Domestic Institutions and European Monetary Integration

The Politics of Monetary and Fiscal Convergence in Italy 1992-1998

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Abstract

This thesis analyses how Italy succeeded in fulfilling the macroeconomic convergence criteria agreed upon at the Maastricht conference in late 1991. It is argued that economic policy reform in Italy between 1992 and 1998 has to be understood primarily as the result of two sets of factors: international financial and political pressure; and domestic political and socio-economic institutions. The institutionally grounded concept of 'executive strength' is regarded as particularly important, as 'weak' Italian governments had been the main reason for unsustainable economic policies in the past.

Methodologically, the study uses an historical-institutionalist approach to explain institutional and policy reform. From both an empirical and theoretical perspective, successful macroeconomic convergence during the 1992-98 period represents an anomaly. Hence the study of successful policy reform can be regarded as a 'deviant case study' which is implicitly comparative in nature.

The thesis analyses in a historically-detailed manner institutional and policy reforms in the four most relevant policy areas, that is, budgetary policy, pension reform, private and public sector wage policies, and monetary and exchange rate policy. It is argued that policy reforms in these four areas made an important contribution to monetary and fiscal convergence.

The study finds that the obstructive character of domestic institutions – and especially executive weakness - was overcome thanks to international pressure. Nonetheless, domestic institutions continued to affect policy outcomes. By comparing the French and Italian macroeconomic policy regimes, the concluding chapter provides a second-line defence in favour of the domestic-institutional and 'executive strength' accounts.

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List of Abbreviations

AN	*Alleanza Nazionale*
ARAN	*Agenzia per la Rappresentanza Negoziale delle Pubbliche Amministrazioni*
CADES	*Caisse d'Amortissement de la Dette Sociale*
CCD	*Centro Cristiano Democratico*
CDU	*Cristiani Democratici Uniti*
CGIL	*Confederazione Generale Italiana del Lavoro*
CISL	*Confederazione Italiana Sindacati Lavoratori*
CNAV	*Caisse Nationale pour l'Assurance Vieillesse*
CS	*Cristiani Sociali*
CU	*Comunisti Unitari*
DCI	*Democrazia Cristiana Italiana*
DPEF	*Documento di Programmazione Economica e Finanziaria*
ECB	European Central Bank
ECR	Equilibrium Contribution Rate
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
EU	European Union
FI	*Forza Italia*
FIOM	*Federazione Impiegati Operai Metallurgici*
GDP	Gross Domestic Product
IMF	International Monetary Fund
INPS	*Istituto Nazionale della Previdenza Sociale*
IPE	International Political Economy
IR	International Relations
LN	*Lega Nord*
MF	Minister of Finance
MP	Member of Parliament
OECD	Organisation for Economic Co-Operation and Development
PCF	*Parti communiste français*
PCI	*Partito Comunista Italiano*
PDS	*Partito dei Democratici di Sinistra*
PLI	*Partito Liberale Italiano*
PM	Prime Minister
PPI	*Partito Popolare Italiano*
PR	*Partito Radicale*
PRI	*Partito Repubblicano Italiano*
PS	*Parti socialiste*
PSBR	Public Sector Borrowing Requirement
PSDI	*Partito Social-Democratico Italiano*
PSI	*Partito Socialista Italiano*
RC	*Rifondazione Comunista*
RGS	*Ragioneria Generale dello Stato*
RPR	*Rassemblement pour la République*
RSU	*Rappresentanza Sindacale Unitaria*
RU	*Unità riformista*
SDI	*Socialisti Democratici Italiani*
SI	*Socialisti Italiani*
TEU	Treaty on European Union
UD	*Unione Democratici*
UDF	*Union pour la Démocratie française*
UIC	*Ufficio Italiano dei Cambi*
UIL	*Unione Italiana del Lavoro*

1 INTRODUCTION: ITALY, EMU AND THE POLITICS OF MONETARY AND FISCAL CONVERGENCE

This thesis analyses how Italy succeeded in fulfilling the macroeconomic convergence criteria agreed upon at the Maastricht conference in December 1991. It is argued that economic policy reform between 1992 and 1998 has to be understood primarily as the result of the interaction of two sets of factors: international financial and political pressure; and domestic political and socio-economic institutions.

The study of macroeconomic convergence and domestic institutions is of great importance for several reasons. First, an examination of the factors that influenced macroeconomic convergence will shed light on the sustainability of Italian economic policies. A conceptual framework for understanding convergence will thus provide an analytical tool for evaluating whether Italian membership of Economic and Monetary Union (EMU) will be viable in the long run. Second, a study of macroeconomic convergence in the context of increasing internationalisation will add to the current theoretical debate on how the 'international' and the 'domestic' interact and what role domestic institutions play in the context of increasing economic interdependence (Keohane and Milner 1996; Milner 1997). The case study of Italian macroeconomic reform will also evaluate the theoretical and empirical relevance of convergence theories that posit that economic internationalisation leads to an increasing homogenisation of both macroeconomic policies and macroeconomic policy-making institutions. Third, a study of Italian macroeconomic policy reform will provide clues as to how a traditional 'macroeconomic under-performer' managed to overcome domestic obstacles and achieve major macroeconomic reform. This will provide more general insights into the conditions that affect the initiation and content of economic policy reform.

On 1 January 1999, eleven European Union (EU) member countries formally created EMU. The creation of a single currency marked the end of a process of intergovernmental monetary co-operation that had begun in the late 1960s. Attempts to create intra-European exchange rate stability such as the Werner plan, the 'snake in the dollar tunnel' and the 'snake' were followed by the creation of the European Monetary System (EMS) in 1979. The EMS turned out to be more successful than previous attempts to stabilise intra-European exchange rates (Gros and Thygesen 1998; Ungerer 1997). During the late 1980s and early 1990s, the EMS even evolved into a quasi-fixed exchange rate system and member countries increasingly aligned their monetary policies on German monetary policy. As inflation rates converged to German levels, realignments became less necessary. However, the degree of convergence differed among member countries.

Despite overall increasing convergence, persisting dissatisfaction with the asymmetric nature of the system, which placed the burden of adjustment on the 'weak currency' countries, became increasingly vocal and led to several reforms of the international institutional framework, such as the Basle-Nyborg Agreement of 1987 and the Franco-German Council of 1988. Partly as a response to the failure of these reforms to eliminate the asymmetry, the idea of closer monetary co-operation emerged in the late 1980s. This eventually led to negotiations to create an Economic and Monetary Union and finally to an agreement on the Treaty on European Union (TEU) in December 1991. The TEU provided for - among other things - the creation of EMU in three stages by 1997 or, at the latest, 1999 (Gros and Thygesen 1998; Moravcsik 1998).

In order to qualify for stage 3 (that is, EMU membership), countries were required to fulfil so-called convergence criteria. Article 109j obliged prospective members to observe the following criteria:

> (1) the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing member states in terms of price stability;
> (2) the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6);
> (3) the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other member state;
> (4) the durability of convergence achieved by the member state and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest rate levels.

A separate protocol clarified that the inflation rate must not exceed - over a period of one year before the examination of the fulfilment of the criteria - the average of the three best-performing countries by more than 1.5 percentage points. Long-term interest-rates were allowed a larger margin of two percentage points (Gros and Thygesen 1998: 432).

On 3 May 1998, the Council of the European Union took the decision to create EMU. All the fifteen EU member countries, except for Greece, Sweden, the UK and Denmark, became founding members of EMU. These four countries did not join EMU for various reasons: Greece did not meet the convergence criteria; Sweden chose an informal opt-out by not adhering to the Exchange Rate Mechanism (ERM) in the two-year run-up to EMU; and Denmark and the UK had negotiated an opt-out clause in the Maastricht Treaty, which did not commit them to joining EMU.

To the surprise of many observers, Italy became a founding member of EMU. In the late 1980s and early 1990s Italy was facing major fiscal problems.[1] At the same time, it had been unable to achieve the same degree of monetary convergence within the ERM as most other member countries. Notwithstanding current macroeconomic problems, the Italian government under Prime Minister Giulio Andreotti signed the TEU in December 1991, thus committing Italy to respect the convergence criteria. Given that public debt as a share of gross domestic product (GDP) stood at more than 100 per cent and that a budget deficit of 9.3 per cent of GDP was expected for the year (which was in fact over-shot), it was not quite clear how the Italian government would be able to honour this commitment (Daniels 1993; *Istituto Affari Internazionali* 1993: 128).

The TEU negotiations were concluded in December 1991, the Treaty was signed by the heads of state in February 1992 and came into force on 1 November 1993. It was approved by the Italian cabinet in April 1992 and ratified by the Senate in September and the Chamber of Deputies in October 1992. Naturally the Treaty did not oblige member countries to meet the Maastricht criteria. However, as there was never any doubt that Italy would ratify the TEU and seek EMU membership, the convergence period effectively began with the signing of the TEU. At that time, there was little doubt about the practical implications that the meeting of the convergence criteria would have for macroeconomic policy (*cf.* Verdun in Pochet 1998).

It was only due to a major macroeconomic effort starting in the early 1990s that Italy was able to meet the deficit criteria and make considerable progress in terms of stabilising and then reducing public debt by 1997-98. Although Italy's government debt exceeded the limit set by TEU, Italy benefited from the 'dynamic

[1] Italy was not the only country that did not respect the monetary and fiscal criteria in the early 1990s. However, Italian macroeconomic indicators exceeded the reference values so considerably that it

interpretation' that stipulated a reference value equal or less than 60 per cent of GDP "unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace" (TEU, Art. 109j). Italy also met the monetary criteria: Italy had re-entered the ERM in November 1996 and it met the inflation and long-term interest rate targets (*Presidenza del Consiglio dei Ministri* 1998). Thus Italian macroeconomic policies during the 1990s not only defied the predictions of observers at the time but - as will be demonstrated below - also represented a puzzle in light of political-institutional theories of economic policy.

In order to demonstrate that Italian convergence policies do indeed require an in-depth explanation, I first review the academic literature regarding the various aspects of European monetary co-operation and integration.[2] Then I briefly discuss the possible relevance of domestic-institutional approaches to macroeconomic policy. I argue that Italy's macroeconomic achievement in the 1990s represents a puzzle with respect to these theories. The research design and methodology of this study are outlined in the last section.

1.1 Economic and System-Centred Explanations of Monetary Co-operation and Integration

International-political and economic approaches are the natural starting point for explaining policies of monetary co-operation and integration. Traditionally the International Relations (IR) and International Political Economy (IPE) literature has focused on the political or economic characteristics of the international system or has relied on the notion of national interest to explain a country's (foreign) economic policies (Morgenthau 1993 [1948]; Waltz 1979). However, in the late 1970s and early 1980s approaches that focused on the benefits and costs of co-operation rather than on political power alone became more prominent (Keohane and Nye 1977; Keohane 1984; Krasner 1983). Finally, economic theory accounts of monetary co-operation were developed from the 1960s onwards (Mundell 1961; McKinnon 1963; Kenen 1969). All of these approaches stress the overriding importance of systemic-level variables for international monetary co-operation and integration. The most

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seemed virtually impossible to meet the criteria by 1998 – let alone by 1996 (that is, the earliest possible EMU starting date).

representative accounts of monetary co-operation are briefly discussed here: hegemonic stability theory, neo-liberal institutionalism and the various approaches related to the capital mobility hypothesis.

One influential strand of the IPE literature, the so-called hegemonic stability theory, argues that the stability (or instability) of an international economic order is the result of the presence (or absence) of a hegemonic country willing and able to uphold the rules consistent with this order. Hegemonic stability theory comes in three varieties with respect to international monetary co-operation. Kindleberger (1973) stresses the benign function of a hegemonic country in the international economic system: the hegemon acts as a stabiliser and provides public goods, such as for example monetary stability. Gilpin (1981) emphasises the military-coercive nature of hegemony: the hegemonic country resorts to the use of force, or at least the threat of the use of force, and enforces the 'rules of the game'. A third variant highlights the ideological aspect of hegemonic power (Ikenberry and Kupchan 1990). Hegemonic countries use ideology to create consensus and thus exercise a socialising influence.

Considerable doubt has been cast on the relevance of these theories in the case of European monetary co-operation and integration. It has been argued that Germany – as a potential hegemon - failed the test for the first two accounts of hegemonic stability theory: it more often than not pursued domestic objectives instead of acting as a system-stabiliser; moreover, it did not possess a sufficient degree of military and economic dominance to fulfil a hegemonic-coercive function on the European level (*cf.* McNamara 1998: 23-29). As I will show in more detail in Section 1.2, the third, ideology-centred variant cannot provide a sufficient explanation of monetary integration either – at least as far as monetary and fiscal convergence is concerned.

Neo-liberal institutionalism, the capital mobility hypothesis and economic theory approaches are equally insufficient to explain satisfactorily monetary co-operation and integration (in the context of EMU) – as will be shown below. Neo-liberal institutionalism emphasises the possibility of co-operation in the context of international anarchy and increasing economic interdependence (Keohane and Nye 1977; Keohane 1984). It argues that the possibility of co-operation exists despite anarchy and the absence of a hegemonic country. Monetary co-operation is possible

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[2] With respect to monetary policy, 'co-operation' is defined as a situation where states retain ultimate authority over monetary policy. 'Integration' describes a situation or process where this authority is partially or totally transferred to the supra-national level.

because, by reducing transaction costs and uncertainty, it guards against opportunism in the form of beggar-thy-neighbour policies (that is, competitive devaluations) and thus makes the game of co-operation a positive-sum-game. On that account, the institutionalisation of European monetary co-operation provides EU member countries with a framework that prevents them from 'cheating'. Moving from the EMS regime to EMU could hence be interpreted as a permanent 'locking in' of commitments.

Finally, the so-called capital mobility hypothesis stresses the importance of systemic variables for an understanding of monetary co-operation. Partly overlapping with neo-liberal institutionalism, this approach focuses on the benefits countries can derive from monetary co-operation. The structural power of financial markets and increasing trade interdependence are regarded as primary sources of exchange rate co-operation (Dyson 1994: 260-97). In short, the argument goes as follows: in a system of free trade and free movement of capital (for example, Common Market), a country (with the exception of the hegemonic country) cannot pursue an independent monetary policy and a policy of fixed exchange rates at the same time. In the interest of preserving open capital markets, countries have an incentive to sacrifice an independent monetary policy in favour of fixed exchange rates. This situation is also known as the 'inconsistent quartet' (*cf.* Padoa-Schioppa 1996). On this account, full-blown monetary union as compared to a system of fixed but adjustable exchange rates may provide further economic benefits than the ones already achieved through exchange rate pegging (*cf.* Gros and Thygesen 1998: chapter 7).

Related to the capital mobility hypothesis are various economic theory approaches such as the theory of optimal currency areas. These approaches focus exclusively on the economic costs and benefits of monetary co-operation in terms of its distributional consequences. Economic theory suggests that a country's economic characteristics should have an effect on its exchange rate policy. With increasing openness an economy tends to become more sensitive to changes in the external value of the currency. This suggests that with increasing openness a country should have an increasing interest in a competitively valued as well as a relatively stable currency (Frieden 1991). More generally, theories of optimum currency areas have stressed the relevance of a high degree of factor mobility (Mundell 1961), the size and openness of the economy (McKinnon 1963) and the degree of commodity diversification (Kenen 1969) – which are all important because they can function as insulation mechanisms against a variety of economic shocks. Empirical research based on the theory of optimal currency areas has shown that openness and size do indeed increase the likelihood that a country pegs its currency (*cf.* Edison and Melvin 1990).

In sum, all of these systemic approaches are to a certain extent plausible. However, although there is considerable empirical evidence that confirms the link between increasing levels of trade and financial integration on the one hand, and lower degrees of currency fluctuation in Europe (Frieden 1996a) on the other, neither the capital mobility hypothesis nor neo-liberal institutionalism can satisfactorily explain the successful pursuit of macroeconomic convergence.

Regardless of whether they stress economic or political conditions, the problem with systemic theories is that they do not directly address the issue of agency and individual interest. Benefits and costs of monetary co-operation are derived from the political and economic characteristics of the international system. However, first, these incentives tend to be ambiguous and indeterminate as a result of the functionalist reasoning that underpins their derivation (De Grauwe 1997). For example, increasing openness increases the incentives for both increasing stability *and* a competitive exchange rate, without suggesting which one is of greater interest to a given country. Second, the analysis of costs and benefits is primarily 'country-centred' and disregards the differentiated effect monetary co-operation has on domestic groups and domestic conflict over exchange rate policy (Frieden 1991, 1994). Third, these approaches are generally unable to explain divergence in policy on monetary co-operation, especially when countries occupy similar systemic positions. For example, why was Italy 'uninterested' in achieving the same degree of macroeconomic convergence in the 1980s as France, even though both countries occupied very similar structural positions in the international economic system?

The same critique applies, generally speaking, to all other system-centred (political or economic) accounts of monetary co-operation (Henning 1998; Dyson 1994: 304-306) as well as to state-as-unitary-actor approaches to monetary integration (Giavazzi and Pagano 1988; Moravcsik 1998; Sandholtz 1993; Mazzucelli 1997). (The two approaches are of course the two sides of the same coin.) Seeking to explain a state's policy on monetary co-operation, the former approach analyses the incentives and constraints created by the international political and economic system, while the latter approach focuses on a state's attempt to maximise (political or economic) benefits. All these accounts can potentially rationalise why countries were willing to co-operate on monetary matters, give up monetary sovereignty and pursue policies of macroeconomic convergence. But they fall equally short of explaining different policies on monetary co-operation.

Moreover, these system-centred approaches are to a certain degree premised on the assumption that the state is a rational actor with a fixed preference hierarchy and the ability to pursue policies consistent with its national interests. By dismissing the domestic level in favour of international constraints, systemic as well as state-centric approaches fail to explain *how* states were able to implement successfully convergence policies. Naturally the state-as-unitary-actor assumption is an analytical tool rather than an ontological fact. But it is precisely when an analytical tool cannot explain real world phenomena that it needs to be substituted - or at least supplemented - with other tools.

In order to understand macroeconomic convergence adequately, it is necessary to take a Weberian approach to the state, according to which "[t]he state is neither unified nor does it have an ability to act. The state is nothing but a collection of institutions and rules" (Smith 1993: 49). This definition of the state allows for the analysis of how preferences are formulated, policy decisions taken and policies implemented. This seems a particularly plausible approach to adopt when it comes to economic policy (low politics) as opposed to security policy (high politics). As Krasner (1978) put it:

> There is, however, no reason to assume that foreign economic policy-making is identical with foreign political policy-making. Any economic decision is likely to affect groups within the society differentially, creating the potential for societal conflict. For this reason it is questionable to assume that policy can be understood solely by examining the motivations and perceptions of central decision-makers. In a political system where state power is weak and fragmented, foreign as well as domestic economic policy can be influenced or even determined by societal groups (pp. 70-71).

Thus on descriptive as well as conceptual grounds, there are reasons to reject systemic reductionism. As Gourevitch (1986) argued in a seminal study of international economic crises:

> The issue, then, is not whether the international system shapes domestic politics but how and through what mechanisms. Unless the international situation is completely coercive, as may be the case with foreign occupation, countries do have choices. The selection they make from among those choices depends on domestic politics, on the

> distribution of power within countries and the various factors that influence it - societal forces, intermediate institutions, state structure, ideology. The international economy affects national policies by acting upon domestic actors (p. 65; similarly Zysman 1983: 56).

In other words, the opening of the black box of the state allows for an analysis of both preference formation and domestic conflict over policy. It also allows for an analysis of how and why states were *able* to implement appropriate policies independent of their willingness to do so. This study avoids the shortcomings of systemic approaches and emphasises domestic preference formation and the government's ability to implement policies in accordance with international commitments. These issues will be discussed in more detail in Chapter 2.

More generally, this study also argues that the source of diverging policies can be found in diverging preferences and differing abilities to implement convergence policies. Two examples will have to suffice here to indicate the importance of domestic institutions and the corresponding inadequacy of purely systemic approaches to international monetary co-operation and macroeconomic convergence. Firstly, the example of Greece illustrates the relevance of a state's ability to implement adequate convergence policies. The Greek government credibly professed its wish to become a founding member of EMU but failed to do so in 1999 because it was unable to achieve a sufficient degree of convergence. Secondly, the inability of a systemic-functional approach to account for diverging preferences is reflected in the empirical fact that some EU member countries did exhibit diverging preferences. Sweden, Denmark and the UK were unwilling to join EMU. Systemic approaches would have to resort to various, arbitrary *ad hoc* assumptions in order to explain these anomalies (see Grieco 1995).

In short, the inclusion of domestic politics and, more specifically, preference formation and implementation of macroeconomic policies into an analysis of monetary integration and macroeconomic convergence is necessary. But an unstructured analysis of domestic politics would be no less arbitrary than adding *ad hoc* assumptions to system-centred explanations of country preference formation. I thus argue below that a specific focus on domestic institutions is central for an adequate understanding of macroeconomic convergence.

1.2 Domestic-Level Accounts of Monetary Integration

Haggard and Simmons (1987) state that:

> [C]urrent theories of international regimes have ignored domestic political processes, in part because of the lure of parsimonious systemic theory. This neglect has extended to the issue of how regimes actually influence national policy choices [...]. There are both methodological and theoretical reasons to open the black box of domestic politics (p. 513).

However it is not entirely fair to say that IR theory has been solely concerned with systemic theory. The separation between the 'international' and the 'domestic' has never been that stark in IPE (Gourevitch 1978, 1996). In addition to systemic factors, IPE has traditionally emphasised three types of domestic accounts (Hall 1986, 1997): society-centred, institution-centred and idea-centred explanations. I will argue that neither society-centred nor idea-centred accounts are sufficient to explain macroeconomic convergence unless they include a thorough analysis of the independent effect of institutions on macroeconomic policy.

Society-centred explanations of (foreign) economic policy generally regard government policy as the product of interest group influence. The interests of societal groups in turn are usually derived from the position of these groups relative to the international economic environment and hence closely related to the (expected) distributional consequences of economic policy decisions (Frieden 1991, 1994; Hefeker 1997). With regard to monetary co-operation and integration, this poses several problems. McNamara (1998: 32-42) has argued that the preferences with regard to European monetary co-operation are unstable and that moreover there is no empirical evidence that interest groups were the driving force behind EMU. Indeed, there is considerable evidence that the creation of both the EMS and EMU were driven by political rather than economic factors (Ludlow 1982; Story 1988; Mazzucelli 1997). Clearly, with respect to both EMS and EMU there were economic incentives for domestic interest groups to influence policy. But historical research has shown that interest groups only had an impact at critical junctures (such as regime reform) and that even then their impact differed across countries depending on national domestic-institutional characteristics (Kaltenthaler 1997).

More generally, there are two main problems with respect to pure interest-group approaches: domestic distributional consequences of exchange-rate co-operation are difficult to determine, and society-centred approaches neglect the importance institutions play in the domestic policy process.

First, the exact distributional consequences of exchange rate policy are difficult to determine (see Giovannini 1995; *cf.* Frieden 1994a). Exchange rate policy not only affects domestic interest rates and inflation but also international competitiveness. It also tends to affect fiscal and wage policy. Put differently, as policy choices with respect to exchange rate policy have complex distributional consequences, the costs and benefits for domestic sectors or groups is highly situationally dependent. This is all the more true with regard to macroeconomic convergence, which is a much more complex process than simple exchange rate co-operation, as it directly affects fiscal policy and related areas.

A second major shortcoming of a pure society-centred approach is its neglect of the role of domestic institutions. As Kaltenthaler (1997, 1998) asserts, societal influence on the policy-making process depends on how influential interest groups are domestically; and their relative influence is largely a function of how the state and society are organised since the institutional characteristics of the state-society relationship largely determine the influence and access to the policy-making process of societal groups (Katzenstein 1976, 1977a, 1977b). Even though institutions are not the only factor determining societal influence, they tend to be a crucial, intervening variable in the interest mediation process (*cf.* Gowa 1988).

In short, analysing the benefits and costs of monetary integration for domestic interest groups and subsequently concluding that the groups – notwithstanding the uncertainty regarding the distributional effects – that stand to benefit were the driving factor behind integration is too simplistic. Since the influence of interest groups is at least partly determined by the institutional characteristics of the political system, one needs to take into account the effect of domestic institutions – at least as a working hypothesis - and see how domestic institutions have played an empirically verifiable role in domestic policy formation.

Another major IPE approach is the idea-centred approach (Hall 1993; *cf.* Goldstein and Keohane 1993). With regard to European monetary integration McNamara (1998) argues that the success of the ERM in terms of achieving exchange rate stability can be explained by the changing policy beliefs of decision-makers. The change from what Ruggie (1982) called 'embedded liberalism' to 'competitive liberalism', that is, broadly speaking, a shift from Keynesianism to monetarism and German-style monetary policies, was a response to the increasing systemic constraints (especially increasing capital mobility) that national policy-makers faced. However, various responses were theoretically (and practically) possible so that ultimately this shift has to be understood in terms of the policy-makers' economic ideas that evolved in response to policy failure - and thus in terms of a change in the dominant policy paradigm. As a result, other European countries sought to emulate German monetary policy.

While this may or may not explain the stability of the EMS relative to the 'snake', as an explanation of integration and convergence, it is insufficient. First of all, even if one grants that all countries have come round to the idea of 'competitive liberalism', then this approach cannot explain why some countries decided to stay outside EMU, even though they have (or could have) fulfilled the convergence criteria. Secondly, and more importantly, at best this approach accounts for the willingness of policy-makers to create a monetary union. It does, however, disregard the capability aspect. That is, even if policy-makers have a preference for 'competitive liberalism' (and hence for EMU), it still does not explain how EMU membership was achieved. The capacity of governments to implement convergence policies and qualify for EMU membership critically depends on a country's ability to implement convergence policies (Walsh 1994). This is why an analysis of political institutions is indispensable.

For very much the same reason, Marxist-informed approaches fall short of providing an adequate explanation of EMU and especially convergence (Hueglin 1992). In fact, a Structuralist Marxist approach takes into account domestic institutions to the extent that it regards the autonomy of the state as the bearer of the long-term interest of the capitalist class. However, this view is too deterministic and does not allow for institutional variation. Structuralist Marxism would regard the state under capitalist conditions of production as autonomous without, however, demonstrating how this autonomy is anchored in specific rules and institutions. By positing autonomy as a premise and by not allowing for a historically detailed analysis of how this autonomy is underpinned by a certain set of rules and institutions, Structuralist Marxism would have difficulties explaining the differences in attitudes of advanced capitalist Western European states towards monetary co-operation. The diverging policies of France and the UK are only the most striking example of how attitudes differed.

Similarly, Instrumental Marxism, which regards the state as the instrument of the capitalist class, disregards institutions altogether and would thus fall under the distributional-societal approaches discussed above. Similarly, bureaucratic models or individual leadership seem to be more useful for explaining negotiation processes (Dyson 1998; Kaltenthaler 1997, 1998) rather than the success and failure of co-operation and convergence. Bureaucratic struggles or personal leadership may be important at certain stages of the integration process. However, fiscal policy, for example, is not the exclusive domain of a bureaucratic elite, let alone an individual leader. In democratic regimes, parliaments usually have the last word with regard to budgetary decisions. Whether the bureaucratic elite dominates monetary policy-making depends at least as much on elite cohesion as on the wider political-institutional structure of the monetary policy-making regime (and especially the existence of an independent central bank). Hence, if anything, whether or not a bureaucracy or clearly defined elite determines monetary co-operation and convergence will depend on the wider institutional framework within which policies are formulated, fought over and implemented.

This suggests the need for a sector-specific analysis of domestic institutions. This is not to say that 'domestic institutions' can fully explain Italy's successful convergence. Rather, discounting them as a crucial intervening variable makes any account inadequate. This claim is tentatively supported by institutionalist theories of macroeconomic policy.

1.3 Institutional Influences on Macroeconomic Policy Outcomes

The institution-centred approach to political economy posits that institutions can explain or, at least, strongly influence policy outcomes. This approach has provided important insights with regard to how and why institutions affect economic policy (*cf.* Katzenstein 1976, 1977a, 1997b; Hall 1986; Zysman 1983; Henning 1994; Walsh 1994). The recent interest in how domestic institutions affect (foreign) economic policy has more explicitly drawn on comparative methodology (Keohane and Milner 1996; Milner 1997), thus offering the possibility of a synthesis of comparative politics and IR theory (Milner 1998; Caporaso 1998). The two best-known approaches that are relevant with regard to macroeconomic convergence are briefly sketched here (see Chapter 2 for more detailed discussion).

First, certain domestic-institutional arrangements are more conducive to fiscal discipline, as measured in terms of the size of budget deficits and the size of public debt, than others. Grilli *et al.* (1991) find that 'representational' (as opposed to majoritarian and presidential) democracies, and fractionalised party systems, are associated with high public debt. Similarly Roubini and Sachs (1989a, 1989b) conclude that there is a correlation between the size of budget deficits and public debt on the one hand, and the political characteristics of governments on the other hand. More specifically, "[w]eak and divided governments (as evidenced by the expected tenure in office, and by the number of political parties that share power in the governing coalition) have been less effective in reducing the budget deficit than have stable and majority-party governments" (Roubini and Sachs 1989a: 102). Both results are consistent with the basic insight that 'strong', single-party governments are much more successful at controlling fiscal policy than 'weak', multi-party coalition governments.

Although the Sachs-Roubini results have been challenged (*cf.* Edin and Ohlsson 1991), the majority of studies arrive at largely similar conclusions (Borrelli and Royed 1995; for survey *cf.* Milesi-Ferretti 1996; Alesina and Perotti 1999). That is, broadly speaking, strong and stable governments (characterised by a low number of coalition parties, a 'reductive' electoral regime, and a high degree of cabinet cohesion) are capable of decisive action on the fiscal front and thus are able to pursue responsible fiscal policies over the long term. In contrast, weak, unstable governments do not possess this capacity. Hence they delay decisive action, which leads to persistent budget deficits and the accumulation of public debt. These results suggest that domestic political institutions matter, for whether a government is strong or weak and whether a party system is characterised by a high or low degree of centralisation, will be strongly influenced by domestic-institutional arrangements, such as the nature of the electoral system or a parliamentary or presidential constitution.

While some studies have focused on formal political institutions, others focused in more detail on the rules and procedures that govern the budgetary policy-making process. The expectation that 'strong' budgetary rules (such as formal laws limiting the influence of parliament on budgetary legislation, voting procedures that enhance the position of the executive, and provisions that attribute a dominant role to the prime and finance minister in the budgetary process) are associated with smaller deficits and lower debt has been confirmed by empirical tests (Von Hagen 1992; De Haan *et al.* 1999). Von Hagen (1992), for instance, creates a complex indicator[3] to measure the impact of different budgetary rules and finds support for the so-called 'structural hypothesis', according to which "[b]udgeting procedures lead to greater fiscal discipline if they give a strong prerogative to the prime minister or the finance minister, if they limit universalism, reciprocity, and parliamentary amendments, and facilitate strict execution of the budget law" (Von Hagen 1992: 37). This 'hierarchical-transparent' type of budgetary rules contrasts with the 'collegial-intransparent' type, which is characterised by a weak position of the prime minister and finance minister in the budget process, ample opportunities for parliament to introduce amendments and so on.

In short, there is strong evidence that both formal-political and budgetary-institutional characteristics affect budgetary policy outcomes (also Hahm *et al.* 1996; Von Hagen 1992; Von Hagen and Harden 1994 for European countries; Kontopoulos and Perotti 1999 for OECD countries). Hence the claim that institutions 'matter' with regard to budgetary policy outcomes is well supported.

Another very influential domestic-institutional approach to macroeconomic policy that is concerned with the influence of central bank independence on monetary performance also found strong empirical support.[4] For a number of reasons it is plausible to assume that central bank independence is positively correlated with price stability, the most important being central bankers' preference for price stability as opposed to politicians' interest in economic expansion. Statistical studies have confirmed that (in developed countries) greater central bank independence is conducive to lower inflation (Cuckierman *et al.* 1994; Grilli *et al.* 1991; for a survey of the literature see Eijffinger and De Haan 1996). Qualitative studies also tend to confirm the relationship between central bank independence and low inflation (Goodman 1992; Scharpf 1991). However, these studies also suggest that other political-institutional factors can affect policy outcomes. This is, for example,

[3] The indicator takes into account: (1) the strength of the position of the prime minister (or finance minister) in intra-government budgetary negotiations; (2) the limits (or lack thereof) to parliamentary amendments; (3) the type of parliamentary votes (item by item or global); (4) the timing of parliamentary votes; (5) the degree of transparency of the budget; and (6) the amount of flexibility in the implementation process.

[4] Other factors such as labour market institutions and in particular the organisation of collective bargaining are of considerable importance with regard to wage policy, and thus indirectly, price stability (for detailed discussion see Section 2.4).

reflected in the criticism that the exclusive focus on central bank independence as an 'institutional fix' has received (Hall 1994; Posen 1993, 1998). Notwithstanding this critique, cross-national evidence strongly suggests that on average central bank independence has a tangible and predictable impact on price stability.

To summarise, there is a considerable amount of evidence that macroeconomic policy outcomes are affected by domestic-institutional characteristics of a country's policy-making regime. However, a weakness of policy area-specific analyses is that they do not take into account possible 'interaction effects' (*cf.* Henning 1994; Iversen and Pontusson 2000). Such interaction effects can potentially be very important (*cf.* Parkin 1987; Burdekin and Laney 1988). For example, expansionary fiscal policies tend to put upwards pressure on prices. The interaction effect on the policy level in turn largely reflects interaction at the institutional level, which complicates an institutionalist interpretation of macroeconomic policy. For example, a strong, cohesive and insulated executive is capable of pursuing a low inflation monetary policy in spite of the fact that the central bank is not independent. Nonetheless, central bank independence is 'on average' associated with lower inflation. In other words, it is possible that a strong, cohesive government 'neutralises' the effect of 'central bank independence'. Similar interaction effects exist between wage bargaining institutions and monetary policy regimes with respect to monetary performance. Institutional and policy interaction make it more difficult to arrive at an institutionalist explanation of macroeconomic policy outcomes (especially in the context of a case study), as the economic policy outcomes are the result of not only one policy and one institution but of a combination of interaction effects on both the institutional and the policy level.

