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The governance of domestic fiscal stability in the Eurozone prior to the financial crises (2000-2007). What lessons for implementation of the TSCG?

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Abstract

After its first thorough revision in 2005, the Stability & Growth Pact (SGP) has recently been transformed into a Fiscal Stability Treaty, which in all likelihood will become operational as from January 1, 2013. Part of this treaty is the incorporation of balanced budget rules into domestic constitutions and into national budgeting processes. These rules concern general government public finances and not only central government budgets. This paper discusses the effectiveness of such domestic rules for general government, by looking at the political capacity of EMU member states to domestically implement EMU fiscal rules in the period 2000-2007 (i.e. before the emergence of the financial crises).

Compliance with the EMU rules varied considerably between the –then- euro-12. The paper shows that institutional arrangements to enhance fiscal discipline within central government had almost fully converged between eurozone members and cannot explain these compliance differences. Regarding non-central government sectors it is shown that countries with low compliance either used imposed (rather than agreed) internal stability pacts or did not have such pacts at all.

Compliance problems are subsequently explained by looking at the political capacity of countries to deliberate the EMU stability paradigm with all actors involved. Four countries are looked at in particular: Ireland, Finland, Germany and the Netherlands. Based on this case analysis it is argued that central governments that had a high level of ideological dispersion and competition (dispersed governments) were better in such deliberation than single-party or stable coalition central governments (non-dispersed or concentrated governments). Political backlash on the EMU stability paradigm can be expected to be more prominent in the latter case; the emergence of a modified EMU paradigm (and the resulting modification of the SGP) is mainly the result of political backlash on the original paradigm in these states.

Finally, some lessons are drawn for the implementation of the new Fiscal Stability Treaty.

Keywords: EMU, Stability & Growth Pact (SGP), Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), political capacity, fiscal policy, internal stability pacts

1-INTRODUCTION

> […] An escalating dispute between Madrid and Spain's regional authorities risks undoing its austerity pledge to EU authorities.
> The conflict erupted on Tuesday (31 July) when Jose Antonio Grinan, the President of the Andalucia region, walked out of a meeting of Madrid's Council of Fiscal and Financial Policy when it told him to cut another €3 billion from his 2012 budget.
> […] Regional spending was the main reason why Spain last year missed its deficit targets under EU rules: Andalucia and Catalonia between them have a GDP of €346 billion, or 32 percent of the country's total economy […].
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> *From: EUobserver.com, 27-8-2012*

From the outset the 1997 Stability and Growth Pact (hereafter: SGP), aiming at curbing fiscal behaviour of EMU member states, has been the subject of much political and academic debate, following persistent compliance failures. After its first thorough revision in 2005, the SGP has recently been transformed into a Treaty on Fiscal Discipline (the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, hereafter: TSCG), which in all likelihood will become operational as from January 1, 2013. Part of this treaty is the incorporation of balanced budget rules into domestic constitutions and into national budgeting processes.
As with the SGP, these fiscal rules concern general government public finances and not only central government budgets. As a consequence, from the nineties onwards, domestic fiscal stability pacts have been put in place in many E(M)U member states. This paper discusses the effectiveness of such domestic fiscal frameworks. The main question the paper tries to answer is: *To what extent are EMU member states able to domestically implement EMU rules?*

The paper is structured as follows.
In section 2 the theoretical background of domestic compliance with EMU rules is discussed.
Section 3 deals with the fiscal performance of EMU member states (the euro-12) in the period 2000-2007, i.e. the period before the outbreak of the various financial crises (banking

crisis, eurocrisis). The empirical analysis is focused on the pre-crises period because since 2008 almost all EMU member states show considerable compliance problems as a result of these crises, which makes the period 2008-2012 less suited for analysis.[1]

In section 4 the institutional arrangements (i.e. the fiscal frameworks) that were used by EMU member states in the period 2000-2007 are dealt with, linking these arrangements to the type of government and to in-EMU performance. From this analysis it follows that institutional arrangements to enhance fiscal discipline within central government had almost fully converged between eurozone members before the outbreak of the financial crises, meaning that differences in these institutional arrangements cannot explain compliance differences. Regarding non-central government sectors we find however that countries with low compliance either used imposed (rather than agreed) internal stability pacts or did not have such pacts at all.

In section 5 four countries are studied in some more detail: Ireland, Finland, Germany and the Netherlands. Based on this case analysis, in section 6 an explanation for compliance differences is offered by looking at the political capacity of countries to deliberate the EMU stability paradigm with all actors involved. It is argued that central governments that had a high level of ideological dispersion and competition were better in such deliberation than single-party or stable coalition central governments. Political backlash on the EMU stability paradigm can be expected to be more prominent in the latter case; the emergence of a modified EMU paradigm (and the resulting modification of the SGP) was mainly the result of political backlash on the original paradigm in these states.

Section 7 discusses the implications of these findings for the implementation of the TSCG.

Section 8 concludes.

[1] See Schuknecht c.s. (2011) for a more detailed overview of fiscal developments (aggregated for the euro-12) in various periods (1992-1998, 1998-2004, 2004-2007 and 2007-2011).

2-DOMESTIC COMPLIANCE WITH EMU RULES

In political economy, successful accession to and performance within the Economic and Monetary Union (EMU) has been explained by (the combination of) two factors: political commitment to EMU rules through policy paradigm convergence and adequate budget institutions.

Commitment to EMU rules is often asserted and explained by *ideational or paradigm convergence* amongst EU finance ministers through a process of normative deliberation and policy learning. Prior macroeconomic policy paradigm convergence on West German preferences for stability under ERM prepared other EU countries, especially France, to internalise fiscal policy restraint and later accept the creation of the SGP (Verdun 2000; Heipertz & Verdun 2004, 2005). A policy paradigm is a set of beliefs and assumptions, not only of policy recommendations, but also of the fundamental realities behind them, that make specific policy choices necessary (Goldstein 1993, p. 2-3). Key here is that the stability paradigm discredited public borrowing as a response to economic slowdown and favoured fiscal consolidation, structural adjustment and private economic investment instead.

