Adjusting to EMU:

The impact of monetary union on domestic fiscal and wage-setting institutions

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Abstract

This paper argues that when EU member states joined EMU, this resulted in domestic institutional changes in the areas of fiscal policy-making and wage-setting. The paper argues that these changes were triggered by two facts: (i) in EMU, monetary policy can no longer be used as an instrument for output stabilisation; (ii) the "one size fits all" monetary policy of the ECB potentially destabilises output in those countries whose economic data diverge from the euro area average. Assuming that EMU member states will seek to use fiscal policy or wage-setting in order to re-stabilise output, the theoretical part of the paper investigates the economic and political contexts in which these two instruments can be used as stabilising instruments and specifies the institutional pre-conditions for successful stabilisation. The paper then extrapolates potential problem-pressures resulting from the ECB monetary policy for each country and investigates whether the appropriate set of institutions to deal with this pressure had existed before EMU or whether institutional change could be expected as a reaction to it. In a comparative part, institutional changes that have taken place in 10 Member States since the start of EMU are assessed and compared to the theoretical expectations. The paper concludes that the asymmetric pattern of institutional adjustment in fiscal policy institutions and wage-setting institutions closely follows the approach presented in the theoretical part of the paper.

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Introduction

The paper seeks to provide a theoretically grounded and empirically observable explanation of why and how fiscal policy institutions and wage-setting institutions changed in Member States when they joined monetary union.

If economic policy-making is considered as the interplay of monetary policy, fiscal policy and wage-setting, then there is a high probability that joining EMU has profoundly affected the manner in which fiscal policy and wage-setting are conducted in the 12 Member States of EMU. There are two main reasons for this.

- Firstly, monetary policy in EMU is conducted by a single central bank that does not take into account economic developments in single member states but rather targets the euro-area as a whole. For member states, this might imply that the way monetary policy is conducted at the European level does not correspond to the specific needs of the domestic economy. It is thus quite likely, that fiscal policy and/or wage-setting have to adjust, so as to counterbalance the potentially destabilising effect of a "non-optimal" monetary policy targeting the euro-area as a whole. (obviously, these destabilising effects only occur if the main economic aggregates of member states deviate from the euro-area average underlying the conduct of monetary policy – see below).
- Secondly, domestic monetary policy can no longer be used as an instrument in the interplay of economic policy-making. While this second point may appear trivial, its profound effects should not be overlooked. Indeed, as I have shown elsewhere (Enderlein 2001 and 2003), the importance of monetary policy as a stabilising instruments in the conduct of economic policy was significant in most of the present EMU member states during the pre-EMU period. Consequently, the loss of central banking as a tool in the domestic economy can be considered as leaving a significant gap in economic policy-making.

The paper is organised as follows. Section 1 contains an assessment of existing approaches to the impact of EMU on domestic economic policy-making and identifies an important gap in the academic literature, which this paper intends to fill by focusing on the *cyclical* dimension of economic policy-making. A typology of the main problem pressures and possible adjustments to cyclical phenomena in EMU is presented in section 2. Section 3 analyses what types of fiscal and wage-setting institutions are theoretically required to actually implement adjustment policies and overviews the *status quo ante* in 10 EMU member states (i.e. the state of their economic policy institutions prior to the start of EMU), so as to derive a list of expected institutional adjustment. Section 4 studies the nature of cyclical imbalances that EMU member states had to anticipate before joining EMU, so as to obtain a even clearer picture of the kind of institutional adjustment processes that were required in each single case. The last section overviews actual institutional adjustments between the mid-1990s and 2000, showing that the expected patterns of adjustment can actually be observed.

1. An institution-centred but cyclical approach to economic policy-making

The mains reasons why joining EMU is likely to result in adjustment patterns in domestic economic policy can be analysed from two perspectives.

Studying the trend: economic policy in a long-term perspective

The concept of a long-term trend in the analysis of economic policy-making is widely used in the academic literature as a tool for explaining cross-country differences in economic policy and economic performance (e.g. growth, price-levels, employment, and external value of the currency). On the basis of the assumption that monetary policy, fiscal policy and wage-setting adopt certain types of long-term orientations (e.g. "restrictive" or "expansionary") differences in cross-country performances are derived from theoretical models of how these long-term orientations can be linked to institutional features which therefore affect economic performance on average.

Examples of this literature can be found for both single policy areas but also for the interplay of several policy areas. With regard to monetary policy, this literature has concentrated on the link between political independence and a "restrictive" stance (e.g. Bade/Parkin 1982; Grilli/Masciandaro/Tabellini 1991; Cukierman 1992; Alesina/Summers 1993). In fiscal policy, an attempt was made to detect links between certain institutional features and long-term patterns in public finances (e.g. Alesina/Perotti 1996; Alesina/Roubini/Cohen 1997; von Hagen 1992; Hallerberg/von Hagen 1999). In the area of wage-setting, a still growing body of literature has focused on the link between organisational patterns underlying the wage-setting process and the average levels of real wage growth (Kenworthy 2000 provides an excellent overview; the most prominent examples in the literature are Calmfors/Driffil 1988; Schmitter 1985; OECD 1997; Soskice 1990). Research in comparative political economy has tried to merge these three areas in a single macro-perspective based on formal and quantitative pooled time-series cross-section analyses (e.g. Iversen 1999a; Franzese 2002) or based on historical and institutional analyses (e.g. Kitschelt et al. 1999; Hall/Soskice 2001). The heuristics of this literature has been widely used to study the impact of EMU on economic performance by treating EMU as a single "economic unit" (Hall/Franzese 1998; Iversen 1999b; Iversen 1998b; Soskice/Iversen 1998). While it is fundamentally doubtful that extending the analytical framework of the nation-state to analyses of EMU could yield satisfactory results, since in the special set-up of EMU domestic and supranational instruments of economic policy-making coexist and interact, thereby creating an entirely new institutional set-up, different from the nation-state environment, it is highly improbable that adopting a long-term perspective allows to grasp the real impact of EMU on the economic policies of the member states.

Studying the cycle: economic policy in a short-term perspective

Indeed, the impressive body of literature on long-term economic policy-making can obviously not grasp short-term deviations around the trend. As this paper claims, however, it is precisely these short-term cyclical deviations that have profoundly changed in EMU. The reason is as follows. EMU is not a so-called "optimum currency area" (on the concept see Mundell 1961, 1973; on applications to EMU see Bayoumi/Eichengreen 1993, Krugman 1993), i.e. it lacks economic homogeneity and automatic adjustment mechanisms such as labour mobility (Eichengreen 1993a; Eichengreen 1993b; Decressin/Fatas 1995) and fiscal transfer mechanisms that exist for example in the US (Sala-i-Martin/Sachs 1992; Krugman 1993; Fatas 1998; Bayoumi/Masson 1995). As a consequence, it is rather likely that member states in EMU will be affected by so-called asymmetric shocks. In economic research, there has been a long debate on the nature and magnitude of such asymmetric shocks (the main reference is Bayoumi/Eichengreen 1993), but only little discussion on the possibilities to balance these shocks. While from a theoretical perspective there are two economic policy tools potentially capable to balance shocks, namely wage/price adjustments and – possibly to a lesser extend – fiscal policy adjustments, only little attention has been paid to the practical possibility to use these tools. It is generally argued that (i) wages and prices in EMU member states are too rigid to allow for balancing adjustments (e.g. Layard/Nickell/Jackman 1991) and that (ii) fiscal policy adjustments going beyond the use of automatic stabilisers create significant challenges in terms of their political implementation at both the domestic (e.g. Krugman 2000) and the EMU levels (e.g. Maennig 1992; Schelkle 2001). From the perspective of political science, it is interesting that these two arguments, although focusing on short-term features of economic policy, relate to inherently *institutional* factors (such as wage-rigidity and fiscal institutions), which, in economic models, are treated as exogenous structural parameters that do not adjust to changes in the larger context of economic policy making.[2] But why wouldn't they adjust? Influential approaches in policy research argue that the emergence or changes of institutions can be explained as the outcome of strategic interactions if the original institutions result in a lesser capacity of policy-making systems to adopt and implement effective responses to policy problems (Scharpf 2000: 763).

This paper therefore adopts an institutional but short-term focused analysis of the possible impact of EMU on wage-setting institutions and fiscal policy-making institutions. It argues that joining EMU has created certain needs to adjust the interplay of fiscal policy and wage setting in the domestic environment, due to potentially destabilising economic effects of EMU. It is based on the expectation to detect institutional adjustments in those areas, in which the properties of the relevant institutions in the *status quo ante* (i.e. before joining EMU) were unlikely to deliver policy responses to the expected economic effects of EMU.