The intricate and complex ways in which institutions can affect policy outcomes may seem to cast doubt on the usefulness of the institutionalist approach. However, only because global policy outcomes, and at times outcomes in specific policy areas, can depend on complex interaction between institutions and policies does not mean that institutions do not matter. If anything, it means that the linking of policy outcomes to domestic institutions requires an historically detailed study of interaction effects on both the institutional and policy level. This calls for a methodological approach that is able to analyse historically complex phenomena and causal complexity (Ragin 1987). In what follows, I briefly discuss such a methodological approach and outline what it does and does not claim.

1.4 *Historical Institutionalism and 'State Strength'*

A historical-institutionalist approach can account for the interaction between various institutions as well as between institutional and non-institutional factors (Ikenberry 1988; Hall and Taylor 1996; Thelen and Steinmo 1992). Moreover, historical institutionalism is central to an understanding of the role governments play with regard to domestic economic policy. This makes it the ideal framework for an analysis of Italian macroeconomic policy.

Historical Institutionalism

Historical institutionalism stresses the importance of institutions for an understanding of social and political life (March and Olson 1984, 1989; North 1990). Historical institutionalism is quite distinct from other institutionalisms such as rational choice institutionalism and sociological institutionalism (Hall and Taylor 1996). Thelen and Steinmo (1992) have provided the most concise account of historical institutionalism.

Historical institutionalism puts "the emphasis on intermediate institutions that shape political strategies, the ways institutions structure relations of power among contending groups in society, and especially the focus on the *process* of politics and policy-making within given institutional parameters" (Thelen and Steinmo 1992: 7). In this sense, historical institutionalism helps to open the black box of the state and remove the state-as-rational-and-unitary actor assumption as implicitly posited by systemic-functional approaches.

In its most extensive form historical institutionalism defines institutions as "the formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and economy" (Hall 1986: 19). In this study 'institutions' will be defined in a more narrow and less controversial sense, namely as "such features of the institutional context as the rules of electoral competition, the structure of party systems, the relations among various branches of government, and the structure and organization of economic actors like trade unions" (Thelen and Steinmo 1992: 2). As I will discuss in Section 2.3 and demonstrate in Chapter 4, previous policy choices can – under certain circumstances - also be regarded as 'institutions' from a historical-institutionalist point of view (also Pierson 1993).

Contrary to many other approaches, historical institutionalism does not reify institutions. This has two implications. Firstly, institutions are never the immediate cause of policy outcomes. Under certain circumstances institutions will make outcomes more or less likely but they never predetermine outcomes (Weaver and Rockman 1993). Hence there is no presumption that the presence of institution A will necessarily bring about outcome B. Rather, institutions are regarded as shaping both the objectives of political actors and the distribution of power among them (Thelen and Steinmo 1992: 6). In other words, institutions are intervening variables and, to the extent that they shape power relations and affect the costs and benefits of political action, they influence outcomes. Thus, taking into account the relationship between various relevant actors, historical institutionalism retains the ability to analyse agency. As Zysman has pointed out, "[a]ny useful structural [that is, institutionalist] approach must retain a capacity to analyze the interests of actors, their capacity to act and their influence on structure [that is, institutions]" (Zysman 1983: 349). Historical institutionalism does exactly that by allowing for the incorporation of interest groups, public officials, international pressure and so on into an historically bounded analysis.

Secondly, historical institutionalism is explicitly concerned with institutional change (Thelen and Steinmo 1992). Institutions not only influence policy outcomes but are themselves subject to change. This change may come about in response to a variety of factors such as - among others - international or domestic pressure (Krasner 1988). However, historical institutionalism holds that institutions are still characterised by a certain degree of inertia and that this inertia has an independent effect on policy outcomes. Otherwise they would be a mere epiphenomenon, that is, a reflection of international pressures or of the balance of power between domestic actors. Moreover, historical institutionalism claims that if institutional change takes place, it tends to be 'path-dependent' in that institutions can rarely be built from scratch. They always reflect to some extent prior institutional conditions (*cf.* notion of 'punctuated equilibrium' in Krasner 1988).

Taken together, this allows for the possibility of a dynamic analysis of the relationship between institutions, politics and policy outcomes. Precisely this 'double aspect' of institutions in terms of being both a dependent and independent variable - and hence in terms of being reproduced through individual or collective action as well as influencing individual and collective action (*cf.* Giddens 1984) - makes a detailed historical analysis of institutions and institutional change necessary.

In short, historical institutionalism provides a framework for analysing and explaining both "variation in political behavior and outcomes *over time* as well as across countries, and a framework for understanding the sources and consequences of institutional change" (Thelen and Steinmo 1992: 13). At the same time historical institutionalism focuses on how different variables are linked and this allows us to analyse causal complexity and historical contingency. By assigning an independent effect to domestic institutions, historical institutionalism stands in clear contrast to both systemic-functional and domestic interest-group accounts which tend to disregard the importance of domestic institutions.

The Political System, the State, and Executive Strength

Historical institutionalism is particularly well suited to understand the central role played by the executive with respect to macroeconomic policy. This is so because the relative influence of the executive on policy outcomes is strongly determined by the institutional characteristics of the political system as a whole. More specifically, the 'state strength' literature argues that the autonomy and power of national governments relative to other domestic political actors is central for an understanding of policy outcomes (Katzenstein 1977a, 1977b; Krasner 1977). This literature is not always quite clear about what is meant by the term state. Confusingly, 'state strength' is generally defined as the "capacity of the executive to get its own way" (Zysman 1983: 296) in the face of pressures from other political and societal actors, such as political parties, parliament, unions, employer associations and so on. While I accept this definition of 'state strength' (meaning 'executive strength'), I take the term state (*without* inverted commas) to refer more specifically to the entirety of the institutions of the state (executive, bureaucracy, legislature, judiciary). When a reference to the 'state strength' literature is made, 'state' (*with* inverted commas) will be used to indicate that the term actually denotes 'executive'. 'Government' and 'executive' are used interchangeably. 'Executive strength' refers then to the autonomy, power and capabilities of the executive in the policy process. Finally, the term 'political system' refers to state (as defined above) and all other political actors such as interest groups, political parties, media and so on.

Thus, 'state' (or executive strength) captures the ability of the executive to formulate policies and assert control over outcomes in a relatively autonomous manner. This ability is to a large extent a function of "[t]he number and range of policy instruments [that] emerge from the differentiation of state and society and the centralization of each" (Katzenstein 1977b: 892) – and hence of the institutional features of the state and the political system.

This means that the 'state' is strong if it is able to formulate and implement policies consistent with its own preferences. A weak 'state' is one where policies are the result of societal influence and thus do not represent the preferences of the executive. This analytical distinction between weak and strong 'states' needs to be qualified in several respects. First, 'state strength' is a question of degree.

> The ability of leaders to mobilize domestic resources is a function of (a) the structure of the domestic political system and (b) the convergence between public and private interests [...]. The defining characteristic of a political system is the power of the state in relation to its own society. This power can be envisioned along a continuum ranging from weak to strong. The weakest kind of state is one which is completely permeated by pressure groups [...]. At the other extreme [is a state] which is able to remake the society and culture in which it exists; that is, to change economic institutions' values and patterns of interactions among private groups. Such extraordinarily powerful states only exist immediately after major revolutions [when] the society is weak because existing patterns of behavior have been shattered (Krasner 1978: 296).

In other words there is no such thing as an all-powerful 'state' nor is there a totally weak 'state'. 'States' are *more* or *less* powerful.

The Krasner quote introduces a second caveat, namely that variation in 'state' strength is not exclusively determined by the institutional insulation of the government and its bureaucracy; nor is it entirely defined in terms of its centralisation relative to societal groups as suggested by Katzenstein (1976, 1977a, 1977b). To a certain extent strength and autonomy also depend on a number of other factors such as the incentives for groups to mobilise on a certain issues (*cf.* theory of collective action [Olson 1965]), the presence or absence of international regimes, or even the so-called 'intellectual barriers to entry', that is, the inability of individuals and groups to relate potential policy decisions to their own tangible interests (Gowa 1988; Odell 1982: 347). Institutional insulation is important, however, to the extent that it raises the costs of interest groups to mobilise successfully for or against certain policies that have been decided within these institutions. Hence the question is not so much 'do institutions matter' but rather 'when and how do institutions matter' (Weaver and Rockman 1993; Kent 1993). This is consistent with the claims of historical institutionalism, as discussed above and as defended throughout this study, namely that institutions are important intervening variables but that they do not determine outcomes. The same is true for 'state' strength.

Third, executive strength is not a generalised capacity. It is possible that a 'state' is strong in one policy area and weak in another. As Krasner (1977) has argued, for example, the American 'state' is weak in the realm of trade policy but relatively strong with regard to (international) monetary policy. The claim that 'state' strength seems to vary between issue areas is certainly theoretically and empirically uncontroversial. By implication this means that in order to determine the degree of 'state' strength, each policy area has to be analysed in detail.

Fourth, it is not only possible that there is variation between policy areas, but that there is also variation between the various stages of the policy process within the same policy area. A 'state' could enjoy a very high degree of autonomy at the formulation stage but have considerable difficulties in enacting and implementing its decisions. In practice, however, it is more likely that strength at one stage is reflected in strength at another stage within a given policy area. This is plausible because, for example, a government that is weak at the legislative or implementation stage will presumably have to take into account other actors' interests at the formulation stage.

Hence, in order to determine the importance of executive strength in relation to policy outcomes, it is important to analyse each stage of the policy process, that is, the degree of autonomy at the formulation stage, the capacity to have its preferences enacted (where necessary) at the legislative stage, and the strength to implement or enforce policies against the opposition of political and societal actors at the implementation stage. Respectively, executive insulation from outside influences, the relative power of the executive in relation to parliament and the government's dependence on domestic groups in the implementation of policies will be important.

Overall, the degree to which an executive is able to contribute to shaping policy outcomes depends to a high degree on the institutional characteristics of the political system and, in particular, on the characteristics of the state as well as of the wider political system. In general it is reasonable to expect that the stronger the executive, the more it will affect policy outcomes relative to other actors. This influence varies across different areas and, even though it is not exclusively determined by institutional features, it is certainly strongly affected by it.

How can the 'state' or executive strength argument be tested empirically? The ultimate test consists in demonstrating that a government has the ability to choose between different alternatives, turn them into law and implement policies *against* the opposition of other powerfully placed actors (Nordlinger 1981). In other words it needs to be demonstrated that public policy is more than the sum of societal interests or international pressure. Alternatively, if it can be shown that policy outcomes differed from government preferences, that the government had to compromise or even give up its original plans in response to opposition and demands of other powerfully placed actors, then the government can be regarded as 'weak'. Naturally, strength is a matter of degree.

To sum up, the 'state' (or government or executive) strength argument holds that the executive has preferences of its own and that a strong executive is able to realise these preferences, if need be, against the opposition of other actors. However, whether this 'state' strength argument applies in a given case is primarily dependent on the institutional characteristics of a given policy area. The institutional characteristics of the state (and indeed of the political system) are important in that insulation, centralisation and - more generally - the power of the executive relative to other actors will increase a government's ability and willingness to pursue coherent, long-term policies, while political systems where the executive is weak will make this much more difficult. This is so because the government will be forced to compromise with the conflicting interests of other actors.[5]

In Chapter 2, the concept of executive strength and the importance of domestic institutions will be applied, first, to the Italian political system in general and then to the various policy areas relevant with respect to macroeconomic convergence. It will also be shown that a low degree of executive strength is the single most important factor (albeit not the only one) determining past Italian macroeconomic performance.

[5] If the input in the policy process is dependent on the domestic institutional structure, then the debate between different theories of the state misses the point (Dunleavy and O'Leary 1987). Whether a pluralist, a statist or an elitist state model applies will largely be dependent on the institutional characteristics of a given policy area. For example, the decentralised U.S. policy process makes the pluralist model look more adequate to explain policy formation. By contrast, in political systems where there exists a unified, legislature-dominating executive, policy-making is better described by statist or elite theories.

1.5 Methodological Remarks, Research Question and Plan of Study

This case study of Italian macroeconomic convergence makes use of the results of both comparative and quantitative-statistical studies. It thus allows for a theory-driven but historically detailed examination of policy reform in the various policy areas relevant with respect to macroeconomic convergence.

Methodological Remarks

Quantitative-statistical studies tend to reason in terms of average effects but have difficulties in capturing possible interaction effects with other variables, let alone phenomena like conjunctural causation. Qualitative approaches examine a small number of cases and this allows for analysis of the complex and sometimes historically contingent interaction between different factors. They tend to be historical-inductive and case-oriented (Ragin 1987) and thus tend to overemphasise historical contingencies.

According to Lijphart (1975), there are three types of non-experimental scientific methods: the case study method, the comparative method and the statistical method. Essentially, case studies "are intensive but uncontrolled examinations of single cases that cannot directly result in empirical generalizations" (Lijphart 1975: 160). By contrast, the comparative and the statistical methods allow for the generation of empirical generalisations (Ragin 1987). Again, according to Lijphart (1971), there are six types of case studies: a-theoretical, interpretative, hypothesis-generating, theory-confirming, theory-infirming and deviant case studies (similarly Eckstein 1975).

In terms of method, this study seeks to square a case-study approach with a comparative approach. From the point of view of institutionalist theory, the study of Italian macroeconomic convergence can be regarded as a 'deviant case study'. This is so because, as will be shown in Chapter 2, institutionalist theories of macroeconomic policy would have predicted that Italy would fail in its attempts to meet the Maastricht criteria. Thus, although this study consciously adopts a case-study approach with an emphasis on historical detail, descriptive accuracy and causal complexity, its 'deviant case' character makes this study implicitly comparative (Lijphart 1975). In other words, the study examines a single case (that is, macroeconomic convergence in Italy) in a comparative perspective (based on results of quantitative-statistical and qualitative-comparative studies) "in order to probe the mechanisms of change, the details of the processes, and the presence or absence of specific factors" (Little 1990: 32) – and thus to explain successful macroeconomic convergence.

The implicitly comparative character of a deviant case analysis allows for a more satisfying – because theory-driven – exploration of the conditions, factors and processes that led to convergence. It thus allows for an examination of causal complexity and historical contingency that are difficult to capture in statistical studies. This method is also consistent with the historical-institutionalist approach that holds that institutions do not determine outcomes and that their effect will tend to depend on the presence or absence of other (contingent) factors.

Research Question: Italy and Successful Macroeconomic Convergence in the 1990s

If domestic institutions have been shown to have an independent impact on macroeconomic policy, then it is legitimate to incorporate the study of domestic institutions into an analysis of macroeconomic convergence. This study then examines the politics of macroeconomic convergence in Italy with a special focus on domestic institutions.

Why focus on Italy? First, Italian domestic institutions in the late 1980s and early 1990s were not conducive to sustainable macroeconomic policies. From a cross-national and institutional point of view, Italy's successful convergence policies are particularly puzzling. As will be demonstrated in more detail in Chapter 2, Italy was characterised by a set of institutions that was conducive to short-termist macroeconomic policies that ultimately were unsustainable. From an institutional point of view, it was puzzling that Italy was able to achieve sufficient macroeconomic reform in the 1990s to enable it to meet the convergence criteria.

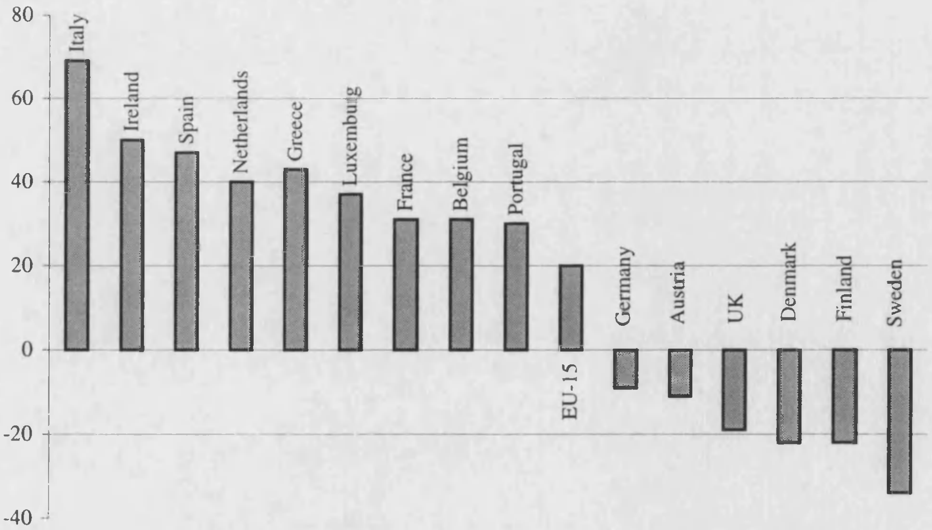
Second, from an historical perspective, Italy's economic achievement is surprising. Italy has been confronted with high deficits and high government debt for more than two decades. Until its exit from the ERM in 1992, Italy had not been able to achieve monetary convergence with the best-performing countries such as France and Germany in that Italian inflation had been constantly and considerably above the European average. Similarly, fiscal policy was way out of line with respect to other European countries. In other words, the comparison of Italian macroeconomic performance of the 1980s with the performance after the early 1990s begs the question of why and how this major policy reform that eventually resulted in successful convergence occurred.

The question of *why* Italy realised such a major effort is without doubt to be found in the need for macroeconomic convergence as stipulated by the TEU. At least, this is true with respect to the second half of the 1990s. But this does not answer the question of how Italy was able to achieve policy reform. In short, from an historical perspective, Italian macroeconomic achievements in the 1990s represent a puzzle that requires an explanation.

That Italy would exhibit a generally positive attitude towards the EMU process would have been expected on the basis of Italy's traditional pro-European policies. In addition to the attitudes of the economic and political elite, public opinion showed considerable enthusiasm – indeed the greatest support among all European countries for most of the period - for European integration as well as EC and EU membership (Commission of the European Communities 1998; *Istituto Affari Internazionali* 1993: 44-46). Moreover, Italian public opinion in favour of EMU was strongest by far among all European countries - even in the face of fiscal adjustment and economic problems (Figure 1-1).

Figure 1-1 Net Support for Single Currency, 1996

(in per cent)



Source: Commission of the European Communities (1996b: 45)

In 1996, for example, after four years of restrictive macroeconomic policies, 78 per cent of Italians were in favour of EMU, while only 9 per cent were opposed to it. Ireland came second with 66 per cent for and 16 per cent against. Thus the interesting aspect of Italian policy toward EMU is not to explain Italy's general interest in joining EMU. Rather, the interesting question is how Italy was able to implement policies that allowed it to satisfy the Maastricht criteria.

Several objections can be raised against the formulation of this research question. One might argue that the threat of exclusion from EMU or the political motivation behind EMU explains the success of Italian macroeconomic efforts (Baun 1996; for contrary view see Moravcsik 1998). However, if domestic institutions affect macroeconomic policy, then, even if one accepts the 'threat-of-exclusion' argument, the question remains of how Italy was able to overcome domestic-institutional obstacles and potential societal opposition to macroeconomic reform, and thus fulfil its international commitments. Alternatively the 'threat-of-exclusion' argument leaves unanswered how the 'logic of domestic institutions' that tended to bias macroeconomic policies towards short-termism and unsustainability was overcome. If the predictions of a well-established body of theory and empirical research are not borne out, an explanation of this 'anomaly' is required. In the case of domestic-institutional theories of macroeconomic policy-making, this means that an explanation of how institutional obstacles were overcome - and how macroeconomic convergence was implemented - is needed. At a minimum, alternative explanations would have to show that domestic institutions did *not* matter.

Another criticism that might be directed against the potential relevance of domestic-institutional factors for the explanation of Italian macroeconomic policies in the 1990s comes from those who suggest that change was due to changing economic conditions rather than to political(-institutional) factors. As Schmidt (1982) asserts, economic policy outcomes can be seen as the result of two broad sets of variables. On the one hand, there are 'socio-economic' explanations drawing on factors such as the level of technological development, demographic changes, labour supply, world market integration, business cycle, international interest rates and so on. Broadly speaking, these factors are regarded as exogenous and as determining policy outcomes. On the other hand, there are 'political' explanations that stress the political determinants of economic policy. The political complexion of party systems, electoral cycles and the nature of political institutions more generally are examples of political factors that can account for policy outcomes.

Naturally these two types of explanations are far from being mutually exclusive. Far from denying the importance of socio-economic conditions, the institutionalist studies reviewed in Section 1.3 also suggest that socio-economic factors matter with regard to policy outcomes (Hahm *et al.* 1996; Bernhard and Leblang 1999). Nonetheless, socio-economic conditions should be regarded as the underlying conditions that provide constraints and opportunities within which policy choices have to be made and implemented. Conditions such as demographic developments or economic shocks do affect policy outcomes. But these conditions are largely exogenous (at least once they have occurred) and there is room for the exercise of political discretion, especially in the medium- to long-term.

As will be shown in the following chapter, the post-war Italian macroeconomic policy regime was characterised by institutional deficiencies – the most of important of which was limited executive strength. The weakness of the policy-making regime in various areas contributed to Italy's poor monetary and fiscal performance. From both an historical and an institutional perspective, the following questions arise then: *How* was Italy able to meet the Maastricht convergence criteria? If domestic institutions biased macroeconomic policy towards short-termism, how was the successful pursuit and implementation of medium-term adjustment and convergence policies possible? If the Italian government was institutionally weak, why was it willing and, more importantly, how was it able to pursue policies that imposed considerable costs on relatively powerful domestic actors?

I will argue that pure systemic, societal-distributional and ideas-centred approaches are insufficient to understand Italian macroeconomic convergence. Instead, any satisfactory account of how and why Italy managed to meet the convergence criteria has to take into account the central role played by domestic institutions in general and executive strength in particular.

Plan of Study

This study analyses the politics of Italian monetary and fiscal convergence. It analyses Italian macroeconomic policy between February 1992 and April 1998, that is, from the signing of the TEU to Italy's entry into EMU. By explicitly drawing upon theoretically plausible and empirically corroborated results concerning the influence of domestic institutions on macroeconomic policy, this study seeks to explain how Italy was able to achieve macroeconomic convergence during the 1990s.

In this study I challenge the reasoning and conclusions that underpin the majority of studies of European monetary integration. I argue that the politics of macroeconomic convergence in the 1990s cannot be understood solely as a functional response by a rational, self-interested country to increasing international economic constraints. I do not wish to argue that scholars were wrong in suggesting that international constraints and domestic interest group politics were important. But I argue that existing studies have significantly underestimated the effects of domestic institutions and in particular the implications domestic institutions have with regard to the capability of a government to implement economic policies (*cf.* Milner 1997).

More specifically, I suggest that 'executive weakness' and other institutional features of various relevant policy areas affect the nature of distributive conflicts and thus help explain historical patterns of inflation, crisis, reform and stabilisation in Italy. While the primary purpose of this study is to understand how Italy was able to achieve policy reform and meet the convergence criteria, the secondary purpose is to analyse institutions (as both dependent and independent variables) and their importance with regard to macroeconomic policy reform in the 1990s.

The study proceeds as follows. Chapter 2 discusses in more detail the institutional framework and history of Italian budgetary, pension, wage and monetary policies. Chapters 3-6 analyse the domestic politics of macroeconomic convergence between 1992 and 1998 with respect to various relevant policy areas and argue that domestic institutions and institutional change are central for a proper understanding of Italy's economic convergence. The final chapter places the Italian experience into a comparative perspective and thus provides further support for the 'institutions matter' hypothesis.

Italian macroeconomic convergence of the 1990s was the result of policy and institutional reform in a number of analytically distinct policy areas. More specifically: the Italian economy had entered the 1990s with relatively high inflation, substantial external and domestic deficits, excessive public debt, and an institutional framework characterised by executive weakness, an unsustainable pension regime, wage indexation and uncoordinated private sector wage bargaining, and limited central bank independence. In order to explain macroeconomic convergence it is therefore necessary to examine if and how political conflict and institutional change in the budgetary, pension, wage and monetary policy areas contributed to macroeconomic convergence.

This selection of policy areas is justified in terms of their effects on macroeconomic performance which are generally acknowledged by the economic and political economy literature - and not least of all by the Bank of Italy itself:

> In accordance with a long-standing tradition, based on theoretical analysis and empirical experience, the Bank of Italy firmly believes that, in addition to an appropriate monetary policy, the defence of the value of money requires the contribution of other policies [...]. The defence of the monetary criterion depends decisively on controlling public expenditure and budget policy [...]. In modern industrial economies an appropriate incomes policy is [also] essential if price stability is to be maintained without incurring excessive costs in terms of economic activity (Fazio quoted in Bini 1998: 660; also Bank of Italy, *Abridged Report*, 1982: 180-186).

Similarly, fiscal stability depends not only on the direct effects of budgetary policy but also on policies pursued in other expenditure related areas - the most important with respect to fiscal sustainability being, as will be argued below, pension policy. Although monetary and wage policy on the one hand, and pension reform and fiscal policy on the other hand, are intimately related, they deserve to be analysed separately since the institutional characteristics of the respective policy-making regimes differ quite considerably in terms of relevant rules and actors.

More specifically, I will argue that the following institutional characteristics are of importance with respect to policy outcomes in the various policy-making areas: executive weakness and budgetary institutions with respect to fiscal policy; executive weakness and an earnings-related pay-as-you go pension system (plus the presence of relatively strong trade unions) with respect to pension policy; executive weakness, trade union fragmentation, insufficient confederal control of wage bargaining, and a wage indexation mechanism with respect to wage policy; and executive weakness and central bank independence with respect to monetary policy. *Why* and *how* these institutional features affect policy outcomes is discussed in the next chapter.

2 THE INSTITUTIONS AND HISTORY OF ITALIAN MACROECONOMIC POLICY-MAKING

During the late 1980s and early 1990s, Italy was facing major economic problems such as decreasing international competitiveness, persistently higher inflation than its European partners, increasing unemployment and above all high public deficits and exploding public debt. Although economic growth throughout the 1980s was higher than the European average, it was clear that the continued deterioration of the other economic indicators would eventually be unsustainable. In 1991, public debt increased above the 100 per cent mark, the year-on-year inflation rate was 6.3 per cent (which was about one percentage point above the EU average and between two and three points higher than in the benchmark-setting German and French economies) and the deficit stood at around 10 per cent of GDP.

This chapter will show that Italy's difficult economic situation in the early 1990s has to a large extent to be seen as the consequence of the Italian government's propensity to accommodate societal demands and its inability to exercise decisive leadership during the period up until 1992 when a major economic (and political) crisis rocked Italy (McCarthy 1995; Bufacchi and Burgess 1998). This propensity was above all the result of a low degree of autonomy and executive strength in various relevant policy areas. In addition, various other area-specific institutional characteristics contributed to Italy's comparatively worse macroeconomic performance.

It is necessary to describe in more detail the institutional features as well as the history of Italian economic policy-making. This will provide the basis for the study of Italian convergence policies in Chapters 3 to 6. First, I discuss the institutional characteristics of the Italian political system, which will demonstrate that institutionally speaking the Italian government is indeed characterised by a low degree of autonomy and strength. Then I analyse the institutional features of the four most important policy areas, which will demonstrate that executive strength provides a central concept for an understanding of macroeconomic policy outcomes. If the institutionalist argument has any validity, then the institutional structure of a policy area should have had an impact on policy outcomes in the past. Therefore, I finally provide a stylised presentation of post-war Italian macroeconomic history up to the early 1990s and argue that it is broadly consistent with the institutionalist argument defended in this study.

2.1 The Structure of the Italian Political System: Actors and Institutions

The Italian state has been called the 'available state' (Di Palma 1980). Historically the Italian state that emerged after the Second World War accommodated societal demands made upon it to the detriment of policy coherence. This has led students of Italian politics to characterise this system as a 'republic without a government' (Allum 1973) and its politics as a 'politics of bargained pluralism' (Hine 1993), thus implying a low degree of government autonomy and strength and a relatively strong influence of other actors such as interest groups and political parties. The Italian state has also been referred to as an 'archipelago' state (Ginsborg 1990: 154), reflecting the lack of centralisation of policy-making. These views are well summarised in the following passage:

> Overall, the policy-making process [in Italy] can be characterized as of the reactive type and accomplished in conditions of emergency. More precisely, policy-making of some importance is rarely initiated in the political sphere. It is usually the product of demands coming from some socio-economic sectors, from international pressures, from outside actors such as collective movements or interest groups (Pasquino 1996b: 155).

This kind of reactive policy-making, incapable of producing cohesive, long-term policies, is primarily the consequence of the institutional characteristics of the Italian polity. The Italian government is weak or, to be more precise, it historically lacked a strong executive capable of imposing short-term costs on societal actors and groups that are necessary to successfully pursue long-term, sustainable policies. Broadly speaking, the post-war Italian political system has been characterised by a weak executive, a fragmented party and parliamentary system and - partly as a consequence of the former - relatively influential societal interest groups.

The executive is made up of the prime minister and ministers. Formally the prime minister is the head of the executive and, according to the Italian constitution, "conducts, and is responsible for, the general policy of the government" (Art. 95). In reality, however, the prime minister's power is heavily circumscribed (Cassese 1980; Hine and Finocchi 1991). First of all, even though the president of the republic appoints the prime minister, the choice of the president is constrained by negotiations between the parties of the government coalition. Moreover, because the government comes into being through a coalition agreement, the prime minister's choice of government ministers is restricted - and usually party secretaries impose them upon him. As a result, post-war Italian governments have been characterised by a low degree of cohesion and collective responsibility. This tendency is reinforced by the relatively high number of parties forming the government coalition, by the high degree of factionalism within coalition parties as well as by a bureaucracy that is controlled by a 'party' rather than by collegial and loyal ministers.

All these features contribute to the weakness and fragmentation of the executive. They also contributed to the emergence of *parentela* and *clientela* relationships (the latter not being a feature that particularly distinguishes Italy from other countries) that make party-political and private interests relatively influential within the Italian bureaucracy (La Palombara 1964). This further weakened the executive. La Palombara (1964) defines *clientela* as follows: "[T]he clientela relationship exists when an interest group, for whatever reasons, succeeds in becoming, in the eyes of a given administrative agency, the natural expression and representative of a given social sector which, in turn, constitutes the natural target or reference point for the activity of the administrative agency" (La Palombara 1964: 262). By contrast, "parentela involves a relatively close and integral relationship between certain associational interest groups, on the one hand, and the politically dominant Christian Democratic Party [...], on the other" (La Palombara 1964: 306).

The relative lack of cohesion of the majority and the lack of prime-ministerial authority within the government primarily reflect the government's dependence on a highly fragmented parliament and government majority. Although all governments in parliamentary systems depend on the support of parliamentary majorities, the fragmentation of the Italian party system and hence the need for multi-party government coalitions makes the task of the Italian prime minister and the Italian executive to pursue autonomous and coherent policies more difficult. This contrasts with parliamentary systems where the number of government parties is low and where parliamentary factions are well controlled by the party leadership. Prime-ministerial and executive leadership is impeded because prime ministers are forced (for fear of losing support of coalition partners) to take into account the interests of the various coalition parties. Hence the prime minister's as well as the government's capacity to exercise leadership is very limited:

> Normally, he [the PM] represents at most a political formula, and his main task is to negotiate agreement on the detailed legislative implementation of that formula between the factions and parties of which it [the government] is composed. Even relatively 'strong' prime ministers are strong only in so far as they can assemble an effective alliance and then hold it together. Their skill is one of negotiation not policy enforcement: reconciling differences, distributing concessions, balancing one group against another, and sometimes just playing for time (Hine 1993: 200).

In other words, the prime minister is primarily concerned with the resolution of short-term conflict and intra-coalition trouble-shooting. Hence government policies tend to reflect short-term pre-occupations rather than long-term objectives (Hine and Finocchi 1991). The executive is further weakened by the fact that powerful party secretaries tend to remain outside the government, which – as the government depends on the support of parliamentary parties – reduces the importance of the cabinet as the body of effective decision-making. This further reduces the strength and autonomy of the executive *vis-à-vis* other actors.

If the weakness of the executive is largely the result of parliamentary fragmentation and poor party discipline, this weakness is further reinforced by the existence of a relatively powerful parliament. Three characteristics of the Italian parliamentary system have been conducive to executive weakness and political instability: bicameralism, parliamentary rules, and a proportional electoral system for the election of both houses of parliament (Hine 1993: chapter 6).

The existence of a bicameral system means that both houses of parliament, the Chamber of Deputies (*Camera dei Deputati*) and the Senate (*Senato*), have to approve a bill before it becomes law. This requirement weakens the position of the executive in that it needs to deal with two legislative bodies over which it has relatively little control to begin with; and either house can block government initiatives. (This contrasts with the degree of control that governments in the UK and Germany, for example, exercise over parliament.)

The existence of parliamentary rules that make the legislative process slow and unreliable further reduces the government's control over the timing and content of legislation (Koff and Koff 2000: chapter 6). The importance of these rules gains weight in the face of the existence of powerful parliamentary committees as well as the divisions within the parliamentary majority and within the majority parties themselves. This combination of rules, parliamentary prerogatives, and fragmentation of parliament is also conducive to the servicing of party-political constituencies and clienteles. The fact that the bulk of legislation deals with minor distributional issues rather than properly addressing broad policy issues may be interpreted as evidence (Hine 1993: 172).

Hence the executive and the legislative institutional features seem to bias policies towards short-term and micro-level rather than the long-term and macro-level policies and legislation. Incoherence is then the result of give-and-take practices between various actors in the legislative process, such as between the executive and parliament, between the two houses of parliament, between parties, between party factions and so on. In this sense, Italian parliamentarism resembles more the U.S. presidential system than other more rationalised European parliamentary systems such as the British or German ones. The relative weakness of the U.S. president and of the Italian prime minister with respect to the legislative process contrasts with the powerful position of the British prime minister and the German chancellor.

A final, and arguably the most important, feature of the Italian polity is a proportional electoral system. This is highly conducive to the proliferation of parliamentary parties. It may well be that the underlying structural cause of parliamentary fragmentation is the existence of various social, economic and cultural cleavages (Lipset and Rokkan 1967). It may also well be that majoritarian electoral systems do not necessarily lead to a pure two-party system (Duverger 1986; Riker 1986; Sartori 1986). However, a proportional electoral regime is undoubtedly conducive to the proliferation of parties and hence potentially to a weakening of parliamentary government. As Pasquino (1996b) cogently put it: "At best, it [a proportional electoral system] reflects the existing political pluralism. At worst, it encourages fragmentation" (p. 142). In the Italian case, the electoral regime goes a long way towards explaining political division between the parliamentary majority and the opposition, between the government and the parliamentary majority and within the parliamentary majority itself. During the post-war period, coalition and hence government instability[1] have been high and are reflected in the number of post-war governments between June 1945 and June 1992 of fifty (Hine 1993: chapter 3).