It has repeatedly been argued that *adequate budget institutions* are also necessary for effective implementation of EMU fiscal rules, as (paradigm-based) commitments to fiscal discipline might be undone by short-term electoral incentives and strategic game scenarios (Von Hagen and Harden 1994, 1995; Hallerberg et al 2001, 2007, 2009; Von Hagen 2002). In order to achieve fiscal discipline centralization of the budget process is needed which can be achieved through two different models. First, there are delegation models in which fiscal authority is delegated to specific actors (often a strong finance minister and/or prime minister) and are thus taken out of day-to-day political deliberations. Secondly, there are commitment or contract models in which all actors involved commit themselves to policy outcomes that are in line with EMU requirements. It is argued that governments made up of closely aligned parties with low competition among them (including single-party governments) generally prefer the delegation model, whereas countries with ideologically dispersed coalitions made up of parties which regularly compete against each other prefer fiscal contracts (Hallerberg et al 2007).

Institutional engineering works from the assumption that policy commitments may be difficult to keep up due to time inconsistencies or collective action problems and seeks to

solve these, given commitment of all actors involved to the stability-oriented policy paradigm in principle. Had this worked in practice, then public deficits and borrowing in the eurozone should have declined over time, which they did not. The SGP compliance crisis of 2003/2004, its subsequent reform in 2005 and the current euro-crisis refute the notion that the EMU fiscal discipline paradigm has subordinated all other claims on public finance and/or budgetary institutions have been adequate.

It is argued here that in order to adequately explain in-EMU performance, policy paradigms, budget institutions and their interplay should be analysed in more detail using the concept of *political capacity*. Following Lehman (1969) political (or systemic) capacity is defined here as the ability to set, pursue and implement goals for the entire political system[2]. Building on that notion it is argued here that for intergovernmental commitments to work "all the way through" the stability paradigm has to be accepted and implemented in all domestic political subsystems. These include the domestic central government level (comprising the central government, parliament and national fiscal bodies), the domestic general government arena (comprising central government, the social security sector and sub-national governments) and the domestic popular arena (consisting of the electorate and other stakeholders). The key argument is that political capacity depends on the composition of government, in the sense that the political capacity to domestically implement EMU rules is greater in dispersed systems of government than in concentrated systems of government, mainly due to lesser electoral vulnerability and larger domestic political networks. This is contrary to most institutionalist literature which, by focusing on the role of veto players in central-governmental decision-making, claims that dispersed governments are less able to effectuate paradigmatic change than non-dispersed governments. To a large extent the main difference between our argument and the prevailing institutionalist argument coincides with a difference in scope. This paper deals with systemic political capacity of central government vis-à-vis other domestic actors rather than with political control over veto players within central government.

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[2] A similar definition has been put forward by Organski and Kugler (1980) who define political capacity as the ability of political systems to carry out the tasks chosen by a nation's government in the face of domestic and international groups with competing priorities.

From the key argument it follows that it is expected that dispersed governments have a better record of implementation of and compliance with EMU rules than concentrated governments. In order to clarify this argument special attention will be paid to domestic political capacity, i.e. how (central) governments have implemented the rules of EMU and the SGP for general government, viz. by inclusion of non-central government sectors through internal stability pacts. This internal dimension is important but has not been fully researched[3], as the institutionalist literature focuses on central government budget rules and procedures. Especially in the case of (federal) states where a considerable part of public finances is in the hands of sub-national governments (and especially if the sub-national public finances are cyclically sensitive), EMU implementation requires the involvement of all government sectors. According to Balassone et al (2004) there is a basic asymmetry in EMU's set-up: EMU/SGP-rules apply to general government, compliance depends on the behavior of all levels of government, yet the central government alone is held accountable. This institutional imbalance is an incentive for central governments to use their political capacity vis-à-vis other government sectors.

Moreover, it is interesting to see how low political capacity may even result in a process of politicisation of and backlash against the EMU policy paradigm and how this feeds back into intergovernmental deliberations. As Puetter (2006) has suggested, even though deliberative intergovernmentalism on the EU level provides crucial informal resources for national finance ministers to implement the EMU rules within their own jurisdictions, effective implementation can fail when finance ministers cannot bring to bear the same normative resources to legitimate restrictions on spending. This prevents paradigmatic achievements reached at the European level through intergovernmental deliberation from being applied to domestic debate. Application of restrictive policies can then result in politicisation of and political resistance to the policy goals inherent in the policy paradigm. SGP and/or TSCG implementation is therefore contingent on the political capacity of government to design economic policies in ways that avoid negative politicisation and backlash in the popular arena as a source of competing claims for policy cleavages. The interest in mechanisms of

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[3] A notable exception is Enderlein (2006) who focuses on changes in domestic fiscal and wage-setting institutions (including social pacts) resulting from EMU membership.

politicisation, backlash and feedback reflects a broader theoretical interest in EU studies in domestic politics and backlash against EU policy (Schmitter 2004; Majone 2005).

3-FISCAL PERFORMANCE OF EMU MEMBER STATES (2000-2007)

The simplest way to measure compliance with EMU fiscal rules is to look at the use of the excessive deficit procedure (hereafter: EDP) as established in article 104c of the Maastricht Treaty and specified –for EMU members- in the SGP. The EDP is supplemented by the early warning mechanism to prevent the occurrence of an excessive deficit. Table 1 shows the use of early warnings and the EDP for the euro-12 in the period 2000-2007. Out of these 12 countries, six have been involved in an EDP, with Portugal being a second offender.