In this context, the following section establishes the link between certain institutional properties and their capacity to adjust to economic challenges triggered by EMU.

2. The need for stabilisation policies in EMU

Short-term deviations of the main economic variables from a long-term trend are well-known phenomena in all economies. There is no clear view in the relevant academic literature on why such cyclical deviations occur. The so-called "keynesian" approaches argue that such deviations can be of a "structural" nature and need to be corrected by stabilising economic policy measures (e.g. Clower 1988; Leijonhufvud 1991), whereas "neo-classical" approaches claim that cyclical deviations are generated by precisely these stabilising measures which in fact have a destabilising effect (e.g. Sievert 1979; Starbatty 1984; see also chapter 1 in Carlin/Soskice 1990). Yet there is a clear common view that cyclical deviations should be limited, so as to avoid resulting economic and social costs (Cassel/Thieme 1999).

From a policy perspective, two questions arise in this context. Firstly, it is necessary to investigate whether and how fiscal policy and wage-setting can stabilise economic cycles in theory, i.e. independently of the required institutional features necessary to actually implement stabilising policies. Secondly, the institutional features come into play: what kind of institutional or organisational structure is required to deliver the desired policy?

The impact of diverging real interest rates within EMU

With regard to the nature of economic cycles, a key distinction is necessary between "demand-side" and "supply-side" phenomena, and also between "booms" and "downturns".

Table 1: Categories of economic cycles

Reason:	Supply-side	Demand-side
Direction:		
Negative („downturn")	I	II
Positive („boom")	III	IV

Supply-side phenomena (fields I and III) are generally defined as those phenomena stemming from structural factors affecting the costs of production, such as the state of the labour market, productivity, inflation expectations, technological factors, exogenous price-shocks (such as the

[2] This point obviously relates to the famous "Lucas critique" (Lucas 1976).

oil-price). It is straightforward to see why such supply-side phenomena are probably not the mains ones likely to generate asymmetric needs for adjustment in EMU member states: most of these factors affect a relatively homogenous economic area such as the euro-area in parallel (Bayoumi/Eichengreen 1993). Demand side phenomena (fields II and IV), on the other hand, are to a very large extend generated by real interest rates, and thus by monetary policy.[3] For this reason, the demand side is much more likely to enter into play as generating asymmetric cyclical phenomena in EMU. While all member states face the same nominal interest rate as set by the ECB, they will have to deal with diverging implications of monetary policy in real terms if the domestic economic conditions are not fully in line with the euro area average.[4]

The main destabilising effects that can be expected to arise from joining EMU are thus demand-driven booms and downturns. Member states with higher inflation rates than the euro area average will face low real interest rates generating higher rates of investment and consumption. In EMU such developments are likely to result in an almost paradoxical effect. Higher consumption and stronger investment are likely to speed up the domestic growth rate beyond the long-term production potential, thereby generating an even higher inflation rate, further reducing real interest rates and ultimately generating cyclical overshooting and price bubbles (for example in the real estate market). Similarly, in a cyclical downturn due to higher real interest rates, growth rates falling below potential growth are likely to result in even higher real interest rates, potentially even triggering a depression.

Such self-reinforcing cyclical phenomena can only be stopped by a sudden decline/boom in exports, caused by the real appreciation/depreciation of the exchange rate. Many economists consider such an adjustment mechanisms via the real exchange rate as the most effective tool in correcting cyclical deviations of member states. From a perspective of political science, however, it would not be very plausible to follow the assume that domestic actors (both in government and organised interests) will passively follow such cyclical overreactions, without considerable scepticism. Indeed, while a boom cycle might bring short-term gains for the economy and thus also for the incumbent government, it is unlikely that governments will allow a cyclical overshooting and growth/price bubble to install, since the risks of a sudden and significant depression are likely to trigger devastating economic consequences for the domestic economy. Cyclical overshooting is nothing different than a Trojan Horse - a gift at short sight only. In a cyclical downturn, it is even more likely and more straightforward that domestic actors will try to correct the economic cycle in a rather swift manner so as to avoid a depression.

But how? How can the two policy instruments remaining under domestic control be used to correct cyclical deviations, and what kind of institutions are required for the implementation of such policies?

[3] "Real interest rates affect investment, which in turn affects the aggregate level of economic activity. Monetary policy is given a central role in controlling the level of economic activity through its role in controlling the interest rates." (Stiglitz 1999: 59) For an overview of the state of the art in economics on the real interest rate, see a special edition of the Oxford Review of Economic Policy, Vol 15 (2), Summer 1999.

[4] At this stage, it is necessary to counter one main argument often made against the importance of differing real interest rates within EMU. Many economists claim that domestic prices across EMU (and thus also real interest rates) are bound to converge, given the mobility of goods and services in the internal market. This argument is however largely based on a theoretical assumption, giving too much importance to price flexibility and factor mobility. As Maclennan/Muellbauer/Stephens (1998) have argued, the role of so-called "spatially fixed factors", such as real estate, the largest share of the labour force, and heavy machinery, in the domestic economic cycle is of crucial importance - and often overlooked in the economic literature. The analyses by King/Rebelo (1999) also confirm the role of spatially fixed factors in economic cycles by highlighting the prominent role of durable consumer goods and capital-intensive investments (both of which are generally spatially fixed) in their sector-specific study of the nature of cyclical phenomena.

The boom cycle

In a boom cycle, wage-setting and fiscal policy need to act jointly, if they wish to correct the imbalances. The key for success is best illustrated by using the metaphor of a car at too high speed. Stopping that car requires both reducing speed and using the breaks. In a car, the combination of both elements is almost automatically achieved, since the same foot controls both the speed pedal and the break pedal. In an economy, wages generate speed and fiscal policies are required to yield a slowdown.

Wages are the main speed engine because of so-called "second round" effects: if actual inflation rates are taken as the point of departure in wage negotiations (so as to preserve the present purchasing power) and implemented, then these inflation rates become self-fulfilling prophecies and will ultimately result in hyperinflation, if not stopped by more reasonable wage claims.[5] The main task of wage-setting in a cyclical upturn is thus to detect growth rates above potential and to discount their inflationary effect in wage-negotiations. For wage-earners, such a discounted wage-rate might be difficult to accept at first sight, as it will be considered as a wage-decline in real terms. In the long run, however, such a discounted wage policy is the necessary condition for correcting the cyclical overheat. But it is not the sufficient condition. Lower real wages can obviously be used by firms to boost production even further, thereby adding further momentum to the boom. The main instrument that can be used to avoid such a phenomenon is fiscal policy. If company taxes are raised by governments as an accompanying measure to real-wage restraint, then the freed production potential cannot result in overproduction, but its monetary equivalent will flow into the budget. Naturally, the policy-mix between counter-cyclical wage-setting and fiscal policy can only succeed if governments do not redirect the additional resources to the production cycle but rather keep them as a surplus (or significantly reduced deficit).[6] For the sake of completeness, it should be added that fiscal policy can obviously not act alone, since tax increases are likely to be followed by higher wage claims from wage-earners, thus possibly triggering a pro-cyclical wage-policy.

In short, what is needed to correct a boom cycle, is a fairly close co-operation between fiscal policy and wage negotiators.

The cyclical downturn

High real interest rates trigger a problem constellation that is the direct opposite of the boom cycle. With rising costs of capital, investments and consumption are slowed down, thus generating lower growth rates. If these growth rates fall below the rate of potential growth, inflation rates significantly fall and real interest rates rise even further. As is the case in the boom cycle, the easiest way to correct this cyclical overshooting would be to change interest rates themselves. In a monetary union, however, this instrument is not at the disposal of domestic actors anymore. In absence of appropriate adjustment policies (see below) the only self-correcting mechanism that could eventually stabilise the downturn is a politically difficult adjustment process via falling prices generated by lower production and higher unemployment rates that at a certain point in time will boost exports, thus correcting the domestic downturn.

[5] Consider the following example. If an economy faces 5% of inflation because the economy is running above potential, then wage-earners will probably ask for a "5% plus x" wage-increase so as to preserve their purchasing power. Is this wage claim accepted, then prices will automatically rise by 5% due to the wage-effect (assuming that growth remains constant). This wage effect will add up to the original inflation effect triggered by growth rates above potential (in this example the original 5%). So second round effects will bring inflation from the original 5% to 10%.