As in all parliamentary systems, however, the Italian executive has instruments to discipline parliament or at least to soften the parliamentary constraint temporarily, the most important of which are its ability to issue decree laws and to request a vote of confidence on legislative proposals. According to Art. 77 of the Constitution, the government can issue decree laws, that is, emergency executive decrees that have the force of law 'in cases of emergency and necessity'. The decree laws have to be converted into legislation within 60 days or else they are nullified. The parliament's power to convert or refuse to convert a decree into law places it in a powerful bargaining position, which not infrequently leads to a negotiation over the content of the decree before it is even issued. The increasing use of these laws can be seen to reflect the weakness of the executive in relation to the legislature (Hine 1993: 149-150).

The government can also ask parliament for a vote of confidence in order to push through a legislative proposal (Art. 94). In practice, this was of rather limited usefulness. If the government is divided because of diverging intra-majority interests, then it is very difficult for a prime minister to force coalition members on a particular proposal. This is probably the reason why governments have never been defeated on a formal vote of confidence (Pasquino 1996b: 149-50). Instead, intra-majority disputes and disagreements between party leaders usually bring about the fall of a government. Hence coalitions are likely to break up before the prime minister can ask for a vote of confidence.

Moreover, votes of confidence are of limited importance since the fall of a government rarely results in new elections. This is partly due to the absence of a German-style 'constructive vote of confidence' that would force new elections in case where a confidence vote is not followed by a positive parliamentary majority in favour of another prime minister. Hence the prime minister is unable to threaten the parties of the majority with new elections. The possibility of forming a new government by way of agreement between party secretaries after the fall of the

[1] The fact that government instability stands in stark contrast with ministerial stability makes no difference, as empirical evidence indicates that it is primarily 'government fragmentation' that is responsible for 'executive weakness' (Roubini and Sachs 1989a, 1989b; Alesina and Perotti 1995).

government is not conducive to either party or majority discipline and therefore represents another element that weakens the executive relative to political parties and parliament.

The parliament is also powerful enough to prevent strong executive action but is at the same time not powerful enough to assume leadership itself (Furlong 1990). Ironically the Italian parliament itself is weak with regard to societal influence. This 'problem of permeability' (Hine 1993: 182), that is parliament's low degree of autonomy with respect to the influence of societal actors and interest groups, is partly due to the above-mentioned wide range of procedural opportunities for parliament to amend, add to or strike out important parts of draft legislation, a strong-committee system, the fragmentation of parliament as well as strong intra-party factionalism (especially within Christian Democratic Party [DCI]). This offers organised societal groups various points of access and hence increases parliamentary sensitivity to local and sectional pressures.

As a result, "the Italian Parliament, with its fragmented party system and its independent-minded members, appears to be a far more formidable obstacle to the concerted will of the political executive than in any other West European democracy" (Hine 1993: 166). Hence the description of Italy as a *partitocrazia* ('party-cracy') is misleading: "The term is generally associated with over-mighty party rule, but even if Italian parties are strong *vis-à-vis* Parliament and government, they are extremely weak as bearers of coherent programmes" (Hine 1993: 306).

In sum, the Italian political system is characterised by a weak executive and a legislature that is relatively powerful *vis-à-vis* the executive but weak in relation to societal interest groups. Executive weakness is primarily the result of a fragmented parliament. This ultimately translates into executive and bureaucratic fragmentation. Thus the inability to centralise decision-making, exercise leadership and co-ordinate various policies makes the Italian government 'weak'. Due to the dispersion and diffusion of power, power in Italian politics is largely negative in nature, that is, various actors have enough power to block policies and force compromises but none is strong enough to dominate the policy process in order to produce more coherent policies. Hence the executive's weakness, being the result of its limited power relative to other actors, forces it to accommodate a wide array of interests. The institutional characteristics of the Italian political system thus explain why Italian public policy has frequently been described as 'muddling through' or re-active. In short, "[a]ccommodation has become the way of Italian political life" (Goodman 1992: 142). The institutional bias towards short-term accommodation and, at best, incrementalism is especially relevant with respect to economic policy reform (*cf.* Dente 1990).

> The distribution of the sacrifices over time and across groups is at the heart of the politics of economic reform. It is not just that the costs are short-term while the benefits are long-term, thus running into political constraints from politicians with a short time horizon. It is also that the costs of reform are often concentrated and readily evident while the benefits are diffuse and the beneficiaries are unknown *ex ante* (Williamson and Haggard 1994: 531).

In other words, a combination of a weak executive and influential societal and other political actors should make radical or at least decisive policy reform difficult if not impossible to achieve.

Italy's parliamentary regime has been described as an *assembly government* (Sartori 1997: chapter 6), characterised by (1) an executive that does not lead the legislature; (2) political power that is not unified and concentrated but scattered and atomised; (3) a lack of collective responsibility; (4) a lack of party discipline; (5) obstacles faced by the prime minister and other ministers to act quickly and decisively; (6) obstructive intra-coalition disagreements and hence uncertain parliamentary support for the executive; and (7) a fragmented executive.

Assembly government contrasts with the more hierarchical and rationalised (British) Westminster, (German) *Kanzlerdemokratie* and (Dutch) *working government* systems. Even though various characteristics are important with regard to executive strength, it seems that the relatively stronger position of the head of government, greater cabinet cohesion and greater control of parliament is primarily the result of a more 'reductive' electoral system. It is the underlying thesis of this study that (in the Italian case) executive weakness is to a high degree the result of the government's dependence on multi-party majorities (*cf.* Rose 1980; Mayntz 1980; Cassese 1980).

In short, as a consequence of the institutional characteristics of the Italian polity the Italian government enjoys a low degree of autonomy and strength. However, as pointed out, executive strength is not a generalised feature. Rather an executive's capabilities can vary across various issue-areas (Katzenstein 1976;

Krasner 1977, 1978; Gowa 1988). It is therefore necessary to analyse in detail the institutional features of the various relevant policy areas.

2.2 *The Fiscal Policy-Making Regime*

As already sketched out in Chapter 1, there is a great deal of evidence that institutional factors affect budgetary outcomes. Although there always is a certain degree of inconclusiveness with regard to cross-country studies of this kind (*cf.* Edin and Ohlsson 1991; Borelli and Royed 1995), there is a clear sense that political and budgetary institutions influence budgetary policy outcomes (Von Hagen 1992; Alesina and Perotti 1995, 1999). This is so because institutions represent 'rules of the game' that have an impact on the strategic interaction between the different actors in the budgetary process.

Institutionalist approaches to budgetary policy can roughly be divided in two: political-institutional and budgetary-institutional approaches. Political-institutional approaches focus on the characteristics of the political system and emphasise the importance of such factors as cabinet fragmentation (Kontopoulos and Perotti 1999; similar Alesina and Perotti 1995), the fractionalisation of party systems (Grilli *et al.* 1991), the number of coalition parties, the longevity of governments, and the nature of the electoral system (Roubini and Sachs 1989a, 1989b).

The argument that these institutional variables affect policy outcomes is roughly speaking the following. Proportional electoral systems tend to produce fractionalised party systems and hence multi-party majorities and governments. The greater the number of parties in a coalition, the more difficult it will be to implement budgetary adjustment as none of the coalition parties will accept a solution that imposes the costs on their constituency. By contrast, one-party governments[2] can simply impose the costs on the constituency of the opposition parties.

[2] There exists a trade-off for a strong government with regard to accountability and ability to impose costs. The stronger a government is in terms of executive control of parliament (and the lower the number of coalition parties), the more it will be held accountable for the costs imposed through a restrictive fiscal policy. By the same token, the parties of a multi-party government could soften the negative feedback by spreading it among them and might therefore be more willing to implement budgetary reform (Schlick 1993; Pierson 1993). This seems particularly relevant in the context of corresponding plurality and proportional electoral systems that magnify or soften the negative feedback effect (also Chapter 4). Cross-national studies suggest however that the capability aspect prevails over the accountability aspect (Alesina and Perotti 1996b). Past Italian budgetary policy confirms this too (*cf.* Section 2.6).

Section 2.1 demonstrated that the Italian political system is characterised by all those political-institutional features that have been shown to be associated with high public deficits and debt, most notably cabinet fragmentation, multi-party majorities, proportional electoral system and fractionalised party system. Italy has the worst record in terms of government longevity among Western democracies and its proportional electoral system leads to parliamentary and government fragmentation which in turn decreases longevity and stability. Indeed cross-national studies assign a composite indicator that would lead one to expect Italy to be the fiscally least responsible country in terms of budget deficits and public debt (Sachs and Roubini 1989a, 1989b; Grilli *et al.* 1991; Alesina and Perotti 1996a).

Another institutionalist approach has focused on more narrowly defined budgetary institutions (or fiscal rules) that govern the budgetary policy-making process rather than the broader political-institutional features described above. Budgetary institutions can be defined as "all political rules and regulations according to which budgets are prepared, approved, and carried out" (Alesina and Perotti 1999: 14). Von Hagen (1992), for instance, creates a complex indicator to measure the impact of different budgetary rules (*cf.* Annex A). Empirical tests confirm the so-called 'structural hypothesis', according to which (strong) 'hierarchical-transparent' budgetary institutions are more conducive to fiscal responsibility than (weak) 'collegial-intransparent' ones[3] (Hahm *et al.* 1996; Von Hagen and Harden 1994 for European countries).

A detailed discussion of these rules would be highly technical. A sketch of Italian budgetary rules will have to suffice here to make the point that the Italian budgetary process is collegial and non-transparent.[4] The government is responsible for the preparation and formulation of the budget. The finance minister, though, has no special status and cannot rely on the support of the prime minister as the latter does not command sufficient authority to exercise influence over his ministers, especially those that are not members of his own party. Thus, "[i]n addition to the tensions between the ministries charged primarily with expenditures and those that try to limit spending, this stage in the budgetary process must contend with divisions

[3] 'Hierarchical-transparent' budgetary procedures coincide with executive strength as discussed in Section 1.4 (Hallerberg and Von Hagen 1999).

[4] For a detailed description of institutions and rules governing the formulation, legislation and implementation of budgetary policy see Onofri (1979); Della Salla (1988); Chiorazzo *et al.* (1994); Da Empoli *et al.* (1995); Verzichelli (1999a: chapter 4); Alesina *et al.* (1998).

within the governing coalition (not to mention within the parties themselves)" (Della Salla 1988: 119). Neither the prime minister nor the finance minister has any special prerogatives with regard to budgetary policy (OECD 1995a). In fact, the 1980s amply demonstrated this weakness at the formulation stage, as on various occasions spending ministers were able to prevail in conflicts over budgetary policy by simply disrespecting the limits set by the finance minister by way of threatening to resign (Verzichelli 1999b: chapter 4). Finally, the high degree of cabinet factionalism and *parentela* and *clientela* relationships, especially between the bureaucracy and interest groups (such as public-sector employees and beneficiaries of various types of income and welfare transfer), limited the autonomy of the executive at the formulation stage.

At the parliamentary stage both houses of parliament have to approve the budget. Both houses of parliament exercise full legislative powers concerning expenditure and revenue matters. Hence what is true for the Italian legislative process in general holds also for the budgetary process in particular (Della Sala 1988: 110). Even though there are rules as to what parliament is allowed to amend (see below), in practice, parliament and government are 'co-participants in the budgetary process' (Della Salla 1988: 110). This means that the budgetary process at this stage is the result of a series of negotiations and compromises - between the government and parliament, and between government and opposition parties - to achieve what is politically acceptable to all actors involved.

Moreover, the Italian budgetary process at the parliamentary stage is also characterised by a high degree of complexity and lack of transparency (Alesina *et al.* 1998; Verzichelli 1999a). These characteristics provide incentives for, and facilitate, creative budgeting. They also reinforce the 'collegial' - as opposed to an 'executive-dominated' - nature of the Italian budgetary process.

At this stage, the problems discussed above, such as the 'problem of permeability', the lack of cohesion of the majority, the inability of the government to determine the legislative agenda and so on, open the executive, and hence the budgetary programme, to short-term political pressures. This tends to result in the accommodation of societal demands channelled through parliament and forces the government to compromise on its proposals (Hine 1993: 182). On an institutional level, the existence of strong committees represent ideal channels of access for societal interests thanks to the informal bargaining that takes place in them. Similarly, these committees provide plenty of opportunities for exchange between parliamentary majority and opposition as well as between the majority parties themselves. This enhances the influence of non-executive actors in the process. Thus, the Italian parliamentary process allows U.S. style bargaining and logrolling, that is, exchange in committees (Visco 1990).

As for the implementation stage,[5] bureaucratic fragmentation and the rules governing the implementation process are not conducive to strong, central control over this stage of the budgetary process either. For example, forecasts by the government (and parliament) seem to be persistently wrong, that is overestimating revenues and underestimating expenditures.[6] Generally, it matters, among other things, how much power the finance minister has to restrain spending (in the case of a foreseeable budget overshoot) and how much flexibility there exists at the implementation stage. The idea behind this is that, on the one hand, a weak finance minister will be unable to enforce expenditure ceilings on recalcitrant spending ministers and that, on the other hand, the less binding and more flexible these rules are, the less commitment is necessary at earlier stages. The Italian budgetary system fares badly in both respects. In addition to a weak finance minister,

> Italy's Budget Law is only weakly binding and the budget implementation system is inordinately flexible. There are no cash limits on spending ministries, the budget minister lacks the power to block expenditures, budget changes and transfers of expenditures between chapters are routinely adopted, and carry-over procedures are extremely flexible (Milesi-Ferretti 1997: 20).

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[5] The problems related to implementation are complex and would require an exhaustive and detailed analysis of the organisation and the recent reform of the fiscal bureaucracy, something which lies beyond the scope and purpose of this study, except to say that the overly formalistic approach and ex-post control as well as the non-binding character of *Corte dei Conti* (Court of Accounts) decisions are certainly not conducive to financial discipline at this stage (*cf.* Alesina *et al.* 1998).

[6] The OECD (*Economic Surveys Italy* 1997: part III) found four main reasons for wrong forecasts: (1) future rates of economic growth were over- and future inflation understated; (2) planned deficit reductions hinged upon one-off measures (whose effects are difficult to predict); (3) intended measures of fiscal restraint were either not fully adhered to, or parliament, overriding government initiatives, approved expenditure-augmenting laws in the course of the fiscal year; and (4) deficit forecasts were extremely sensitive to interest rate developments as a consequence of the high level of debt. Very probably, the limited independence and underdevelopment of the budget service of the two houses (total of 6 civil servants compared to about 200 at the Congressional Budget Office in the United States), whose task it is to evaluate the admissibility of amendments (*Il Sole 24 Ore*, 19 October 2000: 8; Padoa-Schioppa Kostoris in hearing of Budget Commission of Chamber and Senate quoted *Il Sole 24 Ore*, 17 October 2000), also contributes to poor forecasting. Moreover, the lack of transparency of the budget process and of the budget documents makes forecasting difficult. However, the fact that forecasts were characterised by a consistent one-sided bias (that is, underestimation of the deficit) suggests the importance of 'political' rather than 'technical' factors.

Overall, Italian budgetary policy-making institutions are characterised by features that have been found to be empirically associated with above-average fiscal deficits and public debt.

What is the relation between political-institutional and budgetary-procedural variables? I would like to suggest that - even though the two sets tend to coincide in practice (Hallerberg and Von Hagen 1999) - political-institutional strength is more important than 'strong' budgetary procedures. There is plenty of empirical evidence for this claim with respect to the Italian case (see Chapter 3). A brief discussion of the formally most important budgetary rules with respect to budgetary discipline will illustrate this.

In theory, parliamentary amendment power is restricted by the *copertura* principle (Art. 81 of the Italian Constitution) that does not allow deficit-increasing amendments. In practice, this provision has proved ineffective to control budgetary policy for several reasons.[7] First, due to executive weakness, the government tends to anticipate parliamentary opposition and takes into account parliamentary pressures at the formulation stage. The fact that the Italian executive is far from being a homogenous body in that individual party (and intra-party factional) interests are strongly represented in a divided cabinet also contributes to this phenomenon. Second, although in the 1960s there existed both a Keynesian and an orthodox interpretation of Art. 81, in the end the former prevailed. This indicates the greater importance of effective power relative to formal rules, especially since art. 81 had originally been drafted in an orthodox spirit. Third, although parliamentary amendments must leave the state sector deficit[8] unchanged, in practice this constraint can be circumvented by way of parliament proposing higher spending to be implemented by local government and other external agencies (such as social security funds), through the overestimation of offsetting measures, through incorrect forecasts concerning the underlying fiscal developments as well as through making use of accounting loopholes. In other words, there exist no binding deficit targets for the general government sector (OECD *Economic Surveys Italy* 1997: 106; Scioscioli 1987; Milesi-Ferretti 1997). Hence the *copertura* principle is in fact widely

[7] Note that these reasons apply equally to targets proposed by the executive during the budgetary process, as for example in the *documento di programmazione economica e finanziaria* (DPEF), that is, the Economic and Financial Planning Document (since the late 1980s).
[8] The state sector covers the state, other bodies included in the central administration and autonomous national companies. It excludes, for example, social security institutions.

acknowledged to be *pro forma*.[9] Fourth, the primacy of political over procedural factors is corroborated by the fact that reforms of the budgetary process in 1978 and 1988 that were intended to strengthen financial discipline did not result in any considerable improvement of Italian budgetary performance. This suggests that the 'political-institutional' logic overrode merely 'budgetary-institutional' constraints (Della Sala 1988; Chiancone 1992; Hine 1993: 182-187; Eusepi and Cerioni 1993).

All this strongly suggests that formal constraints can be circumvented because of an executive unwilling or unable to prevent this from happening. This leads to the conclusion that 'political-institutional' executive strength outweighs procedural characteristics (for quantitative empirical evidence see Stein *et al.* 1999: 132). More generally:

> The main difficulty in budgetary reform is that there is no real sanction against Parliament – or the government – for failure to meet self-imposed budget-deficit targets [...]. Ultimately, if the government cannot control its own members of Parliament, and cannot agree within its own ranks on higher taxation or lower spending, the budget deficit will continue (Hine 1993: 187).

Scholars debate whether and to what extent parliament was responsible for the worsening of the budget balance proposed by government. This is not the place to discuss this in detail. Nonetheless, even if it were the case that parliament has not directly contributed to increasing deficits in the sense of altering or blatantly disregarding the budget deficit targets (De Ioanna 1993), it is likely that the 'threat' to do so induced the executive to take into account parliamentary (and indeed intra-coalitional) concerns and demands. This was certainly detrimental to budgetary control.

> E' frequente osservare, infatti, nella vita parlamentare dell'Italia, come il governo si presenti all'appuntamento della sessione di bilancio non con la propria proposta da difendere con ogni determinazione e con adeguati poteri e con le corrispondenti responsabilità (cosi come avviene nelle democrazie occidentali), ma come si suol dire, con ampi spazi di manovra finanziaria, con ampie disponibilità di apertura alle categorie sociali, con la dichiarata volontà di contrattare con il parlamento le priorità di bilancio e con un pacchetto di proposte (di norma accrescitive del fabbisogno), da 'concordare'

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[9] For detailed discussion of creative accounting methods see Alesina *et al.* (1998: 39-45), De Haan *et al.* (1999: 295) and Scioscioli (1987).

> con il parlamento stesso, o, più di sovente, con spezzoni del parlamento medesimo (Cavazutti quoted in Monorchio 1996: 422-423).[10]

This broad sketch of the Italian budgetary process shows that the Italian government is very restricted in terms of its autonomy and strength at all three stages of the budgetary process. This weakness is the result of a number of analytically distinctive but inter-related institutional features of the Italian political and budgetary system: a fragmented parliament produces a weak and fragmented executive that is forced to rely on unstable, multi-party coalitions; moreover, budgetary procedures are collegial and 'intransparent'. This means that budgetary decisions and outcomes are to a very high degree the result of compromises between the various actors directly or indirectly involved in the policy process.

I would like to suggest that the most important deficiency of the Italian budgetary system is the executive's inability (or unwillingness) to control budgetary policy. This is primarily a consequence of executive weakness. This weakness finds expression at various levels of the budgetary process and seems ultimately rooted in the political-institutional weakness of the executive relative to other actors in the policy process. At the formulation stage, the weakness tends to make the Italian government unwilling – and unable - to pursue policies of fiscal adjustment. A government's budget proposals will thus tend to anticipate what is politically acceptable to all relevant actors involved in order to pre-empt parliamentary opposition. This also explains budget overshoots that result from inaccurate and over-optimistic forecasts. These optimistic forecasts allow for softer budgets and thus reduce conflict. At the parliamentary stage, the government is generally unwilling (and unable) to use the means available to 'get its own way' such as using parliamentary procedures to seek greater party discipline and hence greater control

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[10] "In Italian parliamentary life it can indeed often be observed that the government starts the parliamentary budget process, not with its proposal to be defended with determination, and adequate powers and corresponding responsibilities (like in other Western democracies), but as one could say, with ample room for financial manoeuvring, with ample willingness to be open to the various social groups, with the declared will to negotiate budgetary goals with parliament, and with a package of proposals (of an expenditure-increasing nature) that needs to be 'agreed upon' with parliament, or, even more commonly, with parts of the very same parliament". Similarly: "*una certa connivenza da parte del governo stesso, che 'si spriva' ben presto alle proposte di modifica parlamentare, senza opporre particolari resistenze*" (Verzichelli 1999a: 62). ["A certain connivance on the part of the government, which 'melts' very quickly in the face of parliamentary amendments, without putting up any particular opposition."]

over committees and majority parties (Visco 1990: 209). Formally, at least, the government has the necessary instruments to induce greater discipline into the process, such as the ability to oppose lax amendments, ask to recall amendments, discipline majority deputies, or involve the finance office to show that amendments are deficit-increasing and inadmissible (Visco 1990; De Ioanna 1993). In practice, the government is politically too weak to make proper use of these instruments. At the implementation stage, the inability to rein in spending is at least partly the result of the inability (or unwillingness) of the finance and prime ministers to impose restraint on self-interested 'political' spending ministers.

In short, budgetary policy is strongly affected by executive power - or lack thereof. As a consequence of executive weakness, budgetary policy is short-termist, incoherent and resistant towards major policy reform. This weakness is particularly visible in a comparative and historical perspective (*cf.* Von Hagen and Harden 1994; De Haan *et al.* 1999).

2.3 The Pension Policy-Making Regime

Similar to budgetary policy-making, a weak executive also plays an important role with regard to pension policy, and especially pension reform. In addition to executive weakness, the nature of the pension system and the structure of interest group representation also matter.

Pierson (1994) has pointed out that the logic and hence the factors behind welfare state expansion may be different to those behind welfare state retrenchment. Hence it is necessary to discuss in more detail the conditions that affect policy in this area. Common sense and historical evidence suggest that social welfare and, by extension, pension expenditure are always difficult to 'reform' (that is, cut). This is due to a variety of reasons. First, the welfare state tends to be very popular with public opinion. Second, social welfare expenditure is difficult to cut due to the existence of 'frozen welfare landscapes' (Esping-Andersen 1990), that is clientelistic, rent-seeking groups that have a vested interest in the existence of social welfare policies. As the 'costs of retrenchment' (or welfare cuts) are concentrated, while the benefits are dispersed, governments tend to avoid retrenchment in order to avoid confrontation with entrenched interest groups. Hence frequently governments seek to avoid cutting welfare programmes and opt, if possible, for higher taxes to compensate for the inability to reform welfare.[11] Generally speaking it is true that "frontal assaults on the welfare state carry tremendous electoral risks [...] everywhere, retrenchment is a difficult undertaking" (Pierson 1996: 178-9).

However, how great these political-electoral risks are and how capable a state is of reforming the welfare system are also influenced by a number of institutional factors. In other words, even if politicians' electoral self-interest makes social welfare reform unlikely to be initiated and difficult to implement successfully, certain institutional conditions can be hypothesised - and have empirically been found - to favour the initiation and implementation of welfare reform (Schlick 1993; Pierson and Weaver 1993).

The first institutional factor is related to the concept of executive strength. At first sight, executive strength seems to have an indeterminate effect on welfare and pension reform. On the one hand, the electoral system influences the extent to which a government is able to absorb the electoral consequences of unpopular welfare reform. For example, a plurality electoral system will tend to make a government unwilling to provoke popular opposition because the electoral consequences of small swings in voters' preferences is likely to lead to outright defeat. By contrast, under a proportional system (like the Italian one), small shifts in electoral support have small consequences on the distribution of parliamentary seats. Theoretically, this would lead one to assume that governments in political systems where electoral regimes have hugely disproportional effects (such as a plurality system) would be less willing to pursue retrenchment policies.

On the other hand, the ability of a government to pursue a reform policy in the face of parliamentary and societal opposition should also be expected to matter. This ability is primarily the result of executive strength. *Ceteris paribus*, a 'strong' government with a high degree of control over a homogenous parliamentary majority is in a better position to implement unpopular reforms than multi-party coalition governments. This is so because the former system is characterised by a very small number of 'veto points' relative to the latter.

From an institutional point of view, there exists a trade-off for strong executives with regard to accountability and ability to impose costs. With respect to

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[11] "Expansion typically benefits a particular group with the cost diffused through general taxation. The losses are spread while the gains are concentrated. In the case of retrenchment the reverse it true: the

parliamentary regimes, a strong, homogenous, cohesive executive can easily be held accountable for the costs imposed by pension cutbacks but will be in a better position to push through reform thanks to its strong control over the policy-making process. By the same token, a weak, heterogeneous, multi-party government, even though it is able to 'spread' the impact of negative feedback and might therefore be more *willing* to initiate pension reform, will be less *capable* of realising reforms due to its weakness (Schlick 1993; Pierson and Weaver 1993). In short:

> Where authority is concentrated [...] governments will be hard-pressed to avoid blame for unpopular decisions, but they will have a greater capacity to develop and implement strategies that minimize the need to force multiple policy changes through institutional veto points. However, they may find it easier to duck accountability for unpopular policies (Pierson 1996: 177).

Theoretically underdetermined, it is an empirical question whether *capacity* outweighs *accountability*. Empirically, both cross-national research and the Italian case suggest that the former outweighs the latter with respect to pension policy (Pierson 1994).[12] In other words, a government's incentive in terms of lack of accountability and hence potential greater willingness to engage in reforms is overridden by the inability to implement reforms – and *vice versa.*

In addition to executive strength, a second set of factors should be expected to matter: the consequences of previous policy choices.

> Social forces are important, because advocates of retrenchment are unlikely to succeed in the face of substantial political opposition. Nevertheless, institutional factors – including the structure of formal institutions, but especially the consequences of previous policy initiatives – are central in determining whether this political opposition actually emerges (Pierson 1994: 50).

This is so because "major important public policies also constitute important rules of the game, influencing the allocation of economic and political resources, modifying the costs and benefits associated with the alternative political strategies, and consequently altering ensuing political development" (Pierson 1993: 596).

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gains (to taxpayers) are diffused through the population whereas a particular interest becomes keenly aware that it is damaged" (Taylor-Gooby 1999: 4).

[12] The accountability-capability framework also accounts for the success and failure of budgetary reform. Alesina and Perotti (1995) found that 'weak', heterogeneous coalition governments are the most likely to initiate fiscal consolidation but are also much more likely to be unsuccessful. By

Hence to the extent to which public policies establish rules and create constraints and incentives that shape behaviour, they can be understood as institutions (*cf.* Section 1.4). This definition of institutions is certainly consistent with the view historical institutionalism adopts of institutions (Bonoli *et al.* 2000).[13]

The institutional character of previous policy choices can be captured in the form of *policy feedback* which can involve various factors such as interest group effects, resources of and incentives for government elites and so on (Pierson 1993). With regard to pension policy, the so-called 'lock-in' effect and the 'interest group' effect can be hypothesised to matter most.

First, within the framework of an earnings-related pay-as-you-go system it is always difficult to reduce benefits, regardless of whether the reform seeks to introduce a re-balancing of the pay-as-you-go scheme or the replacement by, for example, a capitalisation-based system (Vitali and Visaggio 1996). This is so because once a pay-as-you-go pension system matures it becomes 'locked-in' because a re-balancing would create a 'double-payment problem' (that is, current workers would have to finance both the current pensioners' retirement benefits and their own) and affect 'acquired rights' (that is, accumulated, 'earned' pension benefits).

Second, the interest group effect will mobilise trade unions (and other interest groups) to defend acquired rights. Even though the lock-in effect and the interest group effect are analytically distinct, in reality they are intimately related in that certain interest groups will tend to oppose retrenchment in general and will pay considerable attention (as will be shown below) to issues such as acquired rights and the 'double payment problem'. The incentives for mobilisation are thus strongly influenced by the institutional characteristics of the pension regime – and hence by previous policy choices.[14]

Policy feedback should be regarded as a process where institutions and actors interact as to bring about outcomes. The 'rules of the game' established by the

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contrast, 'strong', cohesive one-party governments - though less likely to initiate budgetary retrenchment - are almost always successful in achieving it once it has been decided.

[13] Note that Bonoli *et al.* (2000) argue that 'well-established practices of policy-making' should be regarded as 'informal' institutions. While the emphasis here is on 'formal' institutions (political system and pension regime), this wider definition potentially provides another justification for the inclusion of trade unions into the 'institutionalist' analysis (*cf.* Section 1.4).

[14] Note of course that the relative power of trade unions is not determined by the nature of the pension regime but by the institutional features of the political system.

current pension regime thus determines the costs and benefits of alternative policies and hence provides the incentives for the mobilisation of actors in this policy area. Thus, the pension regime (being the result of previous policy choices) can be regarded as part of the institutional environment that influences and structures the strategic interaction of the various actors (see discussion of relationship of institutions and agency in Section 1.4).

There is evidence from comparative and cross-national studies to confirm the relevance of institutional features (*cf.* Bonoli 2000). Pierson (1994: part I), for example, has demonstrated that the fragmentation (partly private, partly public) and underdevelopment (in terms of benefits and maturity) of the British pension system in the early 1980s created a structure of pensioner-interest representation that made it relatively easy for a one-party government under Prime Minister Thatcher to radically transform British pension policy. By contrast, similar attempts in the USA, characterised by a cohesive, universal and mature public pension system, which was moreover backed by influential interest groups, failed, as they prevented an even relatively strong president such as Ronald Reagan from realising his radical reform proposals. There is also empirical support for this hypothesis from comparative analysis of pension reform in OECD countries that demonstrates the importance of the policy feedback process discussed above (Myles and Pierson 1998 quoted in Pierson 1998b).

What relevance do these theoretical considerations have for the Italian case? The Italian pension system of the early 1990s was characterised by segregated social insurance programmes financed by compulsory state social insurance. Thus in terms of the well-known classification of the 'three worlds of welfare capitalism' (Esping-Andersen 1990), the Italian pension system was characterised by a continental European, conservative Bismarckian regime. Continental European welfare regimes tend to rely on payroll taxes, provide earnings-related benefits, are transfer-oriented and are financed on a pay-as-you-go basis. More specifically, the *Istituto Nazionale della Previdenza Sociale* (INPS) accounted for roughly three quarters of public pension spending (private-sector and most self-employed), while the state-administered public sector pensions accounted for roughly 25 per cent of spending. Schemes for public employees were more generous (for detailed description of pension system see Franco and Frasca 1992; Canziani and Demekas 1995; Cazzola 1995).

Hence, in terms of the institutionalist analysis above, the conditions for successful pension retrenchment were unfavourable. First, the Italian government was traditionally characterised by (weak) multi-party governments. Second, in terms of a possible lock-in effect, the Italian pension regime in the early 1990s was characterised by: (1) inclusiveness; (2) no relevant private-sector options; (3) a high degree of maturity; and (4) a pay-as-you-go system (Franco and Frasca 1992). Third, in terms of the interest group effect, there were relatively strong trade unions that considered themselves defenders of the welfare state. The combination of these three characteristics would suggest that pension retrenchment is extremely difficult to achieve, as - in order to achieve reform - a weak government has to confront powerful and entrenched interest groups that have an interest in defending acquired and mature pension rights.[15] This is borne out by the history of Italian pension policy (*cf.* Franco 1993; also Section 2.6).

2.4 *The Private and Public Wage Bargaining Regimes*

There is great amount of theoretical and empirical literature regarding the relationship between wage bargaining institutions and economic policy outcomes, and more specifically wages, price stability and unemployment (for surveys see Brunetta and Dell'Aringa 1990; Iversen *et al.* 2000). There is disagreement as to whether *and* how labour market institutions affect economic outcomes. Firstly, there is a disagreement with regard to the question of whether there exists a stable relationship between certain institutional characteristics of the wage bargaining regime on the one hand, and wage outcomes on the other hand. Secondly, there is no agreement regarding the question of what kind of relationship there exists (if there exists a stable relationship at all). Notwithstanding this inconclusiveness, I will argue that Italian private and public wage bargaining was traditionally characterised by a

[15]The 'lock-in' effect of a pay-as-you-go system reinforces the 'weak executive' effect. This is so because a pay-as-you-go pension system provides an incentive for decision-makers to break the so-called golden rule (which stipulates that the implicit yield of pension contributions must not exceed the growth rate of the overall wage bill). Due to the low visibility and long-term nature of the resulting consequences, there is an 'intrinsic tendency' of the political system to intervene in a way that results in imbalances (Morley-Fletcher 1998: 25). This is exactly what was responsible for the problems the Italian pension system faced in the late 1980s and early 1990s. Not infrequently, expansionary pension measures - similar to budgetary policy - were accompanied by wrong forecasts concerning future liabilities. These forecasts always tended to underestimate future liabilities (Modigliani and Padoa-Schioppa Kostoris 1996).

number of unfavourable institutional characteristics that, at a minimum, made it difficult to achieve disinflation.

