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Fiscal Adjustment in Southern Europe: the Limits of EMU Conditionality

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Fiscal Adjustment in Southern Europe: the Limits of EMU Conditionality

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ABSTRACT

The EMU fiscal adjustment paths of the four Southern Europe members (Italy, Spain, Greece, and Portugal – SE-4) vary along two dimensions: a) cross-temporal (pre- and post-EMU accession) and b) cross-country. We account for the cross-temporal variation by distinguishing between the ‘hard’ and ‘softer’ EMU conditionality of the pre- and post-accession stage. External constraints in the form of the Maastricht eligibility criteria constituted a significant common ‘push’ factor in the fiscal stabilization process of EMU candidate countries throughout the 1990s. However, their potent does not necessarily lead to fiscal sustainability as demonstrated by the post-accession budgetary outlook of the SE-4. We account for the cross-country variation by introducing additional ‘pull’ factors related to the reform content, context and capability (such as unemployment, the level of social concertation, and government effectiveness). Only in cases where such factors were at work did governments engage in structural reforms to consolidate public finances instead of the less controversial path of macroeconomic policy reform.

Keywords: EMU, Southern Europe, Stability and Growth Pact, conditionality, fiscal policy.

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1. Introduction

External economic pressures in various forms of conditionality policy have long been associated with domestic economic reform. The agreement for the establishment of an Economic and Monetary Union (EMU) among EU member states entailed significant process of fiscal adjustment to meet the Maastricht eligibility criteria. The EMU adjustment process has reinstated the potential of external constraints and provided impetus for further research, given especially that Eurozone expansion is an inevitable corollary of EU enlargement. The EU will assess the readiness of aspirant entrants amid concerns about a premature EMU entry before achieving financial sustainability. The fiscal adjustment zeal of some new EU members resembles in varying degrees past efforts of the four Southern European countries (Italy, Spain, Greece and Portugal– henceforth: SE-4) that paved the way for their EMU accession despite negative speculation in the early 1990s. Thus, reviewing the SE-4 fiscal adjustment efforts can lead to useful conclusions about the role and function of EMU constraints.

Despite the socio-economic and political similarities between the SE-4, and the common nature of the EMU external constraints, we can distinguish two kinds of variation in their fiscal adjustment paths: a cross-temporal variation (pre-

and post-EMU accession) and a cross-country one. The SE-4 constituted a distinct group, upon which EMU exercised very strong appeal because of its economic and political implications. It promised monetary stability and the security of a potentially strong international currency. It also involved a position at the core of a differentiated integration process. The potent EMU attraction helped overcome domestic policymaking constraints and inertia, bringing about budgetary consolidation in all four countries. However, post accession (Italy, Spain, and Portugal entered EMU in 1999; Greece in 2001), the SE-4 have followed divergent trajectories. While Spain has internalized EMU fiscal orthodoxy becoming consequently a stark defender of the rules of the Stability and Growth Pact (SGP), the other three have experienced significant difficulties in complying with SGP budget constraints, adopting instead a revisionist stance in the Pact's reform debate (Blavoukos and Pagoulatos, 2008).

We account for this dual divergence (cross-temporal and cross-country) by drawing analytically on three different literature strands. First, the literature on the political economy of policy reform sets the overarching framework for the role of external constraints in initiating and carrying out policy reforms. The Maastricht eligibility criteria for EMU accession and the terms of the Stability and Growth Pact (SGP) have functioned as such external constraints. Second, we borrow the conditionality concept from the International Relations field to account for the decreasing power of external constraints between the pre- and post-EMU-accession stage. Third, we make use of the insights of the more

specialised literature on fiscal consolidation to examine the different trajectories of the SE-4 in terms of fiscal adjustment.

We attribute the cross-temporal divergence to the shift from the ‘hard conditionality’ of the accession process to the ‘softer’ conditionality of the post-accession stage under SGP rules.¹ Once the external constraint was relaxed following a positive accession decision, the fiscal stance depended largely on the quality of prior fiscal consolidation undertaken in order to obtain EMU membership. As suggested by the relevant literature on fiscal adjustment, a consolidation strategy aimed at appropriate expenditure cuts and structural reforms produces more sustainable fiscal adjustment if compared to primarily revenue-based consolidation.² EMU conditionality set nominal accession targets without prescribing the modality of achieving them. Therefore, the external constraint was a ‘push’ factor to consolidation without however ensuring fiscal sustainability. Only where additional ‘pull’ factors were at work did structural reforms take place. These ‘pull’ factors involved the *content and scope* of reform (we single out severe unemployment necessitating structural reforms), the *context* of reform (facilitating or constraining –we look at the degree of social concertation), and the *capability* for reform (we compare measurements of government effectiveness). All three ‘pull’ factors were at

¹ Our line of (positive) analysis holds independently of whether one agrees or not with the normative blueprint of SGP-prescribed fiscal orthodoxy. We happen to find the main tenets of SGP revisionism (more accommodation of cyclical downswings, greater focus on debt sustainability) well justified. In addition, expenditure cutting is highly controversial if it involves curtailing necessary social programs and transfers. In such case, “adjustment” is not a welcome development.

² By structural reforms we look at privatization/ liberalization, pension system and labour market reform, as these were the items that were prioritized by the dominant economic paradigm of the 1990s –and subsequently incorporated in the Lisbon agenda.

work in the case of Spain, but far less so in Italy, Greece or Portugal, where their absence limited reform only to the macroeconomic policy realm. Thus, these ‘pull’ factors account for cross-country variation.

The next section elaborates on the interplay between policy reform, EMU conditionality, and fiscal consolidation. Following that, we highlight the dual divergence, reviewing the adjustment efforts and fiscal performance of the SE-4 directly before and after EMU accession. We then account for the different trajectories of the SE-4, before concluding with some broader observations regarding the use and function of conditionality.

2. EMU Conditionality and Fiscal Adjustment

The use of international variables to account for domestic structural reforms was on the ascendance in the 1970s and early 1980s, given the external financial assistance granted extensively under the condition of domestic economic policy adjustment. However, conditionality policy generated both virtuous and vicious cycles of influence in recipient countries (Stallings 1992). As a result of the mixed record of conditionality, emphasis shifted to domestic, institutional and socio-political, mediating factors. Two main analytical approaches have emerged: a liberal, focusing on social preferences and interest groups; and an institutionalist, looking primarily at domestic institutional arrangements (Haggard 2000: 21-22). Additional insights have highlighted the implementation stage of reforms and the importance of building consensus

around reform strategies as condition for their political sustainability (Stiglitz 2000: 556, 571). In that respect, government effectiveness is crucial not only at the initiation stage but even more importantly at the implementation stage, when the initial impetus needs to be translated into actual policy outcomes.

