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The Importance of Domestic Political Institutions: Why and How Belgium Qualified for EMU

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Abstract: Why and how did the two European Union countries with the worst debt levels and with yearly deficit levels double the Maastricht target in 1993 manage to get their financial affairs in shape to qualify for Economic and Monetary Union? This paper presents an explicitly institutional approach to the political economy of budget deficits. It discusses the role of one external actor, the European Union, in promoting tighter fiscal discipline in the two countries. The European Union provided an important stick for any failure not to make needed changes, namely exclusion from EMU. This stick alone, however, was not sufficient to promote change in both countries. Indeed, each state made fundamental institutional changes that put the fulfillment of the Maastricht criteria within reach. Consistent with their respective electoral systems and coalition structures, Italy delegated significant power on the making and the enforcement of the budget to a strong finance minister, while Belgium strengthened its High Council of Finance and resorted to budgetary targets in the form of fiscal contracts.

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Introduction

On January 1, 1999, Belgium and Italy joined nine other countries in the European Union in the adoption of the euro. This simple statement of fact would have been unbelievable to many observers only a few years ago, and they had reason to be skeptical. In 1992, the first year after the Treaty of Maastricht had been signed, Italy's fiscal position left it far from the Maastricht criteria levels. Its public debt was over 100% of GDP, and it overshot its estimated budget by L20,000 billion (Felsen 1999, p. 7). Italy's swift departure from the Exchange Rate Mechanism (ERM) in the fall of 1992 seemed to seal Italy's fate outside of EMU. Belgium similarly faced a miserable budgetary situation in the same year. Its deficit finished the year at almost 7% of GDP while its overall public debt was more than double the Maastricht Treaty's target level of 60%.

Yet both countries managed remarkable turnarounds. In November 1996 the Italian lira rejoined the ERM. By 1997, the fiscal year the European Commission used to make its recommendation to the Council of Ministers in March 1998 on which countries should join EMU in the first wave, both countries had satisfied all of the Maastricht criteria but the one that only three of the eleven qualifiers reached as well, public debt. Perhaps most surprisingly, Italy brought its yearly budget deficit down to Germany's level by 1998 at just 2.7%. Belgium reduced its yearly deficits more or less according to its publicly announced "Convergence Plan," and it too cut its deficits below the 3% target level by 1997.

Why did the two European Union countries with the worst debt levels and with yearly deficit levels double the Maastricht target in 1993 manage to get their financial affairs in shape? This paper uses an "analytic narrative" approach to answer this question (see Bates *et. al*., 1998). In section two, it presents an institutional model to the political economy of budget deficits. The model posits that the major public finance problem today is a common pool resource problem. Cabinet members are likely to consider the full consequences of spending for their constituencies as well as the taxation burden *on their constituencies only*, leading to higher spending and higher deficits. There are two institutional solutions within cabinets to this problem, and their use in turn depends upon the number of parties in government—strong finance ministers are common in one-party governments and in political systems

where two clear party blocs oppose each other, while negotiated budget targets in the form of "fiscal contracts" appear in multi-party governments where clear electoral blocs are not clear.

The third section examines the history of Belgian and Italian public finance during the period 1981-97 to consider the implications of the model. Italy introduced a new electoral system during the time period. Consistent with the model, the government soon centralized power around the finance minister. These reforms contributed to Italy's reduction of its budget deficit. In Belgium the government introduced fiscal contracts, an expected outcome given the routine multi-party governments, which largely coincided with the federalization of the country in 1989. The High Council of Finance in particular assumed an important role in monitoring and coordinating budget policies at both the national and the subnational levels once Maastricht was signed. This section also discusses alternative explanations for budget policy in the two countries, such as whether the number of party veto players and external pressure from the European Union affected the policies the states chose. One external actor, the European Union, was important to promote tighter fiscal discipline in the two countries. The European Union provided an important stick for any failure to make needed changes, namely exclusion from EMU. This stick alone, however, was not sufficient to promote change in both countries. Indeed, both countries made fundamental institutional changes that put the fulfillment of the Maastricht criteria within reach. The paper concludes with a discussion of why these institutional changes occurred.

Theoretical Overview

Analytic Narratives

This paper represents an analytic narrative of how Belgium and Italy qualified for EMU, and it is important to be clear about this approach, which is developed in Bates *et. al*. (1998). Analytic narratives combine analytic tools common in political science and economics with the narrative form often used in history. They use rational choice theory to model the processes that cause outcomes. Rational choice theory dictates that the narrative is concerned with the relevant agents at a given period of time, and a major task of the author is to determine who is important and who is not.

Unlike standard versions of rational choice, however, analytic narratives are problem-driven rather than theory-driven. The author chooses a model in the hope that it best explains a given event. By having an explicit model, the author can explain clearly what evidence supports the argument and what evidence disconfirms it. The model therefore subjects the author's argument to close scrutiny. Moreover, the model also suggests implications that follow if the model is correct. The author hopes that her model leads to new insights about given outcomes that she may not have developed without the model.

Analytic narratives expect their authors to ask five questions: 1) do the assumptions fit the facts; 2) do the conclusions follow from the premises; 3) do implications find confirmation in the evidence; 4) how well does the theory stand up by comparison with other explanations, and 5) is the explanation generalizable and applicable to other cases (Bates *et. al.* 1998, pp. 16-18.) This section first develops the model and the model's implications and answers question 2. It also provides alternative explanations. The empirical section asks explicitly questions' 1, 3, and 4, while the conclusion considers question 5.

The Governmental Stage of the Budget Process and the Importance of Electoral Systems

This section presents a theory for the making of budgets within governments, which is based on Hallerberg and von Hagen 1999. The model focuses on decision-making within cabinets at the national level, and in particular on the ministers in the government who formulate the budget. Especially among the parliamentary systems that exist in Western Europe, there is good reason to focus on the government rather than on other institutions. Either a single political party or a group of parties composes a government, and it is the government's responsibility to pass the budget. Party discipline is generally high, and in most cases the parliament passes the government's budget mostly unchanged in Europe's parliamentary systems. It therefore makes some sense to focus on policy-making with cabinets for European countries. Of course, to the extent that parliament is sovereign it must be included in the analysis, and parliament's role will be considered explicitly in the empirical section.

Within governments there are generally two levels of negotiation—those made between members of the same party, and those made among political parties. This difference is important; members of the same political party generally have policy preferences that are fairly close, and they expect to run together in future elections. Members of different parties, in contrast, usually have policy preferences that differ from their coalition partners, and they may run against their coalition partners. One should know how many party actors exist in the cabinet before discussing the negotiations themselves.

An important determinant of the number of party actors is the electoral system. As Duverger (1954) illustrated half a century ago, plurality systems generally lead to a two-party system, and countries with such electoral systems are therefore likely to have one-party majority governments. Proportional representation (PR) systems have more variation in their district magnitudes, though the magnitudes are always larger than those found in plurality systems. They tend to have a larger number of "effective" parties in parliament, and they are likely to be characterized by multi-party majority or either one-party or multi-party minority governments (Lijphart 1984, 161; Lijphart (1994); and Taagepera and Shugart (1989 and 1993). Neto and Cox (1997) add a definitive twist. The effects of pre-existing social cleavages and electoral institutions on the effective number of parties, and hence on the likelihood of one-party or multi-party governments, is multiplicative. The electoral system therefore sets an upper bound. Plurality will usually lead to two-party systems, but the number of parties in a PR state ultimately depends on the number of underlying social cleavages, such as regional, ethnic, or income divides.

Conceptually the number of party actors in government can be treated as "veto players." The number of veto players is equal to the number of actors (usually parties) whose consent is needed for any bill to become law (Tsebelis 1995). Tsebelis (1995) demonstrates that governments with fewer veto players are able to engender change faster and with greater depth than governments with more veto players. The higher the number of veto players, the harder it is for the players to reach agreement to pass laws, and the greater the chance that the status quo will be maintained. Several empirical

studies are consistent with this result.[1] Tsebelis (1995), citing empirical evidence provided by Schick (1993), argues explicitly that increasing the number of veto players increases the size of budget deficits. When just one veto player exists in the government, decisions are more easily reached on the budget than when more than one player can block the budget, and fiscal discipline is consequently more rigid with one veto player than with more than one.