[6] In a system of fiscal redistribution as we know it from several federal nations, such a surplus from higher growth or overshooting would ideally be redistributed to regions with lower growth.

So what about stabilisation? The first factor to take into account, is the powerlessness of wage-setting in a cyclical downturn. Higher real interest rates raise the production costs of companies and also lower consumption and investment. In this context, higher real wages might theoretically generate inflation, thus potentially lowering real interest rates in the medium run. However, in the short run, they would significantly hurt companies, which would have to face rising wage claims, high real interest rates and low consumer demand. Similarly, lower real wages would have a positive effect of production, but would at the same time lower domestic demand even further, thereby creating a context of even further deflation and higher real interest rates. Wage policy can thus not be used as a stabilising instrument in a cyclical downturn.

Fiscal policy, on the other hand, can have a stabilising effect. Budgetary authorities can - to a certain extent - stimulate demand. The main hurdles in the use of fiscal stimulation is not so much an economic ones but rather political ones (for a detailed overview see Scharpf 1987). First and foremost: fiscal stimulation must always be seen in conjunction with the budgetary deficit and the rate of public debt. Indeed, as the neo-classical economic literature rightly points out, fiscal stimulation based on deficit-spending is likely to fail as it will not be followed by consumers anticipating later tax-increases (Lucas 1996). Moreover, the implementation of fiscal stimulation is a difficult task. There are two ways for the budgetary authority to implement such a policy. First, it is possible to lower taxes and to seek to stimulate demand directly at the level of consumer expenditures. Second, it is also possible to increase public spending and to generate a demand effect in specific sectors and indirectly via the so-called multiplier effect.

3. The role of institutions

The preceding section has indicated what types of adjustments are necessary in fiscal policy and wage-setting to stabilize the business cycle under certain constellations. From an institutional viewpoint, it is straightforward to assume, that implementing a certain type of policy adjustment generally requires certain institutional prerequisites, which are analyzed in this section.

Fiscal policy

As discussed above, fiscal policy can theoretically intervene as a cyclical stabilizer in both a boom and a downturn triggered by sub-optimal real interest rates in the EMU environment. In order to implement such stabilizing policies, however, the fiscal authority needs, on the one hand to react in a timely and decisive manner, and, on the other hand, its effect must be large enough to actually yield the desired effect.

A reaction in a timely manner is only possible if the budgetary authority can adjust swiftly to unforeseen circumstances and can push through a policy stance that is economically required as a stabilizing measure. As a large and impressive body of literature has shown, not all types of fiscal institutions are similarly apt to produce desired policy outcomes in an effective manner (von Hagen 1992; von Hagen/Harden 1995; von Hagen/Hallerberg 1997; Hallerberg/von Hagen 1999). The central arguments of this literature relate to the risk of an ineffective fiscal policy outcome if the budgetary process is not dominated by one key actor defending the overarching objective of fiscal policy ("logic of delegation"), or if such overarching objective is not fixed *ex ante* in a contract binding for all participants in the budgetary process ("logic of commitment"). Originally, this body of literature has focused on the effectiveness of fiscal policy to reduce public debt and budgetary deficits. One part of the underlying logic, however, can also be used in the analysis of an effective stabilization policy by the fiscal authority in EMU. Indeed, while the logic of commitment might be effective in yielding long-term goals such as reducing public debt, it is certainly less effective as a tool of cyclical stabilization. The logic of delegation, however, captures a key requirement for fiscal stabilization in EMU, given that stabilizing measures need to implemented in a decisive manner, no matter what kind of policy response they trigger within government or in parliament.

However, even if stabilizing measures can be implemented by the fiscal authority, then this does not automatically mean that these measures are also effective in economic terms. Countries with a very large share of public expenditure as a ratio of total expenditure in the economy can more easily use fiscal measures to influence the economic cycle. But the role of the state as a whole is not sufficient to give a clear picture of the probability that fiscal stabilization will be effective from an economic perspective. Indeed, in relation to the above-mentioned argument of a swift and decisive fiscal intervention, it is straightforward to assume that the main momentum of fiscal stabilization needs to come from the central national government rather than from sub-national authorities that might dispose of a large share in total public expenditures but are generally much less willing to contribute to nation-wide goals of economic policies (Scharpf 1987 provides a detailed overview of why this is the case, Hughes/Smith 1991 confirm the argument). The probability of effective stabilization thus tends to increase with the share of the central governments' expenditures in total public expenditures, i.e. with fiscal centralization.

Both variables described in this section (effectiveness of the budgetary process; role of the central government) can be easily operationalised, so as to show the nature of fiscal institutions in EMU countries prior to EMU.

With regard to the effectiveness of the budgetary procedure, data assembled by von Hagen for the year 1992 on the logic of delegation in the budgetary process of all EU member states provide the necessary overview for the *status quo ante.* Von Hagen looks at four components of the effectiveness of the budgetary procedure. These components are (i) the structure of negotiations within government, (ii) the involvement of parliament; (iii) the transparency of the budget draft; and (iv) the flexibility of budget execution.

Table 1: Effeciveness of the budgetary procedure (1990)

	Negotiation	Parliament	Transparency	Flexibility	Total	z-transformed
France	16.00	18.00	14.66	20.20	**68.86**	**-2.06**
UK	15.00	16.00	16.00	11.40	**58.40**	**-1.30**
Germany	12.00	4.00	17.00	18.60	**51.60**	**-0.81**
Netherlands	10.66	16.00	18.00	5.00	**49.66**	**-0.67**
Denmark	12.33	12.00	13.33	10.40	**48.06**	**-0.55**
Finland	5.00	6.00	17.00	13.00	**41.00**	**-0.04**
Austria	4.00	4.00	15.00	16.66	**39.66**	**0.06**
Portugal	9.66	5.00	7.33	14.00	**35.99**	**0.33**
Spain	6.00	4.00	17.00	5.80	**32.80**	**0.56**
Sweden	5.33	8.00	9.00	5.33	**27.66**	**0.93**
Ireland	3.00	8.00	5.00	11.00	**27.00**	**0.98**
Belgium	1.00	4.00	10.00	11.20	**26.20**	**1.04**
Italy	7.66	6.00	5.00	1.00	**19.66**	**1.52**
Standard deviation					13.74	1.00
Average					40.50	0.00

Source: Von Hagen 1992

As for fiscal centralisation, Scharpf (1987) has developed a useful indicator based on two components[7]: (i) centralisation of fiscal spending (share of the central government in total public spending); (ii) the government spending ratio (total government spending as a share of GDP).

Table 2: Fiscal centralisation (1990)

	Centralisation	Gvt spending ratio	Total	z-transformed
Portugal	80.31	44.48	**35.72**	**-1.64**
Belgium	66.32	53.13	**35.24**	**-1.58**
France	55.19	53.66	**29.61**	**-0.92**
Italy	54.28	51.76	**28.10**	**-0.75**
Great-Britain	61.21	44.41	**27.18**	**-0.64**
Netherlands	45.91	47.74	**21.92**	**-0.03**
Austria	35.46	52.61	**18.66**	**0.35**
Ireland	50.07	36.45	**18.25**	**0.40**
Sweden	27.28	62.72	**17.11**	**0.53**
Spain	39.64	42.49	**16.84**	**0.56**
Finland	29.32	55.06	**16.14**	**0.64**
Denmark	30.59	29.03	**8.88**	**1.49**
Germany	16.84	48.12	**8.10**	**1.58**
Standard deviation			8.59	1
Average			21.67	0.00

Source: Own calculations based on Scharpf (1987). Data from OECD Economic Outlook. In line with Scharpf, the "total" is obtained by multiplication of the two first components, thus reflecting the share of the central state in GDP.

Putting together the results of these two types of country classifications, the following table gives an overview of fiscal institutions in EMU in the *status quo ante* (i.e. the year 1990).

Table 3: Status quo ante in fiscal policy making (1990)

Centralisation Effectiveness of budgetary procedure	High	Low
High	France Great-Britain Netherlands	Denmark Germany Finland Austria
Low	Belgium Portugal Italy Ireland	Sweden Spain

Sources: von Hagen (1992) for the effectiveness of the budgetary procedure; own calculations based on OECD Economic Outlook data for centralisation (based on an indicator by Scharpf 1987).

[7] Scharpf's original indicator contains a third component, which is referred to as the "degree of difficulty" and is measured as the variation in the budget that amounts to 1% of GDP. In fact, however, this third component is a combination of the two first components. For this reason it is not taken into account here.

