities in the East, which had the effect of amplifying government social and tax expenditures.

Marked by the unfavourable juxtaposition of greater fiscal pressure, fiscal profligacy, a restrictive monetary stance and an ensuing appreciated currency, the situation soon became unsustainable. In particular, the BDI was intensively lobbying the Kohl Government asking that alternative ways be found to manage fiscal policy. In other words, currency appreciation here had the effect of mobilising organised capital in favour of expenditure restraints. The subsequent fiscal interventions were in fact concentrated on the expenditure side of the budget, marking a significant shift in the government's fiscal strategy. In parallel, with the *Bundesbank* having relaxed its monetary stance, the DM started to depreciate after 1993. In this respect, in both periods, those of 1990-93 and of 1993-96, there was no room for a compromise between competing socio-economic interests over fiscal reform. In the early 1990s, Germany's revenue-based fiscal adjustment came with currency appreciation. As a consequence, political considerations led to rather loose fiscal discipline. In the second period, once the DM had returned to its initial levels after 1994 fiscal interventions concentrated on the expenditure side of the budget.

But did exchange rate changes at least affect the conduct of collective bargaining? It was indicated earlier that, once the exchange rate proves inadequate to support export growth, business interests try to find compensation in the framework of wage negotiations. Again, not even here were German employers able to immediately obtain visible pay-offs. Following the decision to equalise West and East German wages, the overall level of German wages went up. The most significant increases were registered in 1991 and 1992, when real compensations per employee for the unified Germany grew by 2.4 and 5.2

percent respectively. It has been suggested that greater wage costs were successively used as an excuse to justify employers' insistence on a necessary reduction of their contributions to social security programmes as well as on welfare state reform (Leaman in Berger and Compston 2002). Fiscal adjustment in Germany had no chance of being consensual, as demonstrated by the fact that, at the same time as the Government's fiscal strategy started targeting public expenditures, unions' wage demands relaxed under the threat of growing unemployment. Again, there is no indication that a trade-off existed between fiscal, exchange rate and wage policies. This is reflected in the failure of the 1996 Pact.

As to the evolution of public indebtedness, it is interesting to note how, against Italy's surprising recovery, the German debt-to-GDP ratio rapidly deteriorated, yet not to the extent that it created uncertainty about the soundness of the German economic system. In fact, notwithstanding the revolutionary character of unification, the Federal Government continued to adhere to economic orthodoxy, trying to keep inflation at bay by means of a restrictive monetary stance. Possibly thanks to the country's positive inflation record, international investors did not loose confidence in the prospect of a successful transition in East Germany, as demonstrated by the fact that government bonds continued to enjoy a low risk premium – even after the debt level had overshot the Maastricht reference value - and that, overall, the international value of the DM remained surprisingly stable.

Again, as in the Italian case but in a more dramatic manner, debt changes did not induce a significant shift in the preferences of domestic groups; instead, historical debt levels are of significance. This confirms the centrality of the arguments on credibility, where the latter is built around a more complex set of variables than yearly deficit and debt levels. Domestic preferences were instead more visibly affected by exchange rate fluctuations. However, the resulting new constellation was still not one that would have favoured the formation of an inclusive social consensus over budgetary consolidation.

3. Extending the Argument: Shadow Cases

A two-country comparison always risks becoming entangled into the specificity of the cases treated, raising doubts about the applicability of the research results to other realities. No doubt, the story that has been told here is strongly informed by the politico-economic peculiarities of Germany and Italy. In this section, I intend to test if my general hypothesis about the role of societal preferences and social pacts can be applied to other instances too. With this aim, I introduce the shadow cases of Belgium and Portugal. I will examine if and how socio-economic interests in these EU countries have incorporated debt levels and exchange rate trends into their evaluation of the costs and benefits from fiscal adjustment. As in the previous exercise, I am concerned with exposing the micro-foundations of EMU-induced budgetary consolidation.

Before turning to the analysis, a definitional clarification is necessary. Countries are classified with an eye to long-term developments. High-debt countries are those that have suffered from comparatively high public indebtedness in the period from 1970 to 1998 (e.g. Belgium, Greece, Italy and, to some extent, Ireland). By the same token, low-debt countries are those that, in the same period, have enjoyed relatively low debt-to-GDP ratios (e.g. Finland, Germany, Portugal and Spain). This categorization appears quite functional considering that small differences in the debt burden from one country to the other are not likely to matter, nor to induce different processes of preference formation. Along these lines, Belgium is probably the only country one can meaningfully compare with Italy as it suffered from a similar debt-to-GDP ratio. The same historical perspective is used to identify currency regimes. Hard-currency countries are those that have showed a record of currency stability from 1970 to 1998 (e.g. Belgium, Netherlands). Germany is in this respect a particular example; as the anchor currency of the DM was irrevocably stable, at least in the EU. Soft-currency countries have known frequent depreciations against the DM over the same period (e.g. Greece, Italy, Portugal, Spain).

3.1.Fiscal adjustment and interest politics in Belgium

Stylised facts

The aim of this section is to describe fiscal adjustment in Belgium, the shape of the country's budgetary process and the contribution of social partners to deficit reduction in the 1990s. While the primary interest lies in EMU-induced budget consolidation, the interpretative approach adopted here calls for a consideration of the country's economic history as well. Since the 1970s, in parallel to events in other European countries, Belgium suffered from a growing debt burden. By the end of the decade, the country's stock of debt had already reached a significant level. At that point, political *elites* started accepting the idea that macroeconomic adjustment was unavoidable. In 1981, the Christian Democrat Martens implemented a drastic austerity programme, yet only after having formed a coalition with liberal parties on the right that gave him sufficient political back-up to pursue such an unpopular plan (Jones 2003). The programme displayed positive results with the public deficit set on a firm downward trend after 1982 (Graph 21). It is interesting to note that, in those years, voluntary wage restraint from part of labour unions offered an important contribution to fiscal discipline, as in Italy in the 1990s.

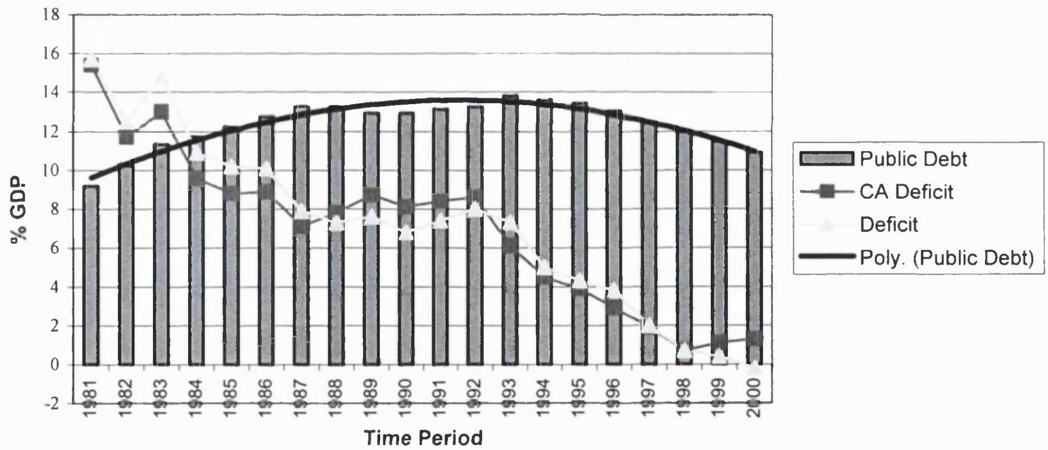
However, from 1987 the net borrowing requirement started to deteriorate again. When in 1991 the country committed itself to EMU, the deficit was about 8 percent of GDP. It was only from 1993 that the Belgian government was able to reduce it to a considerable extent, in the end managing to bring the country into EMU. As to the timing of reform, it is interesting to note that, while certainly visible, the Maastricht-effect was less pronounced in Belgium than in other countries, considering that a trend of continuous deficit reduction had already been set in motion in 1981 – with some observers including Belgium in the category of "early adjusters" (Hancke and Soskice 2003). The size of deficit reduction is testimony of a successful adjustment; yet not to the same extent as the Italian one. In nominal terms, the Belgian government managed to bring the deficit below the Maastricht target. However, in real terms, the country's discretionary fiscal effort was not equal to Italy's. In 1989-1997, the CA primary surplus improved by 3.3 percent of GDP against 9.6 percent in Italy (Caselli and Rinaldi 1998), the difference being larger than the initial gap between their respective deficit levels. The Belgian adjustment tale is also special in terms of its composition. Belgium resorted in the first years to revenue-maximising measures but then switched to an expenditure-based strategy. In the period 1995-98, 80 percent of the improvement of the primary surplus came from lower primary expenditures and only the remaining 20 percent from a rise in total public revenues. Most expenditure cuts concerned the federal level and social security budgets (Ministry of Finance1998). If the debt ratio is such an important determinant of fiscal adjustment, why did two countries with similar debts perform so differently?

It seems that country's currency regime might in fact explain this paradox. The Belgian exchange rate policy is a peculiar one. The country has historically been in favour of exchange rate stability. With the collapse of the Bretton Woods system in 1971, the national government opted almost immediately for a stabilization of the Franc against the DM. It was the significance of export-led growth in this extremely open economy that led domestic actors to prioritise price stability, export competitiveness and economic policy autonomy see (Frieden 2002). Interestingly, this perspective was shared by both export-oriented and sheltered sectors. Currency stability had firstly the advantage of maintaining the price of imported goods constant. Second, an appreciated Franc protected the economy from imported inflation. Third, a stable exchange rate was believed to favour borrowing from abroad, should deficit spending be necessary. This strategy implied costs too. To maintain competitiveness, wage and price developments had to be kept under strict control. In addition, overly expansionary fiscal policies were risky to the extent that they pushed demand for imports upwards, thereby threatening the exchange rate itself (Jones 2003).

Belgian fiscal policy is to be understood against this background; most fiscal decisions happened to be subject to the exchange-rate constraint. There is ample evidence of these two policy areas being strictly interconnected. For example, just before implementing his austerity programme, Prime Minister Martens succeeded in imposing on a recalcitrant Socialist opposition a realignment of the

Franc against the DM, which consisted *de facto* of a devaluation. If industrial sectors welcomed the prospect of greater export-led growth, Socialists feared the impact of a devalued currency on wages. But, in this instance, Martens was sufficiently persuasive in arguing that his budgetary consolidation plan would keep price levels under control, thus pre-empting the inflationary potential of devaluation. In the 1990s, the Belgian Government continued to pursue a hard currency policy line until the adoption of the Euro. This approach required that wage developments also be consistent with fiscal and exchange rate policy choices. And, in 1991-93, unions' lack of discipline together with the continued operation of automatic wage indexation had the effect of widening Belgium's wage gap with trading partners (FT 12/7/1993).

Graph 21. Belgium: Public Debt, CA and Actual Deficit, 1981-2000



Source: European Commission, General Government Data and Statistical Appendix, 2004

The Belgian budgetary process

Engineered to guarantee representation within a divided society, over the years the Belgian electoral system has produced multi-party coalitional governments. The country's fragile institutional set-up has probably compromised fiscal discipline at various times. Not only have budgets to be negotiated between ministers responding to different socio-economic constituencies, but also federalism implied that regional cleavages existed too and that, as a result, multiple institutional levels and actors had to cooperate towards the achievement of the agreed fiscal targets. One can therefore understand why budget reform was on the political agenda for a long time. For example, successful deficit reduction in 1981-87 was preceded by the parliament's granting of special powers to the government and by the introduction of rules requiring a firmer commitment to budget targets from fiscal authorities. Similarly, in 1989, in an attempt to overcome coordination problems between the regional and the federal level, some budget responsibilities were transferred directly to regions. Still, most of these changes were not sufficient to reverse the course of fiscal policy. First, during the 1980s, in spite of positive results, budget targets continued to be regularly overshot (Hallerberg 2003). Second, in 1987, deficit and debt levels started to grow again (Graph 21). When, in 1992, Von Hagen computed structural indexes with the aim of measuring the relative efficiency of different national budget processes, Belgium figured amongst the less virtuous budget systems, together with Italy and Greece (von Hagen 1992).