Though conditionality may have slipped outside the main research focus, it remains highly pertinent. *Formal conditionality policy*, like institutional membership of an international organization or entitlement to other benefits, imposes *direct* external constraints to the targeted countries (Dyson 2006: 13-35).³ In general, (formal) conditionality entails the use of incentives to alter a state's behaviour or policies. Based on power asymmetries, it links perceived benefits for a state by another state or international organization to the fulfilment of specific conditions. In that respect, conditionality is an implicitly coercive instrument to secure compliance with certain desired policy or institutional outcomes (Hughes et al 2004: 525). While traditionally associated with international economic organizations (Killick 1998), the use of political conditionality has grown impressively in recent years, evolving into a primary instrument for the international community to exercise exogenous pressures for political and institutional isomorphism (Checkel 2000). Positive conditionality refers to granting benefits; negative conditionality involves the reduction, suspension or termination of the perceived benefits (Smith 1997: 6).

³ In contrast, indirect external constraints exercise an informal kind of conditionality raising the attraction of the formal conditionality policy. Such constraints relate to mechanisms of ideational contagion mainly through interacting epistemic communities (new policy paradigms like the 'sound money and finance') or pressure emanating from the globalized policy environment (liberalization of capital flows, etc.).

Judging whether a country meets set criteria is often highly subjective, politicizing the entire conditionality policy and linking it with developments beyond the originally specified criteria. Lack of clarity and target mobility create frustration and disillusionment, resulting in less vigorous efforts to comply with the set criteria (Grabbe 1999). An additional concern is the primacy of output focus (satisfaction of specific criteria) at the expense of an interest in the modality of reaching such output (Smith 1997: 8-9). Given such focus, conditionality often ends up faring badly, ignoring the national political, socioeconomic and institutional context, within which it is transcribed into specific policy actions (Killick 1998: 156). Finally conditionality, particularly in its more constraining versions, generates an ownership problem domestically, with reforms often seen as externally imposed, undermining domestic support (Checkel 2000). Subsequently, in such cases, compliance problems emerge, raising doubts about the efficiency and effectiveness of conditionality policies as well as the endurance of achieved reforms.

The EU has relied extensively on conditionality policy in its relations with third countries (Smith 1997) and most importantly with the countries of Central and Eastern Europe (cf. Schimmelfennig et al. 2003, Grabbe 2001, etc). Intra-EU, EMU membership was conditional upon meeting the Maastricht criteria, set in place to ensure fiscal adjustment. In these cases, conditionality relied on the attraction of membership and its perceived benefits, with membership criteria functioning as a set of external constraints (*vincolo esterno*) for aspirant members (Dyson and Featherstone 1996). Although such constraints,

emanating from the supra-national level, may seemingly curtail state autonomy, such a loss may actually empower the state to pursue its own public interest against strong societal and sectoral interests (Moravcsik 1994). Invoking domestically a ‘tied hands’ policy approach and shifting blame to the supra-national level, aspirant members are able, in view of the membership objective, to engineer otherwise elusive domestic reforms. External constraints and “scapegoating” may have either a limited impact, involving -often temporary- shifts of relative power in the policymaking process, or a much broader one, bringing along paradigm shifts with new policy norms transcending the overall policymaking system (Featherstone 2004).

In the pre-EMU accession phase, the power of exclusion exercised intense pressure on aspirant members to redress fiscal imbalances and bring about fiscal adjustment (Dyson and Featherstone 1999). The majority view attributes fiscal adjustment to the constraining impact of the Maastricht criteria (e.g. Busemeyer 2004, Buti and Giudice 2002, Rotte 1998, Rotte and Zimmermann 1998; *contra* Pamp 2007, Freitag and Sciarini 2001). The fact is that the Maastricht criteria gave more emphasis on fiscal consolidation rather than fiscal sustainability.⁴ The former could be achieved through relying on macroeconomic policy reform without need to engage in substantial structural

⁴ Fiscal consolidation is a much debated and highly arbitrary concept, especially as regards what constitutes a fiscal consolidation episode and how to assess success in terms of sustainability. The relevant literature has focused on the timing, duration, composition, and the political, economic and institutional underpinnings of fiscal adjustment (cf. Alesina et al. 1998, Alesina and Perotti 1996, McDermott and Wescott 1996, etc.) but less so on the role of external constraints. For our needs we adhere to the definition of *successful* and *unsuccessful* fiscal consolidation episodes elaborated in these works. The emphasis of the Maastricht criteria on consolidation rather than sustainability holds despite the debt criterion, which focused on the fiscal prospects of EMU candidate countries. On the course to accession, the debt criterion was sidelined, as the nominal target was replaced with a steady decrease of the public debt rate, a more arbitrary and diluted concept.

reforms that involved a much higher political cost for the incumbent government.

Post accession, the Stability and Growth Pact (SGP) was set in place to ensure fiscal prudence. However, the SGP monitoring and corrective mechanism has not been equally effective as shown by the November 2003 crisis and the subsequent reform. The pre-accession conditionality policy was output-focused, driven by the need to foster the new currency's credibility, and could capitalize on the threat of exclusion to achieve tangible results. Compared to the 'hard conditionality' of the pre-accession period, the SGP prescribed a softer and much more politicized form of conditionality, unable to resort to equally powerful instruments of coercion. The shelving of the automatic application of penalties on Stage 3 participants during 'Stability Pact' negotiations in 1996-97 politicised the control process of fiscal discipline within the Eurozone, subjecting it to the ECOFIN power constellation (Heipertz and Verdun 2004: 769-70, 776-77). As a result, should the political environment be conducive, member states could be tempted to free-ride on the Euro credibility and partly relax the budgetary pressure of the external constraints. The SGP 'softer conditionality' provided leeway for such members to breach the letter and spirit of the Pact, generating concern over a 'consolidation fatigue' (von Hagen 2005: 14).