Table 1. Early warnings and excessive deficit procedures (January 1999-April 2008), euro-12 only

Country	**Early warnings recommended by Commission**	**Early warnings issued by Council**	**Excessive deficit procedure (date of Commission Report; date of abrogation by Council)**
France	November 2002	January 2003	April 2003; January 2007
Germany	January 2002		November 2002; May 2007
Greece			May 2004; May 2007
Italy	April 2004		June 2005; ongoing
Netherlands			April 2004; June 2005
Portugal	January 2002		September 2002; May 2004 June 2005; ongoing

Source: DG Ecofin

For EMU members the SGP has an additional rule: their (general government) budget should be close to balance or in surplus in the medium term, i.e. over the business cycle. Using the AMECO database the cyclically adjusted fiscal stance of general government of the euro-12 has been analyzed for the period 2000-2007[4]. From this analysis it follows that three countries were exemplary fiscal consolidators: *Finland, Luxembourg and Ireland*, with an average fiscal position considerably in surplus and in all years much better than the euro-12

[4] We have used the cyclically adjusted net-lending or net-borrowing of general government with the adjustment based on potential GDP used in the EDP.

average. A second group of countries, made up of *Spain, Belgium, and the Netherlan*ds, had a fiscal stance close to balance and sporadically did worse than the euro-12 average. *Austria and Germany* were problematic consolidators with an average net-borrowing position of 1.3 and 2.1 percent GDP respectively. These countries performed worse than the euro-12 average in most years. Finally, there was a group made up of *France, Italy, Portugal and Greece* with cyclically adjusted negative fiscal positions close to or in excess of 3.0 percent GDP.

Interestingly, in all cases there was hardly any difference over time throughout the 2000-2007 period in performance of individual countries compared to the euro-12 average. There was no improvement or deterioration over time of countries' performance relative to one another. A country either underperformed or overperformed, with Austria being the –only-exception to this rule as it alternated relatively good performance with bad performance. Furthermore, for the euro-12 as a whole the period 2001-2004 was a period with rather high negative fiscal positions (on average: -2.6% GDP) but the average structural fiscal stance improved over the period 2005-2007 to -0.7% GDP in 2007.

In order to have more insight in the composition of the fiscal stance of general government, the actual fiscal positions of the euro-12 in 2000-2007[5] were broken down into central government, state government (if applicable), regional/local government and social security funds, as shown in graph 1 for all euro-12.

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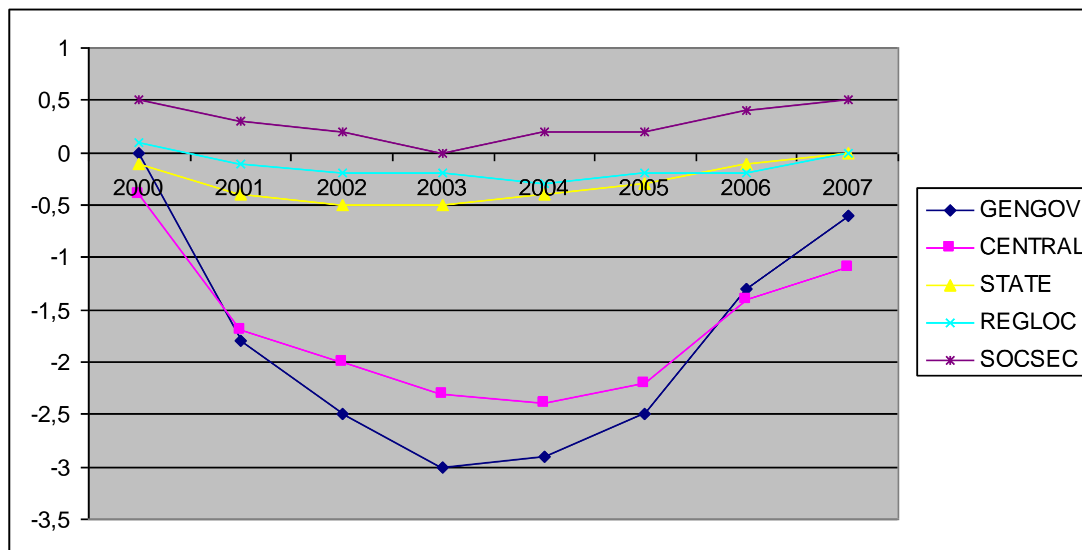
[5] As the AMECO database is limited to general government, EUROSTAT data have been used which do break down the fiscal position of general government but unfortunately are not cyclically adjusted. For Greece data are only available for 2002-2007.

Graph 1. Development and composition of net-lending (+) or net-borrowing (-) of government sectors, in % GDP, euro-12 (2000-2007)



Data: EUROSTAT

On this aggregate level the impact of sub-national finances and social security funds seems to be twofold. First, in the 2002-2005 period -and especially in 2003- these sectors aggravated the central government position, pushing general government towards the dreaded 3 percent line. Secondly, at the beginning and end points (2000-2001, 2006-2007) especially the social security funds had a positive impact on the general government fiscal position.

Table 2 lists the findings of similar analyses for the individual twelve countries (in order of declining structural performance of general government as established above). From the findings it follows that most problematic or bad performers had considerable compliance problems or compliance risks in these non-central government sectors (this is especially true for Germany, Italy and France), whereas exemplary and good performers had not.