Under the threat of exclusion from EMU, in 1990-98, Belgian budget institutions showed clear signs of improvement. The external constraint functioned as a catalyst towards the common goal of fiscal discipline. In this period, the government further strengthened the role of the High Council of Finance, an advisory body responsible for providing government with indications on the macroeconomic scenario and on fiscal goals. The Council set budget targets which political leaders accepted committing themselves to, partly in the fear that failure to adjust public finances would lead to severe electoral punishment. Overall, there is no doubt that the Belgian budgetary process has been subject to some ameliorative restructuring in the 1990s. Measured again in 2001, the Von Hagen structural index showed some improvement. However, it should be noted that, this was modest compared to the experience of other countries that, in the same period, underwent budget reform, e.g. Italy, Ireland, Greece (Hallerberg 2003). Against these data, it can be concluded that political and budget institutions *per se* have not been key determinants of the country's fiscal performance. They fail to explain either successful nominal adjustment or modest real adjustment or the choice over the content of deficit reduction.

The social partners

Moving on to social partners, the interesting trait of the Belgian performance in the 1990s is in fact the failure of social pacts. This contrasts with Italy's glorious results. What does this failure say about social partnership in hard times? Social concertation is deeply rooted in Belgian social history. As early as 1944, in the wake of WWII, trade unionists and employers' representatives drafted an agreement known as "Draft Social Solidarity Agreement". With it, both parties recognised each other's role. They confirmed their right to autonomous collective bargaining. Most importantly, they became budget actors to the extent that the Government was obliged to consult them on various social and economic issues before the parliamentary budget session. Finally, the agreement set the guidelines for the creation of a social security system based on contributions coming from employers and employees. It was in this respect a typical case of tripartite consultation where the Government played only an ancillary role, just having to supervise decisions taken by the social partners. Indeed, any more direct Government intervention, especially in the area of collective bargaining, was badly received by both sides. For instance, in 1976, when in the wake of a deep economic crisis the Belgian Government unilaterally imposed wage restraint, the social partners reacted with disapproval. But, from then onwards, Governments never lost sight of wage developments. The deficit reduction successfully implemented in the early 1980s was set against the background of a typical political exchange between Government and labour unions:

> [The Prime Minister and the Christian Democratic trade union leader] traded-off wage moderation against fiscal consolidation –setting targets for how much restraint the unions could be expected to deliver and how much expenditure reduction they could be expected to tolerate. One result of these meetings was to focus attention on the introduction of subsidies from general coffers for social welfare outlays that traditionally received their financing through payroll taxes. In this way, (the Prime Minister) could use fiscal outlays to reduce labour costs and so compensate for any shortfall in wage moderation (Jones 2003, 13).

After the disruptions experienced in the late 1970s and early 1980s, social concertation came once again to the forefront of governments' agenda at the end of the 1980s, as the project of European monetary unification was taking shape. Comparatively, Belgium continued to show, in those years, weak public finances. After a notable improvement from 1983 onwards, the public deficit and, as a result, the debt burden deteriorated once again. The revival of social concertation led to the signing of a Competitiveness Act in 1989, with which the social partners and Government agreed to control wage increases in comparison with those of the country's main trading partners. When, in 1993, domestic actors registered for the first time a real competitiveness loss, with the public deficit still set on an upward trend, an attempt was made to come to a more comprehensive social pact that would include also employment and social security. After its failure following the withdrawal of Socialist union FGTB (FT 25/10/1993), the Government intervened unilaterally, in spite of widespread protest, and introduced a wage freeze, a change to the price index and a conditional reduction in SSC. A renewed attempt to conclude a social pact failed again in 1994 (Arcq and Pochet in Fajertag and Pochet 2000).

Slowly the attention started to move from public finances to Belgium's increasing unemployment rate. In 1996, the Government and the social partners agreed on a new Competitiveness Act. Here, the focus was on the reduction of labour costs. It was believed that excessive SSC together with the operation of a wage indexation system were undermining national competitiveness and therewith employment creation. And, in this respect, it is interesting to note how, in contrast to Italy, Belgian unions and employers failed to agree on the elimination of the wage indexation system[14]. Amongst other goals, the new pact aimed at "setting out a general framework for lowering wage costs, whilst maintaining financial equilibrium of the social security system by such means as alternative funding methods" (Official Statement, 12/2/1996 in www.etuc.org). But, in 2002, failure to find "alternative funding methods" led to a deterioration of social security budgets (Fajertag and Pochet 2000).

[14] The maintenance of the wage indexation system is well explained by the fact that Belgium, because of the hard currency regime in which it was in, continued to benefit from a low inflation level.

Arcq and Pochet noted how any agreement between social partners and Government was constrained by the inability of the latter to provide the parties with side payments. It was difficult in this respect to come to a compromise over an agenda that included simultaneously fiscal discipline, wage moderation, and welfare reform (Arch and Pochet in Fajertag and Pochet 2000). If this was indeed the case, then it seems interesting to explain why, in Italy, such a compromise was possible with social partners agreeing on deficit reduction, the elimination of the wage indexation system as well as on a qualitatively significant pension reform in 1995. It is argued here that differences between the two currency regimes may have contributed to these divergent outcomes.

Italian unions agreed to the elimination of so-called *scala mobile* in the summer of 1992 in the hope that this move would allow the Lira to stay within the ERM bands. The measure was not sufficient to halt the rapid devaluation of the Lira. However, in the middle of fiscal retrenchment at a time in which domestic consumption was rapidly decreasing, Italy's export-oriented business community could take advantage of the depreciated currency. By default, it left unions with the responsibility of defining the content of deficit reduction, which in fact was based on additional public revenues and was accompanied by a financially neutral reform of the public pension system. No similar trade-offs were possible in the political economy of Belgium. The Belgian Franc continued to be a strong and stable currency. As a consequence, devaluation was not a viable option to boost competitiveness. Moreover, there was no particular advantage from wage moderation in itself; what mattered was rather the development of Belgian wages in comparison to those agreed in Germany, France and the Netherlands. In other words, there were constraints on the type of political exchange social partners could come to under Government supervision. Arcq and Pochet explain this state of affair and its evolution as follows:

> In the eighties and nineties, under pressure to reduce the public debt, [the government] has provided a framework for bargaining by laying down in advance the often narrow margins for negotiations, in an attempt to safeguard the balance between wages, competitiveness and social security. The most recent agreement has also shifted the players' positions somehow. The social partners are attempting to regain a degree of autonomy and the government is

> using what little room for manoeuvre was created by an unexpectedly rapid reduction in the public debt to promote the conclusion of an agreement (Arcq and Pochet 2000, 132).

Sequencing as supporting evidence

In this section, I intend to examine briefly whether a closer look at sequencing may shed additional light on the Belgian political economy of fiscal adjustment. With this aim, it is analysed whether changes to exchange rates and debt levels altered domestic actors' perceptions of the costs and benefits from budget consolidation. Compared with the Italian case, the Belgian experience differs in one important respect, namely the fact that, because of the country's hard-currency regime, the exchange rate did not appear as a realistic instrument to compensate losers. The Franc was quite stable in comparison to other EU currencies (e.g. Italian Lira, Greek Drachma, Spanish Peseta). Still, in the 1990s, minor fluctuations in the exchange rate did take place. The decision to move from a revenue- to an expenditure-based strategy in 1993/94 took place after the nominal effective exchange rate had been losing value for three consecutive years. This development was perceived as alarming considering that ensuing imported inflation was pushing labour costs upwards through the operation of wage indexation, widening the wage gap with the country's trading partners. Against this background, any intervention on the revenue side of the budget would be detrimental to competitiveness. This explains the decision to focus on expenditure restraints. In addition, until then, the debt-to-GDP ratio had continued growing, possibly also being one of the causes behind the Franc's loss of credibility on financial markets. A reversal of the fiscal strategy was deemed necessary, yet fiscal authorities had no alternative but to "go it alone". There was less of a confrontation between the interests of labour and those of business; it was a question of survival of the national economy at large. Cuts were unavoidable, but left unions unsatisfied. Their decision not to sign a social pact is to be understood against this context. The government had no means to pay them off, either directly (more spending) or indirectly (preservation of welfare state).

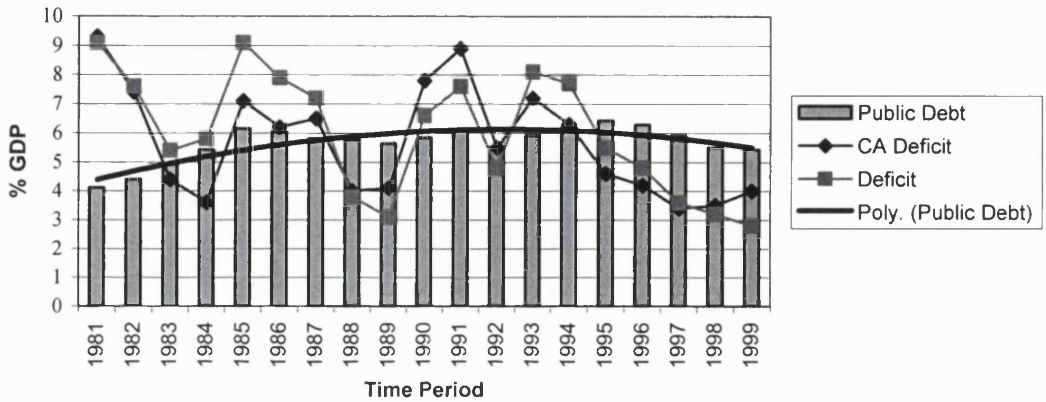
3.2. Fiscal Adjustment and Interest Politics in Portugal

Stylised facts

Portugal had been suffering from a growing debt ratio to GDP since the 1970s, partly as a result of the nationalization of banking and heavy industry in 1974/75, partly because of the presence of a dependent central bank inclined to monetize government debt (de Macedo and Sebastiao 1989). As had been the case of Italy, this particular system of fiscal governance soon led to strong inflationary pressures. In the second half of the 1980s, it became apparent that the situation was not sustainable. In turn, in close collaboration with the social partners, the government implemented a far-reaching fiscal adjustment programme. When in 1991 the Portuguese government committed itself to the project of a single European currency, the debt-to-GDP ratio had already started to decline, signalling one of the most celebrated successes of the social democratic government in office since 1987. However, the improvement was short-lived. From 1992 to 1995, the debt burden deteriorated, registering also the lagged impact of an uncertain deficit trend (Graph 22).

It is striking that the Portuguese CA deficit began to expand in 1992, once the conditions for access into EMU had already been set out in the Maastricht Treaty. In terms of timing, there is hence little evidence of EMU being the main driver of the country's fiscal performance. After significant deficit reduction in 1991/92, the net borrowing requirement increased again in 1992/93 in response to the government's expansionary fiscal policy stance. From Figure 2, it appears that deficit spending was initiated once the economic cycle had turned negative, with the result that the actual deficit turned out to be even higher than the cyclically adjusted one. It started decreasing steadily only from 1992, only to grow again after 1997. Inevitably, unsuccessful deficit reduction fed into the debt, which continued to grow until 1995, marking a modest overall fiscal performance. As to the size, in 1989-1997, the CA deficit fell 1.7 percent of GDP, largely thanks to descending interest payments with, in fact, the primary surplus deteriorating by 0.4 percent of GDP. As for the composition, most of the interventions concerned the revenue side of the budget. In 1991-98, cyclically adjusted revenues improved by 4.2 percent of GDP, while expenditures decreased by 1.1 percent. Primary expenditure growth was driven mainly by greater compensations for public employees. Expenditure restraints were only possible in the field of interest payments thanks to a rapid convergence of short-term interest rates to the EU average.