Given such leeway, the continuity of fiscal balance after EMU accession would rely heavily on the modality of achieving fiscal adjustment in the pre-accession

period. After all, even within highly restrictive fiscal policy environments, national governments still manage to come up with different responses to fiscal adjustment (Mulas-Granados 2006). Such national policy autonomy was furthered by the output focus of the pre-accession period. Meeting the Maastricht numerical targets did not entail or envisage any prescriptive pathway to fiscal consolidation, sidelining concerns about the quality of fiscal adjustment. Individual EMU candidates retained responsibility for their own euro entry strategies and had a good deal of discretion over the sequence of required reforms as long as the policy outcome conformed to the set targets (Dyson 2006: 11).

This indifference over the modality of fiscal consolidation ignored existing evidence that budget consolidations relying too heavily on the revenue side (by raising taxes) rather than on the expenditure side (by cutting the appropriate kind of spending) are less likely to be successful and sustainable (Perotti et al. 1998, Buti and Sapir 1998). Unsuccessful consolidations rely heavily on increasing government revenues, while successful ones tend to lay heavy emphasis on downsizing government spending. Furthermore, successful consolidations involve larger cutbacks of current government spending rather than public investment spending. Finally, successful consolidations tackle more forcefully politically sensitive spending items, such as transfers, subsidies and government wages as compared to unsuccessful ones (von Hagen et al. 2001: 8-9). As a result, successful consolidations are characterized by continued improvements in the budget balance following the conclusion of the

consolidation phase. In success cases government expenditure on subsidies, social transfers and wages remain relatively constant and revenues increase. In contrast, unsuccessful consolidations are followed by a significant deterioration of the budget balance with an increase of expenditure on the sensitive budget items and declining revenues relative to potential output (von Hagen et al. 2001: 10).

Bringing together these insights, the direct implication for the EMU case is that fiscal sustainability could derive neither from the ‘hard conditionality’ of the pre-accession period nor the ‘softer conditionality’ of the post-accession stage. True, the ‘hard conditionality’ of the Maastricht criteria may have contributed to the fiscal consolidation of aspirant members. But the viability of fiscal adjustment in the post-accession phase was determined by the *modality* of fiscal consolidation in each country, whether based on macroeconomic policy or more far-reaching structural reforms. In other words, the way member states responded to the EMU ‘*vincolo esterno*’ affected their fiscal stance afterwards. Eurozone members that engaged in a consistent effort to stabilize their fiscal condition in the course to EMU primarily through expenditure-driven measures aimed to tackle economic structural rigidities have subsequently avoided fiscal imbalances. In contrast, member-states that focused on achieving membership with only nominal fiscal stabilization, primarily through revenue-driven measures and perhaps some accounting massaging, have experienced a post-accession deterioration of their fiscal condition.

In the following section, we look at the fiscal adjustment of the SE-4 and then account for their different trajectories.

3. Fiscal Adjustment in the SE-4

Table 1 summarizes the evolution of the primary and general government balance in the SE-4 from 1990 to 2005. We break this period into two sub-periods (1990-1997/9 and 1997/9–2005) separated by the EMU decision year.

Table 1: Primary and General Government Balance in the SE-04 1990-05

YEAR	GREECE		ITALY		PORTUGAL		SPAIN	
	GGB	PB	GGB	PB	GGB	PB	GGB	PB
1990	-15.4	-6	-11.8	-1.3	-6.1	--	--	--
1991	-11.4	-2.2	-11.7	0.2	-8.1	--	--	--
1992	-11.1	-1.3	-10.7	2	-6	--	--	--
1993	-13.4	-2	-10.3	2.8	-8.9	--	--	--
1994	-9.4	3.1	-9.3	2.1	-6.6	--	--	--
1995	-10.2	1	-7.6	3.9	-4.5	--	--	--
1996	-7.4	3.1	-7.1	4.4	-4	1.4	-4.9	0.4
1997	-4	4.2	-2.7	6.7	-3	1.3	-3.2	1.6
1998	-2.5	5.3	-2.8	5.2	-2.6	0.9	-3	1.2
1999	-1.8	6.5	-1.7	5	-2.8	0.4	-1.2	2.4
2000	-4.1	4	-0.6	5.8	-2.8	0.4	-0.9	2.4
2001	-6.1	3.7	-3.2	3.6	-4.2	-1.2	-0.5	2.6
2002	-4.9	1.1	-2.9	2.7	-2.9	0	-0.3	2.4
2003	-5.8	-0.3	-3.4	1.1	-2.9	-0.2	0	2.3
2004	-6.9	-1.5	-3.4	1.3	-3.2	-0.5	-0.1	1.9
2005	-4.5	0.5	-4.1	0.4	-6	-3.3	1.1	2.9

Source: Eurostat Yearbook 2005

For Greece, Italy, and Portugal, the first period is characterised by a continuous improvement of the primary and general government balance, whereas the second by a deterioration of both. The Greek primary balance moved from a 6% GDP deficit in

1990 to a 6.5% surplus in 1999 only to drop down to 0.5% in 2005; the general government deficit dropped from 15.4% to around 2% in 1999 but climbed up again in subsequent years to 4.5% in 2005. In Italy, the primary surplus soared to 6.7% in 1997 but dropped substantially afterwards (to 0.4% in 2005) and the general government deficit was reduced from 11.8% in 1990 to 2.7% in 1997 but moved again upwards to 4.1% in 2005. In Portugal, the primary balance after 1997 moved from surplus to deficit (from 1.3% in 1997 to -3.3% in 2005) and the general government deficit also exhibited an upward trend (from 3% in 1997 to 6% in 2005). Only for Spain, the EMU decision year does not indicate any change in either the primary balance, which continued to improve (from 0.4% in 1997 to 2.9% in 2005), or general government deficit, which kept dropping (from a 3.2% deficit in 1997 to a 1.1% surplus in 2005).

3.1. Fiscal consolidation in the course to EMU membership

Table 2 provides a detailed outlook of the SE-4 fiscal consolidation efforts up to the decision for EMU accession (for Italy, Portugal, and Spain 1997; for Greece 1999), in terms of both macroeconomic policy and structural reforms.