Knowledge of the number of party veto players, however, can only be the starting point for unraveling the link between institutions and the health of the budget. First, the veto player literature makes the important simplifying assumption that parties are unified actors. In a typical cabinet, however, members of the same party may argue bitterly about the final shape of the budget. As the next section demonstrates, such disagreements are likely even if the players hold the same general spending preferences as long as they represent different constituencies in the debate. This observation leads to a more general point, namely that all types of government require some coordination of the budget-making process if they wish to maintain fiscal discipline. The next section also argues that the number of veto players does affect how the actors can provide necessary coordination, but it is the absence or presence of the coordination, rather than the number of veto players *per se*, that determines the level of fiscal discipline. Even one-party governments can have systematic problems with debt based on the type of institutions they use to reach agreement on the yearly budget.

The Fiefdom Approach

The structure of the bargaining process within the cabinet affects the size of the budget. If spending ministers are left to determine their own budgets, they will select amounts that are larger than what is collectively optimal for the government in power. The reason for this outcome is that the budget process resembles a common pool resource problem.

Consider first the budgeting decision of spending ministers in a given cabinet. A spending minister is responsible for the expenditures of her department, but in bidding for funds she takes into account only that part of the excess burden of taxation that falls on her constituency. An agriculture

[1] See Kreppel 1997, Hallerberg and Basinger 1998, and Tsebelis Forthcoming.

minister, for instance, will be most concerned about the services and goods she can provide to farmers and about the taxes that those farmers must pay.[2] In a completely decentralized budget process each spending minister bids for funds maximizing her utility given the bids of the other spending ministers. If the decision-making rule is simply that the individual bids are aggregated to form a total budget, then spending ministers determine the budget level for their ministry. Individual ministers are responsible for making decisions in their own "fiefdoms." They set policy and budgets on their turf without much explicit interference from other ministers, including the prime minister.[3]

A "fiefdom" approach will lead to both higher spending and higher deficits because it promotes the common pool resource (CPR) problem of budgeting. It is important to note that this outcome holds even if the ministers possess *identical* spending preferences—it is the difference in the consideration of the tax burden that drives the result.[4] Ministers represent distinct constituencies. Individual spending ministers disregard the externality resulting from the common revenue fund. The common pool resource problem also results in higher spending as well as higher deficits and debts.[5] It should be noted that the players would be better off if they all considered the entire tax burden, but, in the absence of any overt coordination, they individually do better if they consider only the tax burden on their respective constituencies.

A large literature has developed examining the conditions under which the players choose to cooperate with each other in such situations.[6] All of these solutions involve the use of selective punishments or incentives and the monitoring of the actors. In the next sub-section I discuss domestic institutional mechanisms to achieve a cooperative solution and reach budget decisions that are closer to the one that is collectively optimal for the government. The first approach involves *delegation*: one member of the government is vested with special strategic powers that allow him to achieve a

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[2] While this example discusses discretionary spending, it is also applicable to entitlement spending as well. The important point is that a minister considers the benefits of spending and the costs of taxation fully only for a subsection of a given party's supporters.
[3] The assumption that a given minister wholly determines policy for her ministry is standard in models of coalition formation. The best example is Laver and Shepsle (1996).
[4] For a more formal treatment of the common pool problem in cabinets see Hallerberg and von Hagen (1999).
[5] A formal proof of the relationship between the CPR problem and higher deficits in a multi-period game is found in Velasco (1999) as well as in [names withheld].

cooperative solution. The second approach involves *commitment* to fiscal targets: playing a cooperative bargaining game at the outset of the budgeting process to agree on the main budgetary parameters allows one to reach the same goal.

Delegation to a Strong Finance Minister and Commitment to Fiscal Contracts

With delegation, governments lend authority to a "fiscal entrepreneur," whose function is to assure that all actors cooperate. To be effective, this entrepreneur must have the ability to monitor the others, possess selective incentives that he can use to punish defectors and/or reward those who cooperate, and have some motivation to bear the costs of monitoring himself.[7] Among the relevant cabinet members, the finance minister often plays the role of this entrepreneur. His interests generally coincide with the general interests. He has the responsibility to coordinate the formation of the budget, and, fair or not, the size of the budget deficit is often the principal indicator that others use to judge his effectiveness. Finally, the finance minister's staff gives him the means to monitor the actions of the other ministries, and, since his prestige and hence his personal benefits depend on the effectiveness of his ministry, he has a private incentive to guarantee that the monitoring occurs. The only question is whether the finance minister has the power to offer selective incentives and/or punishments to the spending ministers.

One practical way to execute delegation is for the finance minister to serve as an agenda setter in the cabinet meeting where budget decisions are being made. The finance minister has the right to make the first proposal for the budget, and he has the power to constrain any amendments that the spending ministers might submit to his proposal. The finance minister’s power as an agenda setter can be measured in terms of the utility his proposal must leave to the spending ministers in order not to be overruled. The stronger he is, the closer the outcome these negotiations must be to his ideal budget. The larger the finance minister’s agenda-setting power, the closer the deficit comes to the collectively optimal outcome.

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[6] Olson (1965); Hardin (1982); Ostrom (1990); Ostrom, Gardner, and Walker (1994).
[7] Olson (1965); Frohlich and Oppenheimer (1978); Cox and McCubbins (1993).

In contrast, under commitment the government agrees to a set of fiscal targets collectively negotiated at the start of the budgeting process. The emphasis here is on the multilateral nature of the negotiations. Coalition partners negotiate the budgets earmarked for different ministries regardless of which party ultimately selects the head of the ministry. This means, for example, that, while a Social Democrat may become the Defense Minister and a Green the Environmental Minister, negotiations among the respective parties determine the budget for both ministers. This practice contrasts with the fiefdom approach where the two ministers would set their respective budgets more or less alone. The commitment approach therefore forces all participants to consider the full tax burden created by additional spending.

This discussion above suggests the availability of two institutional approaches, delegation and commitment to negotiated budget targets, to overcome the deficit bias in public budgeting. The number of party veto players affects the selection of one or the other institution. Delegation is usually the proper approach for governments that have just one veto player, but difficult for governments with more than one veto player. Commitment is the proper approach for multi-veto player governments but more difficult to achieve for single veto player governments.

Members of the same political party likely hold similar political perspectives. The players therefore share the same views regarding the distribution of funds over the various departments, and conflicts of interest among members of the same political party arise primarily from the common pool problem.[8] In a one-party government the different ministers can be fairly sure that the finance minister holds more or less the same spending preferences as they do, and they can trust that their agent will consider the entire tax burden and hence solve the common pool resource problem.

In a coalition government, in contrast, the matter is more complex. Cabinet members have different views regarding the distribution of government spending over the groups of recipients if their party's preferences differ significantly from their coalition partners. Agreement on a budget, therefore, involves a compromise between the coalition partners regarding the distribution of funds

[8] Laver and Shepsle (1994, 9-10), for instance, in summarizing the findings of the case studies in their edited volume, note that the distribution of portfolios among members of the same political party has little effect on the policies which the government adopts. Much more important is the distribution of portfolios among different parties.

for a given budget size. Delegating agenda setting powers to the finance minister now becomes more difficult, as the latter necessarily is a member of one of the coalition parties himself. Delegation then creates a principal-agent problem. The members of the other parties in the coalition suspect that the finance minister will abuse his strategic powers to shift the distribution of transfers in the budget towards his own preferred distribution, at the cost of the recipients favored more strongly by themselves. These members will, therefore, be reluctant to vest the finance minister with strong agenda-setting powers. But, with limited agenda-setting powers, the finance minister becomes unable to achieve the collectively optimal decision. It is important to note here that the principal-agent problem is exacerbated when the political parties expect to run against each other in future elections. When they anticipate that they will be an electoral block that wins or loses together, the principal-agent problem is less relevant.

The same principal agent problem does not arise in the case of commitment to fiscal targets, since all cabinet members negotiate the targets. Thus, governments with two or more veto players are more likely to opt for the commitment approach, and this will be true the more different the initial policy positions are of the coalition partners.

A second issue involves the consequences of a defection. Here, the important distinction is between ministers who expect to run together in the next election and ministers who expect that their parties will run campaigns against each other. In the latter case, overspending by an individual minister from one party in the coalition implies a redistribution of public spending away from the other parties, and, therefore, implies a cost of political support for the other parties in the coalition. The nature of the game then includes a new level of complexity. Any defection can increase the chances of one party winning the elections and hurt the chances of another. In the case where the parties anticipate running together, however, excessive spending simply hurts the coalition. It is therefore possible to delegate power to a finance minister when the parties will stand together in the next election. Any attempt on the finance minister's part to undermine a particular minister or party of a minister will, in the end, undermine her own chances of winning the next election.

