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London, 1st July 2001

The Politics of Budget Consolidation ***External Constraints and Public Opinions***

What is your empirical puzzle?

This thesis is concerned with the domestic politics of Economic and Monetary Union (EMU) after 1992 as far as national budgetary policies are concerned. It is generally recognised that EMU policy formulation, and monetary policy at large, are competence of a small group of political and financial *elites* (governmental actors and bankers). However, after 1992, the modes of EMU implementation involved a larger number of actors. The existence of conditions for entry in the form of convergence criteria pushed for a more or less dramatic restructuring of national economic policies, thereby transforming EMU into an issue for most domestic actors (parties, employers' associations, trade unions, public opinions). It is mainly in the field of budgetary policy-making that the Maastricht commitment to numerical targets touched on politically delicate issues of redistribution and social justice. I believe that the formation of a reasonable degree of consensus between political *elites* and masses as regards EMU-induced consolidation is rather striking, considering also that it challenges previous literature on the political economy of public finances (see below).

Why is this puzzle important to research?

I intend to study the domestic politics of EMU by focusing on public finances. Three reasons explain this choice. Firstly, the convergence criteria on monetary stability, inflation and interest rates, as defined in the Treaty provisions, did not represent a real concern. Statistical evidence shows that convergence on those indicators was relatively rapid and unproblematic (EMI 1995, 1996). Rather, a serious obstacle to the launching of stage three of EMU would have been the poor performance of national deficits. Second, sound economic management was not a new concept to European Governments. Since the 1970s, there has been growing recognition of the fact that high levels of debt and deficit endanger the credibility of the financial stance of the Government and increase interest rate payments, thereby reducing the scope for action within other socio-political areas and priorities. Hence, the concern over public finances has a clear historical and political importance. Third, public finances are also composed of expenditures on welfare. There is an emerging amount of literature studying if sound economic policies have damaged or enhanced European welfare states in a chronic situation of ageing population (Garrett 1998; Scharpf/Schmidt 2000, Rhodes in: Dyson 2001). Contributing transversally to the debate on the future of the welfare state, my research entails a manifest political and social relevance.

What has been written on the puzzle? What is inadequate that prompts the researcher to research it?

There is a large amount of literature on EMU both from an economic and political perspective. Economists have looked at costs and benefits of a monetary union among

EU countries (Emerson et al 1988, 1992; de Grauwe 1997; Artis/Lee 1994). Political scientists have analysed EMU negotiations at the European level with a particular emphasis on the period 1988-1992. They have considered the formulation of EMU policy and tried to assess why it came about at the time it did (Keohane/Hoffman 1991; Tsoukalis 1997), how this happened and what actors, individuals and institutions, pushed for the creation of a monetary union and the introduction of the Euro (Dyson 1994; Mazzucelli 1996; Dyson/Featherstone 1999; Verdun 2000). Less exists on EMU implementation, on when national policy-makers take the results of negotiations back home and confront with their constituencies. To start with, my research tries to cover this temporal gap. Secondly, I believe that the success in national consolidation processes in the late 1990s remains largely unexplained by the literature. Since the early 1980s, sound public finances have been a top priority in the political agendas of most European Governments. In spite of the European-wide aspiration for balanced budgets, EU countries in the 1980s and early 1990s have had very different records of fiscal performances and trends¹. Traditionally, the literature explains budget outcomes on the basis of three main factors: economic conditions, domestic structures (Poterba/von Hagen 1999) and international commitments (Rotte 1998; Rotte/Zimmermann 1998). In the 1990s, economic shocks affected EU countries in a similar way; there is no degree of variation across countries which could explain both very similar or very dissimilar outcomes. Secondly, cross-national differences in institutional structures did not affect fiscal performances across countries since all candidates respected the 3%-deficit target. Nor are institutional structures a convincing explanation of a sound economy within single countries. In fact, consolidation concentrated in 1996-99 when no EU country experienced relevant institutional reforms as opposed to the period 1992-1996. Against this framework, the Maastricht commitment seems to be the most persuasive explanation of successful consolidation. However, if the commitment certainly affected fiscal performances, there is little evidence showing a direct relationship to fiscal trends. Positive trends were manifest only where domestic consensus on EMU adjustment was large both at the level of political and socio-economic actors and at the level of public opinions at large. While recognising in principle that the Maastricht commitment has great explanatory power, my model is more explicit about the conditions under which external commitments are conducive to sustainable budget consolidations.