The main elements of the Italian strategy in the course to EMU membership comprised a continuous increase of tax pressure, a decrease of public debt servicing expenditure –achieved through falling interest rates—, partial reform of pension regimes, a suppression of public sector employment and a squeeze on the cost of local government (Radaelli 2002: 232). Despite the government intentions of a balanced fiscal adjustment (*Documento di Programmazione*

Table 2: Fiscal Consolidation in the SE-4 (1991-1997/9)

	GREECE	ITALY	PORTUGAL	SPAIN
Fiscal Consolidation				
<i>Public Expenditure</i>	<p><u>MEASURES:</u></p> <ul style="list-style-type: none"> - Increase in wage (OECD Economic Survey 1998) and transfer payments (Bank of Greece 1996) -Restraints on government purchases -Restraints on capital expenditures (achieved through equity flotation in public enterprises instead of direct capital transfers) (OECD Economic Survey 1998: 48) <p><u>OUTCOME:</u></p> <ul style="list-style-type: none"> - Primary expenditures rise (von Hagen et al. 2001: 100-1) 	<p><u>MEASURES:</u></p> <ul style="list-style-type: none"> - Controls in public sector pay and hiring - Curtailment of social security benefits (especially pension system deficiencies and health spending - Squeeze on transfers to subnational levels of government (OECD Economic Surveys, 1997: 63-77, 1996: 44, 1995: 39-47, 1992: 38-47) <p><u>OUTCOME:</u></p> <ul style="list-style-type: none"> - Stabilisation of wage payments and social transfers - Primary expenditures drop but mainly due to drop of public investment (Bank of Italy 1998: 233) 	<p><u>MEASURES:</u></p> <ul style="list-style-type: none"> -Expenditure ceilings for public sector wage (Convergence Program 1991: Annex 4) - Strong fiscal expansion after the 1992-3 crisis (social security expenditure and transfer payments) - Further moderate increases in social transfers and wage expenditure (Bank of Portugal 1995-7; von Hagen et al. 2001: 115) -Additional control measures in 1996-7 (OECD Economic Surveys 1998-9) <p><u>OUTCOME:</u></p> <ul style="list-style-type: none"> - Growth of primary expenditures compensated by great fall of interest expenditure (due to interest rates decline) 	<p><u>MEASURES:</u></p> <ul style="list-style-type: none"> -Wage expenditure moderation (agreement with Unions to raise wages and pensions in line with the official inflation target and not the actual inflation from 1995-7) (OECD Economic Survey 1996:138) - Freeze on public sector employment - Financial agreement with regional governments to curtail expenditure and government consumption - Trimming of social transfers (von Hagen et al 2001:118-20) <p><u>OUTCOME:</u></p> <ul style="list-style-type: none"> - Public expenditures drop due to control of primary expenditures but also fall of public investment (Balmaseda and Sebastián 2003: 209)

(Cont. in next page)

Table 2 (cont.)

Structural Reforms				
<i>Social Policies and Pension System</i>	<ul style="list-style-type: none"> - Modest small-scale reform in early 1990s - Report of <i>ad hoc</i> technocratic committee in 1996 (<i>Spraos Committee</i>) shelved after strong sectoral reactions - 2001 reform attempt met equally strong resistance and was withdrawn 	<ul style="list-style-type: none"> - Double reform (1992 and 1995-6) but no final solution (OECD Economic Surveys 1996, 1992) - Additional reforms in 1997 by the Prodi government (OECD Economic Survey 1999: 61). 	<ul style="list-style-type: none"> - Limited reform but only at a later stage (in 2002 and more substantially in 2004) 	<ul style="list-style-type: none"> - 'Social Pact for Progress' in 1991 limited success - Restriction of unemployment benefits, adjustments in healthcare system, pension system (Based on the <i>Toledo Pact</i>- 1995 and the <i>Social Security Consolidation and Rationalisation Act</i>, 1997) (Bank of Spain 1992-6)
<i>Labour Market</i>	<ul style="list-style-type: none"> - <i>Confidence Pact</i> (1997) and following legislative activities (in 1998 – Law 2639/98 and 2000 – Law 2874/00) had limited results (Papadimitriou 2005: 382, 392) 	<ul style="list-style-type: none"> - Reorganization of collective bargaining institutions (establishment of a new central agency – 1993) (Molina and Rhodes 2007, Perez 2000) 	<ul style="list-style-type: none"> -Early Economic and Social Agreement (AES-1990) - Problematic implementation of <i>Strategic Social Pact</i> (1996-9) (ILO Report) 	<ul style="list-style-type: none"> - Substantial flexibility after a three-year pact (1997)
<i>Privatisation</i>	<ul style="list-style-type: none"> - Extensive record with a revenue-raising focus (Pagoulatos 2005: 360) 	<ul style="list-style-type: none"> -Extensive record but the 1994 <i>Privatisation Law</i> a compromise solution (Toninelli 2000) 	<ul style="list-style-type: none"> - Extensive record but with no restructuring of industrial base - Establishment of the state holding company (<i>Partest</i>) facilitated the revenue-raising focus (Clifton et al 2003: 70-72) 	<ul style="list-style-type: none"> - Extensive record but revenue-driven; in need for greater liberalization and sectoral re-regulation (Bank of Spain 1999: 25)

Source: Own Representation.

Economico-Finanziaria, May 1991), budgetary consolidation eventually relied heavily on revenue policies (taxes and social security contributions) and less so on curtailing expenditure (Bank of Italy 1998: 233). Many of the revenue measures were temporary, enacted through supplementary or ‘emergency’ budgets, when the actual budget deviated strongly from forecasts or when the assessment for Eurozone membership was approaching. Thus, especially in the second half of the nineties, concerns were voiced about the adjustment of public finances, urging for a more determined reduction in current spending, increase in public investment and decrease in taxes and social security contributions in relation to GDP (Bank of Italy 1999: 28).

The initiatives to curtail public sector pay were partly undermined by the fragmentation of the wage bargaining system (von Hagen et al. 2001: 107), which led the government to reform collective bargaining institutions (cf. Perez 2000). Thus, in Italy, EMU strengthened pre-existing corporatist tendencies (Featherstone 2004). However, reform efforts were limited to wage negotiations without tackling other considerable rigidities in the Italian labour market (Bank of Italy 1999: 30). In the same vein, the pension system was reformed twice in the first half of the 1990s. However, reforms notwithstanding, pension expenditure continued to rise in the subsequent years, urging a more far-reaching pension system reform (Bank of Italy 1999: 28, 30). Privatisation was extensive (see Table 3), driven by the revenue-raising need and EU pressures to deregulate certain sectors but also regarded as a means to attract direct private investment and to undermine the ‘crony capitalism’

associated with a hard core of ‘national institutional investors’ (Clifton et al. 2003: 52-55). It overall remained a revenue-oriented rather than a structural reform policy (cf. Toninelli 2000).