Wage Bargaining Regimes and Wage Policy

The neo-corporatist literature of the 1970s and 1980s argued that centralised wage bargaining arrangements were important with regard to wage moderation. The concept of 'encompassingness' played an important role (originally Olson 1965). The so-called 'hump-shape' hypothesis of Calmfors-Driffill (1988) that emerged from this literature was particularly influential. It posited that

> large and all-encompassing trade unions naturally recognize their market power and take into account both the inflationary and unemployment effects of wage increases. Conversely, unions operating at the individual firm or plant level have very limited market power. In intermediate cases, unions can exert some market power but are led to ignore the macroeconomic implications of their actions (Calmfors and Driffill 1988: 13).

The practical implication – for which Calmfors and Driffill claimed to have found empirical support – was that unemployment, inflation and wage increases should be lower in countries with either decentralised or highly centralised bargaining regimes, while 'intermediate' countries should fare worse on these indicators. In practice, Calmfors and Driffill equated encompassingness with the 'level of wage bargaining': an unitary, encompassing, centralised union movement will bargain at the national level; a union movement primarily organised on the basis of industry unions will bargain at an intermediate (or industry) level; decentralised, company-level unions will bargain at firm level. Influential as this theory was, there were several problems related to it.

On the one hand, some authors objected to the operationalisation[16] of encompassingness by laying greater emphasis on the concentration of union membership (Schmitter 1981), the level of bargaining and degree of enforceability of agreements (Visser 1990), unions' organisational strength (Cameron 1984; Golden 1993), and the number and size of bargaining units *and* the vertical distribution of authority (Iversen 1999). Generally these critics did not question the importance of

[16] For more detailed discussion of problems involved in the conceptualisation and operationalisation of 'centralisation' and 'encompassingness' see Iversen (1999: 48-57 and 57-60).

encompassingness, which influences the willingness to contain wages and the ability to implement wage moderation on the part of the unions.

On the other hand, other authors have underlined the importance of increasing openness and the resulting conflict of interest between the non-tradables and exposed sectors as well as the importance of the monetary regime for wage outcomes (Crouch 1990; Garrett 1998; Garrett and Way 2000). In a similar vein, yet others pointed to the importance of 'bargaining co-ordination', which under certain domestic and international conditions can function as a substitute for centralisation (Crouch 1985; Soskice 1990). These authors suggested that whether or not a certain set of bargaining institutions would lead to certain outcomes was conditional on a number of factors other than the nature of domestic bargaining arrangements (also Scharpf 1991; Pontusson 2000; Baccaro and Locke 1998; Iversen 1999). Finally, if there ever was an empirical relationship between centralisation and low inflation (Paloheimo 1990; Calmfors and Driffill 1988), then there is evidence that the Calmfors-Driffill relationship broke down in the 1980s and 1990s (Soskice 1990; OECD 1994b; OECD 1997b; Iversen 1999).

Thus, the Calmfors-Driffill argument has been cast into doubt from both a theoretical and an empirical point of view. In fact, the 1990s have even shown that in the context of an increasing competitive constraint and a hard-currency regime (whether this results from an independent, inflation-averse central bank or from fixing the exchange rate is immaterial), the cases of intermediate encompassingness were characterised by superior inflation performance. Theoretically, this was rationalised as follows.

> Full encompassingness of bargaining centralization was not required to give the social partners a sufficient incentive to act in a *martkonform* manner. The labour-market actors simply needed to have enough organizational capacity to reach, and impose on their members, agreements, which recognized that a powerful third party outside the framework of negotiation, would behave in certain predictable ways unless they cooperated (Crouch 2000: 211; *cf.* Streeck 1994).[17]

In other words, recent studies have demonstrated that organisational centralisation and centralised wage bargaining (as the most extreme form of encompassingness) constitute an empirically and theoretically unnecessary condition for achieving wage restraint. The main thrust of this criticism essentially contends that: "Centralization is clearly one means of providing co-ordination, but there can be functional equivalents" (Crouch 2000: 204-205).[18] Moreover, the effective wage constraint stemming from the introduction of a hard currency regime tends to be incompatible with the centralisation of bargaining, especially when centralised bargaining does not to allow for wage differentiation and results in wage compression (*cf.* Baccaro and Locke 1998; Pontusson 2000), as this leads to intra-union wage competition and ultimately wage inflation (for detailed argument see Iversen 1999; Soskice 2000).

Prima facie all this would suggest a rather limited heuristic usefulness of domestic wage bargaining institutions with regard to predicting wage outcomes. However, what matters is not so much whether there exists a stable and empirically confirmed relationship between bargaining institutions and wage outcomes but rather what the institutional pre-requisites for a high degree of capacity for real wage moderation are. In this sense, the discussion so far strongly suggests that the relationship between wage bargaining institutions and macroeconomic outcomes is complex and that other potentially important variables have to be taken into account. However, even if other factors, such as economic openness, currency regime, exposed-sheltered sector conflict, also matter, this does not mean the notion of encompassingness in the sense of 'co-ordination' and 'control over lower level units' is irrelevant to an understanding of wage outcomes. It only means that an analysis of wage bargaining institutions needs to include other factors in order to account fully for wage performance.

The discussion so far also has another significance, which needs to be demonstrated empirically however: certain sets of institutions are not conducive to disinflation. With respect to the Italian case the question is then how wage moderation was achieved *despite* the fact Italy did not seem to share any of the characteristics (such as encompassingness or wage co-ordination) deemed important for its successful implementation (Locke and Baccaro 1996). Hence the question is rather how the domestic-institutional obstacles that characterised the Italian wage bargaining regime and that had played an important role in preventing Italy from

[17] While in the German case this constraint was represented by the *Bundesbank*, in the Dutch, Austrian and Danish cases this constraint was 'imported' as a result of the *de facto* currency peg.
[18] This argument was first proposed as a critique of the Calmfors-Driffill model by Soskice (1990).

achieving inflation convergence in the 1980s were overcome and how conditions were put in place that were compatible with - and ultimately conducive to - wage moderation. In a next step, whether or not - and to what degree - these reformed institutions affected wage moderation will have to be tackled. As these domestic-institutional variables – mainly drawn from empirical studies, the 'state strength' literature and neo-corporatist theory - differ slightly between the private (manufacturing) and public (service) sector (Cella 1995),[19] the two sectors are analysed separately.

The Private Sector Wage Bargaining Regime

The problems resulting from the Italian private sector wage bargaining regime are closely connected with the assumptions of neo-corporatist theory. (Again, this does not imply that there needs to exist a stable relationship between institutions and outcomes.) Traditionally, neo-corporatist theory regarded three factors as pre-conditions for policy concertation in general and wage moderation in particular (Regini 1982; Lehmbruch 1984): (1) the parties to concertation, and especially the unions, have to possess the monopoly of representation; (2) these parties must be able to control the behaviour of their constituent parts; and (3) a pro-labour government must be present.

First, not only will encompassing unions tend to take into consideration the effects of their actions but also 'wage competition' between various sectors will be solved *internally* and hence without detrimental effect for inflation. In the case of national-level bargaining, for example, macroeconomic targets can explicitly be taken into account. Second, the ability of the union leadership to control its constituent parts is crucial as it determines to what extent the former can formulate and implement agreements reached at the national level. Third, the role of the government and more particularly the presence of a pro-labour government have traditionally been regarded as important. Neo-corporatist theories have assumed that there is a sort of exchange between wage moderation and expansion of social welfare

[19] Roughly speaking, the exposed sector comprises manufacturing, food, parts of the financial and energy industries, while the sheltered sector includes government and public services, construction and virtually all private services. Even though it is an over-simplification, the private, exposed and manufacturing sectors on the one hand, and the public, service and sheltered sectors on the other hand, are lumped together. This is common practice in industrial relations research (see Garret and Way 2000).

policies. Naturally a left-wing, pro-labour governments would be - and historically were - much more inclined to enter such an exchange relationship than right-wing governments. Furthermore, Italian scholars, studying the Italian experience of wage policy concertation of the 1970s, have drawn attention to the importance of executive strength in the sense that - like the unions - the government has to (be able to) 'deliver' in order to make exchange and concertation work. At least this is relevant in the case of tripartite concertation where the government is a party to the wage negotiations (Regini 1984).

As for Italy, none of these preconditions seems to have held. At the national level, unions were divided into at least three major, ideologically divided and competing confederations (that is, communist CGIL [*Confederazione Generale Italiana del Lavoro*], catholic CISL [*Confederazione Italiana Sindacati Lavoratori*] and republican-socialist UIL [*Unione Italiana del Lavoro*]), which resulted in a lack of centralisation and representational monopoly. The control of confederations over lower units tended to be weak as demonstrated by past events, such as the Hot Autumn of 1969 or the failure to implement an incomes policy during the early 1980s (*cf.* Section 2.6). Moreover, the Italian government was weak and frequently unable to 'deliver' and furthermore was never dominated by left wing, pro-labour parties (Cella and Treu 1998).

More generally, Italian industrial relations have been relatively conflictual, politicised and poorly institutionalised (Cella 1989; Regalia and Regini 1998; Pellegrini 1998; Negrelli and Santi 1990; Baglioni 1998). The level of wage bargaining frequently changed during the post-war period, leading from confederal bargaining in the 1950s to greater autonomy of industry unions and the bargaining pluralism of the late 1960s and early 1970s, and finally evolved during the 1980s towards a system where the *scala mobile*[20] (at the confederal level), industry and plant-level bargaining co-existed (Della Rocca 1998). Wage determination thus took place at three levels: at the economy-wide confederal level, bargaining took place between the three main union confederations, the main employer association, *Confindustria*, and other smaller employer organisations; at the national-industry level, industry-unions affiliated with the respective confederations bargained with the

[20] In 1975 the so-called Agnelli-Lama agreement determined the introduction of fixed-amount quarterly increases based on the cost-of-living index (*scale mobile*), uniform for all categories of

sectoral employer organisations; at the company-level where a variety of representational bodies existed, workplace representations and unions bargained with management (Treu 1994: 161-162; Pellegrini 1998). In this pluralistic and multi-level system, there was no explicit wage co-ordination. In short, the presence of a fragmented union movement, the absence of a clear hierarchy between different bargaining levels and between medium-strength unions, made a co-ordinated or centralised voluntary policy of wage moderation difficult - if not impossible.

A final institutional problem in the private sector as far as insufficient inflation convergence is concerned was the existence of the above-mentioned wage indexation system (*scala mobile*) that made disinflation more difficult to achieve in both the private and public sector (*cf.* Section 2.6). In the late 1970s and early 1980s, the *scala mobile* determined up to 80 per cent of annual wage increases (Regalia and Regini 1998). Even though wage indexation was downgraded in the mid-1980s, it still created a drag that prevented rapid disinflation. This not only led to the compression of wage differentials, but it also made it more difficult to achieve rapid disinflation.

As suggested in the previous section, at a minimum all these institutional features of the private sector wage bargaining regime combine to make disinflation and co-ordinated wage restraint difficult to achieve. Evidence for this claim will be provided in Section 2.6 and Chapter 5.

The Public Sector Wage Bargaining Regime[21]

In addition to obstacles regarding wage moderation *and* disinflation in the private sector, it was public sector wage policy that - in addition to fiscal policy – contributed to the relatively high levels of inflation in the 1980s (*cf.* Section 2.6). This again was primarily due to institutional problems. One problem had to do with what has been described as 'pluralism without a market', that is, a system where the absence of market pressures combines with pressure stemming from a pluralistic form of union interest representation (Bordogna 1994). Another institutional problem has been identified as a 'regime of double protection' (Rusciano 1990), that is, a

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workers (*cf.* Flanagan *et al.* 1983: 496-566). The regime was extended to the public service sector in 1977.

regime that combines collective bargaining rights with special public employee status. Finally, a 'weak state' or the absence of a *padrone serio* made it easier for unions to achieve wage increases (Salvati 1989).

First, in the 1980s the public sector experienced increasing fragmentation (pluralism) as a consequence of a rank-and-file revolt against the three main confederations. The centralisation of public sector labour relations (including the *scala mobile*) led, among other things,[22] to a compression of wages and created a problem of 'wage solidarity' (Iversen 1999; Bordogna 1994). White collar and managerial employees as well as other occupational groups did not feel sufficiently represented by the confederations. This resulted in the rise of *cobas* (that is, rank-and-file committees) and *sindacati autonomi* (that is, unions independent from the three confederations CGIL, CSIL and UIL) (Carrieri and Tatarelli 1997).[23] Furthermore, in the absence of market competition, the incentive of public employees to moderate wage demands was low. Thus fragmentation (and competition between groups) as well as their relative invulnerability (due to the absence of market pressure) was responsible for increased wage pressures in the public sector, especially during the 1980s (Micossi and Papi 1996).

Second, in 1983 collective bargaining rights were introduced into public sector labour relations without abolishing the special status of public employees, thus giving rise to a regime of 'double protection'. This not only added to the tendencies of conflict and fragmentation in public sector labour relations but also decreased the costs for small groups of employees with a great deal of disruptive power to strike and thus exert pressure on the government to grant them higher wages. This also contributed to growing representational fragmentation in the public sector.

Third, a weak government also contributed to the wage-push inflation in the public sector. More specifically, there existed a "pro-spending *broad coalition* of

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[21] The Italian public wage bargaining regime underwent several changes during the post-war period. This section will discuss the problems related to the public sector wage bargaining regime in the 1980s (see Bordogna *et al.* 1999).

[22] In addition to wage compression resulting from centralisation, other factors (such as satisfaction with work, union policies, orientation of policies) played a role in bringing about disenchantment with confederal unions among the rank-and-file and hence contributed to increasing fragmentation (Bordogna 1994: chapter 6).

[23] The reason why anti-confederal groups have played a more important role in the public (service) than in the private (manufacturing) sector is that wage differentiation in the private sector was achieved through premia at the company-level (which was not possible in the public sector). Furthermore, the obstructive power of even small occupational groups is much greater in some parts

politicians, bureaucrats, civil service unions, public employees and beneficiaries of spending programs" (Brunetta and Tronti 1995: 157). This kind of rent-seeking coalition exists in most countries where public employment makes up a sizeable share of total employment. In a political system, however, where accountability is dispersed and more importantly where the executive is weak and unable to act in a coherent and goal-directed, long-term manner, the temptation for decision-makers to nurture clientelistic relations and to avoid conflicts with militant public sector employees is much greater. Thus the absence of a *padrone serio* or - in the terminology adopted here - the presence of a weak executive made the control of public sector wages even more difficult to achieve.

Finally, as in the private sector, the wage indexation system was also applied in the public sector from 1977 onwards, thus making disinflation harder to achieve. Wage indexation represented another obstacle in that there existed relatively little (downward) wage flexibility. Although reforms during 1983-85 made the cost-of-living adjustment proportional to earnings, wage flexibility was still low (IMF 1998: 21).

Although it is eminently plausible that these features affect wage moderation, cross-country research does not provide unambiguous results. Recent studies have found no evidence for a negative relationship between centralisation of public wage bargaining (arguably a proxy for executive strength) and public sector wage increases (OECD 1997a; Dell'Aringa and Lanfranchi 1999). In fact, if anything, the studies suggest that centralisation (a complex indicator made up of pay negotiation level, budgetary constraints imposed by the central government, pay bill adjustment at the central level and individual pay determination) is positively correlated with wage growth when controlled for employment variation. But not only are there methodological problems (data quality, comparability, period, sample size, periodisation), but these studies do not properly address the relationship between institutional and policy change, either. They moreover disregard a number of important institutional variables, such as government strength and structure of trade unions representation.

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of the service sector (especially transport) relative to the manufacturing sector, thus decreasing the potential costs of fragmentation for break-away groups.

Notwithstanding these empirical results, it is plausible to assume - and consistent with the historical-institutional approach taken here[24] - that centralisation of and authority over public wage determination provide the executive with greater power over the setting of public wages and should hence *ceteris paribus* have a disciplinary effect on wage increases and economy-wide inflation.[25] If Italy with a rather centralised system experienced above-average public wage increases, then this was due to factors discussed above and which were not captured by cross-national studies, such as low executive strength in political-institutional terms, fragmented and militant public sector unions and so on.

In conclusion, the institutional characteristics of the private and public sector wage bargaining regimes not only indicate the institutional obstacles Italy faced in achieving wage restraint and disinflation in the 1990s, but they also provide a good explanation of Italian wage and inflation performance during the 1970s and 1980s (*cf.* 2.6).

2.5 The Monetary and Exchange Rate Policy Regime

As pointed out in Chapter 1, various studies have shown that the degree of central bank independence has *ceteris paribus* a positive effect on price stability (Grilli *et al.* 1991; Cukierman *et al.* 1994; for survey of literature see Eijffinger and De Haan 1996). Qualitative studies tend to confirm the relationship between central bank independence and monetary stability (Goodman 1992).

Most of the explanations of this phenomenon point to the intuition that - for a variety of reasons - the 'political' interests of elected politicians differ from the 'bureaucratic' interests of central bankers (Woolley 1984: 69-87): the greater central bank independence, the more fully central banker's preferences for price stability can be realised. This can also be rationalised by the need of elected politicians to pursue short-term objectives, while appointed, independent central bankers can adopt a long-term view and pursue – largely shielded from domestic pressure - sustainable policies. In any case, it is uncontroversial to state that "[c]entral banks are more

[24] As one author put it: "Uno spazio, come si è visto, non sempre praticato, ma utilizzato ed utilizzabile nelle situazioni critiche" (Bordogna 1994: 240). ["A room for manoeuvre, as we have seen, that is not always made use of, but has been made use of, and is usable in critical situations."]
[25] This will be illustrated by a comparison with the French case in Chapter 7.

conservative than political authorities in the sense that they attribute relatively more importance to the goal of price stability" (Cukierman 1992: 355).

However, the relevance of central bank independence for price stability is not universally accepted and has been criticised on empirical, conceptual and theoretical grounds. Some authors have pointed out that other factors such as the organisation of trade unions, the interests and influence of the financial community or the nature of industry-finance relations have to be taken into consideration (Hall 1994; Streeck 1994; Goodman 1992). Others have claimed that the relationship between central bank independence and price stability is spurious (Posen 1993, 1998). Still others have pointed out the difficulty involved in conceptualising and operationalising 'central bank independence' and hence doubt the validity of empirical results indicating a positive relationship between independence and price stability (Mangano 1998).

What these critiques underline is the problem involved in determining the degree of central bank independence. Central bank independence, similar to executive strength, has to be regarded as a question of degree (Elgie and Thompson 1998). If independence is a matter of degree rather than of kind, the problem is rather how to 'measure' central bank independence. Conceptualisation and measurement are concerned with how best to measure the underlying theoretical variable. This is not the place to discuss the problem in-depth. Rather it demonstrates the need to supplement any index drawn from surveys of central bank independence with an in-depth, qualitative analysis of the institutional features of this policy area. According to the complex indicators developed in the context of statistical studies the independence of the Italian central bank is rather limited (Table 2-1).

Table 2-1 Indices of Central Bank Independence in Selected Countries

	CUKIERMAN (1992)	PARKIN AND BADE (1982)	GRILLI *ET AL.* (1991)	MEAN
Sweden	0.24	0.2	-	0.22
Austria	0.82	-	0.50	0.66
Germany	0.96	1	1	0.99
France	0.26	0.2	0.25	0.24
Italy	0.32	0.2	0.13	0.21
USA	0.64	0.6	0.88	0.72

Source: Iversen (1999: 56)

A qualitative examination confirms this. As in most countries, monetary and exchange rate policies in Italy are formulated and implemented by the executive. The only aspect of monetary and exchange rate policy which does allow for the discretion of parliament concerns the ratification of international treaties on exchange rate co-operation (Walsh 1995). However, once an international monetary regime is in place, the day-to-day management of monetary and exchange rate policies is controlled by the executive or, rather, by the various bodies and actors within the executive. The crucial relationship here is the one between the Italian government and the central bank.

For the purpose of qualitative analysis, central bank independence can be conceptualised along three dimensions: political independence, economic independence and goals (Eizenga 1993). Political independence can be defined as "the central bank's ability to make policy decisions without the interference from the core executive" (Elgie and Thompson 1998: 24), namely the government's ability to intervene in the internal decision-making process of the central bank. This dimension generally refers to the institutional insulation of the central bank from political influence over policy formation through means such as provisions concerning the nomination and dismissal of the governor and other key members of the central bank decision-making body, and budgetary independence.

As for nomination and dismissal, the Italian central bank enjoyed a relatively high degree of independence.[26] All members of the Bank of Italy's main decision-making body, the Board of Management (comprising the governor, the director-general and two deputy director-generals) were nominated by the Board of Directors (a body comprising the governor and 13 elected directors) but had to be approved by the Council of Ministers and the President of the Republic. The terms of the governor and other members of the Board of Management were open-ended and they could not be dismissed for political reasons. Moreover, the central bank administered its own budget, which did not have to be approved by the government. This precluded the possibility of interference on the part of the government through 'financial' pressure (Eizenga 1993).

Economic independence can be defined as "the central bank's ability to use the full range of monetary policy instruments without restrictions from the core executive" (Elgie and Thompson 1998: 25). More specifically, economic independence concerns the power to control monetary policy or the capacity to implement certain policies (concerning interest rates, exchange rates, market intervention, reserve requirement ratio and so on), and the ability to refuse to lend money to the government.

During the post-1945 period, the Bank of Italy's formal power to control monetary policy was rather limited for both legal and technical reasons (Goodman 1992: 56). Changes in the discount rate were proposed by the governor of the Bank of Italy but had to be approved and enacted by the treasury minister. Moreover, central bank independence was also absent with regard to changes in reserve requirement ratios which had to be approved by the Interministerial Committee for Credit and Savings[27] (Passacantando 1996: 121), while foreign exchange regulations and currency controls required the signature of the minister of foreign trade.

As regards the financing of government deficits, until 1981 the Bank of Italy was under an obligation to finance or monetise part of the deficits through purchases of unpurchased government bills. This was part of an agreement reached in 1975 between the Treasury and the Bank of Italy. The so-called 'divorce' of 1981 liberated the Bank of Italy from the obligation to act as a residual buyer of government bonds (Epstein and Schor 1989). Although this reform increased the Bank of Italy's autonomy, its independence still remained limited in the sense that the Bank of Italy did not control all relevant policy instruments. The Treasury could still borrow foreign currency from the Italian Exchange Office[28]; and it could borrow up to 14 per cent of current government expenditures. Finally, the Bank of Italy was under an obligation to provide extraordinary advances to the Treasury beyond the 14 per cent limit, provided that parliament approved the Treasury's request (Goodman 1992: 56).

The Bank of Italy enjoyed greater autonomy with regard to international monetary policy, except for exchange rate regulations and currency controls. Although the government decided the adherence to an exchange rate regime (in case

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[26] The following description refers to the monetary policy-making regime before the reforms of 1992 and 1993.

[27] The *Comitato Interministeriale per Credito e Risparmio* consisted of the Treasury minister as president, the central bank as technical agent and eight other ministers as members. Legally, the power to set credit policy was vested in this committee (Goodman 1992: 54-55).

[28] The *Ufficio Italiano dei Cambi* "is responsible for the technical side of Italian foreign exchange management. Although legally a separate body from the central bank, the UIC [Italian Exchange Office] is nonetheless directly dependent upon the Banca d'Italia, whose governor serves as its president" (Goodman 1992: 56).

this required the ratification of an international treaty, parliament had to approve participation), the timing and size of the market interventions were at the discretion of the Bank of Italy (Passacantando 1996: 120).

The final dimension of central bank independence concerns the existence of a statutory task (such as price stability, inflation rate targets), or the ability to formulate monetary policy goals independently of the government. The Bank of Italy had no explicit mandate to pursue price stability. Beyond Article 47 of the Constitution, according to which "[t]he Republic shall encourage and protect savings [...]; it shall discipline, coordinate, and control the granting of credit" (quoted in Goodman 1992: 54), there were no provisions that would give the central bank a clearly defined objective. This meant that the goal of price stability was of equal importance to other goals such as economic growth or employment. The Bank had the right to propose monetary policy objectives but the government, through the Interministerial Committee for Economic Planning,[29] set general guidelines of economic policy. The central bank was supposed to follow the underlying scenario laid out by the government. In short, the Bank of Italy did not determine its monetary target independently of the government (Eizenga 1993).

To summarise, until the 1992-93 reforms, the Bank of Italy seemed to be relatively autonomous in terms of outside interference, but it enjoyed only limited autonomy with regard to the definition of monetary policy objectives and control over monetary instruments. This means that despite the 1981 reform (that is, the 'divorce') the independence of the Bank of Italy should not be exaggerated.[30] In strictly legal-institutional terms, the Treasury retained ultimate authority over the use of nearly all monetary policy instruments. Even with regard to the monetisation of government debt, there were still various ways in which the government was able to borrow money from the Bank and which could thus potentially threaten price stability. The abolition of the obligation to act as a residual buyer of government securities seems to have been the only characteristic that granted the Bank a certain

[29] The *Comitato Interministeriale per la Programmazione Economica* was created in the 1960s to set economic policy guidelines. By law, the Interministerial Committee for Credit and Savings must take these guidelines into account when setting credit policy (Goodman 1992: 54).

[30] Addis (1990) has suggested that the rather informal arrangement, whereby the Bank was relatively autonomous with regard to government interference in the context of Italy's ERM membership (*cf.* Section 2.6), was consistent with the preferences of policy-makers as well as their inability to bring about normative change at the legislative level. Given the weakness of the Italian government in the policy-making process, this is in fact a quite plausible hypothesis and is indirectly supported by this study (*cf.* Chapter 6).

degree of autonomy *via-à-vis* the government in as far as the control of instruments was concerned. Hence the Italian central bank enjoyed at best a moderate degree of independence from the government. Case studies of central bank decision-making tend to confirm the Bank of Italy's only limited autonomy (Goodman 1992: chapter 5).

However, some authors have suggested that while legally speaking the Italian central bank was only a technical agent, in practice, it did have much greater influence over monetary policy than a purely legal analysis would suggest. This – it is suggested - was primarily due to its outstanding domestic and international reputation (Posner 1977). However, the fact that studies of Italian monetary policy demonstrated that the Bank of Italy was overruled several times throughout the 1970s and that its preferences were disregarded several times by the Treasury in the early 1980s confirms the ultimate legal (and hence *de facto*) supremacy of the Treasury over the Bank (Goodman 1992: chapter 5).

It is true that adherence to the ERM gave the Bank of Italy an informal mandate to pursue price stability. But this was always subject to the government's willingness to accept the external constraint and the *de facto* degree of central bank independence. In fact, as I will argue in more detail in Section 2.6, the fact that Italian inflation throughout the 1980s was higher than in other European countries indicates that the Bank of Italy was not independent *enough* to be able to squeeze out entirely inflation, and that hence the only limited degree of central bank independence was at least one important explanatory factor with regard to Italy's inflation performance in the 1980s.

Nonetheless, it also clear that, despite the low level of central bank independence, the Italian monetary policy-making machinery was more insulated from societal pressures than the fiscal policy-making regime. As a result, the executive enjoyed a greater degree of autonomy and strength. This is for several reasons. The Italian parliament had no direct power with regard to monetary and exchange rate policy, except for the ratification of treaties relating to international monetary regimes. It had no competence regarding the day-to-day management of monetary policy. In this respect monetary policy-making was more autonomous than, for example, fiscal or pension policy-making and hence less subject to parliamentary and societal pressures. The monetary policy process tended to be more insulated and hence executive strength tended to be greater, even though this was not entirely due to institutional factors. As Gowa (1988) pointed out, three factors potentially matter in this respect. The existence of international regimes (such as the EMS); information problems as regards the unclear and probably less visible consequences of monetary policy (at least compared to the distributional consequences of budgetary or pension policy); and the absence of influential interest groups that are solely concerned with the consequences of monetary and exchange rate policy (as opposed to, for example, groups defending interests related to public expenditure) also enhanced executive autonomy and by extension central bank autonomy.

This brief discussion strongly suggests that monetary policy and hence the Bank of Italy possessed a limited degree of autonomy, at least as long as the executive resisted from interfering with monetary policy-making. In the final analysis, however, the limited institutional independence from the executive made the Italian central bank much more vulnerable to domestic pressure than would have been the case if it had been independent.

2.6 Italian Macroeconomic Policy: A Preliminary Test of the Institutionalist Argument

The preceding analysis of the institutional characteristics of the policy-making regimes demonstrates that the Italian government enjoyed a low degree of executive strength. However, the importance of executive strength varied across areas. While executive autonomy and strength was arguably lowest in the fiscal and pension policy area, it was greater with regard to monetary policy (similar Tullio and Ronci 1997). Generally, however, the institutionalist analysis suggests the importance of executive weakness. If the institutionalist approach is of any value, it should explain past Italian macroeconomic policy performance on the basis of institutional weaknesses in these four areas.[31]

During the 1950s and 1960s, Italy like most other Western European economies experienced a long phase of economic expansion. In addition to favourable socio-economic conditions, domestic factors also contributed to rapid economic growth, price stability and good budgetary performance. The political hegemony of the industry-friendly DCI that pursued a policy of labour exclusion

[31] For a similar account with a greater emphasis on partisan politics and ideological fragmentation see Salvati (2000).

(Lange *et al.* 1982) as well as a divided labour movement (in combination with high unemployment) prevented labour from demanding 'irresponsible' wage increases or an 'irresponsible' expansion of social welfare programmes (Salvati 1985). As a matter of fact, during this period Italian monetary performance was so impressive that the *Financial Times* awarded the 'monetary Oscar' to the lira as the most stable currency in January 1960 (Ginsborg 1990: 265).

The weakness of the Italian economic policy-making regime was only fully exposed in the wake of the first oil shock in the early 1970s. A government unable to implement fiscal restraint and control the explosion in welfare spending, an at best moderately independent central bank and an industrial relations system not at all conducive to wage restraint meant that Italy fared worse in terms of monetary and fiscal performance than many other industrialised countries throughout the 1970s and never quite caught up in terms of fiscal consolidation and price stability with the best-performing countries in the 1980s (Table 2-2 and 2-3).

Table 2-2 Net Borrowing of Government, 1960-1990

(period average annual change; as a share of GDP)

	1960-67	**1968-1973**	**1974-79**	**1980-90**
Italy	1.8	4.8	9.2	10.9
Major Seven*	0.3	0.5	2.6	3.2

Source: OECD *Historical Statistics* 1992 * G-7 countries

Table 2-3 Consumer Price Inflation, 1960-1990

(period average annual change in per cent)

	1960-68	**1969-73**	**1973-79**	**1979-90**
Italy	4.0	5.8	16.1	10.6
Major Seven	2.9	5.6	9.7	5.5

Source: OECD *Historical Statistics* 1992

The inclusion of centre-left parties, such as the Italian Socialist Party (PSI) into the government coalition in the 1960s made the government more sympathetic towards demands from trade unions. Falling unemployment contributed to the increasing labour militancy that exploded during the so-called 'Hot Autumn' of 1969 and subsequently led to economic turmoil in the face of external economic shocks (Ginsborg 1990: 309-337). Part of the reason for the subsequent wage explosion had to do with the inability of the leadership of the confederal unions to control the rank-and-file and industry unions. This was primarily an institutional problem, namely, the inability of the confederal leaderships to gain control over rank-and-file and industry unions resulted in demands for higher wages (Table 2-4). The government's unwillingness and inability to counteract higher wages through appropriate monetary or fiscal policy measures led to higher inflation.

Table 2-4 Hourly Earnings in Manufacturing, 1960-1990

(period average annual change in per cent)

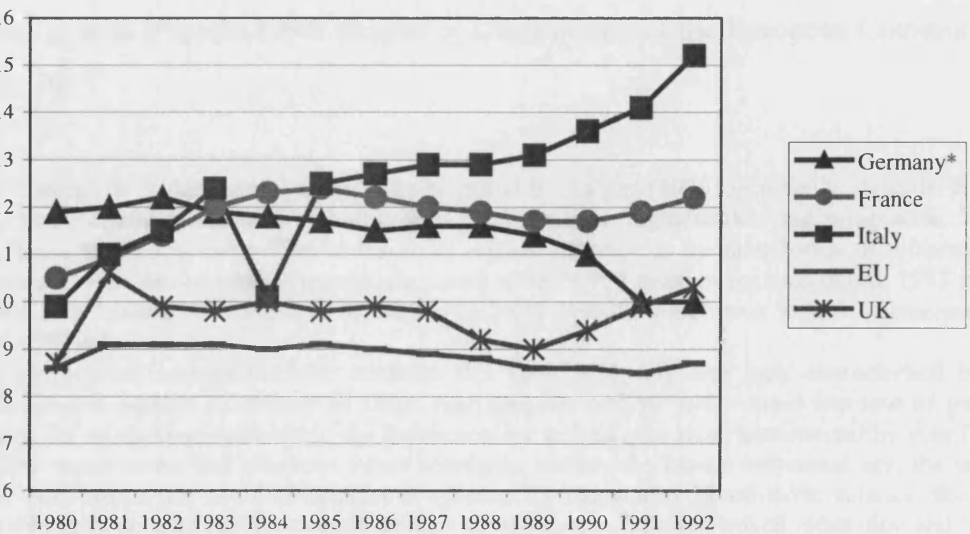
	1960-68	1968-73	1973-79	1979-90
Italy	8.0	15.3	22.1	11.4
Major Seven	n/a	10.3	10.5	5.4

Source: OECD *Historical Statistics* 1992

The combination of a weak government and strong unions also led to an expansion of social welfare and pension programmes which would put strain on fiscal policy for decades to come. While the weakness of the Italian pension policy-making system contributed to the rapid expansion of welfare and pension spending in the 1970s, it was also responsible for the failure to achieve welfare pension spending reform in the 1980s (Morcaldo 1993: Franco 1993; Ferrera and Gualmini 1999: chapter 1; Figure 2-1).

Figure 2-1 Old-Age and Survivors' Pension Spending, 1980-1992

(as a share of GDP)



Source: Eurostat 1996b * West Germany

Certainly, economic, demographic and labour market changes also mattered. Nonetheless, in a comparative perspective 'political' rather than socio-economic factors explain the disproportionate expansion of pension spending after 1975 (Franco 1993). It is certainly true that the continuous expansion of pension expenditure was "congruent with the competitive mechanics of the Italian system of polarised pluralism"[32] (Ferrera and Gualmini 1999: 33; Ferrera 1984: chapter 6). From an institutional perspective, however, expansion and retrenchment failure can be understood as the result of the fragmentation and low degree of executive autonomy *vis-à-vis* parliament and the presence of relatively influential societal groups. Moreover, the (institutional) lock-in effect discussed above made retrenchment difficult to achieve.