Graph 22. Portugal: CA, Actual Deficit and Public Debt, 1981-99



Source: European Commission, European Economy, Statistical Annex, 2004

As to exchange rate policies, Portugal has gone through several regime changes. In 1989, the Escudo joined the ERM. The choice of opting for exchange rate stability came after the country had suffered for a long time from imported inflation. From 1973 to 1989, average annual depreciation against the DM had amounted to about 15 percent (Frieden 2002). The Social Democratic government that had brought the country into the ERM bands was keen to stick to the exchange rate commitment and managed in fact to preserve a good degree of stability thereafter. Behind this decision was the belief that a strong exchange rate would force domestic firms to improve competitiveness (FT 3/11/1992). When in September 1992 the Spanish Peseta devalued by 6 percent, Portuguese monetary authorities attempted to resist speculative attacks on the Escudo, but were forced in November to devalue by the same amount. The national currency remained relatively weak until August 1993 when the ERM imploded and all currencies were allowed to float within a 15-percent band (FT 23/11/1993).

Overall, in spite of the marginal devaluation in 1992, the Portuguese government remained keen on currency stability. To be sure, export-oriented sectors appreciated the decision to follow the Peseta suit, but lamented the fact that the currency continued to be too strong. With this approach to the exchange rate came the fact that domestic interest rates had to be maintained relatively high to defend the parity. Such a restrictive monetary stance was especially detrimental to the interests of SMEs (FT 8/11/1993). In spite of the unpopularity of economic policy, even in the following years, the government went on prioritising exchange rate stability over monetary easing (FT 28/10/1994). Finance Minister Daniel Bessa commented: "the only way Portugal can regain competitiveness is by continuing to lower inflation and interest rates –unless it devalues, but that would be worse" (FT 26/3/1996).

The Portuguese budgetary process

Similarly to Italy, Portugal has historically been characterised by a very unstable institutional set-up. After democracy was restored in 1975, a proportional electoral system generated multi-party coalitions. Not only were Governments made of a large number of parties, but also they were highly unstable, changing almost yearly. The emergence of a single-party majority Government in 1987 under the social democrats of the PSD, a party at the right of the domestic political spectrum, opened up a unique period of institutional stability, which lasted until 1995 when a new minority Government took office (Magone 2000). From 1987 to 1995, even the budget process reflected the rise of political stability. Decision-making was centralised around the Finance Minister who, during that period, managed to exercise a good degree of control over public finances. In sum, the efficiency of the budget institutions was significantly improved, at least until 1995 (Hallerberg 2003).

Nonetheless, there is insufficient evidence to prove that the centralization of budget policy-making improved the country's fiscal performance in a dramatic fashion. True, from 1987 to 1988, when the newly appointed Government implemented a far-reaching and unexpectedly popular fiscal adjustment programme, deficit and debt levels visibly diminished. Yet, such a trend had already begun in 1985. Moreover, as of 1989, the net borrowing requirement was rising again and did so until 1991 when the PSD government was confirmed in office with a large majority at the end of quite an aggressive electoral campaign. Over that period, deficit deterioration was caused by the government's decision to raise monthly paychecks for all public employees, a decision reached in the run-up to the elections. In addition, it does not seem that the establishment of a minority Government in 1995 and the ensuing weakening of the Finance Minister had an immediate negative effect on fiscal policy outcomes. One has to wait until 1997 to see deficit levels deteriorate. Arguably, having obtained green light for access into EMU, Portugal did not feel the threat of exclusion from European monetary integration.

In all these respects, it does not seem that political and budget institutions were somehow responsible for the country's sub-optimal fiscal performance in the 1990s. Contingent factors (e.g. electoral cycles) and Governments' responsiveness to socio-economic interests seem to have played a greater role.

The social partners

Social concertation was initiated in Portugal at a time when the other European countries were starting to distance themselves from it. After the creation of the Standing Committee for Social Concertation (CPCS) in 1984, Government, employers and part of the labour unions intensified contacts with each other. This led to the approval, in 1986, of the first Income Policy Agreement. Not surprisingly, wage policy was the first area to be subject to a trilateral agreement. At the time, wage-driven inflationary pressures were believed to be the country's most urgent economic problem. The exclusive focus of the agreement was to control wage growth (Royo 2002). On the other hand, the Economic and Social Agreement (AES) signed in 1990 was more comprehensive, as it attempted to tackle issues of health and safety, vocational training and working time reduction. Its success was constrained by the non-participation of Portugal's largest union confederation, the communist CGTP, and by the ensuing difficult implementation of the pact's provisions.

A response to those difficulties was found in 1996 when the Government first presented a Short-Term Social Concertation Agreement and then inaugurated a programme entitled "Strategic Concertation to Modernise Portugal", which became the Strategic Concertation Agreement (1996-99). Among the decisions taken within the pact was the setting of minimum terms for collective bargaining in all sectors – establishing for example benchmarks for wage rises - and the reduction of the working week from 44 to 40 hours in two consecutive years (FT 25/1/1996). The latter agreement had two important features. First, it was meant to be comprehensive; social partners were asked to contribute to diverse and wide policy areas, such as income and employment policies, social security, environment and agriculture. Second, it introduced majority voting as a substitute for the previous consensus-building strategy that had been used within the AES (Campos Lima and Naumann 2000).

What induced Portuguese social partners to take part in social dialogue in spite of the fact that the country had no a corporatist tradition? The Portuguese Confederation of Industry (CIP) was rather sceptical about the whole experiment. It accused social concertation of being "a complex system controlled by the State". Moreover, organised capital was critical of the very inefficiency of the system. It would not matter if the agreed measures were economically desirable or not, as their implementation would be nonetheless blocked by labour representatives at the workplace. In spite of its rhetorical scepticism, the Confederation nonetheless participated in the agreements. On the other side of the spectrum, national labour unions were quite divided in their appreciation of the social dialogue. The CGPT that refused to sign the 1996 agreement insisted that bilateralism was the best approach to industrial relations. Conversely the view of the General Workers' Unions (UGT) was positive. It was recognised that social pacts had allowed inflation control; industrial conflict had declined; unions proved stronger, obtaining much larger real wage rises than in the periods where no collective agreement existed (http://www.eiro.eurofound.eu.int/ 1999/12/ inbrief/pt9912171n.html).

Overall, it can be observed that the determinants of social concertation in Portugal have been quite similar to Italy's. All parties involved agreed on the fact that exclusion from EMU would be extremely detrimental to the national economy. By helping to keep inflation at bay, fiscal discipline would allow to improve the country's competitiveness. But at the basis of the country's macroeconomic adjustment was a "distributional coalition" so that all reform attempts have been labour protective overall (see Rhodes in Pierson 2001). In particular, the absence of wage moderation might explain Portugal's disappointing fiscal performance in the 1990s.

Sequencing as supporting evidence

Did changes to the debt level and the exchange rate lead socio-economic actors to alter their perception of the costs and benefits from fiscal adjustment? The debt-to-GDP ratio continued growing until 1995, yet it was not particularly high and certainly not sufficient to allow deficit reduction to take place only through financial channels. In that respect, fiscal consolidation was bound to be a difficult political exercise to start with, as competing groups were required to reach an agreement over the distribution of the real adjustment burden. In 1992 the Escudo became subject to continuous speculative attacks. Monetary authorities were eventually forced to devalue in November and again in May 1993. While in 1992 CA revenues increased by 4.4 percent, in 1993 they decreased. There were no visible trade-offs between fiscal and exchange rate policy. To be sure, the initial depreciation had not been sufficient to fuel exports; for this to happen, one has to wait until 1994 (Bibow 2001). In that respect, export-oriented sectors were still not satisfied in the early 1990s. Social pacts only allowed inflation control, but were not signed against a framework of visible macroeconomic trade-offs between policy areas, as was the case of Italy. The fact that one of the unions did not participate is indicative of the fact that it was not only a question of macro-interests but also of confederations' political and cultural heritages, which overshadowed grand plans.

The use of shadow cases should have corroborated a few ideas behind the present thesis. First, fiscal consolidation episodes are deeply embedded in their wider societal context. Second, socio-economic interests are probably more important than institutional structures to the extent that they often end up shaping institutions from within. Third, all high-debt countries have a strong incentive to consolidate (e.g. Italy, Belgium). Yet, as evident from Table 12, not only does their level of commitment differ, but so does the composition of adjustment. In particular, hard currency regimes are unlikely to opt for revenue-based consolidations (e.g. Belgium, Germany). By the same token, soft-currency regimes are not as afraid of greater fiscal pressure if the exchange rate remains a viable competitiveness-boosting instrument (e.g. Italy, Portugal). In this respect, one should include the currency regime to better account for the choice over composition. The combination of debt level and currency regime is what opens up opportunities for a political exchange between social partners. It is possible than in turn the presence or not of this exchange, exemplified in the successful conclusion of a social pact, affects the relative size of deficit reduction and even its persistence.

Table 12.The Hard-Soft Currency and High-Low Debt Divide: a Synopsis

	HIGH-DEBT	LOW-DEBT
HARD-CURRENCY	**BELGIUM** (failed pact) Large Deficit Reduction Switching Strategy	**GERMANY** (failed pact) Small Deficit Reduction Switching Strategy
SOFT-CURRENCY	**ITALY** (pact) Very Large Deficit Reduction Revenue-Based Strategy	**PORTUGAL** (half-pact) Very Small Deficit Reduction Revenue-Based Strategy

Needless to say, these results are rather indicative but it does provide a roadmap to understanding the link between fiscal, monetary and wage policies in the run-up to EMU. It will be interesting to verify if and how these relationships have changed once EMU entered into full operation. And in the next chapter, I intend to look more closely at the German and Italian experience with fiscal discipline and social concertation after 1998 to test the extent to which EMU membership created a constraint or rather an opportunity. The next chapter will also offer a more general discussion on the political economy of fiscal consolidation and on future research trends and agenda.

CHAPTER VIII

The Political Economy of Italian and German Fiscal Consolidation

1. Changing Models of Capitalism in the Euro-zone?

This research project has provided a detailed analysis of the process of EMU convergence, of its politics and economics. At the same time, it should allow us to draw some conclusions about the changing nature of capitalism*s* and, in turn also of neo-corporatism, in EMU. The fact that countries reacted dissimilarly to a common constraint is in support of the so-called divergence theory, according to which deeper economic integration does not necessarily eliminate cross-country differences in the way in which economic systems are organised. In a more sophisticated fashion, the varieties of capitalism literature would argue that national systems are perpetuating themselves through the exploitation of their respective institutional comparative advantage (Kitschelt et al. 1999; Hall and Soskice 2001). Still, the story told here is peculiar in that it corroborates the divergence school of thought but contradicts the concept inherent to the varieties-of-capitalism literature, according to which domestic institutions continue adapting themselves to newly emerged circumstances, thus maintaining the system almost intact. The examples of Italy and Germany would in fact not confirm this latter point.

The Italian economic system changed quite remarkably in the 1990s. It achieved financial stability and improved its external credibility. In addition, social partners started being involved in decision-making in a more mature manner than was the case in the past and centralised collective bargaining was institutionalised. By contrast, the German coordinated market economy (CME) started visibly to crumble. Fiscal discipline appeared to be a more troublesome target and continues to be so at the time of writing. Social partners lost ground to the advantage of an almost fully sovereign state (Vail 2002). To what extent are these changes contingent? Are they structural, pointing to a transformation of the two respective models of capitalism and of corporatism? Was unification the cause of the German disease or was it just the event that brought existing structural weaknesses to light? These are some of the issues that will be briefly discussed here, inferring from events in the run-up to EMU, but in particular in light of the subsequent evolution from 1999 to 2004.There is an additional theme to take into consideration. With the entry of EMU into operation, the European economic landscape has been dramatically altered. Euro-zone countries are now under a single monetary policy rather than in the process of making their own converge as much as possible. They have been deprived of the interest and exchange rate instrument. With fiscal policy being also relatively constrained under the Stability Pact, wage policy remains by and large the only game in town. It is certainly worth asking if the convergence process has brought about some form of institutional adaptation with the inevitable narrowing of differences between CMEs and LMEs, as suggested above. However, the investigation around the working of different varieties of capitalism under the new EMU regime is a different but similarly worthwhile matter of empirical investigation, which could be developed in future research. The following paragraphs look at these issues.