**Table 3: Country Breakdown of Amounts Raised by Privatisation (1990-2001)
(in USD million)**

YEAR	GREECE	ITALY	PORTUGAL	SPAIN
<i>1990</i>	-	-	1092	172
<i>1991</i>	-	-	1002	-
<i>1992</i>	-	759	2206	830
<i>1993</i>	35	3039	422	3222
<i>1994</i>	73	9077	1123	1458
<i>1995</i>	44	10131	2362	2941
<i>1996</i>	558	11230	3001	2680
<i>1997</i>	1395	23945	4909	12532
<i>1998</i>	3960	15138	4299	11618
<i>1999</i>	4880	25594	1620	1128
<i>2000</i>	1384	9729	3256	1079
<i>2001</i>	1305	2653	353	741

Source: OECD Financial Market Trends, No 82, June 2002.

In Portugal, the revised Convergence Programme after the 1992-93 currency crisis placed a strong emphasis on fiscal consolidation on its own merit and not only as a by-product of negative inflation dynamics and falling interest rates (von Hagen et al. 2001: 113). Still, significant gains from the decline in real interest rates permitted Portugal to meet the Maastricht criteria without enacting any major curtailment of government primary expenditure, which actually increased during the consolidation period. Despite this rise of current primary expenditure, the budget deficit declined as a result of the sharp reduction in interest expenditure and the high growth of tax revenue (Bank of Portugal 1999: 21-22). This interest-free ride conveyed an image of nominal

fiscal convergence and a short-lived illusion of fiscal discipline (Braga de Macedo 2003: 191-92).

The gradually restored fiscal credibility of the Portuguese government was not fed by additional structural measures to bolster the diminishing competitiveness and sustain the catch-up process. Instead, it made social groups more intemperate (Braga de Macedo 2003: 183-84, 192). Strong increases in real wages and relative unit labour costs in 1998 and 1999 (Bank of Portugal 1999: 26) resulted from the problematic application of the comprehensive Strategic Social Pact for the 1996-99 period, set in place to engineer labour market reforms (ILO Report). In the social policy field, the incremental shift from the massive infrastructure building to increased expenditure for classic social risks (pensions, unemployment benefits) contributed to the deterioration of the primary balance with no evident conclusive success of the specific reform mix (Guillén et al. 2003: 259-61). The extensive privatisation programme (see Table 3) was primarily used to improve artificially fiscal performance and nominal convergence to the deficit criterion, through the creation of a state holding company (*Partest*) that enabled the government to register privatisation proceeds as fiscal revenue. The government remained very selective even protectionist, prioritising specific strategic national investors while sidelining more objective criteria based on the investor's financial position, technological or operative know-how (Clifton et al 2003: 70-72).

The Greek path to EMU placed strong emphasis on high public investment levels to achieve faster growth and fiscal restraint through both revenue increases and expenditure reductions (Greek Convergence Program 1994–updated version). However, despite intentions for a balanced focus, fiscal consolidation and the improvement of the primary budget balance in the 1990s relied heavily on the significant and almost continuous rise of public revenues as percentage of the (cyclically adjusted) GDP and much less so on the curtailment of primary public expenditure (Bank of Greece 1999: 32). Public expenditure rise was due to the increase in wage and transfer payments (von Hagen et al. 2001: 100-101) whereas restraint was more successful on government purchases and capital expenditures, with a substantial reduction in the latter category achieved through equity flotation in public enterprises instead of direct capital transfers (OECD Economic Survey 1998: 48). Making the most of permitted accounting discretion, the Greek government moved (parts of) public investment expenditure off primary budgetary expenditures without affecting actual levels of public investment but improving overall primary expenditure performance.

Whereas fiscal consolidation produced tangible results bringing down the deficit within the Maastricht limits, the record of structural reforms during the same period was mixed. Labour market reforms, initiated in 1997, failed to address the key weaknesses of the Greek labour market, being neither radical nor consensual and failing to produce any meaningful results in curbing the most important labour market rigidities (Papadimitriou 2005: 382, 392). The

small-scale pension reform of the early 1990s generated some savings in the subsequent years (von Hagen et al. 2001: 101), but was modest and did not provide a long-term solution in the face of stiff union opposition and internal party dissension (Featherstone 2004). Concerns about pension system viability led to the establishment of an *ad hoc* committee of technocrats in 1996 ('Spraos Committee'), the Report of which was shelved after confronting strong sectoral reactions (Featherstone et al. 2001). Privatization policy was more successful (see Table 3), but instead of alleviating public debt, the high proceeds were partly used to finance current government expenditure (Pagoulatos 2005: 360).

In Spain, fiscal consolidation was based on wage moderation (accompanied by a freeze on public sector employment and a financial agreement with regional governments that had in the past conducted a more expansionary public pay policy), trimming of social transfers and curtailment of government consumption (von Hagen et al 2001: 118-20). Wage control, exercised through collective bargaining agreements, was fundamental in restructuring public finances, with the increase in real wages not exceeding labour productivity and hence not affecting negatively competitiveness and growth (Bank of Spain 1998: 12). However, the decline of public investment during the same period raised concerns about the prospects of real convergence with the EMU partners (Balmaseda and Sebastián 2003: 209). On the revenue side, a major income tax reform in 1999 aimed to stimulate economic activity by increasing disposable income (Bank of Spain 1999: 18-20).

The EMU third stage found the Spanish economy in a position to pursue real convergence, featuring a successful liberalisation programme and a significant record of structural reforms already under way (Bank of Spain 1998: 19-25). This was made feasible by the successful social concertation achieved during the fiscal consolidation period, which paved the way for extensive pension and labour market reforms. Labour market rigidities were significantly tackled after a three-year pact was signed in 1997 between the main trade unions and employers' associations. Pension and healthcare system reforms were initiated with the 1995 'Toledo Pact', an agreement of an *ad hoc* Parliamentary Committee to which the main interest groups adhered, and came into force with subsequent legislation (Featherstone 2004). In general, the Spanish welfare state witnessed a clear redesign of several key social policy aspects with emphasis on rationalisation, increased efficiency and cost-control (Guillén et al. 2003: 249-252). The privatisation record of both the Socialist government in the early 1990s and Aznar's Conservatives from 1996 onwards was very extensive (see Table 3), despite the differences in scope and ideological underpinnings (Clifton et al. 2003: 74). However, in certain areas, privatisation preceded sectoral re-regulation and market liberalisation, suggesting possibly a policy focused on revenue-raising rather than restructuring the production base or improving market functioning (cf. Bank of Spain 1999: 25).