Table 2. Fiscal performance of non-central government sectors, 2000-2007, euro-12

Country	**State government (for federal countries only)**		**Regional/local government**		**Social security funds**	
	Pattern	Position	Pattern	Position	Pattern	Position
Finland			=	-	=	++
Ireland			=	0	=	+
Luxembourg			=	0	≈	++
Belgium	=	+	=	-	A≈	+
Netherlands			=	-	=	0
Spain	=	-	=	0	=	++
Austria	=	0	=	+	=	0
Germany	≈	--	≈	0	≈	0
France			A-typical	Falling from + to -	≈	--
Greece			=	0	=	++
Italy			≈	--	=	+
Portugal			=	-	≈	++

***Pattern** =: steady, non-cyclical; ≈: cyclical, more or less in sync with central government; A≈: countercyclical to central government*
***Position** 0: average position over 2000-2007 in balance (between +0.15 and -0.15 % GDP); position – resp. +: small deficit/surplus (between 0.15 and 0.5 % GDP); position -- resp. ++: large deficit/surplus (larger than 0.5 % GDP)*
Own calculations based on EUROSTAT data

In those cases where the fiscal position of the *social security funds* was stable and in balance or surplus, or cyclical but in (large) surplus, or countercyclical, this sector did not create problems with EMU compliance; on the contrary: these funds then acted as a cushion that softened the blow. This is true for ten out of the euro-12; it is true for all exemplary and good performers. France and Germany stand out as their social security funds were cyclical but on average not in surplus.

The *regional/local government* in nine out of the twelve cases was a-cyclical and showed a surplus or a small deficit. In two cases the regional/local public finances were cyclically sensitive: in Germany this potential problem was limited because the fiscal position of this sector was in balance, in contrast to Italy where it had an average deficit over 2000-2007 of 0.6 percent GDP. The regional/local sector in France followed an a-typical pattern with a fiscal stance that gradually dwindled from a surplus of 0.2 percent GDP in 2000 to a deficit of 0.4 percent GDP in 2007.

If we look at the *federal states* Germany stands out again, as the *Länder* finances were cyclical (contrary to the state government sectors in Belgium, Spain and Austria) and showed a relatively high average deficit (0.9 percent GDP on average in 2000-2007).

4-INSTITUTIONAL ARRANGEMENTS (2000-2007)

Institutional arrangements for central government

As was put forward in the introduction, theoretically the choice between a delegation model and a contracts model depends on the ideological distance and level of political competition among government parties. Based on indicators[6] for these two variables Hallerberg et al (2007, 2009) have come up with expected forms of fiscal governance for the EU-15. From their analysis it follows that throughout the period under consideration here (2000-2007) Belgium, Finland, Luxembourg and The Netherlands were expected contracts states. Austria, France, Germany, Greece, Ireland, Italy, Portugal and Spain were expected delegation states. In three countries (Austria, as of 2000; Ireland, as of 1998; Italy; as of 1997) the political context changed in such a way that they changed from expected contract states to expected delegation states immediately prior to or in the early years of EMU.

Research on the actual use of procedural and numerical fiscal rules on the central government level is abundant (Hallerberg et al 2001, 2007, 2009; Hallerberg and Bridwell 2008; European Commission 2006, 2007; Groenendijk 2006). From this literature it follows that the delegation and contracts models are archetypical; in reality all countries use both delegation elements and contracts elements. Examples of delegation elements are a high agenda-setting power of the minister of finance in budgetary planning, centralization of budget negotiations and the existence of cash limits during budget execution. Delegation elements mainly refer to budgetary procedures. The contract (or: numerical) approach mainly concerns institutionalized political commitment to the use of (multi-annual) fiscal

[6] These indicators include the average number of parties in government, changes in coalition or ruling party, and the mean ideological range of coalition parties. This last indicator is computed following Tsebelis (2002).

targets or outcomes. Table 3 shows indices for the existence of delegation and contracts elements for the euro-12, prior to (1991) and in-EMU (2004).

Table 3. Delegation and contracts index (0-1), central government budgeting (euro-12, 1991 and 2004)

	Delegation index		**Contracts index**	
	1991	2004	1991	2004
Delegation states	0.49	0.68	0.43	0.73
Contracts states	0.38	0.54	0.43	0.78

Own calculations for euro-12, based on data in Hallerberg et al (2007) [7]

Prior to EMU expected delegation countries relied a bit more on delegation measures than expected contracts states, but expected delegation countries and expected contracts countries did not differ at all as far the use of contract elements is concerned. Due to a considerable increase in the number of fiscal rules (multi-annual frameworks, budget balance rules, expenditure rules, revenue rules and debt rules, all possibly ranging from central government to local government), which followed a more general trend that started in the early 1990s, in-EMU both the delegation aspect and the contracts aspect of central government budgeting have been strengthened, interestingly enough to the same extent by both expected delegation and expected contracts states.

Hallerberg et al (2007), the European Commission (2006, 2007) and the OECD/World Bank Budget Practices and Procedures Database (based on data for 2003, updated in 2007) provide scores on budgetary institutions for individual countries for the period under consideration in this paper. These data have been extensively analysed trying to link to them to fiscal performance as discussed in the previous section, by using and (re)calculating different indices for budgetary procedures and rules, for the four different groups (exemplary, good, problematic and bad performers), at different points of time. Our unequivocal conclusion is that exemplary and good performers did not have better budget

[7] Including the annex to Hallerberg et al (2007) on http://userwww.service.emory.edu/~mhalle2/research.html.

institutions (at the central government level) than problematic and bad performers[8]. The procedural rules concerning budget planning, approval and implementation seem to have almost fully converged among the euro-12, as has the use of numerical rules.

Institutional arrangements for non-central government: internal stability pacts

Not only has the number of fiscal rules generally increased over the past twenty years; there has also been increased coverage of the government sub-sectors (European Commission 2006). While in the early 90s such rules were mostly applied to territorial (i.e. regional and local) governments, in the later years they have been increasingly applied to the general government sector and to the social security sub-sector. The nature of these new rules was different though, as they were frequently based on agreements without strong compliance mechanisms, whereas the rules applied to sub-national governments often were enshrined in regulation. Interestingly enough, there was a clear difference between expected delegation and expected contracts states. Expected delegation states had a higher number of (numerical) fiscal rules implemented at regional and local level than contracts states, but relatively few rules for general government and the social security sector. The larger political dispersion of governments in expected contract states seems to promote fiscal rules at the central level mainly, whereas expected delegation states relied on relatively few rules at the central level and put more emphasis on rules to fiscally constrain regional and local governments.