As pointed out above, only countries rank in the north-west cell could rely on fiscal institutions capable of successfully correct cyclical imbalances before joining EMU. However, as pointed out above, in the special circumstances of a cyclical overheat, fiscal institutions cannot act alone, but require support by wage-setting.

Wage-setting

The aggregated wage-setting process in a domestic economy results from a sum of individual wage-bargains. For the issue analysed in this paper it is important to identify under what institutional conditions wage-setters at the various levels of the wage-setting process are capable of taking into account the requirements of cyclical stabilisation.

Many different approaches have been developed on theoretically sound and empirically detectable links between institutional or organisational features of the wage-setting process and the resulting economically relevant outcomes. The dominant approach in economics is the approach that decentralised wage-setting systems are likely to produce economically superior outcomes in terms of unemployment and growth (good overviews of existing theories are provided by OECD 1997 and Traxler/Kittel 2000). From the perspective of this paper, however, it would be false to take up the conclusions of this debate. Rather, it is necessary to try to find out how institutional features could relate to the capacity of wage-setters to act as cyclical stabilisers in a boom cycle.

In this special context, the decentralisation hypothesis can hardly be upheld. Indeed, a cyclical boom is generally accompanied by falling unemployment rates (which can even go down to levels of "full employment"). Under such conditions, however, there is no clear limit to wage-claims, given that anticipated inflation increases (growth rates are above potential), real interest rates are low, and there is no automatic adjustment mechanism preventing wage-earners from issuing inflationary wage claims.[8] What is needed in this special context is thus not a decentralised wage-setting process in which rational actors set their wages from their micro-perspective. Indeed, social theory clearly and plausibly points towards the difficulties of decentralised institutions to accept "deferred gratifications" (i.e. the acceptance of today's losses in view of future gains) in system of collective action that might be subject to free-riding behaviour (see mainly Elster, 1979). In such a system, there is no incentive whatsoever for the individual wage-setter to accept real-wage restraints, as there is no guarantee that other wage-setters will adopt the same behaviour (see also Scharpf 1987).

A more convincing hypothesis to the particular problem of cyclical stabilisation can be derived from so-called "corporatist" approaches, which argue that only co-ordinated and centralised wage-setting systems are capable of influencing concretely defined target rates of wage variations at the aggregate level (e.g. Schmitter/Lehmbruch 1979; Streeck/Schmitter 1985). From the perspective of this paper, it appears reasonable to assume that such concretely defined target rates are required so as to allow for an effective interplay between fiscal stabilisation and wage-driven stabilisation in a cyclical overheat. Indeed, in such a context, there needs to be a wage-setting authority capable (i) to detect *ex-ante* the rate of wage variation required for cyclical stabilisation, (ii) to enforce that rate in the actual wage-setting negotiations (so that the *ex-ante* and *ex-post* rates match), and (iii) to enter co-ordinated stabilisation efforts involving fiscal policy.

As for the two first criteria, it is clear that the wage-setting-process needs to be structured in a way that allows for a *clearly identifiable instance of internal leadership*. Capturing this instance is not an easy task, given the focus of the relevant literature on either "co-ordination" (Soskice 1990) or "centralisation" (Cameron 1984; Schmitter 1981; Calmfors/Driffill 1988) of wage-

[8] In the pre-EMU economic environment, it was obviously central banks that played this role. By increasing real interest rates as a reaction to inflationary wage claims, central banks in many OECD countries managed to contain such wage-claims (see for example Scharpf 1987).

setting systems.[9] For the purpose of this study, it appears most useful to follow an indicator developed by Golden/Wallerstein/Lange 1997 on the role of union federations in wage-negotiations.[10] What Golden/Wallerstein/Lange's data do not capture, however, is the special role of "pattern-bargaining-systems". Such systems are characterised by semi-centralisation, in which there is horizontal co-ordination (Traxler/Kittel 2000). One union plays the role of a leading wage-setter, whose agreements are generally followed by the remaining unions – Germany and Austria fall under this category (Traxler/Blaschke/Kittel 2001). Pattern-bargaining systems were added to the Golden/Wallerstein/Lange indicator as scoring "high" with regard to internal leadership. [11]

Table 4: Internal leadership in the wage-setting process (1990)

	Golden et al.	Traxler et al.	Internal leadership
Belgium	4		Low
Denmark	1		Low
Germany	1	Pattern	High
Finland	9		High
France	4		Low
UK	1		Low
Ireland	3*		Low
Italy	1		Low
Netherlands	9		High
Austria	3	Pattern	High
Portugal	1*		Low
Sweden	9		High
Spain	3*		Low

Source: Golden/Wallerstein/Lange 1997 (Variable: CONINV); Traxler/Blaschke/Kittel 2001.
*own classification based on the European Industrial Relations Review

As for the third of the above-mentioned criteria, a separate indicator needs to be developed. As outlined above, the link between wage-setters and the government is of crucial importance in the successful implementation of domestic stabilisation. If no such link exists, it is doubtful that the policy-mix between fiscal-stabilisation and wage-setting can yield good results. Golden/Wallerstein/Lange's data-set contains a variable precisely indicating the involvement of governments in wage-negotiations on a range from 1-15. For the purpose of this study, the cutting point between systems with "high government influence" and "low government influence" was set in between 4 and 5, as 4 refers to cases in which governments provide wage-setters with macroeconomic data only, whereas 5 indicates that governments make concrete and clear wage-recommendations to wage-setters (values higher than 5 indicate consultations between

[9] Due to space constraints, it is not possible to enter a detailed assessment of the very subtle debate on different sub-categories of centralised and co-ordinated systems. Kenworthy (2000) gives an excellent overview of the relevant literature.

[10] The indicator goes from 1 to 11 whereby higher numbers indicate a stronger involvement of union confederations. The way the indicator is built, however, clearly indicates that the assumption of internal leadership is only met by systems ranking 9, 10, or 11, as only these systems indicate wage-bargaining at the domestic level.

[11] Please note that as Portugal, Ireland, and Spain are not covered by the Golden/ Wallerstein/Lange data, these cases were analysed and scored individually, mainly on the basis of analyses in the *European Insdustrial Relations Review*.

governments and wage-setters). A change was made in the Italian (scoring 8), as the Italian government sets a legally binding reference value for the variation of consumer costs. The fact that there is legal action by the government does not give an indication of the nature of the link between the government and wage-setters. In line with the mainstream view in the literature, the wage-setting system in Italy is thus treated as having a "low" degree of dialogue with government (e.g. Regalia/Regini 1999; Regini 2000). Cases not covered by Golden/Wallerstein/Lange (Ireland, Portugal, and Spain) were taken from a comparable assessment in Traxler/Blaschke/Kittel (2001).

Table 5: Capacity of dialogue with government (1990)

	Golden et al.	Dialogue with governement
Belgium	4	Low
Denmark	5	High
Germany	3	Low
Finland	9	High
France	3	Low
UK	2	High
Ireland	-	High
Italy	8	Low
Netherlands	6	High
Austria	6	High
Portugal	-	Low
Sweden	1	High
Spain	-	Low

Source: Golden/Wallerstein/Lange 1997 (Variable GOVINV). Missing values taken from Traxler/Blaschke/Kittel. For the special case of Italy, see text.

On the basis of the two preceding tables, the following overview of wage-setting the *status quo ante* can be established.

Table 6: Status quo ante in wage-setting institutions (1990)

Dialogue with government	High	Low
Internal leadership		
High	Denmark Finland Netherlands Austria Sweden	Germany
Low	Ireland	Belgium France Italy Portugal Spain UK

Source: See tables 6 and 7

Putting together the information on fiscal institutions and wage-setting institutions, it becomes clear that only one EMU member state completely fulfilled the institutional prerequisites of domestic stabilisation before joining EMU: the Netherlands. The special status of the Netherlands is not really surprising – and to a certain extend even confirms the approach chosen in this paper – since the Netherlands *de facto* have been member of a currency union with Germany since the 1979. Without going too much into details, it is interesting to note that right after the Dutch decision to almost fully reproduce German monetary policy in the Netherlands[12], the wage-setting system changed (*Wassenaar agreement* in 1982*)*.

For all other countries, the status quo ante indicates that reforms were necessary to prepare for joining EMU. In the following list, the missing features and the expected reforms are listed.