1.1.The Italian variety before and after Maastricht

One of the weakest European economies since the 1970s, Italy has been catching up with its EU partners in the 1990s. First, against any rational expectation, the country succeeded in correcting serious fiscal imbalances, thereby gaining access in the first wave of EMU. Budget consolidation was facilitated by the country's parallel success in the fight against inflation, obtained mainly through the abolition of the wage indexation system. Surprisingly enough, in spite of the tremendous fiscal restriction, growth rates have not been as negative as might have been expected. With the improvement of the economic fundamentals came significant changes in the organization of the national economic system. The most visible novelty in the 1990s has probably been the intensification and subsequent institutionalisation of consultation rounds between government, employers and unions (Regini and Regalia 1997; Regini 1999). Until then, the varieties-of-capitalism literature had described Italy as an ambiguous model; however, there is no doubt that in the 1990s it started to resemble more and more the typology of CMEs. Needless to say, the EMU constraint represented a powerful incentive as in fact, after 1998, the tension towards fiscal discipline softened and so did the demands for social concertation.

Having secured EMU membership, fiscal authorities relaxed their stance and in 1998, 2000 and 2001 the country's structural deficit even deteriorated by 0.2, 0.7 and 1.1 percent of GDP respectively (Table 13). Still, deficit levels remained overall in control and most importantly in line with the Growth and Stability Pact provisions, at least until 2003. It is to be noted however that Italy fulfilled its international commitment from 1998 to 2003 only because the EMU-induced 4.1 percent of GDP fall in interest payments contributed to maintaining the net borrowing requirement under control. Indeed, discretionary fiscal policy was slightly expansionary as authorities aimed at reducing the country's comparatively high fiscal pressure, which had gone up by 6.2 percent of GDP in 1991-97. Already the Prodi Government had introduced a far-reaching tax reform in 1998. Income tax brackets were reduced to 5 from 7 and the maximum rate cut to 46 from 51 percent. In 1999, the D'Alema Government opted for total SSC relief in the South for all new employment contracts (European Commission, 2004, 64). After a rapid rise in the early 1990s, labour taxation went down to initial levels and from 1997 to 2001 overall fiscal pressure decreased by 2.7 percentage points of GDP. Tax alleviation was responsible for the slight deterioration in the country's fiscal position considering that spending levels remained relatively stable, in spite of a few attempts to alter their structure.

Table 13. Italy: Details of Fiscal Adjustment, 1998-2004

	Δ CA deficit	Δ CA TR	Δ CA TE	ΔInterests
1998	-0.2	-1.6	-1.4	-1.1
1999	1	0.3	-0.8	-1.6
2000	-0.7	-1.4	-0.8	-0.2
2001	-1.1	-0.2	0.9	0
2002	0.9	0.1	-0.8	-0.7
2003	0.3	1.3	1	-0.5
2004	0.2	-0.7	-0.8	-0.3
Tot 98-04	**0**	**-2.2**	**-2.7**	**-4.4**

Key: Δ CA deficit = change in cyclically adjusted public deficit (as of % GDP); Δ CA TR = change in cyclically adjusted total revenues (% GDP); Δ CA TE = change in cyclically adjusted total expenditures (% GDP); Δ Interests = change in interest payments (% GDP).

Source: European Commission, CA General Government Data, 2005.

Against this framework, social concertation lost momentum. In 1997, at a time when politics started to regain ground and the national party system to look more bipolar than ever, the Prodi Government already made an attempt to reduce the input of social partners into fiscal policy-making. He delegated to a technocratic commission the draft of a proposal for a vast welfare state reform without the initial consent of labour unions[1]. Subsequently, in 1999, Prime Minister D'Alema extended access to the negotiating table to a much larger number of socio-economic actors in the attempt to empty social partnership of its strong political connotation. The social pact signed in 1998 was by no means comparable to those achieved during the financial emergency. The so-called Christmas Package introduced measures to enhance labour market flexibility, but the government's commitment to it was moderate and labour union representatives continued to complain about delays in the implementation of the pact provisions. The launching of the EU Lisbon Strategy and renewed external pressures on the fiscal policy of the newly appointed Berlusconi Government created once again an environment favourable to the signing of a social pact in 2002. The latter revolved around wage moderation but also contained provisions for tax reform and a major review of the 1995 pension reform (Patto per l'Italia 2002). Still, the fact that CGIL, the largest union confederation, refused to sign it is indicative of the declining importance of social concertation.

The weakening of consensual fiscal policy-making depended on numerous concomitant factors. First, the end of the financial emergency coincided with the loss of a significant incentive. Second, the business community had less of an interest in striking a deal with the unions. EMU membership by itself guaranteed relatively low and, most importantly, convergent interest rates. In parallel, the loss of the exchange rate instrument deprived industrialists of an important compensation mechanism, one that in the 1990s had allowed them to recoup international market shares, even if the gain was short-lived. On the other hand, even unions had little to offer. Once the wage indexation system had been eliminated, they only had a marginal role when it came to affecting inflation levels. Nor can they signal with monetary authorities. With Italy representing about 20 percent of Euro-zone GDP, their inflation expectations are insufficient to impact on the ECB's policy decisions. This has loosened up the link between

[1] The Prodi Government was not sufficiently strong to proceed and the proposal failed to translate into concrete policy outcomes when faced with unions' opposition.

wage, fiscal and monetary policy, possibly creating policy mix problems. And indeed, an important finding behind the present thesis is that the particular constellation of socio-economic preferences in the 1990s was not only significant in that it allowed for successful fiscal consolidation, but also because it created sufficient room for an effective coordination between wage, fiscal, and monetary policy, which does not seem yet available in EMU[2]. Thirdly, consensual policy-making faded away together with the demand for the social-partnership model with the coming to power, in 2001, of the rather concertation-avert Berlusconi government.

In conclusion, it could be probably said that the Italian variety of capitalism has moved in a direction that makes it more similar to the CME-model. However, the new institutions remain empty shells where the interests of national economic agents do not exploit them to full potential. It is possibly the case that the process of policy and institutional learning is still under way. Moreover, when EMU entered in operation in 1999, Italy's restructured institutions were too "young" to bear the impact of a completely new regime. First, after the Bank of Italy had made a tremendous effort in the 1990s to establish credibility for low-inflation also in the face of wage bargainers, the interest rate instrument was lost. Second, the loss of the exchange rate itself made social partners more sensitive to the relation between wage and productivity growth, with the result that firm-level bargaining acquired greater importance to the detriment of the successful experience of central wage determination characterising the 1990s.

1.2.The fate of *Modell Deutschland* in the Euro-zone

In recent times, a heated debate has developed around the reasons behind the demise, in the 1990s, of the German variety of capitalism. The weakening of the German economy comes after its extraordinary success in the 1970s and 1980s, when the country proved well equipped to sustain the international economic crisis managing, against the odds, to deliver low inflation, high growth and employment rates. One of the most exploited explanations of the recent fall calls

[2] This issue will be further discussed in 1.3.

re-unification into question. From a rather different perspective, Kitschelt and Streeck indicated that the very peculiarities of the German system (i.e. the stability of the political system and incrementalism in decision-making) themselves impeded a constructive response to changing external circumstances (Kitschelt and Streeck 2004, 3). Along similar lines, this research work has argued that this historical event probably simply had the effect of bringing existing structural weaknesses to light. Namely, *Modell Deutschland* started to fade when faced with a macroeconomic environment in which Germany's original social institutions proved unable to perform as in the past. This does not necessarily mean that Germany has stopped being a CME but that, in the new context created by EMU, domestic institutions are operating in a way that leads to sub-optimal macroeconomic results. First, the country had to give up control over exchange rate policies. Second, monetary policies at large are now the exclusive responsibility of the ECB, with the result that national wage bargainers have lost an important reference partner (see Soskice and Iversen 1998). Growth is no longer dependent upon the behaviour of other countries, as when exports were driving the German locomotive. In addition, with Germany being *de facto* the anchor for wage setting in the Euro-area real exchange rate adjustment is not available (Hancke and Soskice 2003). With this come fiscal difficulties with slower growth having detrimental effects for the budget balance. In contrast to Italy, Germany did not even have the option of taking advantage of the regime change. The monetary straightjacket the country suffered from in the 1990s happened simply to be perpetuated under the new EMU regime[3].

Fiscal management changed with the coming to power, in 1998, of the Red-Green coalition under Chancellor Schröder. The latter was not subject to the unification-induced structural constraints the previous government had had to deal with, as the transition was more or less complete, as was the injection of extraordinary resources into the East. The Chancellor succeeded in cutting spending by 0.8 percent of GDP in 1998-2002 as well as in reducing fiscal pressure by 1.6 percent of GDP over the same period. In this fashion, fiscal discipline was preserved until 2000. However, since then Germany has

[3] This issue will be further discussed in 1.3.

experienced growing public deficits to the point where the country failed to respect the SGP provisions. According to the EU Commission, excessively numerous and inconsistent tax reforms, coupled with generally lower growth rates, produced lower-than-expected public revenues with the result that deficits surged (Table 14). This explanation is surely representative of the economics of the German fiscal performance; still it might be interesting to dig into the political rationale for so many tax reforms. Secondly, the figures illustrate that at the heart of the deterioration in 2000 is actually discretionary fiscal action leaving the impression that the federal government consciously relaxed fiscal policy for mere electoral purposes. Again, the picture will be complete only after politics are brought in.

Table 14. Germany: Details of Fiscal Adjustment, 1998-2004

	Δ CA deficit	Δ CA TR	Δ CA TE	Δ Interests
1998	0.3	-0.2	-0.5	0
1999	0.5	0.4	0	-0.1
2000	-0.4	-0.8	-0.4	-0.1
2001	-1.5	-1.5	0	-0.1
2002	-0.4	0	0.4	-0.2
2003	0.3	0.4	0	0
2004	-0.1	-1.4	-1.3	-0.1
Tot 98-04	**-1.3**	**-3.1**	**-1.8**	**-0.6**

Key: Δ CA deficit = change in cyclically adjusted public deficit (as of % GDP); Δ CA TR = change in cyclically adjusted total revenues (% GDP); Δ CA TE = change in cyclically adjusted total expenditures (% GDP); Δ Interests = change in interest payments (%GDP); Δ TE no I = change in cyclically adjusted total expenditures excluding (non adjusted) interest payments (% GDP).

Source: European Commission, CA General Government Data, 2005.

To what extent is a reference to social consensus useful to understand the German experience after 1999? Following Kohl's failed attempt to bring business and labour together, the ball fell in the court of the new Social Democratic Chancellor. Schröder was eager to show he was a supporter of concerted reform. By December 1998, the Government had already succeeded in getting the social partners to sign a new 'Alliance for Jobs'. Participating parties wanted to discuss measures to boost employment. But, the pact contained also provisions aimed at "fundamentally" restructuring the national system of social security (http://www.bundesregierung.de/ artikel,-56651/Gemeinsame-Erklaerung-des-Buen.htm). What changed in the constellation of domestic socio-economic interests that allowed German social partnership to reappear? Certainly, business continued to promote its tax-alleviation agenda just as it had done under the previous government. Yet, at this point, tax relief in the form of lower non-wage labour costs represented an area of common agreement between employers and employees. The considerable increase of SSC in the early 1990s was fundamental to exacerbating unions' concerns for excessive non-wage labour costs. Nevertheless, this was not sufficient in the end to set up the terms of a political exchange as *IG Metall* refused, as a matter of principle, to consider SSC during wage bargaining rounds (Streeck and Trampusch 2005). At the root of the new social pact were also strategic considerations. The BDA and the BDI thought that this was their only chance to influence a traditionally more union-friendly Government coalition (Streeck and Hassel 2004). By the same token, the DGB was initially sceptical, as it expected Schröder to be sensitive to its claims anyways.

Interestingly enough and against functionalist predictions, the social pact was signed in spite of the growing organizational weakness of both organised capital and labour, with the first internally divided by the confrontation between large companies and SMEs and the second suffering from on-going membership losses. This confirms the interpretative perspective adopted in the present thesis according to which social concertation is driven above all by a convergence of interests rather than by the existence (or not) of the appropriate institutional preconditions. In the context of the new Alliance, labour unions in particular managed to obtain important results; higher SSC were imposed on self-employed and pension reform was successfully postponed. Yet, on the whole, negotiations proceeded at a slow pace and hardly any comprehensive cross-sectoral fiscal decision was taken.