3.2. Fiscal performance in the post-accession EMU era

Once membership was achieved, the SE-4 could potentially free ride on the common currency's credibility without being individually penalized by financial markets. Given the politicisation of the ECOFIN decision, the SE-4 could count on a favourable Council disposition towards greater discretion or toleration of a less austere fiscal stance. Laxity expectations remained low in the first couple of years after 1999 when the rhetoric for strict application of SGP rules aimed to bolster the new currency's credibility vis-à-vis financial markets. Portugal paid the price of this imperative. However, expectations arose after 'the big beasts in the Euro jungle', France and Germany, exhibited also a less restrictive fiscal policy, undermining SGP credibility. Hence, the Eurozone was receptive to the SE-4 displaying fiscal consolidation fatigue.

In Italy, the fiscal stance relaxed substantially after 1998. A further small decrease of transfer and wage payments was balanced out by a rise in government purchases (but only a very timid rise in public investment), leading to an overall small increase of primary government expenditure. At the same time, tax revenues declined following a broad based tax reform (von Hagen et al. 2001: 110). As a result, the Italian primary balance showed significant deterioration, taking overall deficit performance right at the edge of the three percent threshold (see Table 1).⁵ No significant progress was made on the reform front either, since EMU membership seemed to have relaxed in Italy the

⁵ Following data revisions in 2005, the Italian general government deficit actually exceeded 3 percent in some occasions.

perceived need for structural reforms on the supply side (OECD Economic Survey 2004).

In Portugal, the intention of redressing public discontent over EMU-induced fiscal austerity was evident already in the 1997 Convergence Programme. According to that and although a further decline of the budget deficit was envisaged, spending and tax measures should be geared to comply with the social responsibilities of the government (Portuguese Convergence Programme 1997: 14). The procrastination of unpopular reforms in the 1990s led to a stagnating economy and higher inflation, with the government reversing earlier policies of wage moderation and thus contributing to a rapid deterioration of public finances (Braga de Macedo 2003: 181, 192). After the 2002 election, the new Conservative government revised upwards the deficit indicator for the previous year, bringing Portugal in breach of the three percent threshold. This breach occurred at a time when the ECOFIN political constellation still abided by fiscal orthodoxy as envisaged in the strict application of SGP rules. Thus, Portugal experienced disciplinary action through the invocation of the Excessive Deficit Procedure and was forced to urgently renew fiscal consolidation measures (Bank of Portugal 2002). These measures brought the Portuguese deficit again under the three percent threshold but at great political cost for the incumbent Barroso government (Busemeyer 2004: 13). However, after the short, EDP-imposed interlude of renewed fiscal discipline, Portugal reversed to expansionary fiscal policy, with increasing primary deficits (see Table 1).

In Greece, after the 1999 peak of the primary surplus, primary balance deteriorated sharply, even registering primary deficit in 2003 for the first time over a decade (see Table 1). Although exceptional factors accounted partly for the budget deficit increase (the 2004 Olympics), this development owed much to excessive primary expenditure and a revenue shortfall (Bank of Greece 2004: 23-25, 2003: 18-19). The overrun in almost all items of primary expenditure was offset partly by a cut in public investment budget outlays for the fourth consecutive year (Bank of Greece 2003: 20-21). The state of Greek public finances was given a new twist following the fiscal audit instructed by the new centre-right wing government after the 2004 elections. The audit led to an upward revision of Greek fiscal indicators after 2000 but did not put into question the achievements of the earlier fiscal consolidation period. Despite continuation of the extensive privatisation, re-regulation and liberalisation programmes, neither the labour market nor pension system rigidities have been successfully tackled.

In total contrast, fiscal prudence in Spain so far has been sustained with the Spanish government running consistently primary surpluses (see Table 1). Primary current expenditure as GDP percentage remained by and large constant whereas revenues were not negatively affected by the 1999 and 2003 tax changes of a contractionary nature (Bank of Spain 2003: 121-6). As a result, Spain has complied with the SGP condition whereby the cyclically adjusted general government balance has to be close to zero or in surplus. However, certain developments have mitigated the success story in the post-accession

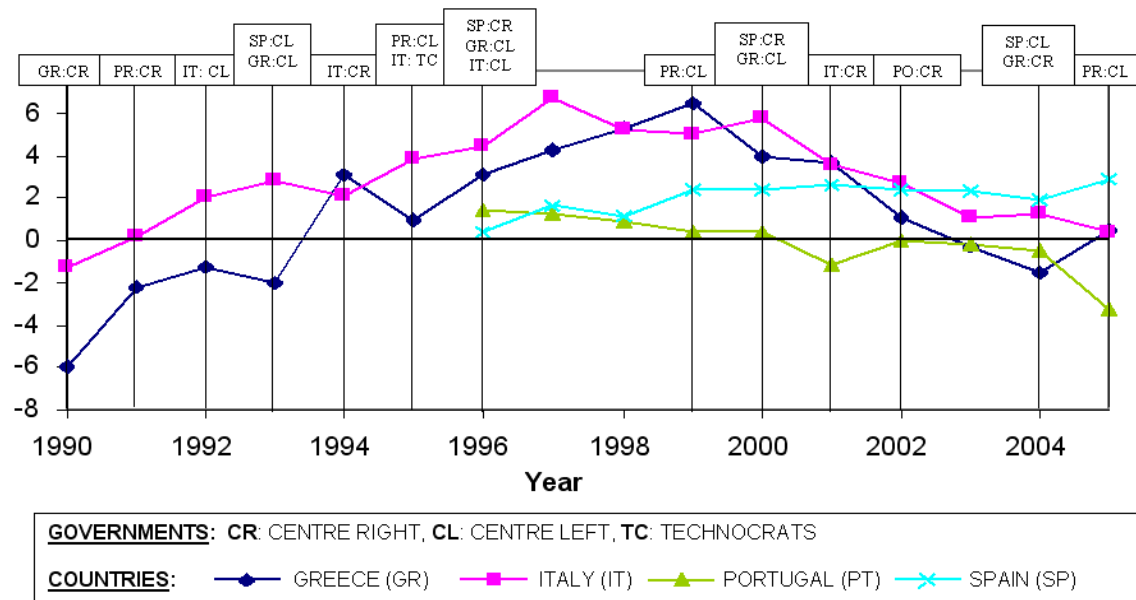
phase. Negotiations for a new Pact to tackle further labour market rigidities came apart in 2001, and the government ended up acting unilaterally. In addition to that, the 2001 pension reform did not involve all social actors (Guillén et al. 2003: 251), raising doubts about the depth and longevity of the extensive social concertation achieved during the fiscal consolidation stage in the 1990s.