Third, the punishments that may be levied if given players are caught breaking the budgetary contract also differ across the two budgetary approaches. In the delegation case, the ultimate

punishment is dismissal from office. In the case of commitment, a defecting minister cannot be dismissed easily by the prime minister if a coalition partner supports its minister. The most important punishment mechanism here is the threat that the coalition breaks up if a spending minister reneges on the budget agreement. Thus, punishment leads to the death of the government rather than the dismissal of a single individual.

For a single-party government, in contrast, the enforcement mechanism of the commitment approach is rather weak. Consider, for example, a single-party government with a weak prime and finance minister. If this government negotiated an agreement on a set of fiscal contracts at the outset of the budget process and an individual spending minister reneges on the agreement during the implementation phase, the other cabinet members cannot credibly threaten the defector with dissolution of the government. They would punish themselves by calling for elections. Without a credible threat at the outset, the entire cabinet would just walk away from the initial agreement.

The issue of punishment is also critical for the consideration of when ministers will agree either to delegation to a strong finance minister or to fiscal contracts. If the punishment cannot be credibly enforced, cabinet members have no incentive to cooperate with any agreements they make. In one-party governments, this credibility is missing if certain cabinet members are viewed as irreplaceable. In Japan, for example, every faction of the LDP must be represented in an LDP government, and the prime minister is often weaker than the faction leaders within his own cabinet. In coalition governments, such fiscal institutions will fail if there are parties that cannot be excluded from future coalitions. These parties correspond to Laver and Shepsle's (1996) strong parties, that is, parties that cannot be excluded from any possible coalition.

The model therefore yields several testable hypotheses:

Hypotheses Related to Institutional Choice:

H1: States with coalition governments where coalition parties expect to run against each other in future elections will opt for either fiscal contracts or fiefdom.

H2: States with one party governments, or states where there are clear electoral blocks where coalition partners win or lose elections together, will opt for either delegation to a strong finance minister or fiefdom.

H3: The fiscal institution will not be durable if the punishment mechanism for defectors is not credible.

Hypothesis Related to Institutional Performance:

H4: States without either delegation to a strong finance minister or fiscal contracts are fiefdom states. They will have, all else equal, higher deficits than if they had used one of the two institutions.

Empirical evidence from Hallerberg and von Hagen 1999 provides statistical tests for **H1**, **H2** and **H4**. They argue both that the number of veto players affects institutional choice as well as that the institutional constraints on the CPR problem have a real effect on the size of deficits. They examine the budget institutions and the fiscal performance of the EU 15 for the time period 1981-94. In a test of **H1**, they find that of the twelve states that had two or more veto players and that were consequently predicted to use fiscal contracts, eight of them used contracts and three used no institutional solution to the CPR problem. In support of **H2**, of the three states predicted to use delegation, two did and one chose no institutional solution. Pooled time series regressions provide evidence for **H4**, namely that it is the absence or presence of these fiscal institutions, rather than the number of veto players per se, that affects the size of the deficit, with states with one of these fiscal institutions having higher deficits than those that did not.[9]

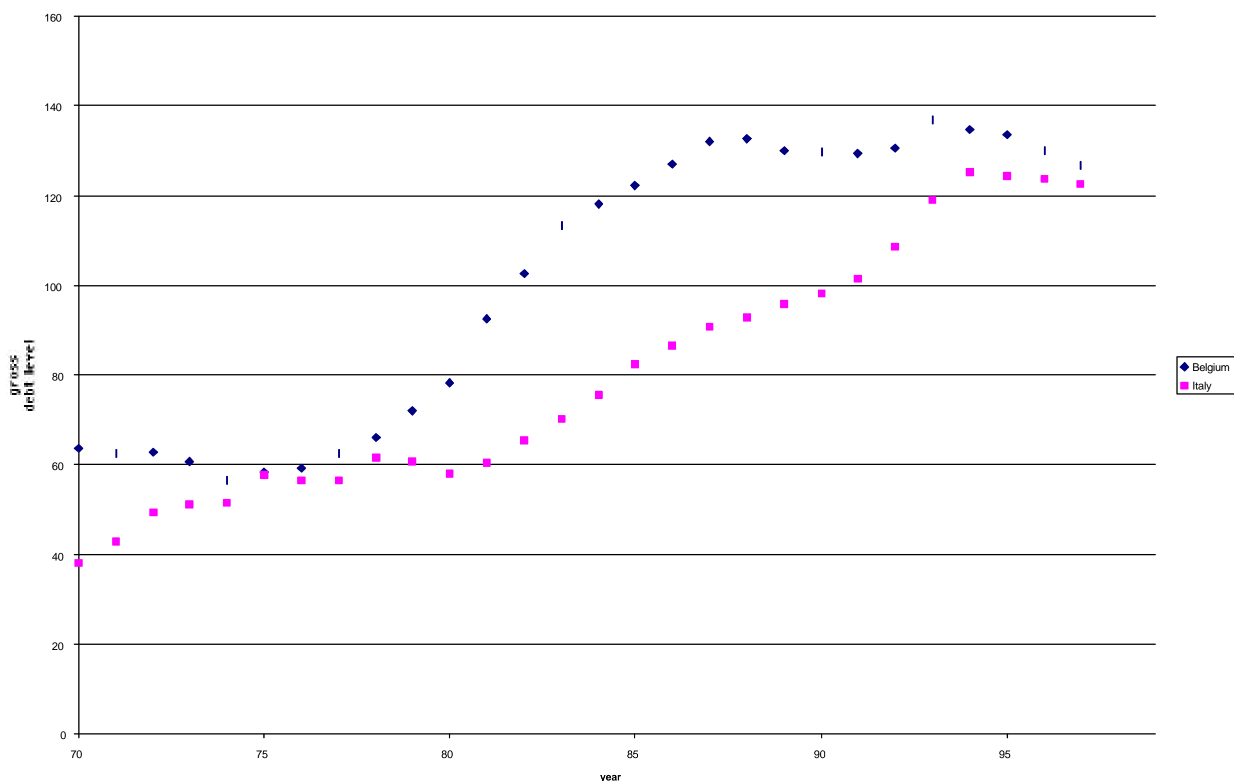
Yet Hallerberg and von Hagen 1999 do not trace the development of these institutions over time in any detail, which is a common restriction in statistical studies. They also provide no discussion of **H3**. They therefore do not explain why some states use these institutions and others do not. Another problem in the article is that, by ending the analysis at 1994, they miss the critical time period 1995-97 when several European Union states managed to get their deficits in order. Indeed, based on their framework, both Italy and Belgium were good examples of the "fiefdom" approach and should not have qualified for EMU. This paper fills many of the gaps of Hallerberg and von Hagen 1999 through more detailed study of two important cases, Belgium and Italy.

[9] The regressions control for macroeconomic conditions, and they examine other political variables considered to be important, such as partisanship and a change in the government in a given year.

Alternative Theoretical Approaches

Before proceeding further, one should address alternative explanations for budget policy in Belgium and Italy. Like in the present study, some writers focus on the effects of electoral systems on public finance, and these *electoral institutionalists* assert that the proportional representation systems result in high levels of public debt. Proportional representation leads to indecisive governments, a higher turnover of cabinets, and greater polarization of the political system, which lead, in turn, to governments that are not able to handle crises (Roubini and Sachs, 1989; Alesina and Perotti 1995; Alesina, Roubini, and Cohen 1997) and cabinet ministers who do not consider the future implications of their actions because they do not expect to remain in power (Persson and Svensson 1989; Roubini and Sachs 1989; Alesina and Tabellini 1990; Grilli, Masciandaro, and Tabellini 1991; Hahm 1994). These arguments are closely related to the veto player literature (Tsebelis 1995). So long as Belgium and Italy maintained proportional representation systems, one would expect them to have difficulties reducing their budget deficits. Any movement to a plurality electoral system, however, would lead to more decisiveness within cabinets and longer-lasting governments that could handle the difficult task of enforcing budget discipline. Given that the two countries reduced their deficits significantly, one would expect a move to plurality in both states at some point before they met the Maastricht criteria on deficits.

A second alternative focuses on the role of external actors, and in particular on the role of world markets. Some authors argue that, in a world of greater capital mobility, it is more difficult for states to run budget deficits because markets will punish lax states (Garrett and Lange 1991, Simmons 1998; for contrary evidence see Oatley 1999). With regard to Belgium and Italy, each country had substantial public debts that needed capital for their financing, and capital may have dried up had the states remained outside of EMU and outside of the new "core" of the EU. Strong pressure from another external actor, the European Union, also played a pivotal role according to this view. Markets followed closely both public pronouncements and private leaks from Brussels, and the European Union institutions responsible for overseeing the states' progress on deficits, such as ECOFIN and Directorate General II of the European Commission, mindful of their influence on the markets, used the markets to apply pressure on intransigent states. The financial penalty for missing the euro boat,



therefore, could have been severe in both counties.[10] For this model to hold, one would expect that government bond interest rates would have increased noticeably whenever it seemed likely that a country would not make it into EMU. These rates would presumably have been higher than rates in the country before Maastricht.