The (updates of the) 1999-2007 Stability Programmes of the euro-12 shed some light on the use of so called *internal stability pacts* in the period 2000-2007. In the –scant- literature on such pacts (Balassone et al 2004; OECD 2003, 2005) two approaches are mentioned: a cooperative approach which is thought to be especially suited for federal states, and a rules-based approach which is more suitable for unitary states. However, as with the delegation

[8] That does not mean that institutions do not matter. There are clear suggestions in the research literature that on an aggregate level budgetary procedures and budgetary outcomes are linked (European Commission 2006, 2007).

versus contracts idea for central government, in practice countries make different choices and often adopt eclectic approaches.

Some of the euro-12 have simply relied on *existing rules* regarding balanced budgets and/or borrowing restrictions for regional and local government and have deemed these to be sufficient. This applies to our three exemplary performers: Finland, Ireland and Luxembourg.

In Austria, Belgium and the Netherlands (one problematic and two good performers) so called *agreed internal stability pacts* were established, which were not enshrined in legal acts. In Austria a financial burden sharing agreement was agreed upon in 2000 (for 2000-2005) and was reinstated in 2004 and 2007 for subsequent periods. The Austrian pact contained specific fiscal targets and a SGP-like penalty system. In Belgium an agreement on an internal stability pact was reached in 2000 and has been updated since. In the Belgian system the High Finance Council (a consultative body) sets fiscal targets for the different entities and is in charge of monitoring communities and regions; regions act as watchdogs for local government. In 2003 this system was supplemented by peer review on the communities and regions level. The Netherlands has been relying on existing rules until 2004 when an administrative agreement was conducted between central and local government, which primarily focuses on the improvement of information on the fiscal stance of local government, but which also contains reference values for local government deficits.

Introduction of top-down regulatory frameworks similar to the SGP itself, sometimes referred to as *imposed internal stability pacts* (Balassone et al 2004) can be witnessed in Spain (as from 2003), Italy (introduced in 1999), Greece (introduced in 2004) and Portugal (introduced in 2002). These countries made use of either their annual budget laws (Italy) or specific budgetary stability laws (Spain, Greece, and Portugal). In all cases the framework included monitoring mechanisms and the possibility of corrective measures. Of this group, only Spain has held to the SGP without difficulty.

In Germany the discussion on a national stability pact became part of a broader and ongoing discussion on the future of the German federal system. In the meantime, as from 2003, the coordinative role of the Financial Planning Council (in which all government levels are represented) has been strengthened and agreement was reached between the different levels of government on how to share a possible SGP-sanction. Something similar goes for France where implementation of EMU rules on the sub-national level became part of a

larger modernization process of the French public finances. France was still very much in the stage of raising awareness of the importance of EMU rules; to that end in 2006 the first National Public Finance Conference was held.

Conclusion on institutional arrangements

As far as the non-central government level is concerned, all expected contract states have used either existing rules or agreed pacts, whereas the outcome for expected delegation states is not clear: they used existing rules, agreed pacts, imposed pacts, or were still on their way towards a pact. Generally, expected delegation states had a higher number of (numerical) fiscal rules implemented at regional and local level than contracts states. On the central government level we have established that the distinction between delegation states and contract states did not hold when it came to actual institutional arrangements, as these arrangements have almost fully converged among the euro-12.

However, it is also clear that all problematic and bad performers were expected delegation states; with the exception of Ireland and Spain all exemplary and good performers were expected contracts states. Ideological dispersion (which underlies the distinction between expected delegation and expected contract states) thus seems to be an important variable. Because the expectations regarding fiscal governance that are inherent in the use of the terms expected delegation countries and expected contracts countries obviously do not hold (any more), we will from now on refrain from the use of these terms. For the sake of clarity we will refer (as we already did in section 2) to these states as having *concentrated governments* or *dispersed governments*.[9]

For explaining compliance such dispersion, and mechanisms of politicization of and backlash on government policies, are probably far more important than adequate budgetary institutions at the central government level as the latter have become a constant for the euro-12. This finding is in line with those of Hallerberg et al (2007) and Hallerberg and

[9] As the classification by Hallerberg et al. (2007) of countries in expected delegation countries and expected contracts countries was already based on ideological/political dispersion, the classification of countries in concentrated/dispersed government systems is identical to the delegation/contracts classification.

Bridwell (2008) who argue that the choice and impact of institutions to strengthen fiscal discipline in the end depend critically on the wider political environment.

5-CASE ANALYSIS

The findings on fiscal performance and institutional configurations are surprising in that countries with the greatest clarity of political responsibility and authority performed worst in budget restraint. Countries that had single-party or stable-coalition governments, that should have allowed key central government actors to impose a coherent logic on line ministries and non-central government (with or without a negotiated contract), obviously failed to do so. One possible and obvious explanation involves a systematic difference between southern EMU member states on the one hand and the other EMU member states on the other. The four worst performers in the period 2000-2007 (France, Italy, Portugal and Greece) may have had in common that fiscal consolidation was at odds with their fundamental fiscal doctrine. Obviously, this does not explain the position of Spain as a good performer or the positions of Austria and Germany as problematic performers. One could of course point to some specific and unsystematic features of these countries in terms of economic developments; in the case of Germany the re-unification has obviously had a negative impact on fiscal performance.