What are the causal claims you are interested in? What the simplest model you can propose?

I am interested in analysing the conditions under which an international constraint such as the Maastricht commitment to a 3%-deficit contributes to the success of national budget consolidations. I argue that the success of an externally imposed consolidation depends largely on the level of domestic consensus on EMU.

Why do you like your model? Why superior? Does it advance our knowledge?

It strikes me as surprising that, during the 1990s, most EU Governments managed to put their public finances in order. My model offers a parsimonious explanation of this phenomenon. Consolidation depended on an external commitment, the Maastricht convergence criteria, but was the more successful, the greater the degree of domestic

¹ Cross-national variations are determined on the basis of both elements, level of the budget deficit and trend of the consolidation process.

consensus on EMU adjustment and the greater the level of public support for European monetary integration at large, as reflected in opinion polls. This model is particularly innovative to the extent in which it appreciates the role of public opinions in monetary policy-making against the widespread view of it being an elite-driven phenomenon. Such an approach will show useful to analyse cases in which public opinions were directly involved into EMU politics by means of referenda.

What the policy implications? How and where applied? How can they change the policy making process?

My research has important policy implications as to two main contexts. Firstly, since the 1970s, budget consolidation has been a politically difficult exercise. The issue lead to dramatic conflicts of interest between winners and losers from expenditure cuts and/or tax increases. The imposition of an external constraint proved successfully in neutralising domestic conflicts, thereby improving the political and, successively, economic viability of sound economic management. Secondly, a better understanding of the domestic politics of public finances should contribute to the design of a more efficient macroeconomic co-ordination in the newly created monetary union. In spite of the existence of EU legal requirements and of a system of multilateral surveillance on the conduct of national budget policies, still there are domestic differences in the interpretation of the modes and aims of fiscal policy.

What is the research design?

At the core of my research is the collection of data about domestic actors' preferences for budget consolidation strategies. In this context, I will downplay the importance of the traditional elements affecting budget policy, economic conditions and domestic structures. Instead, I concentrate on the Maastricht commitment. In Italy, the improvement of consensus on EMU adjustment between 1996 and 1999 conditioned the special performance of its public finances in this period. For the same token, the external commitment was responsible for Germany's adjustment to a 3%-deficit from 1996 to 1997, while the fragmented *elites'* support for EMU and the sceptic public opinion can be accounted for the poor performance of the country's fiscal trend.

What is the sample?

The question is researched on the example of two most dissimilar cases, Germany and Italy. Despite having the same fiscal performance in 1997, they had very different fiscal trends (Italy: positive; Germany: negative), a different degree of *elites'* consensus on EMU (Italy: totally supportive; Germany: fragmented and incoherent), a different level of public support for the single currency (Italy: enthusiastic; Germany: negative). For both cases, I will refer to the period 1996-99. In both countries, adjustment was considerably accelerated in those years. There, it is legitimate to argue that the external constraint has been the main factor affecting the politics of budget consolidation in the individual countries, although under certain conditions.

What are the data and data sources?

Data will be collected from multiple sources. I will describe domestic actors' preferences for budget consolidation strategies by referring to public statements (parliamentary hearings in the case of political parties) and semi-structured interviews. Newspaper articles will be used for crosschecking actors' positions. If most policy actors may have been reluctant to publicly come out against EMU, there is certainly a greater degree of variation as to their fiscal preferences.

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