The 1980s provide further evidence. There were various retrenchment attempts (let alone proposals) but most of the measures were watered down by parliament. The fact that the government sought to push through these measures with the help of decree laws, which were subsequently substantially modified by parliament and sometimes not even converted at all, makes this evident. The combination of a weak executive and particularistic-clientelistic interests that were hostile to reform prevented coherent reform, regardless of the political will of the executive. There were at least three pension reform proposals between 1984 and 1992 but they all foundered because of the inability of the executive to prevail over parliamentary and societal opposition. If there was retrenchment, it was minor in terms of savings, and the savings more often than not were neutralised by expansion in other parts of the pension system (Ferrera 1984: chapter 5; Commission of the European Communities 1996a: 76).[33]

[32] The concept of 'polarised pluralism' was proposed by Sartori (1976) in order to describe a party system that is characterised by a high degree of party-political fragmentation and antagonism. To the extent that a highly fragmented social insurance regime allowed for the distribution of differentiated entitlements to a selected party clientele, the social security and pension regimes before 1992 can be regarded as a 'natural' complement to the Italian party system, which was indeed fragmented and highly polarised.

[33] An international comparison also confirms this view. Not only was Italy characterised by the highest pension outlays as a share of GDP, high pension deficits and a rapid increase of pension spending. By international standards, the Italian pension regime was also characterised by very liberal eligibility requirements and generous award standards, namely the lowest retirement age, the highest accrual rate, one of the most advantageous systems for calculating pensionable salaries, the most favourable rules on seniority pensions, earnings- as opposed to inflation-linked indexation and liberal rules concerning the cumulability of benefits (Franco and Frasca 1992: 78).

The weaknesses of the fiscal and monetary regimes also contributed to Italy's comparatively poor performance in these areas during the 1970s. Deficit-financed fiscal expansion, which reflected executive weakness, was a way to soften the negative consequences of the oil crisis during the first half of the 1970s. Thus even in the face of adverse international economic conditions, "[s]trong unions continued to demand growth, and weak governments were only too willing to accommodate" (Goodman 1992: 146). The lack of central bank independence and in particular the obligation of the latter to finance public deficits resulted in comparatively high inflation rates during the 1970s (Table 2-3). Moreover, the breakdown of the Bretton Woods system and the failure of the 'snake' deprived the Italian government of an immediate external constraint to restrain domestic demands for macroeconomic expansion. This led to two balance-of-payment and financial crises during the 1970s (Goodman 1992: chapter 5).

In addition, the above-discussed weaknesses of the private sector wage determination system contributed to a high level of labour militancy in that the confederal unions were either unwilling or unable to control rank-and-file demands. In fact, the unions achieved 100 per cent protection of real wages against inflation through the 1975 agreement on the *scala mobile* (Salvati 1985: 444-5). By contrast, countries like Germany or Austria responded very differently by pursuing restrictive fiscal and monetary policies as well as relatively greater wage restraint. Different sets of labour, monetary and budgetary policy-making institutions enabled them to avoid balance of payments crises (Scharpf 1991). By contrast, institutional weaknesses in the monetary, fiscal and wage policy areas meant that Italian macroeconomic policy "remained hostage to political demands for growth" (Goodman 1992: 158) which resulted in poor fiscal and monetary performance.

However, the Italian experience of the 1970s also suggests that economic stabilisation policies (that is, policies aimed at re-gaining the confidence of international capital and foreign exchange markets through a reduction of fiscal deficits and inflation) were possible - under certain conditions. After the parliamentary elections of June 1976 and in the face of economic difficulties, the Christian-Democrat-led government under Prime Minister Andreotti formed a government of 'national unity' that depended on the support of the Italian Communist Party (PCI) in parliament. When in September 1976 the lira came under attack once more and another crisis loomed, the PCI supported the government and its restrictive economic measures in order to avoid a major economic crisis.[34] The co-operation of the PCI helped to bring the trade unions into an agreement with the International Monetary Fund (IMF) in April 1977 that subsequently resulted in the successful stabilisation of 1977-78, partly as a result of an agreed policy wage restraint.

Successful confederal (and quasi-centralised) bargaining and wage moderation was short-lived. Union confederations (and employer associations) and the government set non-enforceable targets for plant-level bargaining. However, increasing rank-and-file pressure and divisions among the main union confederations, as well as a government unable to live up to its commitments led to the rapid breakdown of co-ordinated wage moderation in 1978. In addition to conflicts at the political level between the PCI and the DCI, the breakdown of a concerted policy of wage moderation was the consequence of the absence of the features associated with successful incomes policy and 'political exchange', namely a weak government and divided, medium-strength confederal unions unable to control their constituent units and rank-and-file (Regini 1982; Golden 1988). This again suggests the importance of institutional factors.

It has been argued that the government of national solidarity and the consensus between the DCI, PSI and PCI (and their affiliated union confederations) acted as 'functional equivalents' to the institutional characteristics associated with policies of wage moderation and that it was a weak government and an obstructive bureaucracy that did not keep their promises rather than the inability of the unions to implement wage moderation that was responsible for the failure of centralised or co-ordinated wage moderation (Regini 1984). While government weakness played an important role in the breakdown of centrally negotiated wage moderation, it cannot be denied that there were also substantial rank-and-file pressures that thwarted wage moderation. In short, wage moderation was made impossible as a result of the conflicting interests of the main union confederations as well as by their lack of authority over the rank-and-file (Golden 1988). Thus growing trade union dissent, which once more reflected the inability of the confederal leadership to control its members, and increasing friction between the PCI and the DCI, mainly due to the

[34] The willingness of the PCI to support the government was of course also motivated by wider political concerns, such as the threat posed to the Italian Republic by terrorism and political

continued costs of austerity, provoked a government crisis in January 1979 and led to parliamentary elections in June 1979.

Continued attempts during the early 1980s to achieve some sort of wage bargaining co-ordination and wage moderation broke down entirely with the conflict over the downgrading of wage indexation in 1984 and the resulting referendum of 1985. This conflict pitted the PCI and the CGIL against the moderate union confederations and the Socialist-led government, which - after attempts to arrive at a negotiated solution had failed - issued a decree that downgraded wage indexation (Frieden 1994a).

The period of 'consensual stabilisation' was followed by a period of 'semi-conflictual stabilisation' between 1980 and 1992 (Salvati 2000: 48-54, chapter 5), with the return of the PCI to the opposition and increasing resistance among unions, especially within the communist confederal union CGIL, to wage restraint.

From an institutional point of view, this 'semi-conflictual stabilisation' can at least partly be understood as the result of institutional change that took place in the late 1970s and early 1980s and which subsequently affected policy outcomes. If until the late 1970s there existed an "endogeneity of monetary policy with respect to fiscal policy" (Fratianni and Spinelli 1997: 263), this changed as a result of the transformation of the institutional framework within which Italian monetary policy was conducted. In terms of international institutions, Italian membership in the fixed (but adjustable) exchange rate regime of the EMS had an important impact on Italian monetary policy. In terms of domestic institutions, the 1980s differed from the 1970s primarily in terms of greater central bank independence, which was the result of the so-called 'divorce' (*cf.* Section 2.5). Moreover, domestic institutional reform in the form of the downgrading of the wage indexation mechanism in the mid-1980s also helped to reduce inflation (Frieden 1994a).

Monetary policy change in the 1980s was a response to a changing international economic environment. In 1979 international conditions, which had been relatively favourable, changed again dramatically. The double impact of the second oil shock and the high-interest policy in the USA led the Bank of Italy to tighten monetary policy to defend the lira and avoid a depreciation-inflation cycle that would ultimately have led to yet another balance of payments crisis. The

instability. It also reflected a re-orientation of the PCI's wider political strategy in terms of achieving response differed this time compared to the mid-1970s when a combination of monetary expansion and depreciation was seen as the solution. According to Goodman (1992: 164-165), increasing capital mobility, the potential negative effects of wage indexation on devaluation and the absence of immediate elections after June 1979 made the government sympathetic to the views of the central bank and hence accepted the Bank of Italy's preferred policy option of non-devaluation and increasing interest rates.

In this situation, characterised by high inflation, deteriorating competitiveness and high interest rates, which aimed at defending the ERM peg, *Confindustria* called for a devaluation of the lira and wage restraint. However, the government and the central bank resisted devaluation despite societal pressure. By resisting devaluation, the government forced the (exposed) manufacturing sector to resist union demands for higher wages and thus indirectly imposed monetary discipline on the most important part of the Italian economy. This contributed to the strikes of September 1980 and the subsequent defeat of the unions through the 'March of the Forty Thousand', which are commonly regarded a symbolic turning point in Italian labour relations and macroeconomic policy.[35]

Hence (semi-conflictual) stabilisation, partial wage moderation, and lower inflation were achieved during the 1980s in spite of - rather than thanks to – domestic wage bargaining institutions. The degree of wage moderation that was achieved was mainly the result of the 'implicit' incomes policy imposed by the exchange rate constraint and the dominant position of the (internationally exposed) metalworker sector in private sector wage determination. Nonetheless, the institutional features of the wage bargaining system prevented rapid disinflation (due to the drag created by automatic wage adjustment) and made a policy of voluntary wage moderation difficult to implement (as a result of medium-strength unions, fragmentation and the lack of confederal control over lower level bargaining).

During the 1980s, the Italian executive was able to resist expansionary monetary policy by adhering to the ERM and a relatively hard currency policy. It was nonetheless only a *relatively* hard currency policy because Italy never fully

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reform through co-operation (Ginsborg 1990: 378-401).

[35] The strikes pitted *Fiat* middle-level managers and white-collar workers against the unions. In the end, the unions had to concede defeat. These events have traditionally been interpreted as the end of the political-social wave of trade union mobilisation and contestation that had started in the late 1960s.

converged on German inflation levels. Despite several devaluations between 1979 and 1987, when the ERM turned into a quasi-fixed system, an anti-inflationary policy was still being pursued - as the size of the devaluation never fully compensated for the loss of competitiveness incurred through the previous real appreciation of the lira (Farina 1992: 11). But this was an indirect, gradual and ultimately insufficient way to resist societal demands and impose costs on powerful societal groups such as exporters and unions. Ultimately, this gradual strategy reflected external constraints and domestic opposition, as well as the presence of a weak executive.

This is broadly consistent with the political-institutional argument. As indicated above, executive strength in the monetary policy area increased in the late 1970s and early 1980s. This was mainly due to ERM membership and the increased independence of the Bank of Italy, which had been liberated from the obligation to act as residual buyer of government bonds. In fact, monetary policy did indeed become more restrictive. In other words the executive became 'stronger' by using the external constraint. At the same time, domestic institutional reform, that is, the greater independence of the central bank, had a positive effect on monetary performance. But this change also affected macroeconomic performance in another way. Fiscal policy started to spin out of control because fiscal deficits translated into higher public debt as a result of the central bank's ability to refuse to monetise government debt as well as a result of high interest rates stemming from the hard currency policy.

The political-institutional approach also explains why the government – although interested in fighting inflation and using the external constraint to achieve this goal - did not achieve convergence with German inflation rates. It is certainly plausible that persistent expansionary fiscal policies had an inflationary effect.

> On the whole it seems reasonably sound to say that monetary policy has been aimed mainly at stabilising the exchange rate, with periodic concern not to allow it to appreciate too much, while on the other hand budget policy has been directed towards an extremely gradual reduction of the PSBR [public sector borrowing requirement]. This reduction becomes more substantial if we consider the primary PSBR, but the speed of improvement has been so slow that it has not been able to prevent further deterioration of public debt [...]. Italy, not having completed the real adjustment, did not succeed in the nominal one. She paid very low immediate costs, but managed to keep inflation under control, relying on the reputation of the Bank of Italy, and turned

> the inconsistency between monetary, fiscal and wage policies into an increase in the public debt (Onofri and Tomasini 1992: 81-82).

As far as fighting inflation is concerned, the Italian government was interested in reducing inflation but was searching for a very gradual way that would spread the costs over a longer period of time. Moreover the government's inability and weakness in the budgetary realm, which prevented it from imposing the costs of fiscal restriction necessary to achieve inflation convergence, explains the 'extremely gradual reduction of the PSBR'. However, in the absence of the ability to control fiscal policy, reducing inflation to European levels proved impossible. This also reflected the Italian government's greater weakness with respect to budgetary policy relative to monetary policy.

Hence the view, according to which "[t]he government itself misperceived the systemic constraints when it allowed wages in the public sector to behave in a manner incompatible with the disinflationary target pursued by the monetary authorities through the fully stable exchange rate" (Onofri and Tomasini 1992: 90), is mistaken in that, rather than a misperception, it was both the government's unwillingness and inability to overcome domestic opposition to a programme of fiscal austerity that made disinflation difficult, if not impossible, to achieve politically. The contrast with France's successful convergence after Mitterrand's U-turn that was accompanied by an extremely restrictive fiscal policy is illuminating (*cf.* Muet and Fonteneau 1990).

Another, complementary, interpretation focuses more on the monetary side. Because the Bank of Italy was not independent enough from government discretion, it was not able to pursue a monetary policy restrictive enough to neutralise the inflationary consequences of an expansionary fiscal policy. Throughout the 1980s high public deficits and increasing debt (which was partly a consequence of the inability to monetise deficits) had inflationary consequences. Moreover, due to high (and positive) interest rates, the stock of public debt as a share of GDP increased very quickly. Although inflation fell from 11 per cent in 1982 to 7 per cent in 1985, the Bank of Italy was not able to eliminate the inflation differential with the best-performing ERM members. Due to its limited independence, the only way the Bank of Italy could hope to win support for low-inflation policies was by adhering to the

ERM and to a relatively strong-lira policy. In this way it could achieve a reasonable degree of inflation without antagonising domestic groups too much.

Clearly, the Bank of Italy faced a difficult task. The existence of high public deficits led to considerable capital inflows that pushed the lira to the upper limit of the ERM band during the late 1980s. This problem was made worse by the liberalisation of capital controls in 1988 as well as by favourable market expectations concerning Italian EMU membership in the early 1990s. The problem with regard to Italian inflation performance was the following:

> Italy's higher inflation rate necessitated higher interest rates, eventually attracting large-scale inflows of short-term capital investment [...]. This meant an accumulation of foreign exchange reserves [and] at times a downward pressure on interest rates that was not consistent with the fight against inflation. Given the exchange rate constraint, therefore, the monetary policy stance could not be tightened further to squeeze out inflation without at least temporarily aggravating the capital inflow (Sarcinelli 1995: 400).

During this period the Bank of Italy was trying to stabilise the exchange rate by intervening in the foreign exchange market while sterilising these interventions to keep inflation from rising. The dilemma hence was that the Bank of Italy could not raise the discount rate to dampen domestic inflation because it would have pushed the lira above the upper limit of its fluctuation band. As Italian competitiveness had already declined due to the persistent inflation differential, this was certainly not the preferred solution from the government's point of view. On the one hand, devaluation would have been necessary to restore competitiveness. On the other hand, increasing interest rates to dampen inflation would have pushed the lira above the upper limit of band, increased the debt burden, and would have required a revaluation of the lira that would certainly have been bitterly opposed by domestic exporters (Walsh 1996: 286-88).

Despite the problem represented by this economic dilemma, the institutionalist argument is still valid. A truly independent central bank keen to reduce inflation could have pushed the government to revalue the currency or have raised interest rates to dampen domestic inflation and thus force the government to pursue more restrictive fiscal policies. Admittedly, this would have been a difficult thing to do for any central bank. But there are examples such as that of the Federal Reserve policy of the late 1970s and early 1980s when the U.S. central bank pursued a high-interest rate policy despite the worst post-war recession and despite declining U.S. competitiveness which resulted from the appreciation of the dollar and massive capital inflows. Sarcinelli (1995) shares this view:

> [T]o be effective against chronic high inflation, monetary policy must impose very high social costs, which are hard to make people bear, especially when the mandate to ensure monetary stability is lacking or uncertain. Otherwise, monetary policy must be flanked by consistent fiscal policy and incomes policy (p. 400).

The limited independence of the Bank of Italy is not only indicated by the institutional weaknesses - but also in actual policy experiences. With respect to the 1970s, the central bank did not think that it had the mandate *not* to accommodate the government's indications for a relaxation of monetary policy (see Salvati 2000: 38, 66; Goodman 1992: chapter 5). Clearly, the changes of the late 1970s and 1980s increased the independence of the Bank of Italy, but it had neither a mandate nor unlimited control over monetary instruments. Throughout the 1980s, the Bank was not independent enough to pursue a tough anti-inflation policy that might have allowed Italy to achieve monetary convergence (Bruni and Monti 1992: 48-49, 56).

This is not the place to discuss whether a totally independent Bank of Italy would have pursued this policy. Rather it serves to demonstrate that in the absence of an independent central bank, monetary convergence was *impossible*. This demonstrates the relevance of the institutionalist approach. The government was too weak to implement fiscal adjustment and the Italian central bank was not strong enough to impose the costs necessary to achieve full inflation convergence.

As already suggested, the relative weakness of the Bank of Italy was also reflected in its gradual approach to fighting inflation. The recourse to periodic devaluations that never fully compensated exporters for the accumulated loss of competitiveness can be regarded as evidence in that it shows the gradual and indirect way in which the Bank of Italy was constrained to impose monetary discipline. Between 1970 and 1987, Italy devalued no less than eight times in slightly more than eight years (Table 2-5).

Table 2-5 Devaluations against the German Mark, 1979-90

(*vis-à-vis* German mark, in per cent)

	SEPT. 1979	MAR. 1981	OCT. 1981	JUNE 1982	MAR. 1983	JULY 1985	APRIL 1986	JAN. 1987	JAN. 1990	CUMULATIVE
Italian lira	2.0	6.4	8.8	7.2	8.2	8.5	3.0	3.0	3.7	63.5

Dutch guilder	2.0	--	--	--	1.9	--	--	--	--	4.0
French franc	2.0	--	8.8	10.6	8.2	--	6.2	3.0	--	45.2

Source: Gros and Thygesen (1998: 69)

This changed after 1987 when the ERM turned into a quasi-fixed exchange rate system. However, during this period the inflation differential with the other European countries started to widen, mainly as a result of inflationary public sector wage settlements. While the exposed manufacturing sectors showed relative wage moderation during the 1980s as a result of the switch to a hard currency policy, domestic inflation was driven by inflationary wage settlements in the public sector, not least through its expansionary effect on fiscal policy deficits (Micossi and Papi 1996).

Comparative data on public service and private manufacturing sector strikes as well as wage increases confirm this view. Wages in the public sector increased more rapidly than in the manufacturing sector during the 1980s, and strike activity was more intense in the public sector, indicating greater wage pressures (Cesos [various years]; OECD *Economic Surveys Italy* 1997: 97, part III). Despite various attempts to control public wages, successive Italian governments were unable to enforce public wage restraint for long, which eventually resulted in major wage increases. The proclaimed goal of government to rein in public wage increases was often ignored. Ministerial delegations would negotiate with their respective bureaucracies and would not infrequently disrespect ceilings on wage growth set by the government. Furthermore, ceilings would be circumvented by legislative action granting indemnities and premia to certain groups of public employees (Ferner and Hyman 1992: 571). Parliament (invoking the principle of *par condicio*) would extend above-limit wage settlements negotiated by individual ministers to the public sector as a whole. Overall:

> In contrast to other countries, the expansion in the government wage bill continued in the 1980s, compromising efforts of fiscal consolidation. Recurrent hiring freezes introduced since 1983 had only a limited impact, due to the exemptions granted to individual administrations and lack of enforcement. Wage demands from militant unions met weak resistance from the government more interested in minimising

> conflicts than in avoiding distortions in wage differentials, budgetary overruns and risks of wage spirals (OECD *Economic Surveys Italy* 1997: 96).

As suggested in Section 2.4, this has to be seen in the context of a weak executive and the institutional obstacles that characterised the public sector wage bargaining regime, such as increasing fragmentation and the loss of control over wage bargaining in the public sector by the confederal unions.

As a result of re-kindling inflation, the Italian current account balance that had been close to zero in 1987 moved into deficit due to the deterioration of the real exchange rate. This led to increasing criticism from exporters and import-competing sectors (Walsh 1996: 286-87). Nevertheless, the government refused to devalue. Whether it would have been willing and able to resist calls for devaluation under the increasingly difficult economic conditions of the early 1990s is impossible to say since attacks on the lira after the Danish referendum in June 1992 quickly forced Italy to renegotiate its exchange rate within the ERM and finally to float the lira in September 1992 (*cf.* Chapter 6). Ultimately, the 1992 devaluation has to be seen as resulting from the unsustainable character of Italian macroeconomic policy as reflected in the continued rise in public debt, high public deficits and persistently high inflation.

In short, an institutionalist approach - with a special emphasis on executive strength and variation of strength across policy areas – explains post-war Italian macroeconomic policy well. The bias towards short-termism and incoherence in Italian macroeconomic policy-making was primarily the result of the need of governments to accommodate the interests of a variety of political and societal actors. This was the consequence of the government's unwillingness or inability to impose the higher immediate, short-term costs required to successfully pursue long-term objectives such as sustainability. This reflected the institutional deficiencies of the Italian macroeconomic policy-making regime. Hence this confirms the view according to which the domestic-institutional structure of the political system – and especially the executive weakness - is a critical intervening variable without which the interrelationship between international economic pressures and domestic political strategies cannot be understood (Katzenstein 1976, 1977a, 1977b).

Not only does the institutionalist approach explain past macroeconomic policy well, but it also suggests that the pursuit of sustainable medium-term macroeconomic

3 BUDGETARY POLICY AND THE POLITICS OF FISCAL ADJUSTMENT

Public policymaking in action is epitomized through the budget (Wildavsky 1986 [1975]: 2)

The fiscal situation in Italy in the early 1990s was dramatic. Net borrowing was at 11.1 per cent of GDP in 1990 and 10.1 in 1991 compared with an average of 1.8 and 2.7 per cent in the other three major EU countries (France, Germany, UK).[1] Gross public debt stood at 101.5 per cent and 108.7 per cent in 1991 and 1992 respectively (Table 3-1). The only good news was that the primary deficit (that is deficit net of interest payments) was close to zero in 1991. By then the high debt burden had become the major problem and accounted for the quasi-totality of public borrowing. Despite these unfavourable circumstances and the existing 'fiscal deficit bias' of political and budgetary institutions, Italy managed to reduce its net annual deficit from 9.6 to 2.7 per cent as a share of GDP between 1992 and 1997 and thus met the Maastricht deficit criteria. New borrowing was reduced by more than 6 points over the same period.

Table 3-1 General Government Net and Primary Borrowing and Debt, 1991-1998

(as a share of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998
Net Borrowing	10.1	9.6	9.5	9.2	7.7	6.6	2.7	2.7
Primary Borrowing	-0.1	-1.9	-2.6	-1.8	-3.5	-4.0	-6.6	-4.9
Debt	101.5	108.7	119.1	124.9	125.3	124.6	122.4	118.7

Source: Bank of Italy, *Abridged Report*, 1999

The fact that growth averaged only about 1.2 per cent per annum and unemployment was standing at an all-time high of around 12 per cent during this period made the fiscal adjustment all the more remarkable from an economic and political point of view (Table 3-2).

Table 3-2 Real GDP Growth, 1992-1998

(annual change in per cent)

1992	1993	1994	1995	1996	1997	1998
0.8	-0.9	2.2	2.9	1.1	1.8	1.5

Source: OECD *Statistical Compendium - Historical Statistics* 1999

[1] Unless indicated otherwise, the economic data refer to OECD *Statistical Compendium* 1999.

As argued in Chapter 2, the history of Italian fiscal policy suggests that Italy's dramatic financial position in the early 1990s has to be understood as the result of both 'weak' political-institutional and - to a lesser extent - budgetary-procedural characteristics of the fiscal policy-making regime. In Italy high public debt was primarily the result of the first oil shock in whose aftermath decision-makers were unwilling or at least unable to pursue adequate adjustment policies (Giavazzi and Spaventa 1989). Even though public debt remained at moderate levels in terms of the debt-GDP ratio until the late 1970s, it exploded afterwards as a result of the switch to a hard-currency policy in 1979-81 (ERM membership and 'divorce') and the resulting high (positive) interest rates. This led to the dramatic financial situation of the early 1990s (OECD *Economic Surveys Italy* 1997: part III; Table 3-3).

Table 3-3 Net Borrowing, Primary Borrowing and Public Debt, 1985-1991

(as a share of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Net Borrowing	8.3	11.4	11.2	10.5	11.5	12.3	11.4	11	10.7	9.8	11.1	10.1
Primary Borrowing	3.2	5.3	4.2	3.1	3.5	4.5	3.1	3.2	2.8	1	1.6	- 0.1
Public Debt	57.7	59.9	64.7	70.8	76.3	82.7	86.5	90.6	92.8	95.8	98	101.5

Source: OECD *Statistical Compendium - Historical Statistics* 1999

As will be shown in more detail in Chapter 4, although Italian public expenditure was low relative to the EU average, the increase in public outlays for social and public services was a major factor in preventing the government from exercising expenditure restraint. As a result, the (albeit unsuccessful) fiscal consolidation in the 1980s was primarily revenue-based, that is it relied above all on revenue increases (Franco 1993; De Ioanna 1993; Morcaldo 1993; Chiorazzo *et al.* 1994).[2] However, by the early 1990s, the Italian government's revenues as a share of GDP were almost identical with the EU average (Table 3-4).

[2] Alesina and Marè (1996) have calculated the 'full compliance deficit' and have estimated that if tax evasion in Italy had been at comparable levels as, for example, in the UK, Italian public debt in the mid-1990s would have stood at about 60 per cent of GDP instead of 120 per cent. Political-institutionally speaking, the problems regarding the low efficiency of the tax administration, administrative weakness, the unusual complexity of the tax system, and the fragmentation of the production structure (that is, a large number of self-employed individuals and a high number of unlisted companies) were conducive to large-scale tax evasion (for a critical discussion of the Italian tax system see OECD *Economic Surveys Italy* 1996; part IV; for most recent reforms see OECD *Economic Surveys Italy* 1999: 66-71; for problems involved in the administrative control of public spending as well as comparative evolution of revenue and expenditure see OECD *Economic Surveys*

Table 3-4 Government Revenue by Category, 1990

(share of GDP)

	Italy	EU
Personal income tax	10.3	10.5
Corporate income tax	3.9	3.0
Employers' social security contributions	9.2	6.2
Employees' social security contributions	2.5	4.1
Property taxes	0.9	1.8
Taxes on goods and services	11.0	12.5
Other	1.3	1.5
Total Revenue	39.1	39.6

Source: OECD *Economic Surveys Italy* 1996: 91

Both the long-term development of public finances and anecdotal evidence tends to confirm the view that the government was not able to adjust fiscal policy quickly enough. This is consistent with an institutionalist interpretation of Italian debt. During the 1980s interest group pressure on weak, multi-party governments not only prevented successful fiscal reform, it actually led to an overall expansion of, for example, welfare spending, as a result of both discretionary action as well as 'non-decisions'. This was also a reflection of executive weakness in other policy areas.[3]

> Where non-decisions prevail strongly and are considered part of a country's culture of government, the government budget becomes heavily dependent on institutions in the public sector, the social security system, the welfare system and labour market regulations. Non-sustainability of public finances may then be caused by weaknesses in these areas (Perotti *et al.* 1998: 45).

In short, a weak executive was neither able to control spending on, for example, social welfare, nor was it able to bring about adequate fiscal adjustment (Carfora and Cappellacci 1993: 211).

The period immediately preceding the phase of fiscal consolidation illustrates this well. In September 1991, the Andreotti VII government (April 1991 - April 1992) consisting of the traditional government coalition introduced a new package of

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Italy 1997: part III; also Tanzi 1996). However, even if these problems played a role in bringing about high deficits, this does not undermine the institutionalist interpretation defended here. Similar to socio-economic conditions (*cf.* Section 1.5), tax evasion (and related tax-collection-related problems) can be regarded as exogenous relative to which a government has to adjust budgetary policy.

[3] This is another reason why pension as well as (public and private) wage and monetary policy are analysed separately.

fiscal restraint for 1991. Revealingly,[4] it was almost entirely based upon revenue gains as well as one-off measures (such as advanced payments on imputed capital gains and tax amnesty). By the time the new three-year 1992-94 budget plan, which aimed to achieve a falling public debt-GDP ratio by 1994, was announced in May 1991, it was clear that it would not meet its targets, as it relied on over-optimistic forecasts concerning interest rates and growth (*The Economist*, 5 October 1991; OECD *Economic Surveys Italy* 1992: 36-49). A detailed analysis of 1992 budgetary policy-making shows all those elements that have traditionally characterised Italian budgetary policy-making: intra-coalitional disputes, parliamentary amendments, weak government proposals, wrong estimates and forecasts, a weak executive and a weak prime minister (Verzichelli 1999b: 185-190).

As successful fiscal consolidation did take place in the 1990s, the question is how institutional obstacles - and particularly executive weakness as discussed in Chapter 2 - were overcome. I first analyse reforms of the early 1990s concerning political institutions as well as budgetary procedures. Sections 3.2 to 3.4 discuss budgetary policy during the three different legislative periods. Finally, the questions of how institutional reform affected policy outcomes and how policy reform came about in the absence of substantial institutional reform are addressed.

3.1 Political-Institutional and Budgetary-Procedural Reform in the 1990s

Both political-institutional and budgetary-procedural factors have been identified as underpinning executive weakness in the budgetary process. Therefore it is necessary to analyse the institutional changes that took place during the period immediately preceding fiscal adjustment to evaluate to what extent this affected the government's ability to implement more disciplined budgetary policies.

As this study seeks to understand both how institutions affect policies and how and why these institutions themselves change, it is important to analyse the 'politics of institutional reform'. According to historical institutionalism, institutional reform

[4] Budgetary consolidation was mainly based upon revenue increases rather than expenditure cuts. The latter is more difficult to implement due to 'concentrated' resistance by those on whom the cuts would primarily fall. Revenue increases (that is, tax increases) can be more evenly spread. As weak governments are more responsive to societal and parliamentary pressure, it is not surprising that Italian governments have primarily relied on revenue increases and have as a result been unable to bring about a decisive consolidation of public finances (*cf.* Alesina and Perotti 1995).

is bound to be difficult as institutional arrangements are inert and because there are actors and interests that support them. Generally, institutional change tends to be the outcome of domestic and international pressures. But external and domestic pressures for change are themselves mediated by pre-existing institutional structures, and hence institutional change tends to be path-dependent (*cf.* Section 1.4). Moreover, if institutional factors have visible distributional consequences, then there will be conflict over the reform of those institutions. During the 1990s, reforms of political and budgetary institutions took place in Italy. However, none of them achieved any significant strengthening of the budgetary policy system. Although this confirms - as will be shown - the 'path dependency' view of institutional change, it does raise the question of why and how fiscal consolidation was possible in the 1990s.

Reform of Political-Institutional Structures: The Politics of Electoral Reform[5]

In Chapter 2, 'government instability', 'distributional conflict', and 'electoral system' were identified as contributing to fiscal instability, all of which 'capture' executive strength. In parliamentary systems like the Italian system, executive strength is to a large extent determined by electoral institutions. Roughly, the relationship can be envisaged as follows: 'weak' electoral rules (for example, proportional system) lead to parliamentary and executive fragmentation which in turn increases government instability, reduces party discipline, prime-ministerial strength and ultimately executive strength. By contrast, 'strong' electoral rules (for example, simple plurality) reduce fragmentation and strengthen executive authority.

Institutional reform with a view of strengthening the executive in general and the electoral system in particular had been on the agenda in Italy for quite some time. This was an implicit recognition of the dysfunctional nature of the Italian political system. Reformist forces among the political parties and Italian society demanded greater transparency, efficiency and 'governability'. Thus the Bozzi Commission (1983-85), the short-lived De Mita-Iotti Commission (1992-94) and more recently the so-called *Bicamerale* (1997-98) under D'Alema were dedicated to formulating proposals in this respect. Essentially all reform proposals came to nothing as a result

[5] Note that the discussion of executive strength in this section is of similar relevance to all policy areas examined in this study. Hence the arguments and conclusions reached here should be borne mind when reading Chapters 4-6.

of a series of crosscutting vetoes and the need to accommodate a diverse and large number of party interests. The Bozzi Commission, for example, produced six minority reports. The high number of parties with heterogeneous interests made any attempts to arrive at meaningful institutional reform impossible (Pasquino 1990; Pappalardo 1995). Constitutional changes (as opposed to electoral system reform) were even more difficult to achieve, as this would have required a 'bipartisan' approach due to the need for a two-thirds parliamentary majority.

The politics and outcomes of electoral reform also demonstrated the inability of the Italian political system in general and the executive in particular to bring about substantial change and hence confirm the relevance of path dependent institutional development. A weak, fragmented government, dependent on the support of several parties over which it had little control, was unable to impose change on a reluctant parliament. Parliamentary parties - and especially the smaller ones - opposed any reform of the existing proportional electoral system that would have resulted in a reduction of parliamentary parties, as it would have eliminated them from parliament. The bigger parties that might have been expected to benefit from a more reductive system were also reluctant to push for change, mainly as a result of their reliance on smaller coalition partners. Institutional inertia in terms of electoral and more generally political-institutional reform was hence primarily due to the pre-existing proportional system that allowed for the existence of small parties, which in turn were able to block any reform that aimed at strengthening the electoral system. This was so because "proportional representation is a rather conservative electoral system; it preserves the existing forces, that is, a constellation of interests that strenuously oppose any change – and have resources to do this – and that indeed impede reform" (Pasquino 1992: 13; Nohlen 1984b).

Nonetheless, changes to the electoral system did take place in the early 1990s. They were primarily the result of referenda and public pressure and can be said to have come about *despite* parliament and political parties. An electoral reform movement headed by a cross-party coalition of reformers led by DCI dissident Mario Segni emerged as a response to the failure of successive attempts to achieve institutional reform in the 1980s – and hence a response to the unwillingness and inability of government and parliament to bring about meaningful change (Pasquino 1992). More specifically, the declared goal of the electoral movement was to introduce governability and transparency. Although this reform movement was not directly inspired by the realisation that macroeconomic reform was necessary, it is nonetheless important to examine the reform it induced in order to demonstrate the importance of path dependency and the potential effects of increased executive strength on macroeconomic policy.