Even if timid, decisions taken in the framework of the new social pact nonetheless exercised an impact on the country's fiscal performance. Requests for lower corporate taxation put forward by the business community together with unions' insistence on the preservation of the welfare state had no other effect except to relax fiscal discipline in the presence of a Government coalition that was in constant search for the largest possible consensus. Added to this was slowing economic growth which amplified the negative impact of tax relief on the state budget. Against this background, the European Commission itself repeatedly urged the German Government to re-launch social concertation, especially with the view of guaranteeing the effective implementation of the EU Lisbon Strategy. Yet, in May 2003, the Alliance officially ceased to function. It was soon clear that structural reforms would have to follow the more traditional parliamentary root. The subsequent pension reform was supported by a large inter-party consensus forged in Parliament rather than the result of the operation of corporatist mechanisms.

In conclusion, this thesis suggests that at the root of the German demise is the disaggregating of the favourable constellation of socio-economic preferences that had allowed successful macroeconomic adjustment in the past decades. The distributional implications of re-unification contributed to it having instead the effect of bringing existing structural weaknesses to light.

1.3.Italy and Germany in Comparative Perspective

It was the aim of the present research project to explain why Italy's experience with fiscal consolidation in the 1990s was comparatively more successful than Germany's. The question does not overlook important and deeply rooted differences between these two politico-economic systems (e.g. relative influence of economic orthodoxy, monetary institutions, models of corporatism, etc.). Before EMU convergence, it was clear that Italy and Germany represented two extreme poles and that the conditions that made the latter successful were exactly those the Italian system was mostly deficient in. Germany performed well until the late 1980s thanks to fiscal authorities' pursuit of economic orthodoxy, to the presence of an independent and inflation-averse central bank and to collaborative relations between social partners. At the opposite extreme, Italy achieved quite disappointing economic results due to governments' excessive fiscal profligacy, to the presence of a politically dependent central bank and to conflictual industrial relations. Quite paradoxically, these very differences are part of the explanation of their performance in the 1990s rather than a methodological limitation. The underlying argument made here is that their two different economic and institutional heritages exercised feedback effects (see Pierson 1996; Pierson 2000) in a way that allowed Italy to exploit a peculiar comparative advantage over Germany.

What exactly does this comparative advantage consist of? Italy's high public indebtedness, wide inflation and interest rate differentials vis-à-vis its trading partners and a weak currency regime induced powerful domestic groups to form preferences over macroeconomic adjustment in such a way that a compromise between competing interests was achievable. Here, exchange rate, monetary, wage and fiscal policies were interlocked in such a way that budget actors had a real-time perception of possible trade-offs between different areas. True, the Italian government had much less room for manoeuvre than its German counterpart but was quite independent in the case of exchange rate and monetary policies. The currency was floating from 1992 to 1996. *Bankitalia* was then freed of the burden of supporting the external value of the Lira. Monetary policy has thus been supportive of fiscal consolidation overall, with short-term interest rates set on a continuous downward trend since 1992 (Table 15). In the face of fiscal retrenchment, when compensations in the form of greater public spending failed to be a viable instrument for consensus building, at least exchange rate developments offered a short-term leeway. Moreover, the country benefited from the regime change after 1999 in terms of improved credibility. EMU membership allowed for example a revaluation of the Lira without an overly restrictive monetary policy being needed for that purpose.

Table 15. The status of different policy areas before and after Maastricht

	GERMANY		**ITALY**	
	Pre-Maastricht	*Post-Maastricht*	*Pre-Maastricht*	*Post-Maastricht*
Exchange Rate Policy	Constrained	Single	Independent	Single
Monetary Policy	Constrained by fiscal policy	Single	Moderately independent	Single
Wage Policy	Constrained by monetary policy unemployment	Independent	Constrained by exchange rate	Independent
Fiscal Policy	Constrained by unification	Constrained by SGP	Constrained by high debt ratio	Constrained by SGP

By way of contrast and quite paradoxically, Germany was subject to a much larger number of constraints. Relatively autonomous in the 1980s, fiscal policy came under fire in the face of the costly re-unification. The resulting fiscal interventions attracted the attention of the *Bundesbank* adding a monetary constraint, as central bank authorities reacted quite strongly to the unification-induced fiscal expansion. This in turn affected wage developments. In 1991-92, as the central bank was reducing the money supply, West German wages increased exponentially. All this impacted on the external value of the DM in a way that was damaging to business interests. Thus the exchange rate failed to be a compensatory device to the extent that the abolition of capital controls prevented monetary authorities from managing the international value of their currency. At the same time, financial markets never lost confidence in the DM. As a result, there was no room for market-induced fiscal gains and any fiscal restriction had to affect real government activities, thus targeting one socio-economic category rather than another. True, after 1994, once employment loomed as a much more urgent problem than inflation, wage bargainers returned to restraint, but this made their opposition to welfare cuts probably even more fierce, thereby leaving the size of the win-set over fiscal stabilization small. In this respect, consensus building was a much more difficult exercise than it had been in Italy. Modelled around the German institutional set-up, EMU just happened to perpetuate this regime, adding to the system's incapacity to react to the new challenges (e.g. competition from East Asian markets, more favourable labour market conditions in Central and Eastern Europe).

Having provided for an evaluation of macroeconomic policy constraints and opportunities in Italy and Germany in the run-up to the single currency and once in EMU, I intend to discuss in the following sections the political economy of fiscal consolidation more in general.

2. The Political Economy of Fiscal Consolidation

At the present time, there is nothing more politically salient and theoretically challenging than the economics behind fiscal adjustment and the commitment to fiscal targets. The Maastricht Treaty had imposed significant reform pressures on EMU candidates in the early 1990s with the result that traditionally undisciplined countries finally succeeded in putting their budgets in relative good order (e.g. Italy, Greece). In addition, the subsequent SGP created an institutional environment in which fiscal misbehaviour would be punished. At the time of writing, a proposal has been put forward that suggest a reform of the SGP on the grounds that it has forced Euro-zone countries to adopt pro-cyclical policies in recession, which soon become politically unsustainable, as the French and German experiences demonstrate. What is clear is that there is no political consensus over the relative importance of such things as a Stability Pact. In this context of uncertainty, the economics profession has come to the fore tasked with the ungrateful job of measuring the Pact's costs and benefits. In this chapter, I discuss briefly my main findings concerning the economics of persistent fiscal discipline setting them in the context of the current academic debate.

2.1. The economics of fiscal adjustment

In the economics literature on the topic, two separate research agendas are distinguishable. One focuses on the economic and political determinants of fiscal adjustment. It is about quite static models identifying the relative importance of economic (e.g. starting position, currency regime) and political factors (e.g. type of government, budget and labour market institutions) for fiscal policy outcomes (e.g. size, composition and duration of fiscal adjustment). The second agenda revolves around the macroeconomic consequences of consolidation, after a seminal work by Pagano and Giavazzi (1991) established that, under certain circumstances, budget consolidations have non-keynesian effects. From a political economy perspective, this thesis has suggested that there is some connection between the determinants of fiscal outcomes and their general macroeconomic effect. Certainly, there are strong elements of endogeneity that actually put into question the very decision to distinguish between the two research agendas. For example, as has been demonstrated here, the persistence of fiscal discipline depends on domestic interests having solved, within a relatively stable equilibrium, distributional conflicts over the content of adjustment. Rather than being affected by the composition of adjustment itself, persistent fiscal discipline can only come after successive game rounds between competing domestic socio-economic interests. Against this background, the following discussion will treat the two research agendas as two sides of the same coin, focusing on the most relevant issues concerning budget consolidation: initial debt levels, currency regimes, political and fiscal institutions, labour market institutions, and sustainability of fiscal discipline.

Initial debt levels

In this thesis, I have often recalled findings from the economics literature according to which high-debt countries perform better than low-debt countries when trying to put public finances in order. This is to say that, in high-debt countries fiscal discipline is successfully achieved, as well as being preserved for a longer period of time. The argument rests on three possibly-not-necessarily alternative explanations. First, credible contractions in high-debt countries induce a significant reduction of long-term interest rates, thereby allowing for better investment conditions (Giavazzi and Pagano 1990; Giavazzi and Pagano 1996; McDermott and Wescott 1996; Alesina and Ardagna 1998). Cheaper money would impact for the greatest part on investment, and only marginally on private consumption (Zaghini 1999). Second, highly indebted countries tend to rely more on expenditure cuts than on greater revenues to consolidate their budgets; this should explain long-lasting discipline (von Hagen, Hallett and Strauch 2001, 20); the argument is thus related to the strand of literature ascribing superior overall performance to expenditure-based fiscal adjustments (Perotti 1996). Third, it has been also noted that the composition of consolidation does not matter once agents in high-debt countries believe that the change is structural and that a dramatic fiscal policy regime is under way. By expecting lower fiscal pressure in the near future, consumers and investors are encouraged to be more active (Blanchard 1990; Sutherland 1997; Ardagna 2004). This thesis confirms that governments in high-debt countries have the option of obtaining deficit reduction by "signalling" with financial markets. It adds to the existing literature where it suggests that this opportunity is quite valuable when they are asked to adjust within a short-time horizon, one in which there is little time available to forge a broad (stable) social consensus in favour of austerity. At the same time, my research refutes the argument according to which fiscal consolidation would be more successful in these countries because of their inclination to opt for primary spending restraints[4]. Finally, to the mechanistic view of agents consuming and investing more in the expectation that fiscal authorities will "behave", I juxtapose a micro-foundational interpretation that hinges on interest groups' actual preferences formed in response to a specific macroeconomic environment. By means of example, one of the arguments was that, after having suffered from comparatively high interest rates, business actors in high-debt countries will strongly advocate fiscal adjustment as a means to obtain less restrictive monetary policy conditions, and this happens (1) the deeper the economic integration, hence the greater the external competition; (2) when the exchange rate stops being an effective and/or realistic economic policy tool; and (3) under capital mobility, when high interest rate differentials also mean currency appreciation – under floating exchange rates. This shows that there is more at stake than just investment rising after interest rates have been reduced. Normally employed to detect significant correlations, econometric analyses tend to miss qualitative aspects of investment behaviour. On the other side, in the case of Italy, the most intriguing aspect seems to be the contribution to exports to GDP, which was important over 1992-96. This leads us to a brief evaluation of the role of currency regimes in fiscal adjustment, whether the debt level is high or not.

Currency regimes

There is abundant evidence coming from the economics literature showing that, when accompanied by currency devaluation, fiscal adjustment is more likely to

[4] It is fair to say that some economists have attempted to dig into the political economy of fiscal consolidation. For example, with the aim of accounting for the persistence of expenditure-based adjustment, Perotti argued: "Ex post (expenditure-based consolidations) are more persistent exactly because only strong governments can and want to implement them...cuts in the wage bill and transfers might be politically costly because they reduce the bargaining power of organised labour" (Perotti 1998, 371).

be successful, as export-led growth will produce expansionary effects counterbalancing the fiscal restriction (Lane and Perotti 1997; Alesina and Ardagna 1998; Lambertini and Tavares 2003). While not all economists confirm this correlation (Alesina and al. 2002; Ardagna 2004), the literature generally shows that fiscal discipline and devaluation are not inconsistent, as traditional Keynesian macroeconomics would predict. There are then strong empirical foundations supporting the suggestive interpretation offered here according to which, in Italy, revenue-based fiscal adjustment was traded with currency depreciation. The country's successful deficit reduction in 1992 was preceded by 11-percent devaluation of the Lira against the DM. It was not so much a question of positive net exports contributing to GDP growth, but of business actors advocating fiscal adjustment as a means to avoid appreciation once the currency started floating in September 1992 and high interest rate differentials risked attracting excessive foreign capital. At the same time, wage moderation agreed in the framework of social pacts had the effect of absorbing the potential inflationary impact of the weak Lira (see also (Alesina and Ardagna 1998).