Figure 2: Comparison of Belgian and Italian Gross Debt Levels 1970-1997

The Cases of Belgium and Italy 1980-97: Do the facts support the model?

Overview

Both Belgium and Italy represent important case studies to determine whether changes in budgetary institutions contributed to their fiscal turnarounds. Together they constituted the two countries with the most serious budget situations when the Treaty of Maastricht was agreed to in December 1991. As Figure 2 illustrates, Belgium got into trouble already in the late 1970's, but its

[10] This argument is especially prevalent in the popular press; see, for example, "Italy's Turn to Make Waves," *The Independent*, March 29, 1997, where Philip Chitty from the bank ABN Amro states that "there is no middle

debt level ballooned in the early 1980's and did not decline with any regularity until the mid-1990's. Italy's debt level increased more gradually but also more steadily through the 1980's. Like Belgium, its debt started to decline in the mid-1990's as well.

The following section considers first the electoral and fiscal institutions that existed in the two countries during the period 1981-94 for Italy and 1980-90 for Belgium. Italy presents an especially strong example to test both the theory developed here and the electoral institutionalist approach—it is the only EU country in the last 20 years to make a significant change to its electoral system and then to stick by that change for at least one additional election, long enough for the change to have an effect on the corresponding fiscal institutions.[11] Before the electoral reform was introduced in 1994, the country had maintained a fairly traditional system based on proportional representation. The new electoral law introduced a "mixed" system based both on plurality for 75% of the seats and PR for 25%. This change made the system somewhat like the German electoral system, and the expectation would be that the possible fiscal institutions would come to resemble the German case as well, that is, that delegation to a strong finance minister in the presence of two clear electoral blocks would be the likely solution to the common pool resource problem.

Narrative I: Italian Fiscal Institutions and Fiscal Performance, 1981-92

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ground here. Either Italy makes it and Italian bonds converge towards German bonds, or Italy doesn't and bonds go stratospheric. It's a binary game." For a contrary view see Mosley (1999).

[11] France also made a significant change to its system in 1986 when it moved from a 2-stage plurality system to PR, but in the next election held just two years later the country switched back to the old system. The new system did not exist long enough to have a real impact on budgetary institutions. Similarly, Greece has fiddled with its system, but in all cases the district magnitude has remained relatively low, and there was not a major shift from one type of system to another like there was in Italy.

Before the first elections under the electoral reform in 1994 Italy used a two-tier proportional representation system. Seats were awarded in fairly large constituencies, and a second allocation of seats was done to smooth out any great discrepancies from the first round. The allocation of seats was therefore relatively proportional to the proportion of votes cast for parties. An important feature of the system was that voters could express their preferences for specific candidates on the party lists.

Based on this electoral system, one would expect that Italy would usually have multi-party coalition governments, and such governments were indeed the norm in post-war Italy. During the 1980's there were a series of coalition governments composed of five parties (the *pentapartito*). These five "veto players" were required to approve the budget, and with so many veto players delegation of fiscal powers to a finance minister was clearly infeasible. It was unlikely that the four parties that did not receive the finance minister's portfolio would be able to trust the one party that did to monitor and enforce the budget fairly.

H2 predicts that delegation to a strong finance minister would not have been a likely budgetary institution, and in fact the finance minister was weak relative to other ministers. Three ministries (treasury, budget, and finance) participated in the budget formulation stage. Consequently, while there were some negotiations between the finance minister and the individual spending ministers, the negotiations were not that regulated.[12] A possible alternative to the finance minister as fiscal entrepreneur is the prime minister, but in Italy the prime minister was weak as well—constitutionally he had little control over individual ministers, and in practice he neither selected nor appointed the spending ministers (Pitruzzello 1997).

The alternative for Italy that, incidentally, had worked quite well with five parties in Finland was negotiation of fiscal contracts. These contracts, however, were not put in place. Spending ministers enjoyed a remarkable level of independence and autonomy.

H3 predicts that fiscal contracts will not work in the absence of credible punishment mechanisms, and indeed, such mechanisms were lacking. The principle way to sanction a party that overspends in a commitment framework is to exclude the party from the coalition and to find a new

[12] Alesina, Mare, and Perotti (1995) as cited in DeHaan, Moessen, and Volkerink (1999), p. 294.

partner. In the Netherlands, for example, party alliances are fluid, and one party can credibly threaten another to refuse to ally with it if it reneges on a promise. In contrast, in Italy it was difficult to make similar threats. One party, the Christian Democrats (DC), simply could not be left out of any coalition. They held the Center of the political spectrum, and a coalition without them was not possible. In Laver and Shepsle's (1996) terms, the DC was a strong party. No party could credibly threaten the Christian Democrats as long as the political system remained in force. Similarly, it was difficult for the DC to threaten the other parties in the coalition because it also had few alternatives to choose from.[13] With many parliamentary seats going to extremist parties who were not considered *koalitionsfähig*, and whose share of seats reached as high as 40% of the total in the early 1970s, there were few alternative coalition possibilities (Strøm 1990, 160). The result was that the parties could not credibly threaten to leave a current coalition partner out of a future government if that party reneged on its agreement. A commitment to fiscal contracts was therefore out of the question.

The expectation from **H4** from the composition of the fiscal institutions was fiscal laxity. Indeed, during the period the gross debt level as a percent of GDP more than doubled from 60% in 1981 to 125% in 1994 (*Statistical Annex of European Economy).*

Before moving on, one should note that Italy did begin one crucial reform, namely the reworking of the financing of local governments during this period, in 1992. Before the 1990's the central government financed localities almost exclusively through grants. Politicians in these localities had no incentives to save the government any money because they had no control over the raising of taxes that financed them. Moreover, the central government's willingness to bail out insolvent municipalities was a common, and repeated practice. In budgetary terms, these bailouts affected the gross debt levels only and not the yearly deficits. The reforms hardened the budget constraint through increases in the localities' financial autonomy as well as through the introduction of cash controls on local expenditure (Bordignon 1999).

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[13] This is not to say that parties did not threaten each other and dissolve governments; indeed, the opposite was the case. The issue, however, is whether one party could exclude another in future coalitions as punishment for a given act. The reality for many years was that there were reshuffles in the Italian cabinet of individuals but not of parties, and even the individuals had a tendency to reappear again and again, but simply in different positions.

Yet, as will be developed later in the paper, these reforms by themselves did not solve Italy's problems, and one can exaggerate their importance. The mere fact that the locality debt forgiveness did not enter into yearly debt calculations meant that the reform cannot explain why Italy got its deficit below 3% of GDP. Instead, it took a fundamental reorganization of budgetary institutions at the national level to meet the Maastricht targets.

Belgium Public Finance 1981-89

Belgian fiscal policy also resembled a classic case of the fiefdom approach in the 1980's. It used a proportional representation electoral system with multiple cleavages in society, including most importantly a language divide between Flemings and Walloons, and, as Neto and Cox (1997) would predict, coalition governments with several parties were common. Successive governments attempted to set spending targets, as indeed one would expect given coalition governments, but these targets failed. It took a fairly radical solution, namely the passage of constitutional reforms that moved Belgium from a unitary to a federal state, to begin to break the institutional impasse. It was not until the strengthening of one fiscal institution in particular, the High Council of Finance, as well as the establishment of the Maastricht criteria that Belgium finally turned the corner.

In practice, Belgian cabinets in the early 1980's tried to introduce budgetary targets as one would expect under a coalition government, confirming **H1**, but the targets failed miserably. The situation was especially dire during the period 1981-83, when the debt level literally doubled and interest payments increased from 10% to 17% of the total budget (Smits 1985). The governments in power in the early 1980's took two steps. First, they asked for, and received from, the parliament in successive years "special powers," which allowed the government to pass decrees on budget and other economically important areas without approval from parliament. Second, they agreed to different budgetary targets in an effort to get their deficits under control.