Table 7: Overview of needs for adjustment

	Fiscal policy	Wage-setting	Expected reforms
Austria	1 feature missing (centralisation)	Both features present	Budgetary centralisation
Belgium	1 feature missing (budgetary effectiveness)	Both features missing	Reform of budgetary procedure Dialogue with government Internal organisation of wage-setting procedures
Danmark	1 criterion mising	Both features present	Budgetary centralisation
Germany	1 feature missing (centralisation)	1 feature missing (dialogue with gvt)	Dialogue with government Budgetary centralisation
Finland	1 feature missing	Both features present	Budgetary centralisation
France	Both features present	Both features missing	Dialogue with government Internal organisation of wage-setting procedures
Ireland	1 feature missing (budgetary effectiveness)	1 feature missing (internal leadership)	Reform of budgetary procedure Internal organisation of wage-setting procedures
Italy	1 feature missing (budgetary effectiveness)	Both features missing	Reform of budgetary procedure Dialogue with government Internal organisation of wage-setting procedures
Netherlands	Both features present	Both features present	
Portugal	1 feature missing (budgetary effectiveness)	Both features missing	Reform of budgetary procedure Dialogue with government Internal organisation of wage-setting procedures
Sweden	Both features missing	1 feature missing (internal leadership)	Budgetary centralisation Reform of budgetary procedure Internal organisation of wage-setting procedures
Spain	Both features missing	Both features missing	Budgetary centralisation Reform of budgetary procedure Dialogue with government Internal organisation of wage-setting procedures
UK	Both features present	Both features missing	Dialogue with government Internal organisation of wage-setting procedures

Before considering the actual reforms implemented in EMU member states since the early 1990s, it is necessary, however, to also study the expected adjustment pressure, which could be anticipated in EMU member states. The reason for this relates to the differing institutional requirements, depending on the type of adjustment pressure (boom or downturn).

4. Expected economic pressure

Three factors need to be taken into account when assessing the anticipated economic pressure on EMU members: (i) their output gap in relation to the euro-area output gap; (ii) their inflation rate in relation to the euro area inflation rate. Both, the output gap and inflation data are of importance, given that the most straightforward approach to monetary policy – the so-called "Taylor rule" – is conceptualised as setting an interest rate on the basis of the inflation rate and the output gap.

[12] There was only one devaluation of 2 percent in 1983.

Before considering both aspects in detail, it is warranted to briefly look at the relative economic size of each euro area economy. Indeed, one could argue that the economic pressure would be higher, the smaller the economic size of the member state, given that the domestic economic conditions weigh less in the consideration of the ECB when setting monetary policy in view of macroeconomic data in the euro area as a whole. The reason why this factor is not taken into account here, is that none of the present 12 euro area member states accounts for more than 1/3rd of euro area GDP.

Table 8: Share of euro area GDP of member states (2000)

Country	GDP
Germany	32.17%
France	21.71%
Italy	17.73%
Spain	8.70%
Netherlands	5.86%
Belgium	3.73%
Austria	3.15%
Finland	1.93%
Greece	1.82%
Portugal	1.63%
Ireland	1.28%
Luxembourg	0.28%
Total	100%

Source: OECD data

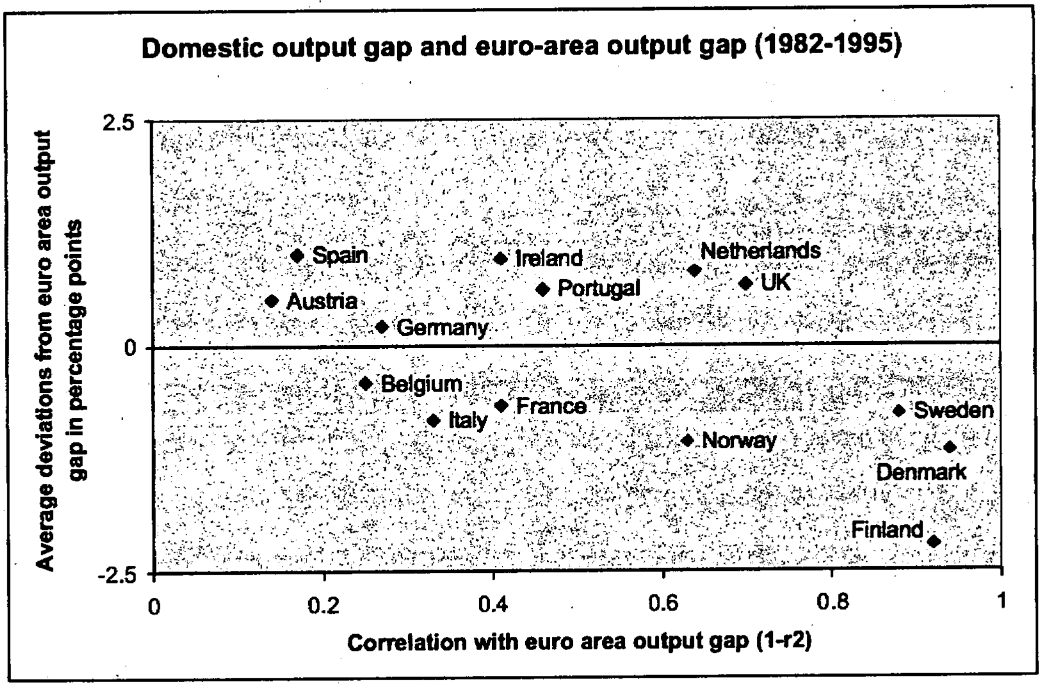
In this context, no EMU member state – not even Germany – could assume that the monetary policy of the ECB would actually fit domestic economic conditions.

Domestic output gap and euro area output gap

In order to get an idea of how domestic output gaps behave with regard to the euro area output gap, two types of analyses were conducted for the period 1982-1995. First, average deviations from the euro area output gap were calculated so as to give an indication of which countries had to expect stronger growth momentum – on average – than the euro area. Second, as an additional information, the correlation of output gap variations was also calculated, so as to indicate the synchronisation of business cycles in the euro area.
The overview figure (see overleaf) should be read in the following manner. Longer distances from 0 on both axes indicate an overall stronger tendency to deviate from euro area output gap data. The more important indicator is on the y-axis. Countries with positive values on this axis are likely to expect higher growth momentum (mainly Spain, Ireland, and the Netherlands) than countries ranking below (mainly Finland, Denmark, Norway and Italy)[13]. Please note that the output-gap table should be read together with the table on inflation data (see below).

[13] Finland's data are somewhat distorted by the exceptionally pronounced recession of the early 1990.

Figure 1:



Source: own calculations based on data from the OECD Economic Outlook. Deviations from the output-gap have been inverted: a numerical value implies average deviations above potential (i.e. inflationary pressure).

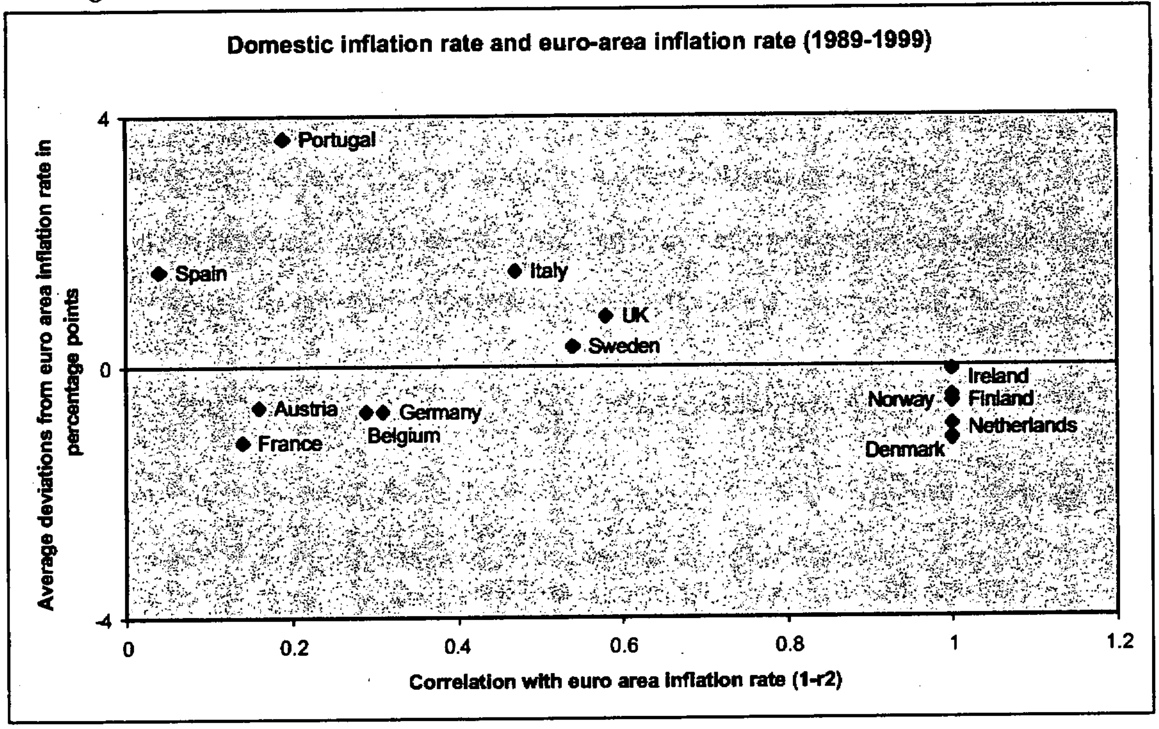
Domestic inflation and euro area inflation