Political and budget institutions

Institutional economists have insisted on the importance of political and budget institutions for fiscal policy outcomes. Under strong governments and in the face of efficient budget institutions, fiscal discipline is more easily achieved (von Hagen, Hallett and Strauch 2001). Conversely, this thesis has showed that social consensus is possibly more important than institutional constraints and opportunities. The latter matter only in the role of mediating variables, but are hardly sole determinants of successful fiscal adjustment. In spite of weak governments and of only moderately efficient fiscal institutions, Italy managed to put state budgets in order. Even in the case of Germany, where some institutional deterioration did in fact take place, raw institutionalist interpretations are not satisfactory as at the core of weakening budget procedures was mainly the Kohl Government's incapacity to solve (unification-induced) distributional conflicts in society. Not even federalism appeared to create a stronger constraint than in the 1980s, for example, as economic indicators suggest that, over the period under investigation, fiscal policy performed more of a stabilising function than had been the case during the adjustment in 1982-88. In addition, if one were to include social partnership and the relative involvement of interest groups in budget-policy making as an example of an institutional constraint, then this thesis suggests that, when it comes to corporatist arrangements, the preferences of the actors involved, even when just strategic, matter at least as much as the institutional setting in which they operate, as is further explained in 2.2. In a nutshell, institutionalist interpretations of fiscal consolidation are mainly deficient to the extent that they do not provide a clear methodological or empirical solution to control for the undeniable endogeneity of institutions, and particularly of socio-economic institutions.

Voluntary wage restraint and labour market institutions

Economic studies suggest that a positive correlation exists between wage moderation and fiscal discipline. When it concerns the public sector, wage restraint is certainly beneficial to public coffers (Ebbinghaus and Hassel 2000). Moreover, by controlling inflationary pressures, it reduces the real value of the debt service. These dynamics are likely to emerge only in the presence of encompassing unions, namely where wage self-restraint is actually feasible. The Italian case supports this hypothesis. The 1992 and 1993 Income Policy Agreements induced a restructuring of collective bargaining towards greater centralization. This created the appropriate institutional conditions for the imposition of nationwide wage moderation. In 1991-2000, real compensations per employee grew on average by 0.2 percent against 3.1 percent in the period from 1971 and 1980 (European Commission 2003b). Undoubtedly, the evolution of labour costs supported fiscal adjustment. It is important to note that wage restraint was the subject of an exchange between labour unions and government, where the latter gave up the idea of retrenching the welfare state and opted for a revenue-based budget consolidation, especially in 1991-93. From there it follows that the ensuing of greater fiscal pressure was socially accepted and did not lead unions to demand higher pre-tax real wages, as envisaged in Alesina and Perotti's critique of revenue-based adjustment (1997). This thesis has also shown that wage moderation is not always and not necessarily conducive to fiscal discipline. With the exception of the immediate unification aftermath when wage equalization between East and West Germany pushed average compensations upwards, German labour unions have behaved quite responsibly during the 1990s. However, this was not sufficient to support the government's still firm commitment to sound public finances. The argument set forth here is that wage moderation is supportive of austerity only when, being the subject of a political exchange between government and unions, it occurs simultaneously to the introduction of consensually agreed fiscal measures; yet, not any type of measure. Certainly, the wage restraint German unions were ready to accept, before the 1996 pact failed, stemmed from a peculiar motivation, namely to create employment. This means that the government was expected to offer in exchange expansionary side payments. In conclusion, the motivation behind unions' self-restraint is variable, and economists should take it into account considering that it is likely to affect unions' readiness to internalise (fiscal) negative externalities.

The sustainability conundrum

As highlighted above, most of the recent political economy literature insists on the non-Keynesian effects of fiscal contractions. As suggested above, this operates through two non-mutually exclusive mechanisms. On the demand side, deficit reduction induces agents to believe that in the future taxes will be lower; domestic consumption is stimulated in turn (Perotti 1998; Giavazzi, Jappelli and Pagano 2000). In addition, credible adjustments allow for a reduction of interest rates, thus fuelling consumer spending and in particular investment (Giavazzi and Pagano 1990; McDermott and Wescott 1996). In 1995 and 1996, when Italy's debt ratio to GDP started decreasing and interest rates levels to soften, investment growth accelerated at a faster rate than consumption. On the other hand, German investment was not necessarily as sensitive to interest rate developments. It actually peaked in the aftermath of unification (1991-92), at a time when interest rates reached historical highs. It continued to lag behind afterwards even if monetary conditions were relaxed. In a nutshell, the demand side channel has a diversified impact on national economies that depends on the specific (often embedded) preferences of domestic economic agents. Generalised models then provide roadmaps, but are not satisfactory when it comes to accounting for individual case studies. On the supply side, the argument is that a fiscal consolidation that relies on cuts to public wages and transfers will lower unit labour costs and improve competitiveness (Alesina and Ardagna 1998; Alesina and al. 2002). The Italian case shows that this is not necessary if the exchange rate is sufficiently low to fuel exports, even in the presence of higher fiscal pressure and comparatively high real unit labour costs. Italy's exports grew by an average of 9.7 percent of GDP in 1992-95, exactly in the period of the floating Lira, but reached a more modest average growth of 3.5 percent of GDP in 1996-98. Even revenue-based consolidations can then guarantee persistent fiscal discipline when the currency regime allows domestic exports to maintain a competitive edge and/or when the intervention is not perceived as just transitory, a state of affair that is likely to emerge there where tax levels were low to start with (e.g. Portugal).

2.2.The new political economy of corporatist patterns

Tripartite social concertation flourished in the 1970s allowing, where present, a smooth passage through times of stagflation. The 1980s witnessed a decline of corporatist modes of decision-making and a general shift of European industrial relations towards greater decentralization. This latter development exercised an impact on corporatist practices to the extent that, by multiplying the centres of responsibility, it made macro-level concertation more difficult. Emerging at a time when forces towards greater decentralization of industrial relations were still at play and in countries that did not have a strong corporatist tradition, social pacts in the 1990s appeared to many to be a theoretically challenging phenomenon. By excluding compensations in the form of greater social spending, governments' pursuit of fiscal discipline was at odds with the logic behind traditional political exchanges. Indirectly, this thesis has thus shed some light on the emergence of social concertation in Italy and its unexpected demise in Germany in a way that privileges a preference-based approach to an institutionalist one.

The literature on the emergence of social dialogue looks at three sets of explanations. The institutionalist perspective is that corporatist agreements come into being where wage bargaining is centralised, intermediate organizations well organised and the dialogue between government and social partners somehow institutionalised. As it has been extensively demonstrated in this thesis, this interpretation fails to account for the success of social pacts in Italy and their failure in Germany over the 1990s. The second strand of literature focuses on the demand side to identify the conditions under which governments have an interest in looking for the support of social partners. Amongst these conditions partisanship is likely to play an important role. In the case of Italy, it was rather the absence of partisanship that made concertation more likely considering that the most relevant social pacts in 1992 and 1993 were signed under formally technocratic governments (see also interview with Andrea Monorchio). The leftist Prodi Government was the one that did most to moderate unions' influence over economic policy-making (Mania and Sateriale 2002).

On a different note, the line of thought adopted here is that macroeconomic conditions are important predictors of the emergence and functioning of social institutions. They matter to the extent that they shape preference formation and, in turn, affect the very operation of those institutions. Hassel has suggestively argued that unions accepted negotiating with government in the 1990s in the attempt to limit the negative impact of the restrictive policy mix (Hassel in Jochem and Siegel 2003). In a more positive fashion, my argument is that tripartite agreements were signed when the general macroeconomic conditions opened up room for pay-offs and compensations that involved areas other than fiscal policy (e.g. monetary and exchange rate policies). Previous studies have attempted to account for the successful implementation of welfare state reform by referring to the important legitimising function that social partners' participation exerted on any reform effort. In contrast to these approaches, this research has explored the micro-foundations of fiscal adjustment, pointing at the significance of social pacts' specific content. True, the sense of financial emergency is an important trigger of corporatism but it is not about an abstract external threat. Social partners take decisions with an eye to the specific distributional implications that the unfolding of the crisis may have.

2.3.Limits and future research agenda

Most of the literature on EMU focuses on the role of European integration and institutions, both national and supranational. More recently, in front of the successive breaches of the SGP provisions by France and Germany, a heated debate has developed that looks at the functioning of EU fiscal co-ordination, and at the relative effectiveness of fiscal targets imposed from above (Pisani-Ferry 2002). Some observers have gone so far as to question the very legitimacy of the EU. By contrast, there is little on the domestic political economy of fiscal discipline. While the economics profession generally agrees on the desirability of fiscal rectitude, it has failed to justify convincingly the need for a rule-based coordination of national fiscal policies as well as to identify the socio-political conditions that best allow for the preservation of austerity, especially in bad times. With the fate of the Stability Pact unclear, there is at present even greater need to identify where fiscal discipline is viable and where it is an unrealistic target. In this thesis, I have somehow attempted to fill in the gaps by showing that fiscal policies remain entrenched in domestic societal contexts so that any successful deficit reduction needs to count on a favourable constellation of socio-economic preferences. By extension, it can be derived that, to be both credible and effective, any attempt at fiscal coordination should take country-specific circumstances into account. Most importantly, and on a more pessimistic note, if it is true that domestic preferences are endogenous, coordination at the EU level is hindered by different national perceptions of the ensuing costs of and benefits from coordination. Once again, the differential domestic distributional effects of such coordination are deemed to be an important factor.

Needless to say, the present work has limits too. First, because the story I have been telling here is strongly embedded in the characteristics of the two countries analysed, any application of the general argument to other countries would have to start from scratch controlling for the multiplicity of economic, social, political and institutional variables that may have a bearing on stabilization. The treatment of the two shadow cases of Belgium and Portugal has required in fact a fresh look at political and fiscal institutions, corporatism and social pacts, and at the peculiar evolution of socio-economic preferences in the two countries. Second, my work falls short of providing a clear-cut hierarchy between alternative explanations. Econometric analyses would have probably served the purpose. It would have been desirable to determine, for example, the relative importance of wage moderation, disinflation and export growth to successful deficit reduction. By contrast, econometrics is unable to capture the aspect of preferences and to correct the most visible methodological and theoretical flaw in the existing literature, i.e. the failure to recognise that preferences cannot be determined *a priori*; they are structured as trade-offs that evolve with the external macroeconomic environment. Given the absence of systematic surveys of social partners' views of fiscal adjustment, any rigid formalization of domestic preferences within an econometric model would have missed the point. Only if public opinion more generally is taken as the reference object, then there might be scope for employing econometrics to establish links and hierarchies between alternative explanations of fiscal adjustment (for a similar experiment see (Scheve 2004). Most obviously, the reader might be disappointed with the fact that most of the arguments here presented not only are country-specific, but have also remained open-ended, as at this stage any evaluation of fiscal policies in EMU and of the transformation of varieties of capitalism in the Euro-zone can be merely tentative.

Leaving methodologies aside, factually, there is now greater scope for research as, with EMU coming into operation, European economic governance has been subject to a substantial regime change. In the new context, Euro-zone countries have lost the ability to manage both the interest and the exchange rate, and with this arguably an important instrument to be used in negotiation with the social partners. At the same time, the preservation of fiscal discipline is a top priority as long as the Stability Pact keeps insisting on the respect of the 3 percent deficit target -even if the EU Commission is deemed to take account of country-specific circumstances more often than before (e.g. level of public debt, will and speed in the implementation of structural tax and welfare reforms). At the EU level, the ECB takes monetary policy decisions with the primary aim of preserving price stability and, in general terms, there is no scope for member countries to affect monetary policy indirectly through the management of their national inflation levels as each of them is too small relative to the size of the union to bear any significant impact[5]. All that remains available is the indirect choice over the real interest and exchange rates mainly through national wage policies. Against this background, there is no surprise then if, in the context of the Lisbon Strategy, the EU has insisted on the need to re-launch social concertation with the aim of promoting (ideally coordinated) wage restraint.