The situation that faced the newly elected (although not new) Prime Minister, Martens, in 1985 was emblematic of the problems facing any attempt to cut expenditures. During the coalition negotiations after the fall elections the future Prime Minister at first tried to write budget cuts of BF

70 billion into the coalition agreement. Yet the future coalition partners could not at first agree on this amount. The reports of the sitting Budget and Finance Ministers indicated that the amount was BF 20 billion too little because of a shortfall in income, while the likely Minister of Economic Affairs wanted to spend more money on the coal sector in both Wallonia and in Flanders. Moreover, during the negotiations, the sitting Ministers of Education still awarded contracts for the building of schools even though there was a moratorium on new school construction emerging in the formation agreement. At first Martens simply dropped any reference to cuts in the coalition agreement, but the deal that emerged in the final document was to cut 200 billion francs without any details about how these cuts would be enforced.

During the negotiations on the budget the next year, it at first appeared that this pledge would be kept. The cabinet agreed to reduce spending by BF 195 billion in May 1985, which, the Prime Minister asserted, meant that the government had met its goal. Yet even within that year the targets did not hold up. The Francophone Education Minister refused to make the serious cuts allocated to him with the assertion that the number of students was increasing; at no time did he provide actual figures of the number of students under his jurisdiction. The government also weakened, and in some cases it abandoned entirely, several planned cuts, including in unemployment compensation and pension funding. Individual spending ministers for their part did not bother to take seriously their requirement to have their budgets approved by parliament, and by the end of 1986 not a single fiscal year 1986 budget of an individual ministry had been approved, even though in theory they were supposed to be passed before the end of 1985. Jozef Smits summed up the sentiment directed towards the new government that had promised real spending reductions: "not only the opposition parties, but also spokesmen for the majority parties expressed their dissatisfaction with the little care the Government was showing about budget orthodoxy (Smits 1987, p. 373)." In the end, the government missed its budget target for 1986 by 2.9% of GNP.

A further problem was the inability of regional groups to exclude one another from any special help from the federal government. The cleavage between Flemish-speaking Flanders and French-speaking Wallonia complicates enormously the conduct of politics in the country, and, by extension, of fiscal policy. Different levels of economic development overlap the traditional cultural

divide, and indeed the economic cleavage has existed for most of the history of the comparatively young country founded in 1830. While in the 19th century Wallonia was the more economically advanced part of Belgium, by the 1980's the disparity had reversed to favor more service-friendly Flanders. It was therefore difficult to coordinate cuts in spending for one or the other group.

A classic case comes from the federal government's bailout of four municipalities in the early 1980's that hurt the federal budget. Liège had more or less fallen into default, and the federal government felt obligated to bail out the city. It assumed the city's debts on condition that the city pay it back over 30 years and that it agree to a restructuring plan. Luckily for the politics of the issue, a corresponding city in Flanders, Antwerp, had similar fiscal problems to the Wallonian city, and the federal government concluded a similar agreement with this city located on the German border as well. Yet the debt levels still did not match. To assure that the federal government was not showing favors to one of the regions over the other, it also "bailed out" two additional cities, Ghent and Charleroi, whose finances were nowhere near as troubled as the other two cities. The result was a significant increase in the debt burden on the federal government.[14]

H3 predicts that the punishment mechanism must have been lacking if the fiscal contracts failed, and indeed the most significant problem in the 1980's was the inability of coalition partners to punish "defectors" who overspent their targets. It is striking how similar Belgium was to Italy. Like in the Italian case, it was virtually impossible for new coalition governments to exclude the centrist Christian Democrats from power. From 1958 to 1999 every coalition government included this centrist party.[15] Moreover, every coalition had to have representatives from both Flanders and Wallonia. To the extent that fiscal issues centered on this ethnic divide, the punishment mechanism was again absent.

The expectation from **H4** of this institutional set-up was, like the Italian case, fiscal laxity, and indeed the overall debt burden worsened throughout the period. From 1980 to 1988 the gross debt burden shot up from 78% to 133% (see Figure 2).

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[14] Interview at the Ministerie van de Vlaamse Gemeenschap, July 9, 1998

[15] Indeed, it took the dioxin scandal in summer 1999 to chase the Christian Democrats finally from power.

A partial solution to the second problem, namely the regional conflict between the Flemings and the Walloons, was to decentralize the country. After elections in 1988 it was initially not possible for parties from the two regions to form a new coalition government. The future Christian Democratic Prime Minister, Jean-Luc Dehaene, agreed to accept King Baudouin's offer to attempt to form a new government, but only if he could negotiate what amounted to changes in the organization of the state itself.

For two weeks fifteen men representing five political parties bargained with each other and established a new constitutional order. [16] What was most important for fiscal policy was the transfer of powers to the regions. From 1989 on, the three regions assumed responsibility over all so-called "territorial policies," such as public infrastructure, special employment practices, public works, agriculture, and the like. The three Communities for their part assumed responsibility over the big-ticket item of education.[17] These bodies received half of their funding from a fixed share of national taxes and some minor taxes they imposed themselves and half from federal government grants. In total, overnight the share of public budget devoted to the regions increased from 8.4% to 33% (Hooghe 1991).

This transfer of competencies did not solve the problems the two nationalities had with one another, but it did relieve pressure (at least for a few years) on their demands on the federal government. The funding structure guaranteed that the regions always got the money promised them, even in the midst of economic recessions, meaning that the federal budget would bear the full effects of any revenue shortfalls. The full debt burden also remained with the federal government. Yet this

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[16] The bargaining would be a fascinating topic for a dissertation in public choice. One of the fifteen persons who was in the room related the following story to me. All negotiations were conducted with the use of spreadsheets that set out the implications of different proposals. At first Mr. Dehaene wanted to negotiate in *n* dimensions, but this was not possible because the negotiators could not understand what it is that they were gaining or giving up, so they refused at first to support any change at all. Dehaene then broke down the negotiations into 2-3 dimensional spaces. This allowed compromises to be struck. After all of the 2-3 dimensional spaces were finished, everything already agreed to was put into one package. I would guess that this is the only time where people writing a new constitutional order literally compared different spread sheets, not just documents.

[17] To keep the levels of government straight, the regions are based on territory and there are now three: Flanders, Wallonia, and Brussels (the last with somewhat reduced powers in comparison with the other two regions.) The three Communities, on the other had, are based on language—Flemish, French, and German. One nuance that is relevant in budget policy is that the Flemish Community and the Flanders region are one, while

change did not resolve the problems within the national government, and there were temptations for the regional governments to create excessive deficits of their own á la the Italian model. Clearly more institutional change was needed to prevent this reform from exacerbating Belgium's fiscal problems.

The Role of the European Union

The Treaty of Maastricht laid out the procedures for the measures EU states would need to take to qualify for participation in EMU. It also detailed the formal role of European Union institutions. The EU was important because it provided the important stick usually missing in both Italian and Belgian finance to coalition partners who regularly ignored the broader budgetary effects of their decisions. To a lesser extent, the EU also provided monitoring of the progress of the states towards greater fiscal discipline.

In fiscal policy there were two important reference values—yearly deficits no larger than 3% of GDP and total gross debt no larger than 60% of GDP. Moreover, these figures were for general government, not just the central government. This provision meant that all levels of government, including city, region, and central government, were included. While central governments were expected to coordinate the effort to reach these targets, they would not be allowed simply to transfer their debts to another level of government. There was some debate in the years leading up to the decision on who would participate on the "absoluteness" of these reference values. The Treaty itself notes in Article 104c that if a ratio has "declined substantially and continuously" it would be enough to qualify a country for EMU, but in practice this looser definition was used only for the gross debt levels. The 3% figure was more absolute. States had to qualify under the Maastricht criteria in the reference year of 1997. States that did not fulfill the criteria would be left out of the first wave of EMU. The European Union therefore had set externally pre-defined budgetary targets as well as a clear deadline when they had to be met. As one official at Directorate General II of the European Commission put it, "the setting of a specific deadline concentrated people's minds."[18]

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this is not the case for the French Community and Wallonia. The exact overlap for the Flemings gives them somewhat more flexibility in budgeting.

[18] Interview at DG II, July 30, 1999.

The Treaty of Maastricht also instructed the European Commission to prepare a report on each country that it thought was running an excessive deficit, and the completed report was then referred to the Council for a vote under qualified majority on whether an excessive deficit indeed existed in a given country. Structurally, Directorate General II (Economic and Financial Affairs) had country desks staffed with bureaucrats whose job was to monitor economic developments, and, since the publication of the Werner Report in 1970, which had recommended monetary unification by 1980, these desks had also monitored fiscal policy. Together with their superiors the country specialists drafted the reports on the individual countries. This procedure was a precursor of the formal vote on which countries would qualify for EMU, for no state judged as possessing an "excessive deficit" would be allowed into the club.