Following the key argument that was put forward in section 2, in this section four selected countries are discussed to see if politicization and backlash have been more prevalent (in the period 2000-2007) in countries with concentrated governments than in countries with dispersed governments, allowing for the systematic explanation by looking at non-southern EMU member states only. The Stability Programmes of Ireland, Finland, Germany and the Netherlands have been analyzed for the period 2000-2007, as well as Commission assessments and (recommendations for) Council opinions. This set of four consists of two countries with concentrated governments, made up of a problematic performer (Germany) and an exemplary one (Ireland) and of two countries with dispersed governments (the Netherlands and Finland). The Netherlands was chosen to match Germany because this

country was the closest to Germany in terms of growth and unemployment rates in the period under consideration[10]. The same goes for Finland which matches Ireland.

Ireland

In the period 2000-2007 Ireland was a country with stable coalitions, a unitary system of government, an intensively-used corporatist system of wage negotiations and strong budget surpluses. The latter were channeled into a contingency, or 'rainy day' fund, invested in future pension obligations, and in infrastructure, especially housing, telecommunications and roads. Multi-annual financial plans were introduced in 2004 and bi-monthly reports of line ministries to the Finance Ministry ensured oversight of expenditure.

A constant priority of the Irish Stability Reports in this period was the need to promote economic development and social improvement through public and private investment, even at the cost of higher-than-average inflation in a strong-growth environment. This meant low income and corporate taxes (to encourage work and company investment), increasing the supply of labour and foreign direct investment from outside Ireland and removing infrastructural bottlenecks to further development. Housing investment was seen both as an economic (immigration-promoting) and a social necessity. The second constant priority was the alleviation of poverty, through employment, greater public housing and through increased pensions for the elderly. A major change has been the switch to domestic-led demand since 2005, attributed to economic development and rising asset prices.

The Irish government stressed that development must be brought forward as quickly as possible (whilst EU structural development funds were being paid). For this reason, it consistently rejected Commission (and more mutedly, Council) demands that government should reduce investment in infrastructure and housing to bring inflation levels down to Maastricht criteria parameters. The government underlined this in its 2001 rebuttal[11] to admonitions to reduce public investment. Although Irish inflation had declined by then, removing worries about an overheating economy, public investment remained just as strong

[10] To this end we have calculated differentials for real growth and unemployment, for all individual countries relative to the euro-12 average, based on data from the AMECO database.

[11] Intervention by the Irish Minister at ECOFIN on the Irish Stability Programme, 12 February 2001.

as before, especially on social affairs. Commission and Council assessments were more friendly to such investment after 2005 than before, which coincided with a reduction in Irish inflation.

Finland

In the period 2000-2007 Finland was a country with broad and changing political coalitions. Finland suffered deep general government deficits in the early 90s but reduced expenditure to generate steady central government surpluses throughout 2000-2007. Parties agreed that budget surpluses were imperative to cover the future cost of ageing on social security sectors of the Finnish budget. Local government was generally in balance and the social security sector had a steady surplus of 2 percent GDP. Changes in government did not affect this performance. Coalition agreements set multi-year expenditure ceilings, which became more politically binding in 2004. Some cyclically fluctuating expenditure (like unemployment subsidies) was excluded from these ceilings. Differences between actual tax revenues and expected revenues resulted in fiscal outcomes that deviated from projected outcomes. Public debt was partly reduced by means of privatisation revenues.

Finland had robust GDP growth in 2000 (5.6%) which stalled in 2001 and resumed after 2003. Despite this, Finland's parties agreed that employment creation as a way to reducing poverty and social exclusion was the country's top economic policy priority. Incentive-based measures such as tax reductions, labour market reform and promoting entrepreneurship figured highly in the Finnish Stability Programmes. Although Commission and Council warned in 2000 and 2001 that tax cuts and spending could undermine SGP commitments, Finnish governments neither subordinated employment promotion to SGP requirements, criticised the rules or strayed from their medium-term pattern of considerable budget surpluses. There are no references to politicisation of the stability paradigm. Public support of the EMU did steadily rise in Finland from 70% in the spring of 1999 to 81% in the spring of 2007[12].

[12] Eurobarometer nr. 51 and nr. 67.

Germany

In the period 2000-2007 Germany was a country with stable coalitions, with repeated federal attempts to negotiate a binding national stability pact, with extended attempts to negotiate corporatist wage bargains, both unsuccessful, and problematic public finances. Internal agreements between the different government levels were limited to surveillance and distribution of EU financial penalties and have had little effect on the sub-national governments. Political capacity to ensure balanced budgets beyond the Finance Ministry was poor.

A constant theme of German Stability Reports until 2007 underlined poor economic growth rooted in the (questionable) stagnation of the world economy preventing an export-led economic recovery or continued stagnation of the domestic economy due to 'abnormal imbalances' when the world economy is growing. The SGP paradigm was rejected in nearly all policy areas or cutbacks were rolled back later. Social security cuts planned in 2004 to meet Commission and Council demands were partially reversed due to political criticism. Cutbacks to unemployment and pension benefits were softened in 2007, planned reductions in fiscal cross-state transfers to East Germany were rescinded in 2008. Election-driven demands for the return of tax subsidies for commuters also became loud that year, and the Finance Ministry found itself fighting line ministries over principles of the relative importance of international aid and investment in education, research and development and SGP rules in spring 2008. Council and Commission reports underlined the reversal of cutbacks and the inability of the German government to improve finances sufficiently during the 2007 upswing. This is buttressed by German stability reports between 1999 and 2007 failing to consolidate budgets until export-led employment growth increased government revenues.

Germany's internal weakness in making budget consolidation a priority was reflected in repeated government demands for lower ECB interest rates and allowances in the budget limits for various forms of investment in the future, particularly research, development and education. Starting in 2000, when the Lisbon strategy was launched, German demands to bracket borrowing to finance these areas from deficit consideration became a lasting, principled counter to the constraints of the Excessive Deficit Procedure.