Until now, Euro-zone countries seem to have followed quite differentiated paths with possibly just small countries having to "look abroad" when taking wage policy decisions (e.g. Belgium, Netherlands). Even on the fiscal front, Euro-zone countries' experiences have varied enormously between 1999 and 2004 with small countries proving more disciplined than large ones. And because the existence of an international binding commitment and budget reforms introduced in the 1990s have been probably necessary but not sufficient to twist governments' hand into austerity, it is here believed that only a societal approach allows for a thorough understanding of the persistent divergence in fiscal performances across the EU. Quite a few issues deserve attention. With Italy showing clear signs of fiscal relaxation especially in 2003 and 2004, it might be worth evaluating if this indeed derives from a different constellation of socio-economic interests, after the entry into operation of EMU minimised the room for comprehensive macroeconomic policy coordination. The absence of visible trade-offs between fiscal, monetary and wage policies may explain why social concertation lost its initial momentum just after 1998. In the case of Germany, there is no doubt that EMU has dramatically changed the national economic landscape. More visibly, wage bargainers have lost their traditional reference partner. If coordination between fiscal, monetary and wage policies was troublesome in the 1990s, as this thesis has attempted to demonstrated, then one shall expect the situation to have further deteriorated after 1999. This is but a matter of empirical investigation, and a worthwhile one as it could in parallel shed light on the current German disease. In addition, this thesis has left out an

[5] Of course, this changes if the three largest economies, France, Germany and Italy find themselves in the same position vis-à-vis the cycle. A related argument would be if in EMU national business cycles have become more alike or they are deemed to converge, on the one hand, or if they would rather diverge in countries' respective struggle to preserve their comparative advantage by means of ad hoc supply-side reform, on labour and product markets.

important societal actor, namely the banking sector. With the latter being particularly influential in German politics, there is certainly scope for extending and enriching the present analysis. More generally, a societal approach should be useful to explain the abovementioned variation in fiscal performances between small and large countries. First, in small countries, labour and capital tend to have convergent preferences as their very existence depends upon external markets. This corroborates the idea that successful fiscal consolidation is more viable where there is large social consensus. Second, it is reasonable to believe that the preferences of socio-economic actors in small countries form in response to the general macroeconomic environment –an idea extensively developed in this thesis- and this should be more visible here than in large countries. The dependence from imports makes small countries particularly vulnerable to the real exchange rate. In turn, they would enact both fiscal retrenchment and wage moderation with the purpose of keeping inflation levels under control as, in light of their modest size relative to the whole Euro-zone, any hope to bear an impact on the ECB's decisions is deemed to remain disappointed. Finally, the same approach can be employed to clarify the dynamics of inter-country adjustment in EMU, an aspect that is to a large extent under-investigated (see Allsopp and Artis 2003).

In conclusion, this thesis set forth a series of propositions that can be brought to bear on a wide variety of problems having to do with the political economy of EMU. Such problems will be of great analytical and policy importance in the years to come.

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Appendix 1a

ITALY: Content Analysis: Ranking of Fiscal Preferences (1992-1997)

Sources:
- CISL
- CGIL
- UIL
- CONFIN
- PRESSL
- PRESSC

		Preferences for Fiscal Adjustment Discipline	No Cuts	More Tax	No Tax	More Exp.	Cuts
	Feb-92	3	X	X	2	X	2
	Jul-92	3	2	2	X	1	X
	Sep-92	3	X	X	2	X	2
	Sep-92	3	X	X	X	X	2
	Sep-92	3	X	X	X	X	X
	Sep-92	2	1	3	X	X	X
	Sep-92	3	2	1	X	X	X
	Sep-92	3	2	1	X	X	X
	Sep-92	3	2	2	X	X	X
	Sep-92	3	1	2	X	X	X
	Sep-92	X	X	3	X	X	X
Amato	Sep-92	3	2	2	X	X	X
Govt.	Sep-92	3	2	2	X	X	X
	Sep-92	3	2	2	X	X	X
	Sep-92	3	2	2	X	X	X
	Oct-92	3	X	X	X	X	X
	Oct-92	X	3	3	X	X	X
	Oct-92	X	3	3	X	X	X
	Feb-93	3	X	X	X	2	X
	Mar-93	2	X	X	X	3	X
	Apr-93	3	X	X	X	2	X
MeanL		3	2	2	X	X	X
MeanC		3	X	X	1	X	2
	May-93	3	1	2	X	X	X
	Sep-93	X	X	2	X	3	X
	Sep-93	X	X	3	X	X	X
	Sep-93	X	X	3	X	2	X
	Sep-93	2	1	X	X	3	X
	Oct-93	X	X	3	X	X	X
Ciampi	Oct-93	3	X	2	X	2	X
Govt.	Oct-93	X	X	3	X	X	X
	13/10/1993	X	2	3	X	2	X
	08/11/1993	X	X	X	X	3	X
	Nov-93	3	2	X	X	2	X
	Feb-94	3	X	X	X	3	X
	Apr-94	2	3	X	X	X	X
MeanL		2	1	3	X	2	X
MeanC		n.a.	n.a	n.a.	n.a.	n.a	n.a
	Sep-94	3	2	1	X	X	X
	Sep-94	3	X	X	2	X	2
	Sep-94	3	2	2	X	X	X

	Oct-94	2	3	3	X	X	X
Belusc. Govt.	Oct-94	3	3	X	X	X	X
	Oct-94	3	X	2	X	X	X
	Oct-94	X	X	3	X	X	X
	Oct-94	X	3	X	X	X	X
	Nov-94	3	2	X	X	2	X
	Dec-94	3	2	2	X	X	X
	07/12/1994	3	2	2	X	X	X
	12/12/1994	3	2	X	X	2	X
MeanL		3	2	1	X	X	X
MeanC		**3**	**X**	**X**	**2**	**X**	**2**
	Jan-95	1	X	X	X	3	X
	12/2//95	**2**	**X**	**X**	**3**	**X**	**3**
	Mar-95	1	X	3	X	2	X
	Mar-95	3	2	X	X	X	X
	Mar-95	**X**	**X**	**X**	**3**	**X**	**2**
	Jun-95	**3**	**X**	**X**	**2**	**X**	**2**
	Jul-95	1	X	X	X	3	X
Dini Govt.	Sep-95	X	3	3	X	2	X
	Sep-95	X	2	3	X	1	X
	Sep-95	3	1	2	X	X	X
	Sep-95	**3**	**X**	**X**	**2**	**X**	**2**
	Oct-95	3	X	3	X	X	X
	Oct-95	1	X	2	X	3	X
	Nov-95	**3**	**X**	**X**	**X**	**X**	**X**
	Nov-95	3	2	X	X	2	X
	Dec-95	X	X	X	3	X	X
	Dec-95	3	2	2	X	X	X
MeanL		3	X	2	X	1	X
MeanC		**3**	**X**	**X**	**2**	**X**	**2**
	Jun-96	X	3	X	X	X	X
	Sep-96	**3**	**X**	**X**	**2**	**X**	**X**
	Sep-96	X	X	3	X	X	X
	Sep-96	2	3	3	X	X	X
	Sep-96	X	3	X	X	X	X
	Sep-96	**2**	**X**	**X**	**3**	**X**	**3**
	Oct-96	3	2	2	X	1	X
	Oct-96	**X**	**X**	**X**	**2**	**X**	**3**
	Oct-96	**3**	**X**	**X**	**3**	**X**	**2**
	Oct-96	3	2	1	X	1	X
	Oct-96	3	X	X	X	2	X
	Nov-96	X	X	X	2	3	X
Prodi Govt.	Nov-96	**X**	**X**	**X**	**3**	**X**	**X**
	Nov-96	**X**	**X**	**X**	**3**	**X**	**2**
MeanL		2	3	2	X	1	X
MeanC		**1**	**X**	**X**	**3**	**X**	**2**
	Mar-97	**X**	**X**	**X**	**3**	**X**	**2**
	Apr-97	**X**	**X**	**X**	**3**	**X**	**X**
	Apr-97	**2**	**X**	**X**	**1**	**X**	**3**
	Oct-97	**3**	**X**	**X**	**3**	**X**	**2**
	Oct-97	X	X	X	X	3	X
	Nov-97	X	X	X	3	X	X
	Nov-97	2	X	X	3	X	X
MeanL		3	3	1	X	2	X
MeanC		**1**	**X**	**X**	**3**	**X**	**2**

N. 84 observations

MeanL(92-97)	**3**	**1**	**X**	**2**	**X**	**X**

MeanC(92-97)	**3**	**X**	**X**	**2**	**X**	**2**

Legend:

CISL	Union Magazine
CGIL	Union Magazine
CONFIN	Confederation's Annual Reports
PRESSL	All Press for Unions
PRESSC	All Press for Confindustria
MeanL	Mean for Labour
MeanC	Mean for Capital

Appendix 1b

GERMANY: Content Analysis: Ranking of Fiscal Preferences (1991-1997)

Preferences for Fiscal Adjustment:

Sources:
DGB
BDI
PRESSL
PRESSC

	Discipline	No Cuts	More TaxG	No TaxL	More Exp.	Cuts
Jan-91	X	1	3	2	X	X
Jan-91	X	3	2	X	3	X
Jan-91	X	3	2	X	3	X
Feb-91	X	X	3	X	3	X
Feb-91	X	X	X	3	X	X
Mar-91	X	X	2	3	3	X
Mar-91	X	X	2	3	X	X
Apr-91	X	X	3	2	1	X
Jul-91	**3**	**X**	**X**	**3**	**X**	**2**
Aug-91	X	2	3	3	3	X
Aug-91	X	2	2	X	3	X
Sep-91	X	1	X	2	3	X
Sep-91	X	3	2	X	X	X
Nov-91	X	3	2	2	X	X
Nov-91	X	X	3	3	X	X
Nov-91	X	X	X	2	3	X
Year 91	**3**	**X**	**X**	**2**	**X**	**1**
MeanL	X	3	2	1	1	X
MeanC	**3**	**X**	**X**	**2**	**X**	**2**
Jun-92	3	2	1	X	2	X
Aug-92	X	3	X	X	X	X
Sep-92	1	3	X	2	X	X
Oct-92	**1**	**X**	**X**	**3**	**2**	**X**
Nov-92	X	X	3	2	X	X
Nov-92	X	1	X	3	2	X
Nov-92	2	3	1	X	X	X
Nov-92	X	3	2	X	1	X
Year 92	**3**	**X**	**X**	**2**	**X**	**1**
MeanL	1	3	2	2	1	X
MeanC	**2**	**X**	**X**	**3**	**2**	**X**
Jan-93	3	X	X	1	2	X
Jan-93	**3**	**X**	**X**	**2**	**X**	**2**
Jun-93	**3**	**X**	**X**	**X**	**X**	**2**
Feb-93	X	3	X	2	X	X
Feb-93	1	X	X	3	X	X
Apr-93	X	X	1	2	3	X