This procedure therefore gave the Commission a formal role in monitoring the budgetary health of all countries. It also provided a yearly reminder within Ecofin (the meeting of the Economics and Finance Ministers) and more broadly in the domestic and international press to states that were not meeting the deficit that they were running out of time to get their act together. Indeed, the Commission was not shy in expressing its opinion—in its first assessment, which was completed in 1994, it found that 10 of 12 EU members were burdened with "excessive deficits."

The Commission also played a role in monitoring the "convergence programs" that member states submitted to it. These plans were to detail how the given state intended to qualify for EMU. The Commission for its part then offered private opinions to both the Council and to the country on the feasibility of the plans. Yet the effectiveness of this procedure was more limited. Countries were under no obligation to submit such programs, and at first there were also no guidelines for what the programs that were submitted should contain. The first Irish program, for example, which was meant to explain how Ireland would qualify for EMU several years down the road, had only three numbers in the entire text and was so vague that it was difficult to understand exactly what steps the country would take.[19] The Commission eventually did set guidelines for the Programs in 1994 and it

[19] Interview at DG II, July 14, 1999.

encouraged states to prepare yearly programs for evaluation, but in practice only the states that were doing well anyway bothered to submit updated versions.[20]

In sum, the Commission was able to judge whether a country had hit the target levels, but it had virtually no impact on how the states were to reach those levels. Domestic institutional changes in Italy and Belgium would play the key role in assuring that the EU's stick of exclusion from EMU was not used against them. The European Union's definition of debt, which was based on general government debt instead of just central government debt, also directed attention to the regions, states, and localities in the member states.

Italian Fiscal Institutions and Fiscal Performance, 1994-97

Italy used a new electoral system for the first time in the 1994 elections. It represented a move away from proportional representation towards a plurality system. In both the Chamber of Deputies and in the Senate 3/4 of the members were elected through plurality and 1/4 through PR. In the vote for the Chamber of Deputies, the preference vote for candidates was abolished, parties had complete autonomy over their lists that existed at the national level, and individuals voted twice—once for an individual and once for a party. The vote in the Senate differed because individuals voted just once for a given candidate, and the party affiliation of the individual was used to determine the PR seats on a regional, instead of national, level (Katz 1996).

These changes were expected to lead to bi-polarity in electoral alliances, and, as **H1** and **H2** predict, the existence of such alliances should have important consequences for the type of fiscal institutions that are possible at the governmental stage in Italy. Examples come from France and Germany. In France, the UDF allies almost exclusively with the RPR while the Socialist Party works equally as often with the French Communist Party, while in Germany during most of the last two decades the FDP and the CDU/CSU confronted the SPD and the Greens. In both cases delegation to a strong finance minister is feasible because the political parties in the coalition consider the electoral

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[20] This was changed under the Stability and Growth Pact. All states are now required to submit their programs, either in the form of stability programs (states taking part in EMU) or in the form of convergence programs

success of their coalition partners as important for their continued occupation of government (Hallerberg and von Hagen 1999). According to **H2**, the existence of two opposing blocks should have made delegation to a strong finance minister the solution to the CPR problem instead of fiscal contracts.

Indeed, Italy moved in exactly this direction institutionally, albeit not as directly as many observers would have liked. One problem that arose was that a clean bi-polar system did not develop as quickly nor as thoroughly as it exists in contemporary France and Germany. During the 1994 electoral campaign, the allies of Forza Italia varied, while the AN ran against the Polo della Liberta, its supposed national partner, in some regions (Katz 1996). Not surprisingly, the Berlusconi government that brought these parties and others together was unstable and lasted a short seven months before falling in December 1994. This result is consistent with both **H2** and **H3**. First, without a clear electoral block it was unlikely that a strong finance minister could exist. It was simply too uncertain that parties would run together in future elections for them to delegate fiscal authority to one individual who may favor one party over another. During this time, while the government took on the unions on pension reform, it did little to combat the deficit.

The caretaker Dini government that followed was unique because all the ministers in the government were unelected (Sbragia 1999). The incentive to provide particularistic goods to ministry constituencies, which is largely an electoral one, had been severed. Indeed, as Figure 2 illustrates, the Dini government took measures that stabilized the gross debt level. Yet there was no reason to believe that these "technicians" could rule for any great length of time. The technicians were also able only to stabilize the debt level, not make any significant cuts.

Italy therefore entered 1996 with most observers convinced that the country would not participate in EMU's first wave. As Chiorazzo and Spaventa (1999) note, at this time "the probabilities assigned to Italy's admission—even late admission—were slim when judged by markets, nil in the eyes of our European partners, as well as of economist and opinion makers (pp. 2-3)."

(states that are the so-called "pre-ins.") See *European Economy, Supplement A*, Number 3, March 1999, which is devoted to budgetary surveillance in EMU.

Italy's general government deficit was still 7.7% of GDP, or over double the Maastricht reference value.

New elections were called in 1996, and this time the electoral system had a clear effect on the electoral alliances in Italy and more generally on the composition of Italy's budgetary institutions. The political parties began to jell into two opposing blocks, one left-center and one center-right, after the election in 1996, and the victorious Olive Tree was more coherent than Berlesconi's coalition. The only problem for the new government, and, as it turned out, it was a significant one, was that the government needed the votes of the reformed communists (Rifondazione Comunista) in the Chamber of Deputies because its majority was limited just to the Senate. The reformed communists did not join the government, but they could block bills in the Chamber of Deputies by siding with the right-leaning opposition.

Soon after the Prodi government came to power, the state initiated an important reform in 1997 of the budget process both within the government and within the legislature. On the governmental side, a legislative decree "increase[d] the autonomy of spending ministers and their flexibility in budget management and control (Felsen 1999, p. 13)." This move represented a strengthening of the executive in its dealings with the legislature. All else equal, however, this change alone could potentially have had little effect if the common pool resource problem remained significant within the cabinet. Giving spending ministers greater autonomy is only useful if the ministers do not use it to carry out the same sorts of policies the legislature would have initiated on its own.

Indeed, the most important reform followed the predictions of **H2**, namely a significant strengthening of the treasury. The reform incorporated the budget ministry into the treasury, creating a so-called "super ministry." It also rationalized the structure of the ministry through several administrative changes that made the bureaucracy more responsible to its leadership (Felsen 1999). These reforms "further centralise[d] control over public expenditure in the hands of the executive counterbalancing the increased autonomy of spending ministries…by more effective 'guardian' control over total expenditure (Felsen 1999, p. 15)." In the context presented here, this reform represented delegation of significant powers to the treasury minister. The treasury can use these

powers to reduce the common pool resource problem within the cabinet. The only outstanding and independent "fiscal" ministry remained the Finance Ministry.[21]

The treasury minister used these powers to actively monitor spending that was passed, and he had the right to withhold spending if departments did not follow correct procedures in order to turn authorized spending in actual spending. This was a noticeable change from the standard operating procedures of the past where the treasury did not have this power (von Hagen 1992). Indeed, there are estimates that 70 trillion lire of authorized spending was not realized in 1996, and this amount more than doubled to 180 trillion in 1997, and one of the principal reasons was Ciampi's close scrutiny of, and refusal to authorize, suspect spending (*Frankfurter Allgemeine Zeitung*, October 27, 1997).

A second significant change occurred within the legislature. As noted above, the relative power of the body vis-à-vis the government declined. The budget process within the parliament was also refined. Instead of voting on the over 5,000 items found in the budget bill, the budget was reorganized according to "functional targets" and "base units (DeHaan, Moessen, and Volkerink 1999)." This measure streamlined the budget and made it more difficult for committees and individual legislators to hide additional spending within the budget.

The predicted fiscal outcome is consistent with **H4**. Italy qualified for EMU with a final yearly deficit for 1998 of 2.7% of GDP. In the final year before qualification, the country reduced its general government deficit 4 percentage points, which represented "one of the largest annual retrenchments recorded in the OECD area (OECD 1998).

Belgium 1990-98

Like in Italy, there was a strong consensus among political parties in Belgium that it was essential for the country to be part of the first wave of EMU. Yet it was still unclear *how* Belgium would manage to get in. Indeed, as late as 1995 the German Finance Minister, Theo Waigel, put Belgium and the other states with weak deficit records on notice that there would be no exceptions for

[21] The Finance Ministry remained responsible for monitoring taxation policy.

countries that did not meet the criteria (Jones 1998). This section indicates that the road to fiscal discipline was driven by truly credible fiscal contracts at the national level. Fiscal contracts between the national and sub-national levels of government also played a critical role. Unlike in Italy, however, where the very structure of coalition government itself was changed, the types of coalitions remained more or the same. The major innovation was the strengthening of one institution, the High Council of Finance, which both wrote the yearly fiscal contracts and monitored their execution.