The Netherlands

In 2000-2007 the Netherlands was a country with broad and changing coalition governments. Multi-annual fiscal frameworks were set by means of coalition agreements and were updated on a yearly basis. This framework worked with expenditure ceilings that were based on conservative growth estimates. Fiscal windfalls were used to decrease the fiscal deficit and/or for tax cuts; fiscal setbacks had to be compensated within the constraints of the expenditure ceilings. If tax cuts were possible these were directed primarily at closing the poverty gap in order to give incentives for labour market participation. Public investment, especially in measures to deal with increasing mobility, have largely been financed out of the Economic Structure Reinforcement Fund, which was funded by revenues from natural gas sales and privatisation. Thus fund was however an integral part of the general government budget.

A fiscal surplus for general government was reached in 1999 and 2000, but due to slower economic growth as from 2001, deficits were run in 2001-2005. Because of an unexpected deterioration in the fiscal stance of local government the deficit breached 3 percent GDP and the EDP was invoked. Measures were taken to improve the fiscal stance, by expenditure reduction and through higher health insurance premiums. An administrative agreement was reached in 2004 with local government on how to deal with EMU requirements. In 2006 general government once again reached a budgetary surplus, helped in part through rising gas and oil receipts. Throughout the 2000-2007 period the medium-term objective of a budget in balance or surplus has never been questioned by the Dutch government in its Stability Programmes.

These four country cases show higher politicised questioning of SGP principles in Ireland and Germany, with concentrated governments, than in Finland and the Netherlands, with dispersed governments, despite economic downturns and fiscal pressure in three of these countries. Finland and the Netherlands took the stability paradigm as a given, whereas Ireland and Germany failed to politically pre-empt or contain competing political demands on economic policy and accompanying paradigms.

6-DELIBERATION AND CONTESTED PARADIGMS

Why did concentrated governments perform less and did they challenge the EMU paradigm more often than dispersed governments? Let us assume that it is the norm for political commitment to fiscal paradigms to be limited in scope and to be contested unless a negotiated agreement exists to extend their consequences beyond the finance ministry. In countries with coalition governments comprised of substitutable partners, the need for consensus is apparent, as the government stands or falls on the agreement. Sub-national governments with independent authority to borrow, tax and spend must also agree on the policies, and rules governing social security funds (that have an equally independent impact on national finances) must be included so that they conform with fiscal consolidation plans. The key issue is not the multilevel character of government per se, but agreement on what the implementation of the policy paradigm means for the existing guaranteed rights of sub-national governments and for stakeholders in social security systems (often represented by social partners). This domestic policy deliberation is the means by which political capacity of central government over sub-national governments and the social security community needs to be constructed. Where a government cannot or does not pursue this strategy, political capacity will be more frequently blocked by politicization and backlash based on policy principles that contradict the legitimacy of the policies of central government.

Collective action is based not only on how interests are pursued in an institutional environment (Scharpf 1988), but also on policy paradigm consensus (Schmidt 2003). Schmidt and Radaelli's work on discursive institutionalism (2004) bring principles and institutions together to argue that policy principles may fail if certain policy actors with veto powers remain unconvinced. They suggest that unitary systems of government may communicate radical new policies directly to *voters* and build legitimacy there, whilst countries with further veto players coordinate amongst *themselves* at the expense of communication with voters, diluting the capacity to translate paradigmatic change into policy change.

From the analysis here, however, it follows that a deliberative paradox that impedes implementation is likely to be strongest in precisely those countries that have unitary governments, for two reasons. First, regarding the *popular arena*, voters can easily identify governments with authority and punish them at the polls. Politically concentrated

governments may therefore be more vulnerable to electoral pressure to support competing policy principles than broad coalition governments where possible blame is easily diffused among all coalition partners. This argument has also been made by Zohlnhöfer (2007) in his application of the literature on blame avoidance to the politics of budget consolidation. Second, regarding the *general government arena*, broad coalition governments, because they consist of politicians from a multitude of parties, have extended political networks that assist adherence with agreements (with social partners, with sub-national governments) whereas unitary governments have limited political networks. Through these extended networks broad coalition governments have a better basis for system-wide deliberation.
Both factors (electoral vulnerability and restricted political networks) will have an impact on the political capacity to put policy paradigms into practice. Therefore concentrated governments (that are most vulnerable in electoral terms and have limited political networks) have the least ability to place EMU-conforming corsets on economic and social policy. They 'cannot engineer politics out of fiscal decisions' and are a distinct source of political backlash and critique of the EMU paradigm. Attempts to implement the SGP raise questions over the scope of policy that were previously unarticulated, touching the budgets of line ministries, sub-national governments and social security. Some of these opposing principles include the fiscal autonomy of the regional governments, and the special treatment of social security programmes as highly sensitive personal transfers funded out of special payroll contributions. This politicization provides the possible backlash.

That leaves us with the way politicization and backlash has fed into the deliberations on the EU level. In the introduction it was argued that such feedback has changed the EMU paradigm resulting in the 2005 revision of the SGP. The original EMU stability paradigm was very much about fiscal trajectories, about steady and rapid decrease of deficits towards balances and surpluses, much in line with the idea of pre-EMU convergence inherent in the Maastricht Treaty. The modified EMU paradigm –which incorporates backlash from its predecessor- focused on the main political issue of fiscal restraint itself and how it fits in with the broader issue of economic stabilization. It allowed for more time for budget consolidation and for more protected areas of the budget.