The relation of the domestic inflation rate to the euro area inflation rate is analysed in the same manner as in the case of the output gap. However, a different time-period has been chosen (1989-1999). The reason relates anti-inflationary policies which European central banks started to adopt at different points in time during the 1980s. The period 1982-1988 would unnecessarily distort the data and would give indications that are of no informative value for this study. The period 1989-1999 offers a could compromise between a reasonable starting point and an acceptable number of years (which is necessary to obtain significant correlation data).

The overview figure (see overleaf) shows that deviations generally remain within a 1 percent margin. While this can certainly be considered as a rather satisfactory result, one should however take into account that one percentage point is the equivalent of 100 basis points in terms of the real interest rate. What is of considerable importance, however, is the fact that a few countries stand out as clearly "high inflationary", namely Portugal[14], Spain, and Italy. As concerns the correlation values, it is remarkable how little synchronisation can be detected.

[14] While it might be argued that Portugal's anti-inflationary monetary policy started later than in other countries, it is nonetheless remarkable that inflationary pressure in Portugal during the 1990s was constantly one of the highest in Europe.

Figure 2:



Source: own calculations based on data from the OECD Economic Outlook

Economic pressure to adjust to EMU can now be put together in a way that allows to derive an assessment of how member states were likely to perceive their own position i.e. which kind of economic pressure they had to anticipate under a *ceteris paribus* assumption.

Table 9: Summary table on economic adjustment pressure

	Inflation	Output gap	Assessment (*ceteris paribus*)
France	Lower than EMU	Lower than EMU	High real interest rates
Germany	Lower than EMU	Average	High real interest rates
Austria	Lower than EMU	Higher than EMU	High real interest rates
Belgium	Lower than EMU	Lower than EMU	High real interest rates
Spain	Higher than EMU	Higher than EMU	Low real interes rates
Portugal	Higher than EMU	Higher than EMU	Low real interest rates
Ireland	Medium	Higher than EMY	Low real interest rates
Italy	Higher than EMU	Lower than EMU	?
Finland	Lower than EMU	Lower than EMU	?
Netherlands	Lower than EMU	Higher than EMU	?

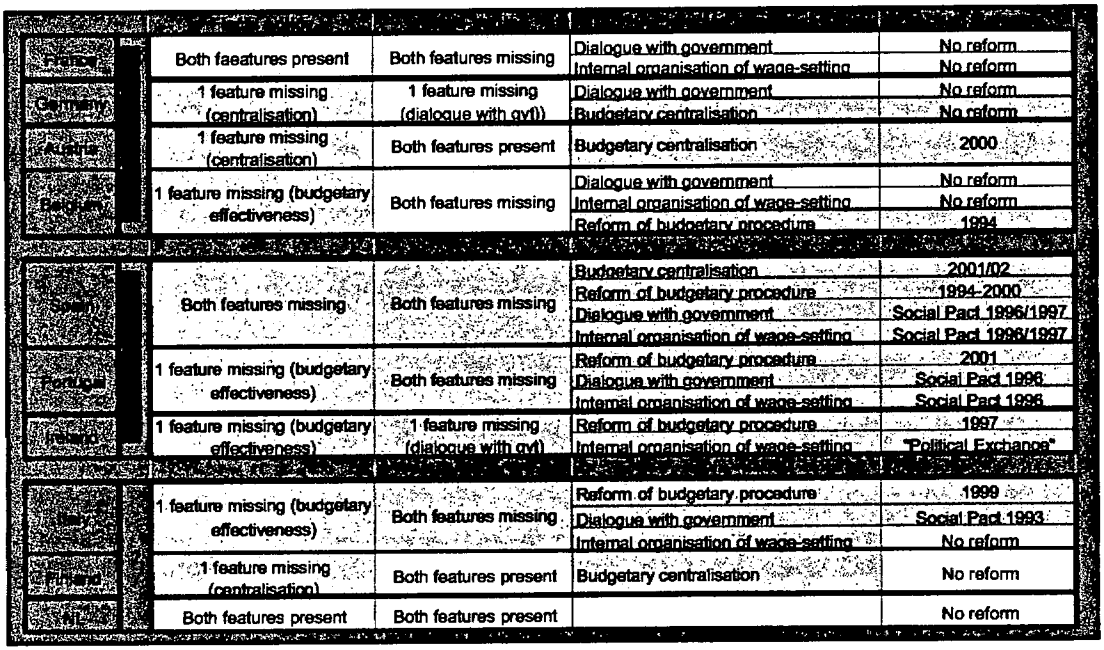
Table 10 indicates that three groups of countries should be distinguished.

- The first group comprises those member states, which were likely to face high real interest rates in EMU – and thus a cyclical downturn. One would expect the countries of these groups not to focus on wage-setting institutions but rather and only on fiscal institutions (as wage-setting is of no use as a cyclical stabiliser in this specific configuration).
- The second group comprises those member states, which had to expect very low inflation – and thus were likely to face the risk of a cyclical boom. One would expect those countries to implement institutional reforms in both fiscal institutions and wage setting. Moreover, one would expect to see the emergence of close links between wage-setters and government in these countries.
- A third group comprises countries that do not easily fit into one of the two groups. The data for Italy, Finland and the Netherlands do not give sufficiently clear indications with regard to the expected adjustment pressure.

5. Actual reforms: an overview

This section gives a very succinct overview of actual reforms of fiscal policy institutions and wage-setting institutions that took place in EMU member states between the mid-1990 and 2001.[15] As sketched-out above, this paper assumes that EMU member states adjusted their institutions when joining EMU so as to deal with the expected adjustment pressures.

Table 10: Expected and actual adjustments



France	Both faeatures present	Both features missing	Dialogue with government Internal organisation of wage-setting	No reform No reform
Germany	1 feature missing (centralisation)	1 feature missing (dialogue with gvt))	Dialogue with government Budgetary centralisation	No reform No reform
Austria	1 feature missing (centralisation)	Both features present	Budgetary centralisation	2000
Belgium	1 feature missing (budgetary effectiveness)	Both features missing	Dialogue with government Internal organisation of wage-setting Reform of budgetary procedure	No reform No reform 1994
Spain	Both features missing	Both features missing	Budgetary centralisation Reform of budgetary procedure Dialogue with government Internal organisation of wage-setting	2001/02 1994-2000 Social Pact 1996/1997 Social Pact 1996/1997
Portugal	1 feature missing (budgetary effectiveness)	Both features missing	Reform of budgetary procedure Dialogue with government Internal organisation of wage-setting	2001 Social Pact 1996 Social Pact 1996
Ireland	1 feature missing (budgetary effectiveness)	1 feature missing (dialogue with gvt)	Reform of budgetary procedure Internal organisation of wage-setting	1997 "Political Exchange"
Italy	1 feature missing (budgetary effectiveness)	Both features missing	Reform of budgetary procedure Dialogue with government Internal organisation of wage-setting	1999 Social Pact 1993 No reform
Finland	1 feature missing (centralisation)	Both features present	Budgetary centralisation	No reform
NL	Both features present	Both features present		No reform

As the table indicates, actual reforms confirm the hypotheses of the paper. Areas in which the paper predicted reform are shown in grey in table 11. Other areas are shown in white.

[15] A more detailed overview of reform patterns in 10 EMU member states is contained in Enderlein (2002).

Group 1: Institutional adjustment in countries facing high real interest rates

Austria, Belgium, France, and Germany make up the group, for which high real interest rates and thus low growth rates could be predicted as potential economic effects of EMU. As explained above, in this specific context, only fiscal policy can be used as a stabilising instrument.