A referendum initiated by the reform movement and held on 9 June 1991 reduced the number of preference votes[6] and led to the creation of a *Bicameral Committee on Institutional Reforms* whose task it was to produce a proposal for electoral reform. Due to obstruction by parliamentary parties and crosscutting vetoes, the committee initially came to nothing. Institutional reform was blocked by a parliamentary and political class that was unwilling and unable to implement change (Pasquino 1997). However, things changed with the April 1992 elections, which have been described as an 'electoral earthquake' and 'landmark elections' because the traditional majority coalition suffered dramatic losses (Pasquino and McCarthy 1993).

In 1992 the Italian political system and more particularly its parliamentary and party-political class underwent a major crisis (McCarthy 1995; Bufacchi and Burgess 1998). Starting with the arrest of a mid-level PSI politician in early 1992, the judiciary began to unearth a network of corruption and collusion, including illegal party financing, public works contracts and so on. The press dubbed this corruption scandal *Tangentopoli* (Bribe City). At the height of the scandal more than half of serving members of parliament were under investigation and suspected of involvement in the scandal. Naturally this accelerated the de-legitimisation of the traditional parliamentary parties and especially the traditional government parties such as the DCI and PSI that had already been evident in the April 1992 general election. Subsequent elections at the of provincial, communal and regional elections (though not strictly comparable) suggest that the DCI, PSI and Republican Party (PRI) suffered a further decline of electoral support (Table 3-5). [7]

[6] The abolition of preference votes was meant to increase the transparency of the electoral process and reduce 'vote buying' and corruption at the constituency level.

[7] Note that the numbers from roughly June 1992 onwards also reflect the break-up of some parties.

Table 3-5 National, Regional, Provincial and Communal Elections, 1992-1993

(vote in per cent)

	1987 (0)	APR. 1992 (1)	SEPT. 1992 (2)	DEC. 1992 (3)	JUNE 1993 (4)	JUNE 1993 (5)	JUNE 1993 (6)	NOV. 1993 (7)	NOV. 1993 (8)
DCI	34.3	29.7	14.0	24.3	22.3	18.7	12.1	14.3	10.7
PSI	14.3	13.6	7.2	9.9	4.7	2.5	0.6	0.6	1.2
PRI	3.7	4.4	1.5	3.6	1.7	0.7	0.2	0.5	0.2
PSDI	3.0	2.7	0.8	4.9	1.6	0.8	0.4	0.9	0.9
PDS	26.6*	16.1	17.8	11.4	9.9	7.7	19.8	4.6	12.1
RC	n/a	5.6	6.7	6.3	5.5	5.1	8.0	1.3	5.3
Rete	n/a	1.9	2.7	4.0	1.8	2.0	1.8	5.2	3.1
LN	n/a	8.7	33.9	13.7	26.7	11.7	30.5	9.6	6.2
Others	18.1	5.1	8.6	9.4	10.8	45.6	17.9	52.2	43.8
TOTAL	100	100	100	100	100	100	100	100	100

Source: Newell and Bull (1997: 86, 89) * PCI

Top row: (0) general election, (1) general election, (2) provincial elections [Mantova] (3) communal elections [55 communes], (4) regional elections [Friuli, Venezia, Giulia] (5) partial communal elections [1,192], (6) provincial elections [Gorizia, Ravenna, Viterbo, Mantova, Pavia, Trieste, Varese, Genova, La Spezia], (7) regional elections [Trentino Alto Adige], (8) partial communal elections [424 communes]

Column: DCI = Christian Democratic Party; PSI = Socialist Party; PRI = Republican Party; PSDI = Social Democratic Party; PDS = Democrats of the Left; RC = Communist Refoundation; LN = Northern League

Encouraged by the outcome of the 1991 referendum, the reform movement managed to organise a second referendum on 18-19 April 1993, which further increased the pressure for reform of the electoral system. This referendum abolished the 65-per cent clause of the electoral law for the Senate which had the effect of creating a single-member, simple-plurality system for three quarters of the Senate seats (Newell and Bull 1997) - and hence a 'stronger' electoral system. As the two houses of parliament had co-equal legislative power, this meant that the electoral law of the Chamber of Deputies also had to be modified.

In addition to the poor electoral performance in the general parliamentary elections, the positive outcome of the referendum in conjunction with the widening of the corruption scandal increased the pressure on parliament to realise electoral reform. While, on the one hand, this made the traditional parties even more reluctant to change the electoral rules at the national level, on the other hand, it meant that a further delay or rejection of the reform would have resulted in certain electoral defeat. At the same time, the technical government of Prime Minister Carlo Azeglio Ciampi, who moreover had been asked to make electoral reform one of the priorities by President Scalfaro, pushed for the rapid adoption of a new electoral law. The Ciampi government left it to parliament to work out the new law but threatened to propose the electoral system of the Senate for the Chamber of Deputies in case parliament was unable (or unwilling) to reform the system. This made the threat of parliamentary elections, which would have been a 'referendum' on electoral reform, a real possibility (Katz 1995).

As a result, the two houses adopted a new electoral law on 3-4 August 1993. The reluctance to adopt a 'stronger' electoral system is nicely illustrated by the following incident. Attempts to introduce dilatory amendments and the resulting shuttling of the reform bill forced the president of the Chamber of Deputies to set a deadline which, if violated, would have resulted in new elections in order to get the legislation approved (Katz 1995). In short, it is fair to say that the electoral reform came about as a result of massive public pressure, a committed, disinterested prime minister and in the last instance through the threat of new elections that would certainly have resulted in a major repudiation of 'obstructionist' parliamentary parties.

These extraordinary circumstances notwithstanding, the content of the new electoral regime reflected inevitable inter-party compromise and hence indirectly the effect of pre-existing institutions. Instead of creating a plurality system that would have eliminated the smaller parties, the 1993 reform replaced the old party-list system of proportional representation with a hybrid system. The new electoral law foresaw a mixed system for the election of the members of parliament (MPs) by combining both proportional and majoritarian elements. Three fourths of the seats were to be distributed on the basis of the majoritarian and the remaining fourth on the basis of the proportional principle (Katz 1995; Parker 1996). Thus, the final result was - of course - a compromise solution that seemed acceptable to the overwhelming majority of party actors.[8] It was a compromise in that it reflected as far as necessary the demands expressed by the 1993 referendum on the one hand, as well as the unwillingness of smaller parties to eliminate themselves (as would have been the case with the introduction of a fully-fledged majoritarian system) on the other hand.

The 1993 electoral reform also showed the inability of the executive to determine decisively the content of electoral reform.[9]

As regards political-institutional features then, the 1990s brought no relevant institutional change, except for the reform of the electoral system. Institutional reform was not only incremental and highly path-dependent but also inadequate in that it did not result in any substantial strengthening of the executive – as will be demonstrated below. As a result of the 'necessary' inter-party compromise, electoral reform only had a limited impact on executive strength. Although it introduced a bipolar logic at the electoral level, the system still allowed for the survival of smaller parties. In fact, the number of effective parliamentary and government parties increased after the reform; and the bipolarisation was at best an incomplete bipolarisation. In short, the electoral reform did not lead to a strengthening of the executive and cannot explain the successful fiscal consolidation of the 1990s.

Reforms of the Budgetary Process

After changes to budgetary procedures in 1978, 1983, and 1988,[10] which had aimed at rationalising the budgetary process (but none of which had led to a substantial improvement in fiscal outcomes), further changes took place during 1989-92 (Della Sala 1988; Verzichelli 1999a). During this period parliamentary rules (mainly established during previous reforms) were interpreted and applied in a progressively restrictive way so that all the amendments to the bills during the budget process henceforth had to respect the restraints previously established. A certain rationalisation also resulted from the strengthening of the position of the presidencies of the two houses and of the relevant commissions with regard to controlling the admissibility of amendments (*cf.* Chiorazzo *et al.* 1994: 240-243; Da Empoli *et al.* 1995; Zangani 1996). Budgetary rules were reformed which introduced budget sessions and deadlines and which resulted in a greater rationalisation of the

[8] For details regarding the precise characteristics of the new electoral system see Parker (1996: 46-7); for detailed analysis of party preferences and negotiations see Pappalardo (1995).

[9] It is of course also true that, due to its technocratic character, the government only had a mandate to 'see through' electoral reform but did not have the legitimacy to determine its precise content. Nonetheless, it is clear that the government – in addition to not being strong enough – would have lacked the power to influence the reform substantially. Its power was negative in that it could push parliament to find an agreement, but it was unable to determine the reform content.

[10] The 1978 reform introduced a new instrument, the finance law, that was to allow for the regulation of fiscal effects of existing legislation. The 1983 reform introduced procedural rules that were to

budgetary process at the parliamentary stage (Verzichelli 1999a). Parliament also modified the treatment of the special funds in a stricter sense. Finally, there were also various reforms at the implementation level (see Sartore 1999).[11]

All this undoubtedly resulted in a greater rationalisation and transparency of the budget process. Nonetheless, this stricter interpretation left substantially unchanged the parity between parliament and government. Even though government proposals are given slightly more weight, the process still relies on a functioning majority-government cohesion and dominance over the budgetary process. The reforms did not achieve any substantial change in this respect. Overall, budgetary policy is still a co-decision process, as the greater rationalisation has not resulted in a tangible strengthening of the executive *vis-à-vis* parliament (for detailed discussion see Alesina *et al.* 1998).

In short, despite a greater rationalisation of parliamentary procedures and greater transparency of the budgetary process as a whole, the Italian budgetary system is still a 'parliamentary regime' (as opposed to a an 'executive regime'). Thus, although changes to parliamentary rules and procedures provided the executive with a wider range of formal instruments that allows it in theory to exercise greater control over the budgetary process, the executive continues to be weak politically (*cf.* Masciandaro 1996: 419; Della Cananea 1997). This interpretation is also corroborated by the most recent survey of Italian budgetary procedures and rules. Based on a mixture of political-institutional and budgetary-procedural characteristics of fiscal policy-making proposed by Von Hagen (1992) and Von Hagen and Harden (1994), De Haan *et al.* (1999) replicated these previous surveys and - on the basis of expert responses - found that the complex indicator for a 'strong' budgetary system[12] had changed little in Italy since the early 1990s (p. 275, 294-296).

Another related point concerns executive strength as well as the distinction between the procedural advantage the government enjoys over the legislature as well as the centralisation of the executive and the cohesion of the government majority. As argued in Chapter 2, Italian budgetary policy often succeeded in finding ingenious ways to circumvent formal rules if not to violate them blatantly. Arguably

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ensure that the various budget documents be approved in time. The 1988 reform formally committed both government and parliament to respect pre-established targets (Chiorazzo *et al.* 1994: 240-241).

[11] In April 1997 the reform of the central government budget was approved. This reform came however too late to have an effect on budgetary policy during the period under consideration (*cf.* Section 7.4 below).

the executive has always theoretically had the procedural means to 'get its way' (De Ioanna 1993: chapter 16). If this is indeed so, then this further demonstrates that 'political power' – which primarily reflects political-institutional characteristics - is more important in determining budgetary outcomes than formal, budgetary rules.

This view is indirectly confirmed by the politics of budgetary-procedural reform. The reforms were aimed at rationalising procedures without however achieving any remarkable strengthening of the executive relative to parliament. The reforms do not seem to have encountered any opposition worth mentioning. Precisely this would have been expected in the case of reforms that change the relative power of the various actors in the budgeteray process. As Milesi-Ferretti (1996) has put it: "Proposals for reforms in the budgetary process are therefore likely to encounter resistance from vested interests – and this may account for the lack of action in Italy on any of these proposals so far" (p. 27). In short, the fact that there was no evidence of substantial conflict over reform also indicates that the reforms did not substantially alter the balance of political power between the executive and parliament. The reforms largely resulted in the *auto*-regulation of parliament rather than increased executive strength (Degni 1999: 46).

As in the case of political-institutional change, the reform of budgetary procedures was 'path-dependent' to the extent that a weak government was unable to introduce or impose rules on a 'strong' parliament. Rules and procedures that might have reduced the influence of parliament over budgetary policy and concomitantly increased the effective – as opposed to formal-legal – control over the budgetary outcomes by the executive would not have been acceptable to parliament. A weak executive was (and would have been) unable to introduce stronger rules. Hence, as in the political-institutional sphere, institutional change with regard to budgetary rules was path-dependent, thus confirming the relevance of the historical-institutionalist approach and institutional inertia.

In sum, both the nature of budgetary-procedural changes and the ease with which a supposedly weak government was able to change parliamentary procedures also indicates that the reforms did not substantially alter the relationship between the executive and the legislature and hence did not substantially increase executive strength as a result of budgetary-institutional reform. Nor did political-institutional

[12] See Chapter 1, footnote 4.

(that is electoral) reform increase executive strength. If the absence of a strong and cohesive executive was the main factor in explaining the rise in creative accounting, budget overshoots, permanent public deficits, and if political power grounded in political-institutional characteristics of the state was the main factor determining executive strength, then the budgetary policy reforms between 1992-98 cannot have been the result of domestic-institutional change.[13]

Hence I argue that Italy achieved impressive budgetary policy reform after 1992 in the *absence* of relevant institutional reform. I first present a stylised account of Italian budgetary policy between 1992-98. Due to a combination of the inevitable complexity of budgetary policy (that is, various phases of formulation, concertation-with-social-partners, parliamentary and implementation stages) and limited space, the reconstruction of the politics at the formulation and parliamentary stage will serve to illustrate my argument according to which policy reform and increased executive strength was primarily the result of intense external pressure rather than a domestic-institutional strengthening of the executive. The theory-driven reconstruction of historical events will primarily rely on news coverage by the *Financial Times* as well as on the purely economic-legal account by Zaccaria (1998) and only secondarily on official government and parliamentary documents.[14]

3.2 The Transition Governments of Amato and Ciampi, 1992–1994

The general elections of 5-6 April 1992 took place under the old (*de facto* proportional) electoral system (Bufacchi and Burgess 1998: chapter 2). In these elections, the traditional parties of government as well as the main opposition parties of the left suffered a combined net loss of votes amounting to almost 11 percentage points, while the new protest parties saw their combined share of the vote rise by 9 points (Newell and Bull 1997). Even though the traditional government parties (DCI, PSDI, PLI and PSI) won enough votes to continue the coalition, they were weakened by this electoral outcome as well as by the corruption scandal, which started in early

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[13] This has naturally important theoretical implications for the institutionalist approach which will be discussed in detail in Chapter 7.

[14] Budgetary policy-making in Italy is an extremely complex process involving a great number of actors, rules and events. The Italian economic press provides detailed coverage (*Il Sole 24 Ore*). As what is of interest here are the decisive moments and major conflicts surrounding budgetary policy, the *Financial Times* is the most appropriate source of information because it only focuses on the most important events. For the quantitative-economic aspects of budgetary policy the annual reports of the Bank of Italy and OECD surveys have been used.

1992 (Table 3-6). Giuliano Amato became prime minister on 18 June 1992 with the support of a 16-seat majority in the Chamber.

Table 3-6 Chamber of Deputies Elections 1992

	VOTES IN %	TOTAL SEATS
-DCI	29.7	206
-PSI	13.6	92
- OTHERS (PRI*, PSDI, PLI±)	9.9	60
TOTAL (traditional parties of government)	53.2	358
-PDS	16.1	107
-RC	5.6	35
TOTAL (opposition parties of the left)	21.7	142
-LN	8.7	55
- OTHERS (Greens, *Rete*, Panella)	5.9	35
TOTAL (new protest parties)	14.6	90
OTHERS	10.5	40
TOTAL	100	630

Source: Newell and Bull (1997: 86)

* Note that the Republican Party (PRI) was not part of the 1992 government coalition

± Liberal Party

The first major reform[15] - and a watershed in Italian budgetary policy - took place under the Amato government (June 1992-April 1993) at a time when Italy was undergoing a severe economic as well as political crisis (McCarthy 1995; Bufacchi and Burgess 1998). In summer 1992 the general economic situation was precarious. Growth was slowing and set to reach a mere 0.8 per cent for 1992, competitiveness of industry had been declining[16] for some time and the fiscal position was deteriorating despite repeated attempts to avoid the overshoot of the budget deficit. The state sector deficit[17] was expected to reach L175,000bn (or almost 11 per cent of

[15] For a detailed first-person account see Barucci (1995).

[16] The cumulative increase in inflation relative to Germany, one of Italy's main trading partners, betwen 1987 and 1992 was more than 18 percent (OECD Statistical Compendium 1999).

[17] The state sector (*settore statale*) covers the state (central administration) but (since 1993) excludes other autonomous agencies and autonomous national companies. The general government sector (*amministrazioni pubbliche*) covers the state sector, local government, and social security institutions. The public sector (*settore pubblico*) covers general government and autonomous government companies and bodies in the market sector. With respect to TEU, the general government deficits are the relevant reference figures (*cf.* Zaccaria 1998: chapter 2). The budgetary figures quoted in the text refer to state sector figures until 1995 and to general government figures thereafter (unless indicated

GDP) instead of the L128,000bn (or 8.5 per cent) originally planned (*Financial Times*, 11 July 1992; OECD *Economic Surveys Italy* 1992: 43). In addition to this already difficult situation, pressure on the exchange rate was increasing after the Danish referendum in June. Markets increasingly perceived Italian budgetary policy to be unsustainable and doubted that the Italian authorities would be able to sustain interest rate increases to defend the lira. The spread relative to German bonds was on the increase. In fact, it was to increase from about 5 to a peak of 8 points in October 1992. Furthermore, in the absence of corrective action, a state sector deficit of about 14.5 per cent in 1993 and about 19 per cent in 1994 was expected.

Visibly in response to these developments, the Amato government introduced an emergency package in early July to contain the fiscal slippage. Even though this still meant a budget overshoot of more than L20,000bn, it targeted fiscal retrenchment worth 30,000bn upon a combination of revenue gains (higher stamp duties, higher one-off taxes on real estate and bank deposits and higher social security contributions paid by employees) and expenditure cuts (freeze of public employment, lower transfers to local authorities and reduced calls on social spending and defence expenditure) in order to contain the budget overshoot. The package was presented to parliament in the form of a decree and was converted after the government made its approval an issue of confidence in order to eliminate 651 amendments. The government won the vote in the Chamber with 318 to 246 after threatening potential deserters among their own ranks with sanctions (*Financial Times*, 30 July 1992). Despite the corrective measures, the 1992 state budget deficit overshot the original target by 2 percentage points (OECD *Economic Surveys Italy* 1993: 38).

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otherwise). This reflects the fact that fiscal targets in Italy are primarily formulated in terms of the cash-borrowing requirement of the state sector (OECD *Economic Surveys Italy* 1996: 42). However, with the EMU deadline approaching, fiscal policy increasingly targeted the general government deficit.

Note that a year-on-year comparison of budget outcomes as presented in Table 3-1 is not always a good indicator of the 'political-budgetary' strength of the adjustment. On the one hand, various changes and revisions of the definitions of 'budget deficit' took place between 1992-98 (Zaccaria 1998: 126; also Bank of Italy, *Abridged Report*, 1997: 82-84). On the other hand, net borrowing figures contain of course a cyclical component. Due to these difficulties, the figures referring to budgetary adjustment 'relative to trend' best catch the 'strength' of the adjustment and are hence the most relevant indicators with regard to a (qualitative) analysis of the politics of budgetary adjustment (for more detailed economic analysis of budgetary outcomes see Section 3.5; also Appendix II; for economic analysis of budgetary policy in the 1990s see Bank of Italy, *Abridged Report*, 2000: 108-116).

During August and early September the pressure on the lira intensified and thus forced additional action on the government. At the height of the crisis – just before the lira devaluation of 12-13 September - the Amato government called for emergency powers (10 September). Although President Scalfaro refused the latter, in October the prime minister won the parliament's approval for a delegation law by both the Chamber (10 October) and the Senate (22 October). The delegation law (no. 421, 1992) authorised the government - among other things - to cut public spending in four main areas through decrees (pensions, public employment, health and local government). After taking into account minor amendments in the Chamber (as, for example, the postponement of the abolition of seniority pensions[18] by 2002), the government imposed confidence votes in both houses on all four articles. There was a considerable amount of opposition as evidenced by the large number of proposed amendments. However, the government prevailed (Zaccaria 1998: 117-119).

Once the delegation law had passed, the most important part of the 1993 budget was secured[19] and the rest passed parliament without any particular problems so that the government did not have to resort to a confidence vote. The 1993 budget sought to raise L93,000bn (or 6 per cent of GDP) in extra revenues and spending cuts to achieve a state sector deficit of L150,000bn or 9.6 per cent of GDP. The strength of the budget was also reflected in the relative importance of expenditure cuts, which represented almost half of the adjustment or L43,500bn. The 1993 budget was finally approved on 22 December (Barucci 1995).

With regard to the fiscal adjustment, there was considerable conflict between the executive and the legislature, and within the executive.[20] There was also opposition from the government coalition parties, mainly from the DCI and PSI. There was vehement criticism from opposition parties, especially from the *Rifondazione Comunista* (RC) and *Lega*[21] and there was also considerable societal resistance, mainly in the form of demonstrations by trade unions, pensioners and self-employed workers (*The Economist*, 26 September 1992; *The Economist*, 31

[18] Seniority (or early retirement) pensions differ from normal pensions in that workers, after having worked for a minimum number of years, have the right to retire regardless of their age.
[19] Thanks to the delegation law, the government achieved (1) a reduction in pension spending via the abolition of the indexation to real wage growth, (2) a freeze of public sector wages, (3) cuts in spending for education, and (4) restrictions on free health care.
[20] There were persistent rumours that ministers were about to resign (*Financial Times*, 2 October 1992).
[21] *Lega* leader Bossi even called for a tax boycott.

October 1992, *Financial Times*, 19 September 1992). Naturally, the government measures enjoyed a certain degree of qualified support, or at least some actors refrained from opposing the measures, such as *Confindustria* and PDS, both of which accepted the necessity of fiscal consolidation (Mattina 1993: 160).

It was thanks largely to the economic and political emergency situation that Amato was able to impose the biggest budgetary adjustment in Italian post-war history and thus to overcome the traditional obstacles to budgetary adjustment. The spread of Italian governments bonds over German ones had increased from about 5 to 8 points since May. After the ERM exit, the lira had fallen from L750 per deutschmark to less than L900. This visibly forced the government to take strong action if it wanted to avoid a financial breakdown. That the government regarded the economic situation as very dramatic is reflected in Amato's call for emergency powers. In addition to economic pressure, the weakening of parliament and traditional political parties - that resulted from the wide-spread delegitimisation of the Italian political class and state - increased the autonomy of the executive. However, it is clear that in the absence of economic pressure such a drastic budget would never have been possible. Moreover, the Italian state and political class was in crisis as a result of the corruption investigations. This reduced the ability and willingness of parliament to bring down the government, as this might have resulted in new elections.

In the end, Prime Minister Amato and Finance Minister Piero Barucci were able to prevail over the various veto players and defended proposals in parliament by using the formal instruments available and thus were able to impose their will on the cabinet and the majority coalition in a context of emergency and parliamentary weakness. It was this assertive attitude that allowed it to achieve an adjustment unprecedented in a large industrialised economy. Not surprisingly, the budgetary reform has been called *la madre delle manovre* (Bernardi 1994: 13). In April 1993 Amato resigned, mainly as a result of his opposition to the 1993 referendum on electoral reform. At that time, the fiscal developments were already out of line with targets.

In April 1993 a new technical government was formed under ex-central bank governor Ciampi (April 1993-March 1994) at a time when the four-party governing majority (DCI, PSI, PSDI and PLI) had been weakened further by the rapidly spreading corruption scandal and a further weakening of the legitimacy of the political class (Pasquino and Vassallo 1995). This - in addition to the still precarious economic situation - provided the executive with greater policy autonomy.

An important feature of the Ciampi government was that the members of government did not have any strong political allegiances and were technocrats rather than party politicians. This increased the government's autonomy from parliament. In principle, the technocratic government had the support of the traditional four-party coalition (as well as solid support from the PDS). The *Verdi* adopted a benevolent attitude towards the government. The broad outlines of government policy were determined by a letter from President Scalfaro in which he asked Prime Minister Ciampi to implement electoral reform, redefine parliamentary immunity, defend the lira and realise public administration reform (Pasquino and Vassallo 1995: 62).

By the time Ciampi took office, the economy was in recession (Table 3-2 above). The expected budget shortfall of about L25,000bn put at risk not only the second tranche[22] of an EC balance-of-payment loan but it also weighed on the value of the lira (Figure 3-1; Bank of Italy, *Abridged Report*, 1993: 76). In order to hold down the deficit to 9.6 per cent of GDP, the new government was forced to introduce a mini-budget in mid-May, raising L12,400bn in new taxes and spending cuts. Most of the L6,800bn extra revenue came from raising taxes (mainly petrol, increasing the size of the end-of-year advance VAT payments required of companies). The spending cuts consisted mainly of cuts in central government transfers to local authorities, the blocking of hiring new teachers and a selective freeze on disbursements from the Treasury's numerous special funds.

Figure 3-1 Lira-German Mark Exchange Rate, 1992-1998

(Lira per German mark)

Source: Datastream

The government won the vote on the mini-budget by a large majority after making it a matter of confidence in the Chamber. Of the 522 deputies present, 311 voted for the government, 98 abstained and 113 voted against. There was support from the four government parties as well as from the Republican and Radical parties. Main opposition came from the *Lega* and RC (*Financial Times*, 7 July 1993). Finally, the newly defined[23] state sector deficit for 1993 reached 9.8 per cent as compared to 10.5 per cent in 1992 and hence overshot the original target of 9.6 per cent only slightly (Bank of Italy, *Abridged Report*, 1994: 71).

On 10 September, the government approved the 1994 budget with tough cost-saving measures. Of a total adjustment of L32,500bn, L28,000bn were to come from expenditure cuts. Cuts concerned pension benefits, health service, public administration, and also included a continued freeze on civil service recruitment [so-called *paccheto Cassese*] (*Financial Times*, 4 July 1993; Zaccaria 1998: 121-125). The adjustment was to bring the state sector deficit down to L144,000bn (or 8.7 per cent) in 1994 (*Financial Times*, 11 September 1993; *Financial Times*, 14 September 1993).

Due to the continued threat of a financial crisis (the exchange rate worsened from L900 per deutschmark to L1000 during the second half of 1993) and the non-party character of his government, Ciampi enjoyed a considerable degree of autonomy. Anecdotally, this autonomy was reflected in the fact that the parliamentary majority was given little say in the preparation of the 1994 budget. A senior Christian Democrat politician was quoted as follows: "The first we knew of the details was from the newspapers" (*Financial Times*, 14 September 1993). The increased autonomy was of course also indicated by the content of budgetary legislation, which reflected economic and technical rather than overtly 'political' considerations in that it largely consisted of expenditure cuts.

This - by Italian standards - extraordinary degree of autonomy was the result of the continued precariousness of the economic situation, the prime minister's

[23] As pointed out, the new definition excludes autonomous government agencies and bodies transformed into limited companies (Bank of Italy, *Abridged Report*, 1994: 71).

readiness to resign (*Financial Times*, 25 November 1993) as well as the continued weakness of parliamentary parties as a result of *Tangentopoli*. By autumn 1993, many members of parliament were under investigation and MPs were understandably reluctant to risk losing their parliamentary immunity in case new elections were called (*Financial Times*, 17 November 1993). As a result, "[t]he Premier's style of action both inside and outside the cabinet was not constrained in this case by the obstacles imposed by mutual vetoes of various party secretaries or by conflict among faction leaders present in the cabinet" (Pasquino and Vassallo 1995: 67).

Not being subject to the need to compromise at the formulation stage and willing to push parliament and resist societal opposition, the Ciampi government achieved considerable structural budgetary reform. The limited size of the adjustment relative to the Amato government has to be understood in the context of stagnating growth. Given that Italy was in recession in 1993, the 1994 budget was certainly constrained at an economic level by finding the right balance between a possible worsening of the recession and the slow-down of budgetary consolidation (Bank of Italy, *Abridged Report*, 1994: 75). However, given these unfavourable circumstances, the total adjustment of L32,500bn was quite impressive, especially since it primarily relied on expenditure cuts. After realising the objectives of this limited mandate, Ciampi resigned in early 1994 and President Scalfaro announced new elections for March 1994.

To summarise budgetary policy under the Amato and Ciampi governments, both governments were able to achieve adjustment in the face of external pressure and a weakened domestic opposition (which was the result of the on-going corruption investigations and the decreasing legitimacy of the traditional political class) that was overcome thanks to decisive action through the use of formal instruments such as confidence votes. The relative to previous governments greater strength of the Amato and Ciampi governments was of course not only reflected in the size of the adjustment (*cf.* Annex B) but also in the fact that the adjustments strongly relied on spending cuts rather than tax increases (*cf.* Alesina and Perotti 1995).

3.3 The Centre-Right Majority and the Berlusconi and Dini Governments, 1994-1996

The March 1994 parliamentary elections were the first elections to take place under the regime adopted in August 1993. Twenty lists obtained seats; there were 8 parliamentary groups in the Chamber and 10 in the Senate, thus resulting in a slightly lower degree of party fragmentation in the Chamber (down from 13 in 1992) and no change in the Senate (D'Alimonte and Bartolini 1997: 116). While there was a reduction in the number of parliamentary groups, it would be misleading to interpret this as greater cohesion and less fragmentation. In terms of lists obtaining seats, the number of effective parliamentary parties actually increased. The left-wing alliance alone consisted of eight parties, which indicates the continued relevance of fragmentation under the new electoral regime.

Defeating the centre alliance of the Pact for Italy and the left-wing Progressive Alliance, the right-wing electoral alliance(s) mainly made up of *Forza Italia* (FI), *Lega Nord* (LN), *Alleanza Nazionale* (AN) won a clear, absolute majority (Table 3-7). Although the victorious right-wing alliance consisted of only three parties, the fact that this alliance consisted of two inter-linked alliances - the Alliance for Good Government (*Alleanza Nazionale – Forza Italia*) and the Freedom Alliance (*Forza Italia – Lega Nord*) - already indicated profound internal divisions. Silvio Berlusconi, the leader of the dominant party of the right-wing electoral alliance, *Forza Italia*, became prime minister (Katz and Ignazi 1996).

Table 3-7 Chamber of Deputies Elections 1994

	LIST VOTES %	PROPOR-TIONAL SEATS N	PROPOR-TIONAL SEATS IN %	PLURA-LITY SEATS N	PLURA-LITY SEATS IN %	TOTAL SEATS N	TOTAL SEATS IN %
Left-Wing Alliance	34.3	49	31.6	164	34.5	213	33.8
Centre Alliance	15.7	42	27.1	4	0.8	46	7.3
Right-Wing Alliance	46.4	64	41.3	302	63.6	366	58.1
Others	3.6	0	0.0	5	1.1	5	0.8
Total	100.0	155	100.0	475	100.0	630	100.0

Source: Elaborated on Newell and Bull (1997: 96-97)

Even before the parliamentary elections had taken place, the 1994 state sector deficit target of 8.7 per cent was expected to overshoot by about L15,000bn, or roughly 1 per cent of GDP (*Financial Times*, 23 March 1994). The overshoot was primarily the result of a deeper than expected recession and higher than anticipated social security spending as well as higher interest rates. The need for corrective action was evident. However, as the Berlusconi government came to power on the promise to relaunch the economy, reduce taxes and provide more jobs, it refused to introduce a mini-budget.[24]

Gradually, though, external pressure increased not least as a result of the government's inaction (*Financial Times*, 14 July 1994). This was reflected in the increasing difference between Italian and German long-term government bond yields (rising to 470 basis points compared to a gap of just over 300 at the beginning of 1994), the fall of the Milan stock price index by more than 8 per cent during the same period and the weakening of the lira (*cf.* Figure 3-1 above; Figure 3-2). The weakening of the lira led to an increase in the discount rate in August to 7.5 per cent by the Bank of Italy and threatened to increase even further the pressure on fiscal policy given that a one-percentage point increase in interest rates increased the deficit by about L15,000bn.

Figure 3-2 Long Term Interest Rates, 1992-1998

(in per cent)

[24] It is true that the Berlusconi government and especially certain members of the AN were less pro-Europe than the traditional government parties (see Dastoli 1996; *Financial Times*, 3 December 1994). However, during 1994, meeting the convergence criteria was at best a secondary consideration, especially because EMU was not to come into being until at least 1997. By the standards of Italian politics, three years is an 'eternity'.

Source: Datastream

By the end of July there existed only a very broad plan on how to achieve the projected deficit target, which the Bank of Italy already criticised as relying on too optimistic assumptions (*Financial Times*, 4 August 1994). This also reflected the government's indecisiveness. Apparently[25] in response to a worsening fiscal situation and increasing international economic pressure (see above), the prime minister embraced the conservative Treasury line to bring the state sector deficit down to L139,000bn (or 8 per cent of GDP) in 1995. In September, the government presented the budget law, broadly in line with the objectives of the medium-term economic plan. The government foresaw L21,000bn in revenue increases (without however increasing overall fiscal pressure by relying mainly on one-off measures such as a tax amnesty) and L29,000bn in spending cuts (mainly in the health and pension areas). The initial wavering reflected intra-coalitional differences (especially over welfare cuts) (*cf.* Chapter 4).

The budget was relatively tough, even if observers agreed that it relied on rather optimistic forecasts (*Financial Times*, 30 September 1994). Spending cuts accounted for two thirds - a considerable part of which was to come from welfare payments and especially pensions. By Italian standards, rather radical welfare cuts[26] led the unions to call a national strike on October 13 and national demonstrations in November. Although Berlusconi vowed to stand firm, both the *Lega* and AN - reluctant to embrace social welfare cuts in the first place - took an increasingly critical position towards welfare cuts (*cf.* Chapter 4). This stance was reinforced by the unpopularity of social spending cuts as well as of the government and of the prime minister more generally.[27]

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[25] That international pressure was the likely cause of the government's change of mind can be inferred from the fact that Berlusconi refused to introduce a mini-budget a few months earlier. Increasing international pressure in terms of increasing bond spreads and a worsening of the exchange rate forced the government to take strong action – stronger in fact than some members of the government coalition deemed acceptable (see below).

[26] The head of the *Confindustria* research department, Stefano Micossi, was quoted as follows: "I scarcely believe that this government has dared do what no one else has dared to do - structural cuts in the pensions and health systems" (*Financial Times*, 30 September 1994).