3.3. In sum...

The SE-4 countries underwent prolonged fiscal consolidation in the 1990s. However, only in the Spanish case fiscal consolidation proved to be sustainable. In Italy, Portugal, and Greece, the fiscal consolidation honeymoon was swiftly brought to an end after EMU entry, with the cyclically adjusted primary balance declining significantly in the years after accession. In contrast, Spain has run balanced or even surplus budgets and primary budget surpluses consistently after accession giving tangible indications of fiscal sustainability (see Figure 1). Spain based its fiscal consolidation on substantial structural reforms that paved the way for fiscal sustainability after accession. Italy, Portugal and Greece relied heavily on revenue-raising policy measures that showcased a temporary improvement of fiscal performance. Assisted by the drop of interest rates and creative use of accountancy rules, the latter three managed to enter the Eurozone without having sufficiently tackled structural

rigidities. Once the threat of exclusion subsided, fiscal performance in these three countries deteriorated again.

Figure 1: Primary Balance, Election Years and Governmental Change



In the labour market, with differing degrees of success, wage bargaining went through a neocorporatist re-centralization process. This was considered a crucial mechanism to maintain international competitiveness in the face of lost monetary policy autonomy (cf. Crouch 2002). While this was an important first step in the course to wage moderation and signalled a substantial level of social concertation, only in Spain was it followed by a more far-reaching tackling of labour market rigidities. Furthermore, concerns about pension system viability led to several reform efforts in all SE-4, only to confront strong sectoral reactions and be withdrawn or watered down in most cases. Such was the case with Italy and Greece but not Spain, where reforms were far-reaching; Portugal

initiated reforms at a much later stage. This highlighted the limits of external empowerment and of EMU's functionality as an external reform stimulus (Featherstone et al. 2001). Privatisation was primarily revenue-driven, not amounting to structural adjustment. The problem was accentuated further by curtailed public investment (e.g. Italy and Spain), raising concerns about future economic growth and the sustainability of fiscal consolidation.

4. Accounting for the SE-4 Divergence

In general, the starting point to account for budgetary upturns is the political partisan cycle on the basis that there is a systematic relationship between the partisan composition of governments and budgetary outcomes. Proponents of this relationship argue that leftist governments are inclined to run budget deficits to finance expansive social policies whereas governments led by rightist parties envisage a smaller role for the state and seek to reduce public spending (Hibbs 1977). Although the general debate remains ambivalent (e.g. Roubini and Sachs 1989 *contra* Hahn Deuk et al. 1996 or Alesina et al. 1998), the works with a specific EMU focus provide suggestive support to the claim that partisan alteration in office did not play a significant role in the course to fiscal adjustment (Freitag and Sciarini 2001). This holds indeed for the SE-4 as illustrated in Figure 1, which depicts election years in the SE-4 and the change of governments without revealing any relationship between the ideological orientation of governments and their fiscal stance.

To account for the different trajectories of the SE-4, we revisit the EMU function as an external constraint. In essence, EMU has been a regulation system that proscribed certain budgetary options to ensure fiscal prudence but prescribed policy models only in particular core aspects of monetary policy and not over the broad spectrum of budgetary policy (Featherstone 2004). External constraints are mediated by forces within the national institutional setting, where the *modus operandi* of the political system determines the degree and modality of internalisation and implementation of these constraints. In its function as an external constraint, EMU offered state actors a strategic tool for fiscal adjustment, the success and effectiveness of which however depended on the way it was internalised by each policymaking system. Especially as EMU touched upon the most sensitive aspects of domestic politics, i.e. labour and welfare reform, the particular characteristics of the domestic institutional setting and political leadership determined its potency as a reform stimulus.

The starting point of divergence among the SE-4 is the socio-political context within which fiscal adjustment took place, in particular the degree of concertation, which varied considerably in terms of scope and magnitude. In Spain, structural reforms in the pension system and labour market were undertaken in a highly consensual environment of social concertation, with EMU pressure promoting cooperation among economic actors (Royo 2006, Perez 2000). The importance of this achievement becomes even more significant considering the unsuccessful attempts in the 1980s and early 1990s that failed to appeal to trade unions and to foster a stable and effective

neocorporatist negotiating environment (Boix 2000: 170-178). The run-up to EMU altered the contours of domestic policymaking, with social partners acknowledging the limitations of the existing system and consenting to far-reaching reforms (Featherstone 2004). A similar concertation tendency was recorded in Italy in the early consolidation stage (Perez 2000, Regini and Regalia 1997) but waned afterwards (Molina and Rhodes 2007). Especially the successive reforms of the pension system highlighted the importance of concertation with social partners for tackling the explosive long-term government liabilities but their incomplete nature also underlined the limits of consensual policymaking (Radaelli 2002: 219, 232; Braun 1996). Similar efforts of a smaller scale were undertaken in Portugal as a result of a defensive reorientation of social actors (Royo 2002). After the 1995 general elections and the rise to power of Guterres' Socialist Party, efforts to engineer labour market reforms were intensified on the basis of a more comprehensive Strategic Social Pact for the 1996-99 period. However, despite the government's positive assessment of the Pact's implementation progress, social partners either did not sign it or criticised its application (ILO Report),⁶ largely suspending the labour market reform zeal of the new government. Greece managed only partially to follow the same path, with only one major Pact signed in 1997 and all government initiative failing ever since (Karamessini 2007: 8). Such relative failure owed much to the lack of firm political commitment to social dialogue

⁶ The largest Portuguese Trade Union (CGTP) was not a signatory partner, undermining the authority of the tripartite monitoring commission and the Pact in general. The Confederation of Portuguese Industry (CIP) voiced concern that the Pact was not effectively applied and so did the General Workers' Union (UGT).

and partial and *ad hoc* attempts undermining a broader approach that could have taken advantage of *qui pro quo* negotiations (Ioannou 2000).

The second point of divergence is linked with the agenda shaping of reform and its content. The SE-4 experienced different initial economic conditions, not so much in terms of growth but more significantly in terms of structural unemployment that affected both directly and indirectly the fiscal adjustment process. The direct effect can be seen in the –complementary to the EMU constraints- reform pressure; the indirect effect is manifest in the achieved level of social concertation, which in turn paves the way for substantial reforms. Contrary to the other three Mediterranean countries, whose unemployment levels were more moderate, Spain faced the most acute unemployment problem in the early 1990s, in the 20% area, which acted as an additional pressure gearing a reform-based consolidation.