Before joining EMU, three out of the four countries of this group did not have appropriate fiscal institutions for the specific type of adjustment pressure they were facing. Only France's institution fulfilled both criteria (centralisation and budgetary effectiveness). As can be seen from table 10, Austria and Belgium implemented the predicted reforms, whereas Germany did not.

During the 1980s and 1990s, **Austria** had been member of a *de facto* monetary union with Germany, but did not have to fear a sub-optimal monetary policy, since structural and business cycle characteristics of Austria and Germany are very closely linked (e.g. OECD 1998). However, when Germany's dominant role as the "trend-setter" of monetary policy-making in Europe came to an end in 1999 and the ECB started setting real interest rates on the basis of euro area average data, the likelihood that this newly defined monetary policy would have destabilising effects for Austria dramatically increased (Enderlein 2001). As indicated above, Austria's fiscal sytem lacked centralisation. In this context, in the fall of 200, the central government of Austria imposed a "Pact for reaching a deficit of 0 percent" upon regional governments and local governments. This pact is based on a co-operative link between sub-national authorities and central government: sub-national governments and local governments have to reach budgetary balances of 0.75% and 0% respectively, and, in exchange, are given a guarantee of fiscal support from central government in periods of cyclical downturns (Hallerberg/Strauch/von Hagen 2001: 18). The underlying logic and implementation of this measure fully corresponds to the hypothesis of this paper.

In **Belgium**, the need for institutional adjustment as a reaction to economic pressures in a monetary union was felt earlier than in many other EMU member states, since Belgium joined a *de facto* monetary union with Germany in March 1992, when the Belgian National Bank (BNB) announced that it would not accept further devaluations vis-à-vis the D-Mark and closely follow the monetary policy of the Bundesbank without taking into account potential destabilising effects.[16] Although this policy was implemented only one year later, after the devastating effects of the 1992-1993 exchange rate crisis (which had shown that Belgian economic fundamentals were not at all in line with German economic fundamentals), Belgian policy actors recognised the need for a reform of the budgetary procedure in 1992 already and started a rather unique reform to considerably strengthen the budgetary procedure. Belgium authorised the *Conseil supérieur des finances* (CSF), which had been a simple advisory body to the ministry of finance until then, to set a binding budgetary balance before the actual negotiations on the budget among ministers actually starts. The CSF has thus become the main player in Belgian macro-economic policy-making, since it largely controls the impact of the Belgian budget on the economic cycle. What is remarkable in this respect is the involvement of the BNB in the CSF. As Hallerberg argues (1999), the three representatives of the BNB play a key role in the CSF and *de facto* set the net balance of the Belgian budget. Although it took some time, before the CSF's new role was fully accepted (Hallerberg 1999), it has now become a powerful substitute for domestically oriented monetary policy in Belgian economic policy making, thus confirming the expectation of this paper.

Contrary to the expectations of this paper, there was no significant step towards fiscal centralisation in **Germany** after the start of stage three of EMU. There are, however, good

[16] In contrast to Austria and the Netherlands, Belgium had preserved its truly domestically oriented monetary policy during the 1980s and early 1990s. Indeed, whereas the r^2 for the correlation coefficients for short-term interest rates between Germany and Austria/Netherlands is of 0.96/0.92 for the period 1982-1995, it is as low as 0.29 in the Belgian case.

explanations why no such reform can be observed. Firstly, there was less awareness with regard to potential destabilising effects resulting from EMU in the German government. Indeed, before the start of stage three of EMU, most German officials assumed that the ECB would take German economic conditions very strongly into account – or even fully target the German economy. This, however, did not happen, and Germany has had to struggle with real interest rates at a much higher level than has been appropriate for the German economy. In September 2001, officials in the German ministry of finance confirmed in interviews for this study that they had underestimated the destabilising impact on Germany of the ECB's monetary policy. Indicating that they had hoped the ECB would have adopted a much stronger focus on the largest economy of the euro area, they clearly pointed out that the main obstacle on the way to fiscal stabilisation was the deeply rooted tradition of fiscal decentralisation in Germany. Indeed, German fiscal decentralisation is much more pronounced than in any other EMU member state. Moreover, the role of the German *Länder* as a co-legislator on matters concerning their own spending authority makes a step towards more fiscal centralisation almost impossible to implement. While it should be noted that a German *"internal stability pact"* has been signed between the central government and the *Länder* in 2001, thus to a certain extent confirming the hypothesis of this paper, the practical implications of this pact should not be overestimated, as it does not considerably limit the spending authority of sub-national governments in Germany.
As mentioned above, no institutional adjustment was necessary in **France** where the highly centralised and very effective budgetary system was already well in place before the start of stage three of EMU.

In short, institutional adjustment in these four country cases is broadly in line with the expectations formulated in this paper. Institutional adjustment took place where expected. Even the German case broadly fits the analysis, although no actual reforms can be observed.[17] What should be highlighted at this stage, is the fact that none of the three countries made serious attempts to build so-called "social pacts" between government and wage-setters. While sharply in contrast with the experiences of countries of the second group, this lack of consultation with wage-setters comes of no surprise for the approach chosen in this paper, since the specific economic situation that these countries were facing simply did not call for such "social pacts".

Group 2: Institutional adjustment in countries facing low real interest rates

Ireland, Portugal and Spain are those countries that had to expect inflationary pressure resulting from low real interest rates when they joined EMU. As sketched out above, there is a need for close co-operation between fiscal policy-making and wage-setting in a context of cyclical overheat. The approach of this paper is confirmed by the patterns of institutional adjustment in all three countries.
When **Ireland** became on of the founding members of EMU, it was had been enjoying a period of strong economic growth for more than five years already, during which the Irish economy had constantly reached growth rates above potential. Inflationary pressures where thus already high when the authority for monetary policy was turned over to the ECB. Not surprisingly, ECB interest rates were considerably lower than appropriate for the Irish economy. In this context, a cyclical overheat could only be prevented by a joint effort of fiscal policy and wage-setting. However, given the approach of this paper, institutional reform were necessary in order to render the budgetary procedure more effective. Moreover, despite a rather successful period of

[17] What should briefly be highlighted at this point, is that the reforms of fiscal institutions did not really result in the actually desired policy outcomes. The reason for this is however not related to domestic institutions but rather to the constraints set out in the Stability and Growth Pact, which considerably limits the scope for fiscal stabilisation in a cyclical downturn.

centralised wage-negotiations in close dialogue with government, Irish wage-setting was clearly lacking strategic leadership in the early 1990s: conflicts among unions were frequent and centralised wage-agreements were not taken up at the local level in many cases.

Ireland's budgetary procedure was significantly altered in 1997 when the Irish finance minister was given the right to veto spending positions agreed by parliament if these positions are considered as going against the global macro-economic concepts of the government (de Haan/Moessen/Volkerink 1999). Moreover, Ireland decided to develop a three-year approach to this macro-economic perspective, thereby strengthening the position of the finance minister's role even further, by adding a dimension of "commitment" to the logic of delegation, which is dominant element in the reform of 1997.

A more difficult task was the reform of the Irish wage-setting structure. As the Irish government could obviously not impose internal leadership to unions, it tried to develop an incentive that should convince the group of unions to ensure implementation of wage-agreements struck at the central level. This incentive was to cut taxes in exchange for actually implemented real wage restraint ("political exchange"). There are now clear indications that this attempt actually resulted in much stronger internal cohesion of the wage-setting process (Stuart 2001), thus producing to a certain extent the desired institutional reform. What should not be forgotten, however, is the price that the Irish government had to pay – namely pro-cyclical tax-cuts, going clearly against the objective of cyclical stabilisation – which resulted in a warning issued by the EU Commission against Ireland for not respecting the recommendations of the Broad Economic Policy Guidelines. In short: while the Irish case confirms the expectations of this paper in terms of institutional adjustment, it also illustrates the political difficulties to successfully implement stabilising measures in the context of a boom.

Given the approach adopted in this paper, **Spain's** economic policy institutions had to be completely overhauled in the context of joining EMU. None of the four institutional criteria in fiscal policy-making and wage-setting was met by Spain in the early 1990s. Yet adjustment took place. It started after the election in 1996 when the Aznar-government succeeded in building an unprecedented dialogue with unions by threatening to privatise the public pension system according to neo-liberal recommendations and only accepted to withdraw this plan when unions agreed to enter direct negotiations with the government of real wage restraint (Pérez/Pochet 1999). In an approach which is very similar to the one of the Irish government, the Spanish government then tried to end conflicts between the two main unions (UGT and CC.OO) by suggesting to build a "social pact" based on an exchange of real wage-restraint against tax-cuts.