[27] Investigations by the magistracy and a poll in late 1994 that showed that 71.9 per cent of Italians were 'little satisfied or not at all satisfied' with the work of the government (*L'Espresso*, 25 November 1994) further weakened the prime minister.

Due to crumbling parliamentary support, the government had to make concessions on pension reform to trade unions and parliament and finally had to accept outright 'capitulation' on 1 December (*Financial Times*, 2 December 1994). After abandoning a large part of pension cuts, which was estimated to have cost about L4,000bn, and after another 0.5 point increase in interest rates (adding another L7,000bn to the government bill) as well as an increase of additional one-off expenditure items (mainly flood damage in the North, constitutional court sentence ordering the payment of arrears on certain minimum pensions), it was clear that the budget was unlikely to reach the projected 8 per cent target (*Financial Times*, 3 December 1994). It was estimated at the time that the 1995 budget would require measures worth L25,000bn in order to meet the targeted deficit (*Financial Times*, 16 December 1994).

As a result of political conflict and the prospect of a weak budget, the international economic pressure increased. At the end of 1994, the lira was heading for a historic low of around L1,050 per German mark. This meant that the lira had depreciated by more than 8 per cent since May. At the same time, the yield differential between Italian and German long-term government bonds widened (*cf.* Figures 3-1 and 3-2; Bank of Italy, *Abridged Report*, 1995: 79). In short, even though the government's 'compromise' on pension reform cleared the way to the approval of the 1995 budget in an atmosphere of impending financial crisis, it was clear that the budget, despite its rather radical intention, was weak and unlikely to meet the deficit target. In addition, the 1994 fiscal year closed with a state sector deficit of 9.5 per cent and hence the original target of 8.7 per cent was not achieved (Bank of Italy, *Abridged Report*, 1995: 74, 78). This increased the need for further adjustment in 1995.

To summarise, the difficulties the Berlusconi government experienced over the passage of the 1995 budget show the continued limited institutional autonomy of the executive despite the 1993 electoral reform *as well as* the importance of international pressure. The limited authority the government enjoyed was due to both intra-coalitional pressures, obstruction on the part of parliament and societal opposition. Clearly, the major reason for the weak government performance was the U-turn of its coalition partners. Unlike previous prime ministers, Berlusconi vowed to take a tough stance rather than negotiate and failed as a result of limited prime-ministerial and executive authority. In the end, Berlusconi was unable to control dissident groups within his majority, especially once the members of the government majority realised the unpopularity of the welfare cuts. Unable to control his parliamentary majority, the prime minister was constrained to give in to societal and parliamentary pressure. This interpretation is also supported by the fact that the original budget was characterised by a relatively high degree of consistency (Zaccaria 1998: 138). However, the government's weakness at the parliamentary stage unravelled what had been achieved at the formulation stage.

On the other hand, even though domestic pressure prevented pension reform, external pressure made the approval of the budget possible. The PDS and most of the other parties were eager to save the (however imperfect) budget and even refrained from bringing down the government in a context of impending economic crisis as reflected in the deterioration of market confidence. Even the cantankerous *Lega* - intent on bringing down the government of which it was a part - wanted to see through the budget before introducing a motion of confidence (*Financial Times*, 16 December 1994). This strongly suggests that it was external economic pressure (in terms of rising interest rates and a weakening of the exchange rate) that allowed the passage of an however imperfect budget: parliamentary parties were not prepared to assume responsibility for a financial crisis that a delay of the budget might have caused. In short, even though external pressure was crucial in guaranteeing a speedy passage through parliament after the 1 December compromise, domestic politics and executive weakness explain the weakness of the 1995 budget. On 22 December, Berlusconi resigned, thus preventing a vote of no confidence that was going to be backed by both the opposition and the *Lega*.

After Berlusconi's resignation, a technocratic government led by former Finance Minister Lamberto Dini was formed in January 1995. The Dini government (January 1995 - May 1996) did not have a clear majority in the Chamber but enjoyed the qualified support of the PDS (Democrats of the Left), the centrist PPI (Italian Popular Party) and *Lega Nord*. By contrast, AN and FI vowed to bring down the Dini government in order to achieve new elections (Pasquino 1996; Bufacchi and Burgess 1998: chapter 10) [28]. The Dini government consisted mainly of university professors, none of whom was a sitting member of parliament (*Financial Times*, 23 January

[28] Regarding himself as the bearer of an electoral mandate as a result of the 1994 elections, Berlusconi disputed the legitimacy of the Dini government and called for new elections (*Financial Times*, 30 December 1995).

1995). Equipped with an emergency mandate from President Scalfaro, the Dini government vowed to implement reforms in four areas: improving public finances; reforming the state pension system; introducing a new electoral law for the regions; and providing for more balanced controls of the media. Dini vowed to step down once the government had implemented its programme. In case of obstruction, Dini threatened to resign (Pasquino 1996a: 140-141).

The first act of the new government was to introduce a mini-budget in order to bring the 1995 budget deficit back in line with the original 8 per cent target (*Financial Times*, 14 February 1995). The government sought to raise L15,600bn in new taxes of which L8,700bn were indirect taxes. Spending cuts were to total L5,200bn, mainly coming from transfers to local authorities (*Financial Times*, 24 February 1995). Compared with previous budgets, the proposed budget was relatively weak and 'painless' as almost three quarters of the adjustment were to come from higher taxes as opposed to spending cuts. The composition of the budget clearly reflected the need to secure the support of the centre-left parties on whose support the government depended for its survival.

As a result of the continued uncertainty surrounding budgetary and pension reform in early 1995, the international financial pressure was enormous. The day before the mini-budget went before parliament, the lira experienced the largest single fall since the crisis of September 1992. Over the two preceding weeks the lira had already lost about 8 per cent against the German mark (*Financial Times*, 28 February 1995; also Chapters 4 and 6).

Despite these pressures, it was far from certain the mini-budget would be passed. Berlusconi had been demanding new elections all along and threatened to withhold approval of the budget in order to provoke early elections (*Financial Times*, 27 February 1995). However, a further weakening of the lira and the emergence of critical voices within FI and AN, urging approval of the mini-budget and arguing that early elections would probably provoke a currency crisis, increased the pressure on *Forza Italia* to let the mini-budget pass (*Financial Times*, 28 February 1995).

Eventually, in mid-March, the mini-budget was passed after the Dini government had imposed a confidence vote on the Chamber with 315 votes in favour, 309 against and one abstention. The government was backed by the centre and left parties, including 17 of the 39 RC deputies. Given the closeness of the vote, this was decisive. Similarly, the centrist PPI, in the process of splitting into pro- and anti-Berlusconi factions, also swung fully behind the government, despite strong pressure from Berlusconi. As announced, the right-wing parties voted against (*Financial Times*, 17 March 1995). A few days later, the Dini government won another confidence vote in the Senate (*Financial Times*, 22 March 1995). Eventually, the 1995 state sector deficit eventually undershot and reached 7.4 per cent - as compared to 8 per cent as targeted. (This was in large part due to a substantial increase in one-off increases and - relative to previous years - stronger economic growth of 2.2 per cent in 1995 [Bank of Italy, *Abridged Report*, 1996: 71].)

The 1996 budget introduced in September sought to raise L32,500bn aiming to reduce the state sector deficit from 7.4 per cent in 1995 to 5.8 per cent of GDP in 1996. The target for general government net borrowing was 5.9 per cent for 1996 (OECD *Economic Surveys Italy* 1996: 48). The 1996 budget was again rather weak and once more the result of considerable compromise between the executive and the centre-left parties supporting the Dini government (*Financial Times*, 28 September 1995; Zaccaria 1998: 150). In absolute terms, spending cuts were small compared to each one of the budgets since 1993. Less than half of the adjustment (L14,600bn) consisted of spending cuts, while the rest of the adjustment fell on increases in revenue (L17,900bn). Furthermore, in addition to overly optimistic assumptions concerning inflation and interest rates, some of the measures (improved income tax assessment, and more efficient curbs on tax evasion) were weak so that the Bank of Italy expected a budget shortfall of about L10,000bn even before the budget had been passed by parliament (*Financial Times*, 29 September 1995).

Despite the rather weak character of the budget, its approval was far from certain. As the government faced a potentially interminable debate over some 2,000 amendments, it decided to proceed through votes of confidence. Initially, Berlusconi had pledged to vote against the government. So did the RC (*Financial Times*, 15 December 1995). However, in two votes of confidence on amendments to the 1996 budget in the Chamber, the centre-right and centrist opposition refrained from bringing down the government. This ensured the budget's survival. Thus the right-wing parties were able to maintain their opposition to the government proposals without having to jeopardise the budget.[29] In fact, there were serious divisions in the

[29] In fact: "The first vote was won by 306 for with 292 against and one abstention. But there were 28 deputies absent, of whom 22 were from Mr Berlusconi's alliance. In the second vote, 310 deputies

right-wing opposition to the budget and over whether to bring down the government. These divisions apparently reflected the growing unease among certain parts of the right-wing opposition to bring down the government over the budget in a situation of increasing interest rates and a weakening of the exchange rate. Due to external pressure and the reluctance of parts of the opposition to risk financial turmoil, a 'behind-the-scenes deal' was finally struck (*Financial Times*, 16 December 1995). Nonetheless, Dini had to retract from a final third vote of confidence which aimed at speeding up the passage of the remainder of the budget and instead preferred to reach a compromise centred around retaining the government's fiscal amendments while allowing a limited number of additions tabled by the Berlusconi camp, including substantial tax benefits for large stock market flotations (*Financial Times*, 19 December 1995). On December 30, Dini presented his resignation to President Scalfaro. After an initial rejection of the resignation and after consultations between the parties did not lead to any agreement, President Scalfaro decided to call new elections for April 1996.

In conclusion, the 1994-96 legislative period demonstrated the continued institutional weakness of the executive in the budgetary process. The Berlusconi government was unable to realise its budgetary objectives, mainly as a result of the fragility of its majority. In the face of enormous pressure from trade unions, the weak coalition crumbled and Prime Minister Berlusconi was forced to drop pension cuts and hence a considerable part of the planned savings of the 1995 budget. The result was a weak budget that looked unlikely to meet its targets. The technocratic Dini government could not even rely on any formal majority – let alone discipline it. Because the Dini government had to take into account the parliamentary preferences of the centre-left on which it had to rely in the face of potential opposition from the right-wing parties, budgets were particularly weak in terms of the structural measures taken.

At the same time, the continued pressure on public finances and the value of the lira made all parliamentary parties more willing to accept a certain degree of budgetary discipline (*Financial Times*, 28 February 1995). There is also evidence that - at least with respect to the 1996 budget - the opposition parties were reluctant to bring down the government even when this would have been theoretically

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supported the motion with 297 against and one abstention. On this occasion 19 deputies were absent, possible.[30] With the governments unable to make their preferences prevail (Berlusconi) or adjusting them to what was politically possible (Dini), budgetary policy could best be described as 'muddling through' in the face of external pressure. In sum, external pressures allowed the government to continue adjustment in accordance with systemic requirements but constrained by domestic party-political preferences and more generally by continued executive weakness. External pressure was the primary reason for the ability of the two governments to pursue a policy of budgetary consolidation, as domestic political actors were, for the most part, reluctant to bring down the government over the budget and assume responsibility for a financial crisis (Bossi in 1994, Berlusconi in 1995).

3.4 The Centre-Left Majority and the Prodi Government, 1996-1998

Because the centre-alliance, consisting of parties that mainly emerged from the centre-oriented groups of the former PSI and DCI, was crushed in the 1994 election by the left- and right-wing alliances, from the 1996 elections there emerged a moderate-left (*Ulivo*) and a moderate-right coalition (*Polo*) both of which excluded extremist parties on either side. There was hence a development from tripolarity to bipolarity between 1994 and 1996, which followed the logic of the 1993 electoral reform. The victory of the *Ulivo* was more the result of tactical alliances than of a major realignment of the electorate. The split of the centre had allowed the left to widen the left-wing alliance to the centre, while the right-wing alliance split (Newell and Bull 1997: 103; Chiaramonte 1997).

The fragmentation of the government coalition and of parliament was considerable. The left-wing electoral alliance *Ulivo* consisted of four main components: (1) the PDS (inclusive of six tiny parties that refused to be absorbed by the PDS [the *laburisti*, United Communists (CU), Social Christians (CS), Social Democrats (SD), Reformist Unity (RU), *Rete*]); (2) a group constituted by the PPI, the Democratic Union (UD) and the South Tyrolese People's Party; (3) the Dini List (made up of four parties); and (4) the Greens (*Verdi*) (Gilbert 1996; for the evolution

of whom 17 came from Mr Berlusconi's alliance" (*Financial Times*, 16 December 1995).

[30] The same pressures - including a reluctant attitude among some parts of the right-wing opposition - had already been evident during the Mancuso affair during which Berlusconi sought to bring down the Dini government (*Financial Times*, 21 October 1995). During this affair, Dini only avoided defeat by pledging to step down by the end of the year. This won him the support of the 24 RC MPs. This

of the main parties see Newell and Bull 1997: 95). By the same token, compared with the 20 lists that obtained votes in the 1994 elections, the 1996 elections resulted in only 13 lists winning seats. In terms of parliamentary groups, there were nine (formerly eight) groups in the Chamber and eleven (formerly 10) in the Senate (D'Alimonte and Bartolino 1997: 116). Hence, while the fragmentation in terms of parliamentary groups remained essentially unchanged, it decreased in terms of lists winning seats. However, the fragmentation of the government coalition was considerable. At best, the 1996 elections introduced a stronger element of bipolarity.

Thirty-two seats short of an absolute majority, a left-wing government under the prime ministership of Romano Prodi (1996-98) was formed which had to rely mainly on the toleration of the RC. The latter was not formally part of the government coalition. The combined vote of the *Ulivo* and RC gave the government a majority of 319 (284 *Ulivo*, 35 RC) out of a total of 630 seats – against 246 *Polo* seats (FI, AN, CCD-CDU) (D'Alimonte and Bartolini 1997; Table 3-8). As pledged, the government's most important goal was to join EMU (Parker 1997).

Table 3-8 Chamber of Deputies Elections 1996

	VOTE	PROPORTIONAL SEATS		SINGLE-MEMBER SEATS		TOTAL SEATS	
	PERCENT	**NUMBER**	**PERCENT**	**NUMBER**	**PERCENT**	**NUMBER**	**PERCENT**
-PDS	21.1	26	17	146	31	172	27
-PPI	6.8	4	3	63	13	67	11
-Dini list	4.3	8	5	16	3	24	4
-Greens	2.5	0	0	21	4	21	3
TOTAL Ulivo	34.7	38	24	246	51	284	45
-FI	20.6	37	24	86	18	123	19
-AN	15.7	28	18	65	14	93	15
-CCD-CDU	5.8	12	8	18	4	30	5
TOTAL Polo	42.1	77	50	169	36	246	39
RC	8.6	20	13	15	3	35	6
LN	10.1	20	13	39	8	59	9
Others	4.5	0	0	5	2	5	1
TOTAL	100.0	155	100	475	100	630	100

allowed him to defeat a motion of no confidence sponsored by Berlusconi by 315 votes to 291 (*Financial Times*, 27 November 1995).

Source: Newell and Bull (1997: 104)

Key: CCD-CDU = Christian Democratic Centre - United Christian Democrats

When Prodi took office, it was already clear that additional budgetary measures were needed to meet the 1996 general government budget target of 5.9 per cent. The overshoot - expected to be in the area of 0.6 per cent of GDP (Bank of Italy, *Abridged Report*, 1996: 77) - was primarily the result of too optimistic growth forecasts, which had overestimated growth by one percentage point, and higher than expected interest rates (*Financial Times*, 10 April 1996). The growth rate would average 1.1 per cent in 1996 as compared to 2.9 per cent in 1995 (Table 3-2 above).

As a result, in June 1996 the government announced a mini-budget. The budget relied on a fall in the discount rate, which explains the difference between the L21,000bn adjustment needed to hold the deficit to L109,000bn and the L16,000bn package of financial measures contained in the mini-budget. The L11,000bn worth of cuts mainly consisted of transfers to various public bodies and agencies such as the state railways, the postal service and so on. Revenue-increasing measures included a tax on housing and anti-evasion measures (*Financial Times*, 20 June 1996).

The limited size and content of the mini-budget and especially its reliance on a fall in interest rates clearly reflected the weakness of the Prodi government as well as the conflicts within the government coalition that pitted Treasury Minister Ciampi against the PDS and the Dini faction. Measures affecting pension and health expenditure were successfully resisted by the unions. This reflected the need of Prime Minister Prodi to maintain the fragile balance between left and right within the government coalition and the necessity to secure parliamentary support from the RC (*Financial Times*, 21 June 1996).

Approved by the cabinet on June 19, the mini-budget was passed by parliament in early August. In order to avoid amendments (mainly tabled by the LN), the government called its first vote of confidence, which it won relatively comfortably by 319 to 284 votes in the Chamber. The passage through the Senate was a mere formality as the government had an absolute majority there.

In the DPEF[31] of July the government proposed an adjustment of L32,000bn targeting a general government deficit of 5.5 per cent (and a state sector deficit of 4.5 per cent) for 1997 (OECD *Economic Surveys Italy* 1997: 62). The proposal was weak, as it did not include several expenditure items (such as VAT repayments to companies, the cost of a 1993 constitutional court judgement on pensions arrears) that in total amounted to almost L20,000bn. Not surprisingly, the European Commission taking account of these omissions projected the deficit to be in the area of 5.4 per cent or about one percentage point higher than the 4.5 per cent state-sector target set by the Prodi government (*Financial Times*, 10 July 1996).

At least since the Council of the EU meeting in Madrid in late 1995, it had been clear that the 1997 budgetary performance would be the decisive indicator regarding fiscal convergence. In other words, not only was Italy going to miss the Maastricht deficit target, but it was also unlikely to meet even its own (insufficient) target. German government officials and EU Commissioner Mario Monti criticised the Italian budget proposal as insufficient and made it clear that flexibility would not apply to the deficit criteria (*Financial Times*, 10 July 1996). However, the DPEF contained a paragraph that stated that the government would retain the option of speeding up fiscal adjustment in view of the meeting the convergence criteria in autumn 1996.

This time it was international 'political' pressure and more specifically the need to meet the deficit criteria, rather than economic pressure that allowed budgetary retrenchment. At the Italian-Spanish summit in Valencia in September 1996, the Spanish government rejected an Italian proposal to seek a re-negotiation or delay of EMU (*Financial Times*, 27 September 1996).[32]

The initial Italian proposal to slow down EMU can be interpreted in two ways – either of which is consistent with the weak executive approach. The Italian attempt to slow down EMU can be interpreted as an act of desperation and fear of being left out. This would clearly indicate the weakness of the executive to achieve sufficient domestic adjustment to meet the Maastricht criteria. The Italian proposal, and more specifically its rejection, can also be interpreted as a conscious attempt to create an external constraint in an attempt to strengthen the executive in dealing with potential domestic opponents over budget policy. Be that as it may[33], the rejection of the

[31] See Chapter 2, footnote 7.

[32] Similarly, Dini had warned Italy's EU partners not to reach a decision on EMU before May 1998 (*Financial Times*, 6 December 1995).

[33] Whether or not Valencia changed Prodi's attitude towards meeting the EMU deadline is unclear. Prodi himself later denied it (see Radaelli 2001) and, in fact, the government programme certainly committed Prodi to joining EMU (Parker 1997). Nonetheless, Prodi is also on record for stating that it would not be a tragedy if Italy would meet the criteria a bit late (*Financial Times*, 2 October 1996).

proposal to slow down EMU did result in a strengthening of the Italian executive in the budgetary process.[34] Apparently in response to these international developments, the government introduced a new DPEF that sought to reduce the deficit by L62,500bn - instead of L32,000bn as originally planned (*Financial Times*, 30 September 1996). The deficit target for general government was re-set from 5.5 to 3.0 per cent and the state sector deficit from 4.5 to 3.1 per cent.

The first part of the budget foresaw L18,200bn in cuts (which affected mainly transfers to local authorities, social security institutions and public utilities) and L14,100bn in revenue gains. The second part – to be introduced in early 1997 – aimed at a total adjustment of L25,500bn - of which L11,500bn were to come from the so-called euro-tax[35] in early 1997 and L18,200bn of savings were to be achieved through 'reclassification' measures (OECD *Economic Surveys Italy* 1997: 64). Further savings were expected to come from lower interest rates and hence reduced debt servicing as a result of falling interest cuts (*Financial Times*, 28 September 1996). Thus the budget made heavy use of treasury and accounting operations (such as delaying repayment of withholding taxes on bonds) as well as one-off measures (such as an extraordinary euro-tax which the government even promised to repay at some point) (Zaccaria 1998: 159-172; Bank of Italy, *Abridged Report*, 2000: 113-114).

However, in an interview with the *Financial Times* shortly after the Valencia summit Prodi seemed to admit that the government changed its attitude once the government had realised that the criteria would not be allowed to be 'bent': "The change occurred after the summer when I saw that other countries were making a serious effort to address their budget deficits (...). I realised Italy too could not miss the appointment with Europe" (*Financial Times*, 2 October 1996). As argued above, actions are more important than statements by politicians. Probably, the most plausible interpretation is that Prodi (and Ciampi) were committed to meeting the deficit criteria but were unable to overcome intra-coalitional opposition. The fact that Ciampi had asked for an initial adjustment of L40,000bn but then gave in to pressure from the Greens as well as the RC (Zaccaria 1998: 159-172) suggests that – even though Prodi and Ciampi were committed to meeting the criteria – they were unable to gather sufficient intra-coalitional support. Thus Valencia strengthened their position. This clearly reflects the importance the EMU constraint played in bringing about greater fiscal adjustment, and thus in meeting the deficit criteria (see below).

[34] This account resembles two-level games à la Putnam (1988) where external constraints can be exploited to overcome domestic opposition, while domestic weakness can be used to strengthen the government's international bargaining position.

[35] Clearly, the name euro-tax was consciously employed by the Prodi government to mobilise support for further budgetary tightening. Given that Italian public opinion overwhelmingly favoured EU and EMU membership (*cf.* Chapter 1.5), the name of the tax reflected the government's interest in 'selling' it to the Italian public. More generally, the discourse of possible EMU exclusion (and 'being left out of Europe' more generally) was (consciously) exaggerated in the sense that it was only the timing of EMU membership that was at stake – not membership in principle. This importance of 'discourse' as an independent variable should not be exaggerated however, since for this kind of discourse to be effective there needed to be real external constraint – and the possibility of failing to meet the convergence criteria was real in 1996.

The one-off nature of the 1997 budget clearly reflected intra-coalitional conflict. Initially (that is before aiming for the three-per-cent deficit target), the Treasury had demanded an initial adjustment of L40,000bn but had to give in to opposition from within the majority (RC, Greens). However, after it had become clear that a greater budgetary effort was needed, no party opposed the size of the adjustment proposed by the government. There was widespread agreement between the government and the opposition on the need to cut the deficit. Instead, the disagreement shifted towards the right mix of expenditure cuts and revenue raising. Even the unions grudgingly assented to the measures after forcing some concessions on the government that would make the tax more equitable (*Financial Times*, 20 November 1996). The deficit target itself was at least formally and publicly not at stake.

This clearly showed the reluctance of parties to be held responsible for not securing EMU membership[36] (*Financial Times*, 11 October 1996). The exclusion of pension and health cuts, for example, saw the Dini faction clash with the leftist wing of the coalition (and RC). As for parliamentary opposition, even though the centre-right criticised the budget (mainly because of its reliance on tax increases and excessive treasury operations), it finally abstained from a crucial vote in the Chamber. Even the RC - after obtaining the progressiveness of the euro-tax and the exclusion of pension measures from the 1997 budget – did not vote against it. The budget was passed with 316 votes against 2 (and 2 abstentions) on 22 December in the Chamber without the government having to call a confidence vote (*Financial Times*, 23 December 1996).

The need to meet the deficit target clearly increased the bargaining position of the government. Interestingly, the government pushed ahead despite considerable opposition. In addition to some opposition to tax increases from a number of right-wing opposition parties, leading industrialists (Fiat CEO Cesare Romiti), usually among the strongest supporters of EMU, were rather unenthusiastic about further budgetary tightening (*New York Times*, 30 August 1996).[37] Nonetheless, the government went ahead with its plan. This clearly shows the enhanced power of the

[36] The importance of public support was shown in an opinion poll in the *Corriere della Sera* showed that 58 per cent of Italians were backing the euro-tax (*Financial Times*, 8 October 1996). Moreover, public support for EMU was high (Figure 1-1).

government *vis-à-vis* domestic actors in budgetary politics as a result of external pressure.

Shortly after parliament had approved the 1997 budget, estimates indicated that Italy was likely to close the 1996 fiscal year with a general government deficit of 7.5 per cent and significantly larger than the officially targeted 5.9 per cent.[38] Given that parliament had just endorsed the 1997 budget aimed at cutting the public deficit by 3 per cent of GDP, further fiscal restraint was necessary (*Financial Times*, 4 January 1997). In the context of modest growth it was naturally difficult to find the necessary means to cover the expected shortfall. It was primarily the political opposition from the RC, the unions and the PDS against further cuts that made it politically difficult to introduce appropriate measures. However, when it transpired that the current trend in spending and receipts was expected to produce a deficit of almost 3.8 per cent (*Financial Times*, 19 March 1997), the government was forced to announce supplementary deficit-reducing measures worth some L15,500bn in March. The package agreed upon aimed to raise almost half the L15,500bn by raiding company funds (L6,000bn), while L4,200bn was to come from accelerated payment of inheritance taxes. Another third was to come from spending cuts (*Financial Times*, 27 March 1997). As a result, the mini-budget had an even greater provisional character than the 1997 budget (for details see Zaccaria 1998: 173-176). The structural weakness of the mini-budget was also reflected in the International Monetary Fund view that the intervention was incompatible with consolidation as the 1997 mini-budget structural impact was estimated to be a mere L1,000bn.[39] Similarly, European Commission announced that Italy would miss the 3 per cent target by 0.2 points and European finance ministers criticised the Italian budget: "[T]he measures taken in 1997 which have a temporary nature should be replaced by structural measures with a permanent impact on the budget" (quoted in *Financial Times*, 13 May 1997).

While new deficit projections certainly weakened potential opponents of the mini-budget, as its rejection would almost certainly have meant Italy's exclusion

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[37] Even central bank governor Fazio agreed with the initial (limited) DPEF, even though he admitted that a further reduction of the deficit in line with meeting the convergence criteria was ultimately a political decision (see Radaelli 2001).

[38] Eventually, the 1996 fiscal year was officially closed with a general government deficit of 6.6 per cent (Table 3-1).

[39] For a detailed discussion of the importance of Treasury operations and accounting reforms see Zaccaria (1998: 199-201) and Reviglio (1998: 20-25).

from EMU, the Budget Commission of the Chamber nonetheless refused to convert the mini-budget decree-law[40] and thus forced the government to submit legislation to the assembly. However, after the government made the conversion of the decree a matter of confidence, the mini-budget was approved by the Chamber with 318 to 260 votes on 6 May. With a centre-left majority in the Senate the mini-budget encountered a smoother passage there (*Financial Times*, 7 May 1997). Eventually, however, Italy was able to meet the deficit target thanks to the impact falling interest rates had on interest payments (see Spaventa and Chiorazzo 2000: 85-87). (The general government deficit turned out to be 2.7 per cent for 1997.).

The weakness of the 1997 budget – let alone of the 1997 mini-budget - in structural terms had been wildly criticised by European officials (*Financial Times*, 13 May 1997; *Il Sole 24 Ore*, 5 September 1997) and it was clear that the 1998 budget would have to contain some structural measures in order for fiscal consolidation to be considered sustainable and indeed to hold the deficit below the three-per cent mark as the one-off measures were to peter out in 1998.

Visibly forced by the uncertainty as to whether or not Italy would meet the deficit target for 1997, at the end of May the government unveiled a three-year macroeconomic programme to cut the general government deficit to 2.8 per cent of GDP in 1998. The government finance bill eventually proposed an adjustment of L25,000bn (or 1.25 per cent of GDP) for 1998 in order to keep the deficit down to 2.8 (rather than - in the absence of budgetary measures - letting it reach 4.1) per cent. Some L10,000bn were to come from revenue increases and L16,500bn from expenditure cuts, of which about L4,500bn were to come from pension cuts. Negotiations with unions as well as the RC over pension cuts dominated 'budgetary politics'. Not only did this represent a significant compromise relative to the L6000bn-L7,000bn worth of cuts initially targeted (*Financial Times*, 29 September 1997), but the fiscal correction was also one of the 'mildest in a decade' (*The Economist*, 4 October 1997; Annex B).

Despite the relatively limited degree of the proposed budgetary adjustment, opposition to the budget was considerable. The RC (and unions) opposed social spending cuts. Once more, the primary conflict was over the composition of the

[40] Opposition came mainly from the RC and the centre-right parties. The RC demanded less welfare cuts, while the centre-right parties demanded greater cuts and less tax increases (*Financial Times*, 7 May 1997).

adjustment rather than its overall size. This was also reflected in the proposition of the right-wing opposition for a common *manovra europea* that reflected the overall consensus regarding the need to meet the Maastricht criteria.

This time the most important conflict pitted the government against the RC. The underlying conflict came to the fore on 1 October 1997 when the RC announced it would vote against the budget even though the government had announced that it would make the vote an issue of confidence. Given the overall consensus concerning the importance of meeting the convergence criteria, the government sought to force the issue by introducing a vote of no confidence, thus threatening early elections (*Financial Times*, 3 October 1997). It was clear that an election at this stage would have delayed the passage of the 1998 budget and provoked a severe backlash from the financial markets. The parties that were to bring down the government would have to take responsibility as a delay in the adoption of the budget might have meant an extension into the following year and hence the possibility of not meeting the crucial 1997 deficit target (*The Economist*, 4 October 1997). Prodi sought to force the issue by calling a vote in parliament. However, as the government was defeated by one vote, Prodi resigned (*Financial Times*, 10 October 1997).

After the prime minister had submitted his resignation, the public and political pressure on the RC to change its position became massive. There was harsh criticism from the media that held the RC responsible for Italy's possible failure to join EMU and for risking a financial crisis. Even the normally hard-line CGIL metalworkers of the FIOM (*Federazione Impiegati Operai Metallurgici*) - in agreement with the confederal leadership - spoke out against the RC (Legrenzi 1998). Moreover, the Milan stock exchange took a dive. Very obviously as a result of these pressures, the RC agreed to resume negotiations with the government and accept a compromise, including the introduction of a 35-hour week, and the exclusion of blue-collar workers from seniority pension cuts (Legrenzi 1998; Walsh 1998). This compromise is consistent with the 'weak executive' approach in that the government was not strong enough to impose necessary short-term costs in order to achieve long-term sustainability. Also, the introduction of a shorter working week only created an additional burden for the Italian economy in the future – and thus represents a policy of short-term accommodation to the detriment of long-term sustainability. Thus, the RC's change of position demonstrates the importance of the international political constraint embodied in the Maastricht criteria. This existence of this constraint was crucial in that it mobilised domestic public opinion against the RC, forced the RC to compromise, and strengthened the relative position of the government. It is hard to imagine that the RC would have backed down in the absence of the Maastricht constraint. This proves that the EMU constraint was an indispensable factor in strengthening the government, weakening potential opposition, and – eventually – in meeting the deficit criteria.

Having obtained the acceptance of the 1998 budget and especially pension measures from the RC, in early November the so-called 'Prodi agreement' on pensions (containing the acceleration of the increase in the early retirement age, the gradual harmonisation of public and private pension regimes and increases in pension contributions paid by the self-employed) was reached between the government and the unions thus clearing the way for the intended expenditure cuts (*cf.* Chapter 4). Having secured a compromise with the RC and the unions, the 1998 budget passed both houses relatively comfortably. The government did not call a vote of confidence. This once more indicated the overall agreement concerning the need to keep the deficit below 3 per cent in 1998 - at least after a compromise had been struck (Zaccaria 1998: 189-197).

In April 1998, the EU finance ministers in Brussels announced that the Italian government's 1998 budget deficit was likely to be 2.8 per cent of GDP. Italy had closed the 1997 fiscal year with a general government deficit equivalent to 2.7 per cent of GDP (Table 3-1; Spaventa and Chiorazzo 2000). In fact, the deficit for 1998 would turn out to be 2.7 per cent of GDP (Bank of Italy, *Abridged Report*, 1999: 100).

In conclusion, the analysis of budgetary politics between 1996-98 shows that executive weakness still persisted and was largely the result of limited executive authority over the budgetary process. In the event, the multi-party character of the government majority, the lack of a cohesive majority and the lack of prime ministerial dominance over the budget formulation process were compounded by the lack of a government majority in the Chamber. Not only did Prodi have to accommodate RC demands but he also had to take into account the mainly partisan interests of his heterogeneous government coalition. Moreover, these weaknesses made the government more receptive to the demands of the trade unions.

This shows that the limited authority of the prime minister within the cabinet as well as in relation to the government majority parties was, despite the stronger tendency towards bipolarity, the main obstacle in implementing fiscal adjustment. Hence it is fair to say that the 'old' institutional logic prevailed in 1996-98. It was only thanks to international pressure, in combination with wide-spread support for EMU among the Italian public,[41] that enabled Prodi to discipline his majority as well as to force the RC and unions to accept the need for budget cuts. The widespread consensus concerning the importance of EMU membership also played a crucial role as it allowed the government to 'impose' policies on its constituent parts that they would have been otherwise reluctant to accept. Hence the EMU constraint was a crucial factor in helping Italy to meet the deficit criteria.

3.5 Conclusion: Fiscal Adjustment without Institutional Reform?

From both a cross-national and an historical perspective, Italian fiscal consolidation from 1992 onwards was impressive. It is true that the fall in interest rates contributed to the good budgetary performance (*cf.* Table 3-1).[42] With a more or less constant debt-to-GDP ratio, interest payments declined between 1992 and 1997 from 11.5 per cent to 9.5 per cent (Table 3-9).