Feedback has primarily occurred through the Council of Ministers. The role of promoting paradigm change at the European level has fallen to those countries which have the most direct political backlash by voters, where attempts to institute constraints on public spending have been most heavily fought and reversed. The critique has been on two levels: first, on the level of the EMU paradigm itself, and secondly, on the level of the Commission's remit to oversee and enforce the EMU/SGP-rules. On the paradigm-related issues, it can be said that the Council's new incorporation of Lisbon goals and its focus on medium-term performance represented an incremental loosening of the policy corset paradigm that member states used to face. Social security spending was not bracketed directly, but investment in future productive capacity was given special consideration in a way that was not considered before. This was as much a result of (Irish) demands that investment should continue regardless of the inflation rate as of (German) demands that it should continue regardless of the deficit. It has been effectively de-coupled due to policy deliberation at the national level that spilled back into deliberations in the Council. Accommodative Council assessments of Stability Programmes underline this. The Commission adapted to the Council's take on a post-EMU paradigm by further developing proposals for budget consolidation over the long term and for approving some public borrowing (for financing structural adjustment) and not approving others.

7-WHAT LESSONS FOR IMPLEMENTATION OF THE TSCG?

To what extent does the TSCG differ from the post-EMU paradigm that emerged with the 2005 SGP revision? The basic fiscal rule that E(M)U member states have to adhere to according to the TSCG is identical to that of the current SGP: budgets should be in balance or in surplus. Assessment of whether a country's budget is in balance is based on the country-specific MTO (medium term objective). The TSCG (and the so-called six-pack of legislative acts that entered into force in December 2011) are a bit more specific about the deviations from and adjustments towards this MTO, but generally the TSCG repeatedly mentions that the assessment will take place "in line with the revised Stability and Growth Pact".

The main new elements of the TSCG are the following:

- The fiscal rules have to be incorporated into national law of the contracting parties through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary process;
- Correction mechanisms shall be put in place at the national level that start working in the event of significant observed deviations from the MTO or the adjustment towards it;
- In case of non-compliance with the above (i.e. if contracting parties do not fully incorporate the rules and correction mechanism into their national framework) the European Commission and/or another contracting party can bring the matter to the Court of Justice.

The 2011 country fiches of European Commission (2012a and 2012b) on the fiscal frameworks of EU member states show that currently many member states have a multi-annual fiscal framework that covers the whole of general government, but few have a framework that has a legal basis in a constitution (or an equivalent legal basis) and incorporates automatic correction mechanisms, which means that considerable changes in the institutional frameworks have or will be brought about in 2012 and 2013 (member states are expected to comply with the TSCG within one year after it becomes operational).

But does the TSCG change the political capacity of member states to domestically implement EMU fiscal rules? The TSCG clearly re-inforces the top-down enforcement mechanisms of the Commission and Council, it ordains the implementation of EMU fiscal rules into national fiscal frameworks, but it does not address the *how* of such implementation.

As Eichengreen (2012: 125, 129) states: fiscal discipline cannot be outsourced. European fiscal problems can only be solved at the national level, not by EU-level surveillance.[13] From the previous sections it has become clear that rules can be put into institutional arrangements that are then monitored by the EU, but actual compliance depends on acceptance throughout the domestic political systems of the underlying policy paradigm, as

[13] Hallerberg (2011) takes this argument even one step further by posing the question whether the European fiscal framework (surveillance combined with support) discourages meaningful domestic reform (and thus works counterproductive).

the result of deliberation in the popular and general government arenas. It is highly questionable whether the top-down approach of the TSCG contributes to such deliberation.

8-CONCLUSION

In this paper it was established that the distinction between (expected) delegation states and (expected) contract states, that is at the heart of the literature on domestic budgetary institutions of EMU member states, does not truly hold in a positive sense, as the in-EMU institutional arrangements on the *central* government level have almost fully converged among the euro-12 at the end of the period 2000-2007. There was however a difference between expected delegation (or: non-dispersed, or: concentrated) states and expected contracts (or: dispersed) states as far as their ability to implement fiscal rules for *general* government was concerned. Dispersed states either used –sufficient- existing regulatory frameworks or agreed-upon internal stability pacts. Non-dispersed states used existing rules, agreed or imposed pacts or did not yet have such pacts. Generally, non-dispersed states had a higher number of fiscal rules implemented at the sub-national level than dispersed states. In short: dispersed states do better when it comes to fiscal discipline.

The case analysis of two countries with concentrated governments (Ireland and Germany) and two countries with dispersed governments (Finland and the Netherlands) seems to suggest that indeed concentrated governments are more inclined to emphasize the political impacts of EMU rules and accordingly question the EMU stability paradigm. Subsequently we have argued that there must be a distinct difference in political capacity to implement the EMU policy paradigm and SGP rules (to which all EMU member states have committed themselves) between concentrated governments and dispersed governments. Contrary to some of the literature, it was argued that dispersed governments have higher political capacity than concentrated governments due to lower vulnerability in the popular arena and due to their possibility to use extended networks in the general government arena.

Our –tentative- analysis of the TSCG showed that these issues are not addressed at all by the new Treaty, which follows a top-down approach aimed at increased surveillance and

enforcement by the EU, simply assuming acceptance of the SGP/EMU/TSCG policy paradigm of fiscal prudence throughout the political systems of all 25 contracting parties.

The implications of these findings are threefold.

First, there is a need to deepen our understanding of the relationship between the political capacity of governments and their composition. The existing literature on veto players and unitary/non-unitary governments is of limited use here, as this literature focuses on political control within governments rather than on the systemic capacity of governments to implement and enforce policies beyond central government itself.

Second, in light of the increased attention within EU studies for politicization of and backlash against EU policies, the case of EMU and the SGP is one that should not be studied in isolation. Further research should focus on comparing the EMU/SGP case with other contended EU policy fields.

Third, member states should combine implementation of the TSCG-rules with deliberation on the underlying policy paradigm in the popular and general government arenas.

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