The third point of divergence is reform capability, in particular the government effectiveness and capacity to translate external (and internal) pressure into tangible reform outcomes. In general, EMU empowered technocratic policy entrepreneurs and the core executive throughout the period of Maastricht negotiations and beyond at the expense of political clientelism leading to budgetary profligacy (Dyson and Featherstone 1999). However, this process was not uniform and did not assume the same intensity. For example, in Italy although the convergence process went hand in hand with the hollowing out and hardening of the Italian state (Della Sala 2003, 1997), macroeconomic

convergence took place in a broader context of a threefold political crisis of authority, legitimacy and distribution between centre and periphery (Bull and Rhodes 1997), which limited government effectiveness and decisiveness. The EMU political connotations and the costs of exclusion largely obfuscated critical questions of broader economic strategy and structural reforms (Radaelli 2002: 236), leading to *ad hoc* measures and blurring the real needs of the Italian economy. Along the same lines, in Greece, the capability of governmental actors to deliver reform was circumscribed by the structural weaknesses of the state and independent policy expertise (Featherstone et al. 2001: 475). Table 4 refers to a complex indicator estimating government effectiveness taking into consideration a series of government-related dimensions like government stability, institutional failure, quality of bureaucracy, policy consistency, etc. (Kaufmann et al. 2007). The Table illustrates the higher effectiveness of the Spanish government throughout the period compared to the other three countries, which constitutes an additional factor of its capacity to deliver on the reform front.

Table 4: Government Effectiveness Indicator in SE-4 (1996-05)

YEAR	GREECE	ITALY	PORTUGAL	SPAIN
1996	0.79	0.97	1.10	1.60
1998	0.87	0.93	1.37	1.70
2000	0.73	0.86	1.10	1.75
2002	0.89	0.88	1.19	1.82
2004	0.81	0.68	1.07	1.36
2005	0.66	0.60	1.03	1.40

Source: Kaufmann et al. 2007, pp. 72, 82-4.

Note: All indicators used are available at www.govindicators.org . Scores lie between -2.5 and 2.5 with higher scores corresponding to better outcomes.

5. Conclusion: Southern Europe and the Limits to EMU Conditionality

The overview of the SE-4 fiscal adjustment pre- and post-EMU accession confirms the two core hypotheses of the budget consolidation literature: fiscal consolidation achieved through structural reforms ensures by and large fiscal balance also in the post-accession phase. In contrast, consolidation relying on short-term, revenue-focused policy measures provides only temporary budgetary relief, capable of exhibiting nominal convergence to the external constraints (the Maastricht criteria in the EMU case) but dubious in terms of sustainability.

At the same time, the SE-4 case shows the limits to EU conditionality policy and more broadly to the effectiveness of external constraints for achieving sustainable policy outcomes. EMU was linked in the Southern European countries with a broader domestic modernization programme and its appeal was further reinforced by a self-imposed political constraint deriving from the threat of exclusion from the EU's political core. Still, however, in three out of the four cases examined, it brought about only a temporary exhibition of conformity but did not produce the necessary reform impetus to sweep domestic reform opposition. This suggests that the emphasis on conditionality policy should be given not on numerical targets and objectives but rather on the quality of adjustment, prescribing specific reform paths to avoid reversion and

lock in reforms as long as the exclusion threat still bears some weight. This holds particularly true for the ongoing enlargement of EMU membership with many new members in the anteroom. The SE-4 experience reminds us of the merits of both caution and patience.

Four main conclusions derive from our analysis. First, EMU conditionality is and cannot be the panacea to all fiscal adjustment problems. External constraints and EMU conditionality policy constitute a necessary but not sufficient condition for sustainable fiscal adjustment. They are ‘push’ factors in the course of fiscal sustainability, but additional ‘pull’ factors should be at work to overcome well-entrenched reform opposition. We discard partisan cycles as an explanatory factor of fiscal adjustment divergence and attribute it to parameters related to reform context (social concertation), content (conducive agenda shaping conditions like structural unemployment), and capability (general government effectiveness).

Second, (hard) positive, pre-accession conditionality is not symmetrical to the (soft) negative, post-accession one. Successful adjustment to the pre-accession conditionality brought about the prize and benefits of Eurozone membership (common currency, monetary stability, etc). Failure to conform to post-accession conditionality, as expressed by the SGP rules, would not result in the suspension of these benefits but only -perhaps- in the activation of financial sanctions. In that respect, SGP sanctions are not really as potent as accession incentives were. If real fiscal adjustment had not been achieved pre-

accession (for various reasons associated with domestic economic and structural conditions, the political and institutional context, or the electoral cycle), then the overall balance between pressures and constraints would most probably tend to be even more unfavourable to fiscal adjustment after the country had entered EMU. This strengthens the argument in support of a front-loaded sequencing of reform. In addition, the considerable flexibility and discretion of the SGP function, especially after its 2005 overhaul, though well justified on economic grounds, has had the perverse effect of probably blurring the clarity of the fiscal adjustment objective, increasing target mobility. In that respect, the Pact's ability to operate as an effective mechanism of exogenously imposed discipline has been compromised, leading to less rigorous compliance efforts.

Third, EMU conditionality policy should be refocused. The principal issue that emerges goes beyond success or failure to adjust to the set criteria. The question of fiscal adjustment should not be that of one-off compliance but of the ability to sustain fiscal balance over the long run. While the Maastricht convergence game was played as a one-off game, the EMU post-accession game is a dynamic, iterated game of indefinite horizon. Although sustainability of public finances was meant to be a central component of the Maastricht architecture, it was relegated into second priority due to the political decision for a more accommodative interpretation of the public debt criterion. The reinstatement of fiscal sustainability and the debt criterion prescribe structural adjustments (pension system, labour market, etc.) and force a revisiting of the

budgetary revenue/expenditure structure. These necessities should be also reflected in the EMU conditionality policy.

Finally, and rather ominously, the force of conditionality relies on the attraction of membership. In the first half of the 2000s the Eurozone was a less attractive place to be compared to that of 1999. Recently this has been changing again, thanks to German recovery. This cannot be devoid of implications as to the alacrity with which Eurozone members (or for that matter even prospective members) would be willing to undergo politically painful fiscal adjustment efforts.

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