The High Council of Finance (HCF) had existed since 1936, but it had previously served only as an advisory body to the Ministry of Finance with little practical importance. The newly constituted HCF, which still remains in the same form today, has 30 members in full council, and it includes representatives from the regions, the Ministries of Finance and of Budget, four other federal ministries, outside experts in tax and fiscal matters, and officials at the central bank. The HCF is broken down into three sections, and it is the section for fiscal policy that is most critical here. It has only ten members: one representative from the Ministry of Finance, six representatives from the three regions, and, perhaps most importantly, the top three officials from the Bank of Belgium—the Governor, Vice-Governor, and Senior Director.[22] This section can recommend to the Minister of Finance at its own initiative that the borrowing capacity of any level of government be curtailed. It also establishes fiscal targets for each level of government.

The HCF assumed a pivotal role after Maastricht, although it required more autonomy in order to carry out its new functions. Parliament assigned the Council the role of monitoring the compliance of each level of government to Belgium's Convergence Plan in June 1992. The stated goal was for the general government debt burden to be reduced progressively to 3% by 1996, or one year before the year that the Council of Ministers would use to decide participation in EMU. The HCF was also the forum in which to decide the responsibilities of each level of government for reducing the overall debt level. Indeed, because the regions received most of their money from federally collected taxes, the regions were especially concerned with how the Convergence Plan targets were to

[22] It is noteworthy that the Council did not include any representatives from parliament.

be met. The agreement was that the real expenditure pattern of the regions should follow real growth rates in the regions and a target figure for the real growth rate regional debts through the year 2000.

The execution of the agreement immediately proved problematic. In 1992 the country headed towards recession, and the recession affected the regions unequally. The HCF, based on the guidelines that new spending should largely follow economic growth, apportioned Flanders 1.25% more spending, Brussels only .45% more, and Wallonia a *cut* in spending of .64%. Politically this was unacceptable; Walloons, already experiencing a sharper hit from the recession, resented the increased spending in Flanders, and the Wallonian regional government exceeded its spending target. Flanders followed suit knowing that Wallonia was not sticking to its target, and the federal government overran its spending limit in what was an election year. Hence, no level of government met its target, and the general government deficit was 6.9%, or 1.2% over the Convergence Plan's target (Stienlet 1999, pp. 12-13).

Indeed, the initial failure of the respective governmental bodies to reign in spending alarmed everyone. Representatives of different levels of government agreed to reinforce the HCF. They required that the Council write a report every March on all levels of government that detailed whether they had reached the targets of the previous year. If the respective governments had not, this notification was expected to be early enough to allow the offender to pass a supplementary budget that reduced its deficit. The levels of government were also expected to abide by the accounting rules of the HCF, which were stricter than the ESA rules that the European Commission used. Reaching the HCF targets would therefore automatically get Belgium under Maastricht's reference level of 3%.[23] The HCF drew up new targets with the same stated aim of reaching the 3% level in 1996. Most of the burden to adjust was placed on the federal government, which was expected to make 2/3 of the reduction in the general government deficit level.

From this point on the targets stuck. Indeed, the federal government was forced to pass repeated supplementary measures to meet the targets every year from 1992 to 1996, which together represented over 6% of GDP (OECD 1999). The final targets were set in 1996 for 1997. The HCF

proposed 2.8%, and for the first time, one of the levels of government differed from the HCF's target when the federal government demanded a deficit of exactly 3%, but even the compromise amount of 2.9% was overly pessimistic. Because of stronger than expected economic growth, Belgium coasted under the 3% reference level with a deficit of only 1.9%, a full percentage point below the target (Conseil Superieur des Finances 1999).

It is useful to take a step back and to consider the role of the HCF more broadly within the theoretical context presented here. The HCF generally wrote the guidelines for the budget and set the deficit targets for all levels of government during the critical four years before 1997. In theory the targets were "recommendations," but in practice all levels of government adopted them unchanged except for in 1996, and even then the differences in targets were minor.[24] One should not forget, of course, that representatives from the federal and regional governments sat in the key section of the Council and participated in the decision-making, but this development still represented a change from decision-making pre-1993. The cabinet and, for that matter, the parliament were both by-passed in the decision-making process. Indeed, based on interviews the author conducted in Brussels of officials at the regional, federal, and European Commission level, it is clear that all sides considered the (non-elected) representatives from the Belgian National Bank to be the key players. The federal and regional representatives believed the bankers to be impartial brokers between the two levels of government, and their suggestions were often incorporated into the Council's recommendations.[25] The perceived credibility of the bankers also carried over to the credibility of the Council's recommendations. The only doubts about the targets arose in 1992-93 during Belgium's recession, and even then all parties quickly agreed to revise them.

The clear "stick" in the process was that no one level of government or political party wanted to be accused of being responsible for the exclusion of Belgium from the first wave. Once again this was a change from the situation in the 1980's, when each of Belgium's regional parties refused to

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[23] In particular, several public institutions are considered "enterprises" under ESA rules and hence do not count towards deficit and debt levels, while they do count under HCF rules. Stienlet 1999, p. 16.
[24] Interview at the Ministry of Finance 7/28/99.

back down in the name of "budget discipline" to the other one. The episode in 1992-93 illustrated that these regional cleavages still mattered, but all sides had a clear incentive to insure that the "defections" did not happen again. Moreover, unlike in the Italian case, a failure to qualify for EMU may have signaled the end of the country itself. Regional leaders had been clamoring for more and more competencies at their level, and a failure by the national government in particular could have provided new ammunition for regional extremists who would like nothing better than to see the federal government collapse (Jones 1998).

[25] The Central Bank also holds an informational advantage over the other participants in the Council. Contrary to the practices of other European countries, the Central Bank itself prepares the national economic statistics on which the debates are based.

Table 1: Expected and Actual Fiscal Institutions in Belgium and Italy, 1981-97

Country	Time Period	Type of Electoral System	Type of Government	Type of Institution Expected	Type in Practice	Fiscal Outcome Expected
Italy	1981-94	Proportional Representation with High District Magnitude	Multi-party coalition government	Fiscal Contracts (**H1**)	Fiefdom	Weak Fiscal Discipline (**H4**)
	1994-97	Mixed System: 75% Plurality and 25% PR	Multi-party electoral alliances, under Olive Tree minority government	Delegation to a Strong Finance Minister (**H2**)	Delegation under Olive Tree	Stronger Fiscal Discipline (**H4**)
Belgium	1981-92	Proportional Representation with Medium District Magnitude, Multiple Societal Cleavages	Multi-party coalition government	Fiscal Contracts (**H1**)	Fiefdom	Weak Fiscal Discipline (**H4**)
	1993-97	Proportional Representation with Medium District Magnitude, Multiple Societal Cleavages	Multi-party coalition government	Fiscal Contracts (**H1**)	Fiscal Contracts	Stronger Fiscal Discipline (**H4**)

Fitness of the Theory, Other Explanations, and Anomalous Findings

The analytic narrative framework asks us to examine whether the predictions of the theory match the data, and to consider whether alternative explanations fare better. While the section above integrates the predictions with the narrative, Table 1 summarizes the tests of the four hypotheses. In every case, the predicted institution matches the observed institution.

Other explanations fare less well. According to the electoral institutionalist perspective, Italy should have improved its budgetary position after it introduced a more plurality-based system in 1994. Indeed, Italy did fare better under the new system. Yet the improvement was not noticeable until after the introduction of new fiscal institutions. Deficits remained high under the first government after the introduction of the electoral system, and only improved after the centralization of decision-making power within the treasury. Belgium runs counter to the predictions of the approach. With an unchanged electoral system, Belgium should have continued to have difficulties

reducing its debts and deficits under proportional representation, but as the narrative indicated Belgium succeeded in meeting the Maastricht criteria on its deficit level.

The explanation that focuses on external pressure is potentially more useful, and it requires a careful consideration of the role of markets for each country and the role of the European Union. It seems clear that the countries would have both paid higher interest rate premia outside of EMU. In Italy, for example, by the second half of 1995 "interest rate spreads came to depend on the probabilities assigned by the markets to the prospect of joining the single currency at the outset (Chiorazzo and Spaventa 1999, p. 12)." The markets therefore punished Italy with higher interest payments on its large outstanding debt as long as the markets believed that Italy would not get its act together.