The fiscal framework was changed in parallel. Starting already in 1994, both the socialist and the conservative governments incrementally streamlined the budgetary procedure (see OECD 2000), before a far-reaching reform was finally implemented in 2000, when a clear administrative distinction was introduced between the economic ministry, in charge of defining the macro-economic impact of fiscal policy, and the finance ministry, in charge of allocating the overall amount decided upon by the economics ministry to the other ministries.

Starting in 1995, Spain also made several attempts to incrementally change the clearly decentralised system of public spending (for an overview, see OECD 1997b; 2001). Although the complex fundamental interplay between the regions and the central government has not been fundamentally altered (Gordo/Herndandez de Cos), the central government since 1997 has the right to veto regional budgets based on increasing debt and deficits (Hallerberg/Strauch/von Hagen). It is this last measure, which most clearly fits the framework of this paper as it gives the central government the possibility to prevent regions from running pro-cyclical deficits in the context of a cyclical overheat.

Given the assessment of economic pressures resulting from EMU, **Portugal** clearly stood out as the EMU member state facing the highest degree of pressure. Institutions had to be adjusted in three areas to successfully meet this pressure – only fiscal centralisation was present. Actual reforms were implemented in two steps. First, in 1996, there was a clear and explicit attempt by

government to end the relationship of "no-trust" between government and unions (da Paz Campos Lima/ Naumann 2000). In December 1996 a "social pact" was signed, containing far reaching measures on joint economic policy management based on real wage restraint in exchange for some tax-cuts. The Portuguese government clearly took a bet on EMU by assuming that falling real interest rates would trigger higher growth rates which in turn would allow to finance the tax cuts (the bet eventually failed, when the Portuguese economy had to face the global economic slowdown starting in 2001).
As concerns the budgetary procedure, Portugal ranked among the least effective EMU members in 1990. This said, budgetary centralisation in Portugal is the highest in EMU, so it is not surprising that the Portuguese government overhauled its budgetary procedure in 2000-2001. This reform considerably strengthens the ministry of finance by giving it the possibility to reject claims by other ministries to increase spending beyond a pre-determined level.

The similarities between the three EMU member states facing low real interest rates and high growth are striking. All of them had to adjust their institutions considerably. All of them used the same approach of a "social pact" when seeking to convince wage-setters to contribute to cyclical stabilisation.

Group 3: Other countries

Italy, Finland and the Netherlands do not really fit into the patterns of the two other groups. Their cases nonetheless add interesting elements to the approach of this paper – especially Finland and the Netherlands, which fully fit the approach adopted here.
The special case of **Italy** can be largely explained by the extreme difficulties of the country to prepare for EMU by meeting the Maastricht criteria – which, to a very large extent – were directly targeting the Italian case (Dyson/Featherstone 1999). Calls to reform the budgetary procedure and to strike a deal with wage-setters were thus present in the very early 1990s already. While facing difficulties in implementing the reform of the budgetary procedure, a series of crucial agreements between the government and wage-setters were reached between 1993 and 1998. These agreements built an unprecedented dialogue and allowed the Italian economy to use wage-policy as a crucial tool in its preparation for meeting the Maastricht criteria (Regalia/Regini 1999).
In the area of fiscal policy, the implementation of a reform of the budgetary procedure only fully succeeded when the Maastricht-process was almost over. The reform, which considerably strengthened the government vis-à-vis the parliament and also gave the finance ministry the possibility to set binding budgetary ceilings (Felsen 1999), was implemented for the first time in 1997. It certainly helped achieving the "miracle" of the Italian budget in 1997. The reform of fiscal institutions did not stop at that moment, thus perhaps indicating that the concerns over the Maastricht criteria were not the only rationale behind it. In 1999, a national stability pact was implemented, so as to revise the only seven years old law on the decentralisation of fiscal spending. This measure is of particular interest as it clearly goes against the dominant doctrine at that time – especially against the recommendations of the OECD, which encouraged Italy to decentralise rather than to re-centralise fiscal spending authority (OECD 2000).
The Italian case does not fully fit into the approach of this paper. Reforms of Italian fiscal and wage-setting institutions can probably more easily be explained by the attempt to meet the Maastricht criteria.
If **Finland** was considered as a special case in terms of identifying the expected economic pressure, then this can mainly be explained by the widely noted strong structural divergence between Finland and the rest of the euro area (e.g. OECD 1998). When discussions on EMU started in Finland, it was easily seen by officials and politicians, that Finland had to prepare for cyclical corrections as a reaction to asymmetric shocks and/or a destabilising monetary policy by

the ECB. When the hard and exceptionally long recession of the early 1990s was over, Finland thus very explicitly entered a discussion on how to use wage-setting and fiscal policy making as cyclical stabilisers.

Finland found a rather creative solution. Instead of using the classical instruments of fiscal policy-making and wage-setting, a system of so-called "EMU buffers" was established. Starting in 1998, employers, employees and the government began to put money in a fund, big enough to finance aggregate wage adjustments of 3% for all wage earners in Finland – an adjustment that is the equivalent of a nominal exchange rate adjustment of 10%. The EMU buffers are an interesting middle-way between fiscal stabilisation and wage-setting adjustments: functioning to a certain extent like an insurance (in this case financed by government and wage-setters), the system allows to adjust to pressures arising from EMU independently from year-to-year fiscal policy-making or wage-setting.

Although Finland was identified as a special case in this paper, its adjustment process is clearly indicating how directly the anticipated impact of EMU resulted in institutional changes – in this special case the establishment of EMU buffers.

Finally, the **Netherlands** were also considered as special case, because no clear type of economic pressure could be identified. As in the case of Finaland, however, the fact that there is no clear type of pressure does not mean, that there is no need for adjustment. What is special in the Dutch case, however, is the fact that even before joining EMU, the Netherlands had a set of fiscal and wage-setting institutions that – given the approach of this paper – fulfilled the institutional adjustments for cyclical stabilisation. However, even in the Dutch case there are clear signs of preparatory measures in anticipation of cyclical destabilisation under EMU. Most importantly, the second Kok-government established an "automatic" system allowing to use fiscal policy in the context of cyclical destabilisation (especially a downturn). The system establishes a procedure for adjusting the budget to unforeseen cyclical circumstances. Missing budgetary income is compensated to 75% by new debt and 25% by tax-increases if the budgetary deficit is lower than 1.75% of GDP before the adjustment procedure. Is it higher than 1.75% of GDP, the part of tax-increases rises to 50% (Hallerberg/Strauch/von Hagen 1999; Ewijck/Reininga 1999). The main objective of this procedure was clearly to avoid lengthy political discussions on tax-increases in a moment of cyclical pressure and thus needs for swift stabilisation.

Although the Netherlands fulfilled the institutional pre-requisites for an effective stabilisation policy before joining EMU, additional adjustments were nonetheless implemented so as to make the Dutch system apt to react swiftly to cyclical imbalances.

6. Conclusion

This paper has explained institutional reforms in fiscal policy and wage-setting in 10 EMU member states since the mid-1990 as an anticipated adjustment process to expected economic pressures arising from EMU. It has shown why EMU member states had to anticipate that the single monetary policy of the ECB could have a destabilising impact for the domestic economic cycles and has sketched-out how wage-setting and fiscal policy can – in theory – be used to correct these imbalances. Based on this theoretical assessment, the paper has developed the assumption that member states anticipated the economic pressure arising from EMU and sought to adjust their economic policy institutions accordingly.

The evidence from actual adjustment processes in the 10 EMU member states studied here, largely confirms the approach of this paper. Countries expecting to face high real interest rates and thus low growth rates focused on the adjustment of fiscal institutions. They did not seek to build close co-operation with wage-setters, as is the case in countries expecting low real interest rates and high growth rates. Three cases do not fit either of these two groups. However, the evolution of economic policy institutions in these countries also provides support for the hypothesis developed in this paper.

Two main theoretical implications could be derived from this paper:

- First, the paper confirms the need in institution-focused comparative political economy to study monetary policy, fiscal policy, and wage-setting in parallel instead of limiting research to only one of these three areas. Indeed, as this paper has shown, the nature of institutional reforms in one area often can only be understood if analysed in their interplay with the two other areas.
- Second, the paper has chosen an economic approach that has almost completely disappeared from comparative political economy. It has focused on the *cyclical* dimension of economic policy-making instead of focusing on the long-term aspects only. The satisfying conclusions deriving from this approach might encourage more research in this area.

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