	Jun-93	2	2	3	X	X	X
	Jul-93	X	X	X	X	3	X
	Jul-93	X	3	X	X	X	X
	Aug-93	X	3	X	X	X	X
	Year 93	3	X	X	1	X	2
MeanL		1	3	X	2	2	X
MeanC		3	X	X	1	X	2
	Jan-94	X	X	X	2	3	X
	Mar-94	2	X	X	X	X	3
	May-94	2	X	X	3	X	X
	Jun-94	X	X	X	2	3	X
	Sep-94	2	3	1	1	1	X
	Oct-94	X	2	X	X	2	X
	Oct-94	1	X	3	X	X	2
	Oct-94	2	X	X	3	X	3
	Oct-94	1	X	X	2	X	3
	Nov-94	X	X	X	2	X	3
	Nov-94	3	X	X	2	X	2
	Dec-94	X	3	X	X	2	X
	Year 94	2	X	X	3	X	3
MeanL		X	2	1	1	3	X
MeanC		2	X	X	3	X	3
	Jan-95	2	X	3	1	X	X
	Apr-95	X	X	X	3	2	X
	Aug-95	2	3	2	X	X	X
	Oct-95	X	X	2	3	X	X
	Year 95	3	X	X	2	X	2
MeanL		2	1	3	3	X	X
MeanC		3	X	X	2	X	2
	01/01/1996	X	X	2	3	X	X
	Mar-96	X	3	2	2	X	X
	Apr-96	X	3	X	X	X	X
	May-96	X	3	X	X	X	X
	Jun-96	X	3	1	X	2	
	Jun-96	1	3	X	X	2	X
	Aug-96	1	3	2	2	X	X
	Sep-96	X	3	X	X	X	X
	Sep-96	X	3	2	X	3	X
	Sep-96	X	3	X	X	X	X
	Oct-96	X	X	3	1	2	X
	Dec-96	X	2	1	X	3	X
	Year 96	3	X	X	2	X	2
MeanL		X	3	2	1	2	X
MeanC		3	X	X	2	X	2
	Feb-97	2	X	X	3	X	X
	Mar-97	X	2	3	3	X	X
	Apr-97	X	X	X	X	3	X
	May-97	2	1	2	3	X	X
	Aug-97	X	3	X	X	X	X
	Sep-97	1	X	X	2	3	X
	Nov-97	X	X	X	3	2	X
	Nov-97	2	X	X	3	X	X
	Dec-97	X	2	X	3	X	
	Year 97	2	X	X	3	1	3

MeanL	1	2	1	3	2	X
MeanC	**2**	**X**	**X**	**3**	**1**	**2**

N. 78 observations

MeanL(91-97)	**X**	**3**	**1**	**2**	**1**	**X**
Interview	1	3	X	2	X	X
MeanC(91-97)	**3**	**X**	**X**	**2**	**X**	**1**
Interview	3	X	X	2	X	2

Legend:

DGB	Union Magazine
BDI	Confederation's Annual Reports
PRESSL	All Press for Unions
PRESSC	All Press for BDI
MeanL	Mean for Labour
MeanC	Mean for Capital
More TaxC	Higher General Taxation
No TaxL	Lower Taxation on Labour or Capital

Appendix 2a

INTERVIEWS: Italy

Ministero del Tesoro
05/03/2003
Semi-structured interview with:
-Prof. Andrea Monarchio, Treasury official responsible for budget

Consiglio dei Ministri
20/10/2001
Semi-structured interview with:
-Prof. Giuliano Amato, former Prime Minister

CGIL
04/06/2003
Semi-structured interview with:
-Dr Lapadula, responsible for economic policy CGIL

SOURCES: Italy

Newpapers
(bulleans: budget law, deficit, social partners, Maastricht, unions, Confindustria)
Corriere della Sera, from 1991 to 1998
La Repubblica, from 1991 to 1998
Sole24Ore, from 1991 to 1998
Financial Times, from 1991 to 1998
Il Mondo, from 1992 to 1993
The Economist from 1991 to 1998

Internal Magazines
Nuova Rassegna sindacale (CGIL), from 1991 to 1995
Conquiste del Lavoro (CISL), from 1991 to 1997
Annual Report (Confindustria), from 1995 to 1997

Appendix 2b

INTERVIEWS: Germany

Bundesministerium der Finanzen
12/11/2003
Semi-structured interview with:
-anonymous, Treasury official responsible for budget
-anonymous, Treasury official responsible for budget

DGB
29/01/2004
Semi-structured interview with:
-Dr. Dierk Hirschel, responsible for economic policy DGB

BDI
14/11/2004
Semi-structured interview with:
-Dipl.-Volkswirt Dietmar Gegusch, responsible for budget policy

SOURCES: Germany

Newpapers
(bulleans: budget law, deficit, social partners, Maastricht, unions, BDI, DGB)
Financial Times
Die Tageszeitung
Der Spiegel
Frankfurter Allgemeine
Handelsblatt
Süddeutsche Zeitung
The Economist

Internal Magazines
Die Quelle (DGB), from 1991 to 1998
Internal press releases (DGB), from 1991 to 1998
Internal press releases (BDI), from 1991 to 1998
Annual Report (DBI), from 1991 to 1998
Annual Report (BDA), from 1991 to 1998

Appendix 3a

Size of Fiscal Consolidation Episodes, Italy 1991-97 (Trillions Lira)

	1991	1992	1993	1994	1995	1996	1997
B. PLAN	*5/91p*	*7/92s*	*7/93s*	*7/94s*	*6/95*	*6/96s*	*7/97*
Total	**49.100**a	**83.000**a	**38.500**a	**47.000**ap	**34.100**a	**33.000**a	**26.500**d
Total WI	**43.400**a	**78.500**a	**31.000**a	**45.000**ap	**32.500**a	**32.400**a	**25.000**a
R	17.400a	16.500a	3.000a	17.800ap	16.500a	11.200a	10.000a
X	16.000a	47.000na	28.000na	25.800nap	16.000na	21.200na	15.000a
Priv. et al.	10.000a	15.000a	n.a.	10.000ap	n.a.	n.a.	n.a.
Deficit	127.800r	150.000o	144.200a	138.600a	109.400a	88.000a	58.700d
Primary	16.000q	39.200r	31.800a	34.150e	80.000a	105.400a	131.000d
SUPP. B.	*5/91*	*7/92*	*5/93s*	n.a.	*2/95*	*6/96*	*3/97*
Total	11.600a	30.000o	12.500a	n.a	21.000h	16.000[i]a	15.500d
R	9.300a	16.200o	7.500a	n.a	15.500h	5.100a	15.050d
X	2.300na	6.800o	4.000na	n.a	5.500h	11.000na	70nd
Priv.	n.a	7.000o	n.a	n.a	n.a	n.a	n.a
B. PROP.	*9/91*	*9/92*	*9/93*	*9/94*	*9/95*	*9/96s*	*9/97cg*
Total	**55.500**r	**93.000**o	**38.500**p	**50.000**d	**34.100**d	**65.100**d	**26.500**d
Total WI	**51.395**r	**90.800**q	**31.000**b	**48.500**d	**32.500**d	**62.500**a	**25.000**d
R	22.700r	34.100r	3.800b	20.200d	18.000d	12.500d	11.115d
X	20.200nr	52.500r	27.200nb	28.300d	14.500nd	22.000nd	13.850nd
Priv.et al.	9.000r	7.000o	n.a	n.a	n.a	n.a	n.a
Deficit	127.800r	155.000o	144.200p	138.600d	109.400d	61.400a	n.a.
Primary	26.395r	50.000p	31.800p	37.500e	n.a.	131.000a	n.a.
EXT. B.	n.a.	n.a.	12/93	n.a.	12/95	Europe	n.a.
Total	n.a.	n.a.	6.700b	n.a.	5.285[ii]e	25.000d	n.a.
R	n.a.	n.a.	6.700b	n.a.	3.800e	12.500d	n.a.
X	n.a.	n.a.	0b	n.a.	1.485e	0d	n.a.
Treasury	n.a.	n.a.	n.a.	n.a.	n.a.	12.500d	n.a.
B. LAW	*12/91*	*12/92*	*12/93*	*12/94*	*12/95*	*12/96*	*12/97cg*
Total	n.a.	**93.300**l	**31.300**l	**49.200**l	**34.100**l	n.a.	**26.500**l
Total WI	**55.200**	**93.300**l	**31.300**	**47.200**g	**32.530**l	**62.500**	**25.000**nf
R	31.700	44.400o	5.000o	23.100g	22.590l	38.000	13.000f
X	20.200	41.900o	26.300o[iii]	24.100g	9.940nl	24.000	12.000f
Priv.et al.	15.000l	9.200l	1.000l	n.a	0l	5.900l	n.a

Legend: Deficit T.= Deficit Target; MB= Mini-Budget; EI=Extraordinary Intervention; n = No Interests; Treasury= Accounting Operations; * = RPP

Sources:
A = Original Dpef
h = Dpef following year
B = Parliamentary Debates
C = Confindustria's Intervention in front of Parliament
D = Bernardi/Parlato
E = Annali CNEL

F = Camera dei Deputati, Commissioni Riunite V della Camera dei Deputati e 5 del Senato della Repubblica. Attivita' Conoscitiva Preliminare all'Esame del Documento di Programmazione Economico-Finanziaria per gli Anni 1999-2001. Audizione del Governatore della Banca d'Italia, Antonio Fazio, 22nd April 1998.
G = OECD, Economic Survey
L = Degni et al, 2001
O = Bollettino Economico BI (o Relazione Annuale)
P = Camera dei Deputati, Debito Pubblico e Fabbisogno. Evoluzione e Politiche di Rientro 1983-1994, n. 35, Servizio Studi, September 1994.
Q = Camera dei Deputati, Debito Pubblico e Fabbisogno. Evoluzione e Politiche di Rientro 1982-1992, n. 108, Servizio Studi, May 1993.
R = Camera dei Deputati, Debito Pubblico e Fabbisogno. Evoluzione e Politiche di Rientro 1982-1992, n. 43, Servizio Studi, October 1992.
T = Camera dei Deputati, Debito Pubblico e Fabbisogno. Evoluzione e Politiche di Rientro 1980-1992, Servizio Studi, April 1992.

Appendix 3b

Size of Fiscal Consolidation Episodes, Germany 1991-97 (Bn DM)

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
B. PLAN	*7/91*	*7/92*	*7/93*	*7/94*	*7/95*	*7/96*	*7/97*
Total	**-16.56**	**-2.53**	**0**	**-0.3**	**10.8**	**-3.4**	**-13.4**
R	26.13	17.3	21.77	2.3	-21.4	-0.9	10.9
X	12.23	10.55	20.26	4.75	-25.69	-11.1	2.4
Other R	2.65	-4.32	-1.45	2.7	-15.2	-6.8	-4.8
Deficit	49.86	38	67.5	68.8	59.8	56.5	57.8
B. PROP.	*7/91*	*7/92*	*7/93*	*7/94*	*7/95*	*7/96*	*7/97*
Total	**-16.56**	**-2.53**	**0**	**-0.3**	**10.8**	**-3.4**	**-13.4**
R	26.13	17.3	21.77	2.3	-21.4	-0.9	10.9
X	12.23	10.55	20.26	4.75	-25.69	-11.1	2.4
Other R	2.65	-4.32	-1.45	2.7	-15.2	-6.8	-4.8
Deficit	49.86	38	67.5	68.8	59.8	56.5	57.8
SUPP. B.	*7/91*	*3/93*	n.a	n.a.	n.a.	*7/97*	n.a.
Total	**-4.8**	**24.6**	n.a	n.a.	n.a.	**n.a**	n.a.
R	6.9	-3.7	n.a	n.a.	n.a.	-9.16	n.a.
X	3	22.5	n.a	n.a.	n.a.	18.7	n.a.
Other R	0.9	1.6	n.a.	n.a.	n.a.	9.8	n.a.
B. LAW	*12/91*	*12/92*	*12/93*	*6/95*	*12/95*	*12/96*	*12/97*
Total							
R	26.86	9.67	18.67	7.47	-31.81	-5.5	
X	11.77	10.55	21.81	-2.27	-26.38	-11.4	

Legend: B. Plan = Financial Plannnig Document; B. Prop. = Government Budget Proposal; Supp. B. = Supplementary Budget; B. Law = Budget Law; Total = Size of Deficit Reduction (bn DM); R = Interventions on Tax Revenues; X = Interventions on Expenditures; other R = Interventions on Other Revenues; D = Deficit Target.

Sources:
Finanzministerium, Finanzberichte 1991-2000

[i] Total 16.000 bn register the impact on 1996 aggregates. They consist of 11.000 bn in spending cuts and 5.100 bn in revenue increases. Yet, the calculation of the impact of the measure on 1997 aggregates involves a minor revision of the figures. The total value is of 18.000 distributed in 11.000 bn on the spending side and in 7.000 bn on the revenue side of the budget (Dpef 1997-99, 39).
[ii] The Government proposal was that of collecting total 5285 just from additional revenues (CNEL 1996, 93). Through the parliamentary passage, it was split between revenue and spending measures.
[iii] Half of which concerning capital spending (Bank of Italy, Relazione Annuale).