Yet, how much of the change in interest rates was due to economic fundamentals and how much to the anticipated inclusion of the country in EMU is unclear. Favero *et. al.* (1999) calculate that, of the improvement of 214 basis point reduction between German and Italian forward rates from March 1996 to 1997, only 65 basis points can be attributed to changing perceptions of Italy's likelihood of EMU participation. Their research suggests that the interest rate premium Italy paid on EMU exclusion was less than 1%. While this amount was certainly an increased cost for the country, it can hardly be the sole reason why Italy reduced its deficit so dramatically.[26]

Even if one believes that Favero et al. (1999) understate the importance of the markets, the narrative here demonstrates that the turnaround in the national budget, which incidentally also lowered interest rates and made qualification for EMU that much easier through an improvement in Italy's economic fundamentals, happened only for the year 1997 during and after the government had passed crucial reforms to the budgetary process. It is likely that the strengthening of the Treasury under Dr. Carlo Ciampi increased his, and his government's, credibility with markets. Even a story that includes a role for markets must therefore take into account changes in Italy's budgetary institutions.

[26] These results are consistent with Mosley's (1999) statistical examination of 15 developed democracies for the period 1981-95 where she finds that every 1% decrease in the budget deficit reduces the interest rate on 10 year government bonds by .05%. She also examines just the 1990's but the results do not change substantively.

The European Union also played a role as an external actor. For Italy, certainly regular reminders from Ecofin and from European Council meetings that Italy was unlikely to get in focused the efforts of the Italian leadership. Yet the Commission's pressure did not in any sense make Italy's inclusion in EMU inevitable. Indeed, the Commission itself anticipated that Italy would not make it. As late as April 1997 press reports indicated that the Commission was privately telling Italy to prepare for life outside of EMU in the first wave.[27]

The European Union role in Belgium is less obvious but still significant. By simply establishing the "stick" of exclusion from EMU, the European Union placed pressure on the federal government especially to abide by the targets. Moreover, meetings of the Ecofin Council to discuss progress towards meeting the Maastricht criteria served as a constant reminder to the Minister of Finance from his peers in other EU countries that the Belgian effort in the early years was not on-target. The Union's designation of Belgium as an "excessive deficit" country was a public statement that Belgium had not done enough. The establishment of a certain target of 3% of GDP by 1997 was also a clear benchmark that had not existed before. While there was already pressure inside the country to do something about the high deficits, it is doubtful that Belgium would have made cuts in spending and raised taxes as quickly and as deeply without the 3% target.[28] Because the target was for "general" rather than simply "central" government debt, it was imperative that the state find a solution to its budget troubles that included all levels of government, and, as one official in the Flemish regional government put it, the HFC became "the natural institution to use" once Maastricht was agreed upon.[29]

Yet, it is reasonable to conclude that it was the HCF, rather than the monitoring that the Commission provided, that was most important to the success of the fiscal contracts in Belgium. The players themselves monitored each other through this forum and laid the path for how to get below the magical 3%. The Union's role was to set the ultimate target at the end of the period and to provide the stick if one or more levels of government failed to keep its target set in the HCF.

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[27] See "Italy Out in EMU Cold," *The European*, April 10, 1997, and "Rome's Euro Prospects Sinking," *The Guardian*, April 17, 1997.
[28] An official at the Federal Finance Ministry admitted as much to the author. July 28, 1999.

In sum, each of these arguments has a contribution to make to the theory, and indeed they explain some of the dynamics of the model. The markets were important because they affected the costs of not imposing fiscal discipline. Interest rate payments on outstanding debt, which was considerable for both countries, would certainly have been higher without EMU participation. Likewise, the European Union assured higher political costs for both countries, and it provided some monitoring of the budget situations in each state. Yet by themselves they do not explain the changes we observe.

It is also important to consider the extent to which the theory presented here is deficient. First, the theory does a poor job of explaining *why* the states made the larger, macro-level changes they did. It is much better explaining the course that the reforms took. In the Belgian case the state federalized itself in 1989, and the actors at all levels relied upon an institution to set and coordinate their budget targets for them, while in Italy a new electoral system in 1994 led to changing coalitions and changing feasible budgetary institutions. The initial changes are generally outside of the model—Belgium federalized in response to more general tension between Flemings and Walloons, while the change in the Italian electoral system had more to do with the collapse of communism and the "clean hands" campaign than with any desire to improve fiscal policy. A "punctuated equilibrium approach" may be more appropriate here, and it may begin to consider the role of external pressure in changing the more general institutional framework in which the budgetary institutions are determined. As Sbragia (1999) explains for Italy, "both geopolitical [especially the collapse of communism] and European Union (EMS and Maastricht) forces 'punctuated' the existing equilibrium of Italian politics and society" and led to the initial institutional changes that structured the budgetary institutions adopted later.

Second, the theory does not explain the growing importance of sub-national budgetary institutions and governments. As the narrative illustrated, both countries hardened the budget constraints on sub-national governments. While this action was a response to the Maastricht Treaty's focus on general government debt instead of central government debt, the theory does not explain what actions governments should take nor how different forms of national-sub-national relationships

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[29] Interview at the Ministerie van de Vlaamse Gemeenschap, July 9, 1998.

should affect the course of those reforms. Given that the central governments made most of the adjustments to get the deficit levels below 3% this oversight does not detract from the narrative, but it does indicate that more research needs to be done to take into account all levels of government.

Finally, the theory also ignores the game played between the cabinet and parliament. While it is clear that important institutional reforms in both countries strengthened the government's hand vis-à-vis parliament (Belgium in 1993 and Italy in 1997), there is not the space in this paper to explain why this change is important theoretically or to explain in detail what the changes were. The reader is asked to consult other papers by the author if she would like to learn more about the parliamentary stage.[30] What can be said briefly, however, is that the changes reinforced the significant institutional changes within the government, and there is little additional value added to including these details in a paper of this length.

Conclusion

This paper illustrates how the two EU countries with the worst deficit and debt problems in 1991 still managed to join the first wave of EMU. In both cases, adequate institutions to reduce the common pool resource problems within the cabinet were lacking. Significant institutional reform was necessary to break the logjam. In the Italian case, after the first elections under the new electoral system, delegation to a strong finance minister became feasible at the governmental stage. In the Belgian case, a body outside of the cabinet, the High Council of Finance, set the targets, and the expectation that Belgium would be excluded if any of the parties failed to adhere to them was a strong stick to keep spending ministers within their mandates.

The reason why the new budgetary institutions stuck, however, is related to Maastricht—it was important enough for politicians to join EMU that they agreed to the institutions, and once again the "stick" of the European Union enters the scene. If this is the case, however, then one cannot be as optimistic about the future of budget policy once states qualified. Finance ministers led by Theo Waigel publicly recognized this problem, of course, and passed the Stability and Growth Pact in 1997

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[30] In particular, see Hallerberg (1999), Hallerberg (1998).

in an effort to give these states new incentives to keep up their newly found frugality. This Pact institutionalized the monitoring function of the Commission, and it creates new sticks in the form of fines for states that do not correct their deficits once they exceed the 3% reference value.

Yet there is a fundamental question about how long both states can continue the centralization of their budget policies. Indeed, Fabbrini (1999) notes pessimistically that "the reduction of the public debt…has been made possible by the *contingent* suspension of ordinary parliamentary life (and not by a *permanent* empowerment of the executive)," and he adds that "as soon as Italy entered the Euro, the old distributive coalitions started to [appear] again (p. 33)." Whether these old coalitions will have any effect depends on the permanence of the new fiscal institutions. The Italian government in July 1999 proposed a further strengthening of the Treasury by combining it with the Finance Ministry, but whether the decision will ultimately be approved next year is unclear. In Belgium's case, the institutional arrangement appears set so long as the economy is healthy. A gale of bad economic results, however, could push the High Council of Finance off track.

More broadly, the analytic narrative approach asks us to consider whether the lessons drawn from the two cases discussed here are generalizable to other cases. Every state has its own particularities, but the narratives presented here are instructive for governments that wish to get their budgets under control. A direct lesson of the theory is that there are different roads to fiscal discipline, but other institutions, in particular whether the government has one or multiple veto players, predetermine the route the country will take. Pressure from outside the country can be helpful in changing the penalties for defections, but ultimately the country itself must remove its own institutional roadblocks. These lessons may be especially applicable in East European countries as they prepare for European Union membership and eventual participation in Economic and Monetary Union.

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