Table 3-9 Breakdown of Public Administration Expenditure, 1991-1997

(as a share of GDP)

	1991	1992	1993	1994	1995	1996	1997
Public Employees	12.7	12.7	12.5	12.0	11.4	11.7	11.8
Social spending	18.3	19.3	19.5	19.5	19.0	19.3	19.6
Interests	10.2	11.5	12.1	11.0	11.4	10.8	9.5
Investment	3.3	3.3	3.0	2.7	2.3	2.2	2.3
Other	9.4	9.3	11.2	10.1	8.8	9.1	8.3
Total	53.9	56.1	58.3	55.3	52.9	53.1	51.5

Source: Elaborated on Bank of Italy, *Abridged Report*, 1998

[41] In 1996, seventy-eight per cent of Italians were in favour of EMU and only 9 per cent against (Commission of the European Communities 1996b: 45).

[42] It has been suggested that certain measures between 1985-1990 had an important effect in subsequent years. Given that the primary deficit was almost balanced in the early 1990s, there is certainly some truth in that. Nonetheless, the five (!) manoeuvres between 1990-1991, for example, only resulted in *temporary* rather than *structural* reforms that were bound to lead to worse budgetary performance in the near future (Spaventa and Chiorazzo 2000: 50). Accordingly, the fiscal adjustment programmes between 1987-92 have been referred to as *manovre senza risanimento* (Verzichelli 1999b).

Nonetheless, discretionary budgetary policy played an important role in bringing about deficit reduction (*cf.* Annex B).[43] The primary balance improved by almost 5 points between 1992 and 1997.

How was this by all means impressive fiscal consolidation possible given unfavourable domestic-institutional factors? First, I show that non-institutionalist explanations do not provide a sufficiently coherent explanation. Then I argue that neither political nor budgetary-institutional reform was substantial enough to explain fiscal consolidation during the 1990s. Although this leads to the conclusion that fiscal convergence was made possible thanks to international economic pressure and the constraint imposed by the Maastricht criteria, it is argued that fiscal reform came about *despite* institutional obstacles. In other words: both political and budgetary institutions need nonetheless to be taken into account for a satisfactory understanding of Italian fiscal convergence.

Various authors have referred to contingent factors in order to explain Italy's impressive budgetary performance: Amato was a technocrat; his government was supported by the president and the corruption scandal weakened possible parliamentary opposition; Ciampi was a technocrat with a high reputation; his government was supported by left-wing parties in search of legitimacy and recognition; Dini was a technocrat and was supported by the PDS; the Prodi government was a quasi-technical government and was headed by a person with strong pro-European convictions and so on. Others have occasionally referred to a newly discovered 'stability culture' and a technocratic elite interested in implementing reforms (Vassallo 2000: 302-303; similar Dyson and Featherstone 1996). It has also been suggested that the reform of budgetary procedures (Hallerberg 2000) and the greater competitiveness of the parliamentary and party-political system introduced with the electoral reform of 1993 (Vassallo 2000: 306) made at least some contribution to budgetary reform. Others have also suggested that the emergence of new societal coalitions were responsible for the budgetary policy reform (Walsh 1999).

There is insufficient space to argue against all of those explanations in detail. Some anecdotal counter-evidence will have to suffice here. The 'technical' or 'prime

[43] As the accounting changes and treasury operations were accepted by the International Monetary Fund (IMF) and the European Commission - and similar operations were used by other states -, they are not discussed here.

ministerial government' (Manzella 1996: 146) explanation seems to underestimate the tensions within the Prodi (and even the Amato) government as well as the different degrees of success the various governments experienced with respect to budgetary adjustment. Stronger budgetary procedures cannot account for the varying degree of success of budgetary adjustment during the 1992-98 period. Greater competitiveness of the electoral system does not explain the Amato reform, nor does it explain the failure of the short-lived Berlusconi government. A weakened parliamentary class eager to avoid elections does not explain budgetary consolidation after 1994. Technocratic elites and the increasing importance of a stability culture were no doubt present, but they cannot explain how an institutionally weak government was able to overcome traditional veto points.

From an institutional point of view one would expect that institutional reforms were crucial in bringing about budgetary policy reform. As already indicated in Section 3.1, neither the reform of the electoral system nor the modifications of the budgetary process have made any substantial contribution to fiscal consolidation. First, the qualitative analysis above suggests that fiscal consolidation was not correlated with the failure or success of political-institutional reform: both the Amato and Ciampi governments have to be regarded as strong governments, while the Berlusconi and Prodi governments were certainly less strong. Naturally this was primarily the result of the defection of the *Lega* and the Prodi government's dependence on the RC. Nonetheless, this shows that - at least in terms of stable and strong majorities - the introduction of a more competitive electoral system did not affect the various governments' ability to achieve budgetary reform. It might be argued that the tendency towards bipolarisation that resulted from increased electoral competition strengthened the authority of the government by virtue of its disciplining effect on the constituent parts of the majority or the groups supporting the majority in parliament (such as the RC). Once again this was not borne out by the Italian experience. In 1995 the *Lega* obstructed the government's attempts to pass a 'tough' budget and deserted the right-wing coalition regardless. After 1996 the RC only backed off from bringing down the government because it faced massive internal and external pressure - not because of the electoral system's disciplining effect.

If anything, the empirical analysis shows how governments after 1994 experienced major difficulties in securing parliamentary support. The fall of the Berlusconi government and the conflicts between Prime Minister Prodi and the coalition parties - over at least the content of the budget - just represent different aspects of the same institutional problem: the limited control of the executive over parliament, the resulting fragmentation of the cabinet and hence the weakening of executive and prime-ministerial authority. In short, given the available evidence, the electoral reforms did not have any substantial impact on the success or failure of budgetary policy reform.

There are other reasons that suggest that electoral reform did not affect budgetary adjustment. First, on the political-institutional level, the electoral reform of 1994 created at best an 'imperfect bipolarism' (Chiaramonte 1997). On the one hand, the 1994 reform did not lead to any substantial reduction in the number of coalition parties and parliamentary groups (Manzella 1996; Verzichelli 1997; Table 3-10).

Table 3-10 Number of Party Actors, 1987-1996

	1987	1992	1994	1996
Lists with more than 0.5 per cent of votes	14	16	14	11
Number of lists obtained seats	14	16	20	13
Number of parliamentary groups*				
- Chamber	12	13	8	9
- Senate	9	10	10	11

Source: D'Alimonte and Bartolino (1997: 116) *at beginning of legislature

Italian governments were not significantly longer-lived than in previous periods, with the exception of the Prodi government. On the other hand, electoral reform did achieve a more bipolar structure. But this change should not be overstated: "The poles are only alliances of parties, and the parties retain their identities, interests and (sometimes) individual parliamentary behaviour" (D'Alimonte and Bartolini 1997: 120). However, even those authors that have the greatest reservations concerning the effective changes admit that the Italian party system has become more competitive (Pasquino 1996; D'Alimonte and Bartolini 1997; Pappalardo 2000). Nonetheless, if parliamentary and government *fragmentation* is the crucial characteristic, then the greater *competitiveness* should only be expected to have a marginal effect at best. Hence on theoretical grounds the electoral reform should not have been expected to matter very much anyway with regard to budgetary policy.

It is true that the reforms of the 1990s went some way to rationalising budgetary procedures. Nonetheless, except for the absence of the provisional implementation of the budget, there is not much evidence that these changes were of any particular importance relative to international pressure. One might expect to find more coherent budgetary policies as a result of more rationalised budgetary procedures. The previous sections made clear that coherence was relatively high with respect to the 1993, 1994 and 1995 budgets.[44] The greater fragmentation and incoherence of the subsequent budgets demonstrated though that 'stronger' budgets did not coincide with 'strengthened' procedures. By contrast, to the extent that budgetary coherence was achieved it reflected the greater political influence of the executive over the budgetary process. This strengthening – as repeatedly pointed out – was due to international pressure and not to domestic-institutional reform.

The following numbers also support this interpretation. During the 1981-92 period, deficit overruns averaged an annual 1.5 per cent of GDP - despite the introduction of supplementary budgets (OECD *Economic Surveys Italy* 1992: 46-47). After 1992 the deviation was only about 0.8 per cent (Verzichelli 1999b: 214-215). It would seem though that this improved performance was due largely to the willingness (and ability) of respective governments to introduce mini-budgets rather than improved budgetary procedures. For example, even though it is true that forecasts of public deficits are difficult in the context of high public debt and volatile interest rates, the fact that the original budget forecast always overestimated revenues and underestimated expenditure during 1992-97 makes it plausible to assume that either the executive was not able to control parliamentary amendments, or it was at least eager to avoid tough budgetary measures by relying on biased forecasts. Either way this indicates that more rationalised budgetary procedures had no relevant effect on budgetary outcomes. By the same token, the fact that the budget target[45] was undershot in 1995 and 1997 - as compared to the near permanent overshoots of the 1980s - points to the increased strength of the executive *once the slippage had occurred* rather than a generally increased control over budgetary outcomes - as evidenced in the fact that the undershoots were only possible after additional mid-year adjustments.

[44] The 1995 Berlusconi budget proposal was strong and coherent but - contrary to the Amato and Ciampi budgets - was weakened at the parliamentary stage.

Put differently, even if it is true that since 1990 parliament respected the - formal - objectives fixed by government and only decided the allocation of resources within the imposed limits (Giuriato 1997) and that the budget overshoots resulted from such factors as too optimistic government forecasts, creative accounting, and the favouring of (overestimated) one-off measures, then this would still indicate the continued 'political' weakness of the executive in budgetary policy-making.

In other words, if the legislative phase does not substantially alter budgetary outcomes in terms of debt and deficits, then the biased forecasts can be understood as the inability (or unwillingness) on the part of the executive to resist pressure from - and overcome the opposition of - parliamentary parties, majority parties and societal actors. Hence the formulation phase would represent the crucial phase of budgetary policy-making (Verzichelli 1999a: 92). Therefore even if the modifications of budgetary procedures in the early 1990s decreased the ability of parliament to substantially alter budget targets, budgetary policy still represented a series of compromises reached at the formulation stage - if not the parliamentary stage in the case where the government was unable or unwilling to reject amendments.[46]

This confirms the view according to which the 'political-institutional' strength of the executive *vis-à-vis* parliament is more important than formal budgetary procedures. In other words, the insufficient extent of political-institutional reform means that there still persists a politics of the 'least common denominator' possible (Koff and Koff 2000: 130-131) - at least from an institutionalist point of view. In fact, the above analysis provides ample evidence for continued problems regarding the meeting of planned deficit targets as well as the important influence of intra-coalitional and intra-majority bargaining relative to 'executive authority'.

On a theoretical level, it is equally plausible that the reform of budgetary procedures, to the extent that it affected budgetary outcomes, was only of limited importance. "It is clear that budget rules and changes in budgetary procedures cannot deliver more responsible fiscal policy decision *per se*, regardless of political will" (Milesi-Ferretti 1997: 35; De Haan *et al.* 1993: 94; Alesina *et al.* 1998: 14; Felsen 1999).

[45] The budget target was measured by the state sector deficit until 1995 and the general government deficit thereafter.
[46] See also analysis by *Promoteia* (2000).

If there is no evidence of an institutional strengthening of the executive in terms of internal cohesiveness of majority and centralised executive authority, how was budgetary consolidation possible? The above analysis strongly suggests that consolidation has to be understood in a 'dialectical' way, that is as the confluence of international pressure and the continued *institutional* weakness of the executive. From this perspective, budgetary adjustment was the result of the impending financial and currency crisis (1992-95) and the increasing impossibility to disregard possible EMU exclusion (1995-98).

The Amato and Ciampi governments enjoyed a considerable degree of autonomy from traditional party politics and were thus able to impose tough budgets on parliament. This autonomy was mainly the result of external pressures such as the impending exchange rate crisis, the devaluation of the lira and the dramatic debt situation, and partly the result of the weakening of political parties as a result of the corruption scandal. The problems of the Berlusconi government and the relative weakness of budgetary measures under the Dini government demonstrate the continued importance of executive weakness as well as the relevance of continued international financial pressure. The Prodi government most visibly demonstrated how the external constraint in the form of precise fiscal targets was used to overcome domestic opposition and executive weakness. Nonetheless, despite continued consolidation, budgetary policy from 1995 onwards was characterised by a 'bargained nature'. The conscious use of the external constraint to enhance the role of the prime minister and the executive was best reflected in the imposition of a tougher adjustment in autumn 1996 on the government coalition and its informal ally.

In other words, budgetary policy-making during the 1990s was determined by a dialectical relationship between external economic (international markets) and political (Maastricht criteria) constraints and domestic institutional weakness. Through increasing international pressure (whether in the form of impending financial crisis or the EMU deadline) the lowest common denominator was raised. Nonetheless, Italian budgetary policy during 1992-98 provides evidence of the continued importance of executive weakness, as evidenced by such characteristics as the gradualist nature of budgetary adjustment, the composition of adjustment and the importance of external pressure.

First, it is true that there were a high number of budgetary manoeuvres. Strikingly, on average the effective reduction of the budget deficit would have missed the planned target by about 30 per cent (Spaventa and Chiorazzo 2000: 61). As mentioned above, part of this underestimation is related to forecasting problems, it is very probable that estimation errors were used as a handy 'political' tool. (The fact that the estimates were biased in one particular direction makes this all the more plausible.) Not being able to make its preferences prevail in the annual budget, the government's introduction of mini-budgets - often under severe external pressure - gave it a better chance to prevail over possible veto players.

Second, the composition of the adjustment involved a lot of tax raising and cuts in public investment (Table 3-9), measures that are usually associated with a 'weak adjustment' (Alesina and Perotti 1995). However, there were also elements of a 'strong(er)' adjustment. More specifically, while the 1990-93 period was characterised by considerable tax increases, the 1993-95 budgets contained considerable cuts in structural spending. By contrast, the 1996 budget was comparatively weak in terms of structural measures. Similarly, even though the 1997 budget coincided with considerable adjustment in terms of deficit reduction, both the 1996 and 1997 budgets were largely monetary-based manoeuvres. According to Zaccaria (1998), 45 per cent of the 1997 fiscal adjustment was based on treasury operations (delay of expenditure or anticipation of revenue), while only 55 per cent can be considered as effective adjustment (pp. 206-8). In short, the 1996-97 budgets were characterised by a "*carenza di una visione progettuale e quindi di un intervento sistematico sui conti pubblici*" (Zaccaria 1998: 210) and hence by greater fragmentation, incoherence, temporary measures and window-dressing. In short, these budgets were weak, reflecting the weakness of the executive in the budgetary process. This was also confirmed by the qualitative analysis above.

Third, there is also plenty of evidence that external pressure strengthened the executive domestically. For example, while in 1997 the government was able to force the issue and negotiate (or rather 'buy') its way out of budget deadlock, in 1998 – with the EMU constraint gone – the government fell.[47] Even though the budget was not substantially altered under the new D'Alema government, it demonstrated the

[47] The attempt by the Berlusconi camp to bring down the Dini government in spring 1994 (and autumn 1994) despite on-going international financial pressure represents the famous 'exception that confirms the rule' (see Section 4.3).

continued institutional weakness of the Italian executive in budgetary policy-making. This indicates the existence of a cyclical pattern of Italian macroeconomic policy that results from a dialectic between international constraints and domestic-institutional weakness (see Section 7.1).

In short, greater executive strength and hence budgetary consolidation was primarily the result of a *vincolo esterno*. Between 1992 and 1995 it was the real possibility of an outright financial crisis that disciplined both majority and opposition parties with regard to budgetary policy. Between 1996 and 1998, with a diminished probability of a financial and currency crisis occurring, the Prodi government successfully used the threat of EMU exclusion to impose more or less severe but necessary budgetary adjustment. Throughout this time though the executive's institutional weakness continued to matter. Hence it is fair to say that Italian budgetary policy reform was in substance a 'policy reform without relevant domestic institutional reform'. The theoretical implications for the institutionalist approach will be discussed in Section 7.3.

4 THE POLITICS OF PENSION REFORM

Domani (Italian for English *tomorrow*)

An important area that underwent reform during the 1990s and thus contributed to fiscal convergence was welfare and particularly pension policy. Pension reform contributed to short-term budgetary consolidation in two ways. First, pension reform made a direct contribution to fiscal consolidation by reducing - or at least by preventing a greater increase of - the pension deficit that had to be financed by the government. Second, pension reform had a positive effect on investor confidence and thus the stability of the lira and interest rates. The level of interest rates was extremely important given the high stock of public debt and the resulting interest payments. In the mid-1990s a one-percentage point increase in interest rates meant a L15,000bn increase in interest expenditure. As will be shown, both effects made an important contribution to successful macroeconomic convergence in the 1990s.

While Chapter 3 focused more narrowly on budgetary policy-making in terms of executive-legislature relations, this chapter will discuss the contribution made to fiscal consolidation by pension reform. Even though budgetary consolidation and pension reform are intimately related, there are several reasons why it is sensible to analyse them separately.

First, societal groups and more specifically trade unions have always played an important role in the formulation and implementation of Italian welfare and pension policy. Even though the participation of societal actors in the making of public policy can be found in almost all areas, Italian welfare and pension policy-making has always been characterised by a particularly high degree of trade union participation (Ferner and Hyman 1992; Regalia and Regini 1998). Second, not only does social welfare spending constitute the single most important item of public expenditure, but pension spending also makes up the largest part of welfare spending. Hence social expenditure reform could potentially generate large savings. In 1992, spending on old-age and survivors' pension alone represented more than 15 per cent of GDP, while public wages made up 12.7 per cent and interest payments 11.5 per cent of GDP. Total government spending was 56.1 per cent of GDP (Bank of Italy, *Abridged Report*, 1998: 99-113). Finally, given that from the mid-1960s onwards, public deficits coincided with the expansion of welfare (and pension) spending in general, reforming welfare and especially pension policy meant tackling an important source of public deficits (Franco 1993).

There are also several reasons to focus more narrowly on pension reform rather than on social expenditure reform in general. First, pension expenditure[1] represents the largest item among social security expenditure. While social expenditure as a share of GDP is broadly in line with the EU average, the composition of Italian social spending is different. At the beginning of the 1990s, roughly 60 per cent of total social security spending was on old-age and survivors' pensions. This is some 20 points above the EU average (IMF 1998: 57). Social expenditure is thus disproportionately biased towards pensions. By comparison, health spending,[2] as the second largest social expenditure item, was not only below the EU average, but its much smaller share of total expenditure offered less potential savings (Table 4-1).

Table 4-1 Social Expenditure by Function

(as a share of GDP)

	EU			ITALY		
	1980	**1990**	**1993**	**1980**	**1990**	**1993**
Sickness, Invalidity, Occupational Accident	8.7	8.8	9.4	6.3	7.7	7.6
Old-age, Survivors'	10.1	11.1	11.9	9.9	13.6	15.5
Other	4.4	4.3	5.3	1.8	1.5	1.5
Total	23.2	24.2	26.2	18.0	22.8	24.6

Source: Eurostat (1996a)

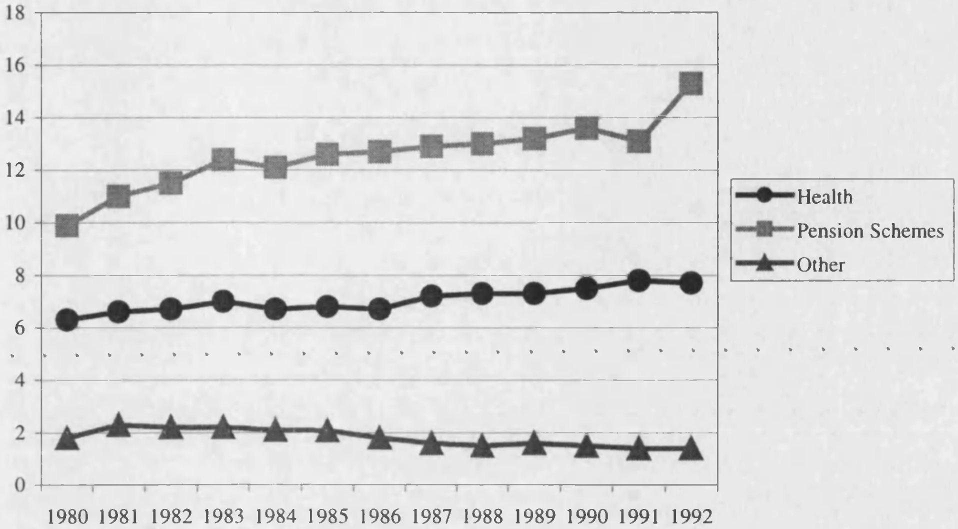
Furthermore, while health expenditure had remained almost constant as a share of GDP, old-age and survivors' pension outlays were the most dynamic component of public expenditure (Figure 4-1).

[1] Generally figures refer to old-age and survivors' pensions which represent by far the largest part of pension outlays. Social and invalidity pensions are negligible by comparison. For example, in 1992, of the L333,000bn in social expenditure, L83,000bn were spent on health, L27,000bn *assistenza* (including invalidity and other types of pensions that combined made up less than L17,000bn) and L222,000bn on *previdenza* - of which L184,000bn alone were spent on old-age pensions (*Ministero del Bilancio, Relazione generale sulla situazione economica del paese* 1993 [Volume I: 73]).

[2] While the financial effect of health policy on public finances was not negligible - the National Health Service was running a deficit of L8,600bn in 1989 (Mapelli 1999: chapter 4; Reviglio 1998: 93-112) -, the greater dynamism of pension expenditure justifies the focus on pension reform.. As for the importance of privatisation, the proceeds from privatisation during 1994-97 (ca. L65,900bn) were used to reduce the stock of debt and thus had no direct impact on deficit reduction (*Presidenza del Consiglio dei Ministri* 1998; also Nicoletti and Goldstein 1996; Reviglio 1998: chapter 8). For welfare reform more generally see Ferrera (1997).

Figure 4-1 Social Expenditure, 1980-1992

(as a share of GDP)



Source: Chiorazzo *et al.* (1994: 230) based on *Ministero del Bilancio, Relazione generale sulla situazione economica del paese*

As a state-run contributory pay-as-you-go pension regime, the state covers the shortfall between contributions and expenditures. As pension spending exhibited the greatest dynamism, the absence of pension policy reform was bound to create dramatic financial problems in the future, especially in the face of adverse demographic developments. In fact, social security contributions in other areas already financed the deficit of pension schemes (IMF 1998; Ferrera 1997: 234). In order to meet its pension liabilities, the system traditionally made recourse to extensive direct allocations and off-budget transfers (IMF 1998: 62). The precise extent of the pension deficit and the impact on public finances is however difficult to establish.

> L'impatto dei disavanzi delle gestioni pensionistiche sulla finanza pubblica non è di agevole misurazione, in quanto tra i conti della previdenza i trasferimenti dello Stato (compresi quelli a copertura dei disavanzi di tesoreria) sono inclusi tra le entrate; ciò naturalmente altera il saldo (Faustini 1996: footnote 47; Ferrera 1984: 81; IMF 1998: 60-61).[3]

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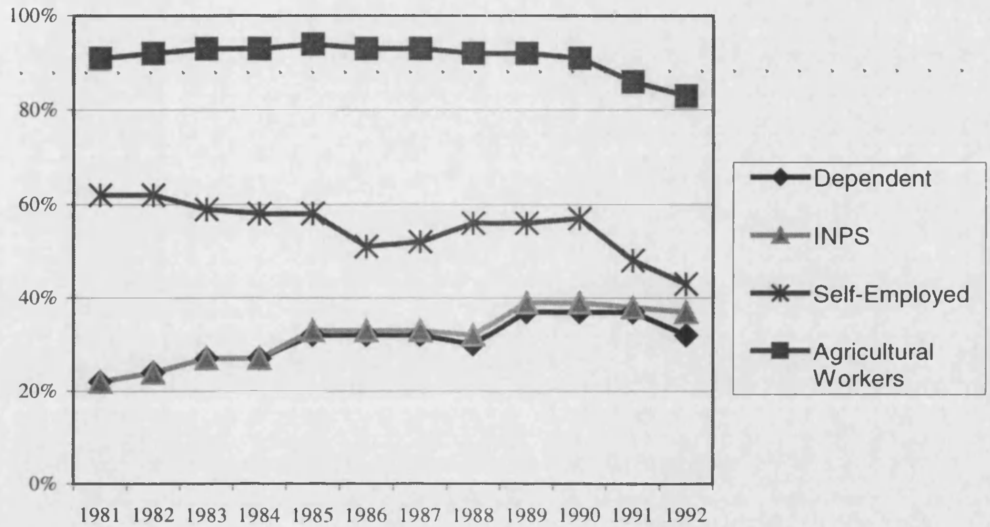
[3] "The impact of pension deficits on public finance is not easy to measure, since the revenues are included in the social security accounts and state transfers (including those to cover Treasury deficits); this of course alters the balance."

Although it is hard to quantify the precise impact of pension spending on public finances, the chronic deficit between contributory revenues and social outlays of the major pension schemes was considerable as partly reflected in the deficit-benefit ratios (Padoa-Schioppa Kostoris 1996). The deficit-benefit ratios indicate the importance of the pension deficit financed by the government (Figure 4-2).

Figure 4-2 Deficit-Benefit Ratios

(per category)



Source: Visaggio and Vitali (1995) based on *Ministero del Tesoro*, *Relazione generale sulla situazione economica del paese*

While the deficit-benefit ratios demonstrate the importance of state transfers, the figures in Table 4-2 give an idea as to the actual amount of state financing. Given that the numbers in Table 4-2 relate to the *previdenza* deficit and given that part of the pension deficit was financed through surpluses of other social security schemes within *previdenza*, the actual extent to which the government finances the pension system is higher than reflected in these figures. While many other EU countries are also characterised by public transfers to social security institutions and especially the pension system, the Italian case was particularly dramatic in that the shortfall was financed through public deficits rather than through current revenues.

Table 4-2 **Consolidated Account of *Previdenza* *[4]**

(as a share of GDP)

1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
0.43	-1.17	-1.37	-2.06	-1.92	-2.09	-2.07	-1.66	-2.23	-2.30	-2.64	-2.51	-3.16

Source: Visaggio and Vitali (1995) based on *Ministero del Bilancio, Relazione generale sulla situazione economica del paese*

* all institutions/ net of contributions of central and local administration

Apart from the question of the precise impact of pension spending on public finances, it was clear that given that there was a limit to increases in contribution rates, budget transfers were bound to increase with the maturing of the system and the worsening of demographic and occupational trends. Hence not only would pension cuts contribute to budgetary consolidation but leaving the system unreformed would further increase the pressure in the future (D'Ercole and Terribile 1998). In short, the reform of the pension regime in particular became a crucial component in preventing a deterioration of the fiscal situation and achieving sustainable public finances.

Although projections of future pension expenditure[5] varied, all of them painted a bleak picture in terms of future spending (INPS 1991; *Ragioneria Generale dello Stato* 1991).[6] A further deterioration of pension deficits was hardly sustainable in terms of either international competitiveness or public finances: the government already financed a substantial part of the pension deficit and large increases in contribution rates would have been hard to sustain at a time when these rates were actually falling on EU average (Ferrera and Gualmini 1999: 93).

Reform was also necessary because the TEU stipulated sustainable public finances (Art. 109j). A 'sustainable position of the public finances' in the medium-term was crucial since budgetary consolidation had to result from the reduction of financial imbalances in all sub-sectors and particularly in the social security system.

[4] *Previdenza* does not include invalidity, disability or social pensions. The deficit hence only reflects the approximate impact of the old-age pension deficit on public finance.

[5] Clearly, forecasts concerning pension expenditure are always risky as they depend on rather uncertain assumptions concerning economic growth and demographic developments (Commission of the European Communities 1996a: 15). Nonetheless, the overwhelming majority of studies in the 1980s and early 1990s demonstrated that the Italian pension system was going to face major difficulties (*Ragioneria Generale dello Stato* 1991; INPS 1991). Trends were even more worrying in a cross-national perspective. In the late 1980s, the OECD (1988a, 1988b) estimated that the 'hidden' Italian pension debt was about 2.4 times of GDP (compared to 1.6 in the UK and Germany).

In the short term, deficits in the pension system can be accommodated with tax increases. However, in order to satisfy the Maastricht fiscal criteria, medium-term sustainability was as important as achieving quantitative budget targets.

In the event, Italian pension reform was crucial in the effort to consolidate public finances. The fact that Italy experienced three reforms between 1992 and 1997 also illustrates this. Following the discussion of the Italian pension policy-making regime in Chapter 2, the question is how a poorly insulated and weak executive was able to achieve relatively successful pension reform in spite of powerful, entrenched interests and the difficulties created by the existence of a pay-as-you-go pension regime. To answer this question, the politics of the various reform efforts between 1992 and 1998 are analysed: the Amato reform; the failure and success of the Berlusconi and Dini reforms respectively; and the 1997 Prodi 'reform'.[7] In the concluding section I discuss to what extent a historical-institutionalist approach can explain Italian pension reform.

4.1 Reforms under the Amato Prime Ministership

As discussed in Section 3.2, throughout 1992 Italy's fiscal situation deteriorated rapidly. At the end of May, the Bank of Italy, for example, urged the government to reform the pension system in order to re-gain control of public expenditure (Bank of Italy, *Abridged Report*, 1992: 153-166). The worsening of public accounts and increasing international pressure on the Italian lira within the ERM prompted the Amato government to present a delegation bill (*disegno di legge delega*)[8] in July. Revealingly, the initial project was not characterised by any particularly rigorous elements. The retirement age for old-age pensions, for example, was to be increased on a voluntary or incentive-basis. In short, the government took an accommodating rather than a problem-solving attitude (see Cazzola 1995: 36). This changed with the August crisis (see Section 3.2), the devaluation in September and the subsequent exit

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[6] As in other advanced industrialised countries, changing demographics are the driving factor behind increasing pension expenditure. Nevertheless, the reform of pension policy still requires a political explanation.

[7] Rather than present a detailed description of changes to the pension system, the purpose of this chapter is to demonstrate how the reforms can be explained with the help of the institutionalist and 'weak executive' approaches (for detailed description of changes between 1992 and 1995 see Cazzola 1995).

[8] As discussed in Section 2.1, a decree-law is introduced by the executive but has to be converted within a certain time. A delegation law – once obtained - authorises the executive to introduce and

from ERM in response to which the *delega* concerning pension reform was substantially revised (Cazzola 1994: 67).

In order to recuperate international confidence, the Amato government introduced a decree-law in mid-September as part of the 1993 budget which among other things made changes to the pension system and aimed at saving L11,000bn in 1993, mainly thanks to the suspension of seniority pensions and higher contribution rates. The emergency measures were converted into law no. 438 (1992) on 14 November. The government prevailed, despite strong societal opposition as evidenced in demonstrations against the government, and mainly thanks to a surprising 'discipline among majority parties' (Cazzola 1994: 67-68). This discipline certainly reflected the external economic pressures in the wake of the currency crisis and the continued nervousness of the financial markets as reflected in the bond yield spreads and the lira value (Figure 4-3). Moreover, the deepening domestic political crisis made the majority parties unwilling to bring down the government despite considerable reservations regarding the measures undertaken (*cf.* Section 3.2).

Figure 4-3 Interest Rate Differentials and the Lira-DM Exchange Rate, 1992-1998

(interest rate differentials, in per cent [left-hand scale]; exchange rate, Lira/DM [right-hand scale])

Source: Datastream

In October 1992 the government obtained a delegation law (no. 421, 23 October 1992) from parliament granting it special powers to cut primary spending in

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change legislation by decree within the limits established by the delegation law but without having to ask parliament for approval.

four main areas: health services, pensions, local government and public employment (*Gazzetta Ufficiale*, no. 257, 31 October 1992). The main goal of the delegation law was to neutralise the causes of explosive growth of public debt and to assure international markets of Italy's commitment to both economic consolidation and – at least on a rhetorical level – to ERM re-entry (*cf.* Section 6.1). In as far as pensions were concerned, the law set three main objectives: (1) financial soundness of the pension system (that is, stabilising the ratio of pension outlays to GDP); (2) equality of treatment (in terms of benefits for public and private sector employees); and (3) development of group or individual retirement provisions.

Subsequently, the government issued a number of decrees determining the content of the reform within the framework established by the delegation law (Corrente 1993; Cazzola 1995). The most important features of the Amato reform were the following (see Ferrera 1997; Monorchio 1996):

- increase in the retirement age from 55 to 60 for women and from 60 to 65 for men (private employees) to be phased in by the year 2002
- gradual increase in the minimum contribution requirement for old-age benefits from 10 to 20 years
- gradual extension of the reference period for pensionable earnings from the last five years to the last ten years (and to the whole career for new entrants in the labour market)
- gradual increase of the contribution requirement for seniority pensions to 36 years for all workers (including civil servants, who enjoyed a much lower requirement of 20 years)
- increase in contribution rates
- changes to the indexation mechanism for benefits

The adoption of the delegation law was made possible through determined government action. Anticipating parliamentary opposition, the government made the non-amendability of the most important articles a matter of confidence (*Financial Times*, 23 October 1992). After some changes in the first session of the Budget Commission of the Chamber, the delegation law was passed thanks to imposing confidence votes on all four articles (*cf.* Chapter 3). Clearly, the government was in a position of strength due to the economic turmoil and pressure on the exchange rate, which allowed it to impose confidence votes on major reform projects that hitherto would have been impossible.

Although the unions were broadly in agreement with the harmonisation of the public and private pension regimes[9] and the need to ensure the financial viability of the system (at least in principle), they did object to particular reform measures.[10] Understandably they were far less enthusiastic about a 'downward' harmonisation as this would infringe upon the acquired rights of their core constituencies such as public employees and private sector workers. In short, trade unions were certainly in favour of greater equality of treatment but not in favour of benefit reductions. Precisely because the executive was in a predominant position once the delegation law had been passed, the trade unions had no possibility of obstructing the less liked aspects of the pension reform. Under the normal procedural framework, changes would not have taken place or would have been substantially watered down. The difficult economic situation put the government in a position of strength and made it willing - using the formal means available - to take strong action.

It is true that the Amato reform was characterised by a certain number of weaknesses (Castellino 1996; Gronchi and Aprile 1998). Above all the gradual phasing-in of changes regarding retirement age and seniority as well as the real labour income de-indexation demonstrated that the government pursued a policy of 'blame minimisation' by avoiding the immediate costs of modifying the less visible elements of the pension system. Notwithstanding these weaknesses, in a historical perspective, the Amato reform represented the most extensive reform in decades. The Amato reform was "strikingly innovative for the Italian policy-making system" (Regini and Regalia 1997: 212). This is reflected in the amount of savings and in the breaking the reform deadlock.

The proclaimed aim of the reform was to hold future public pension expenditure constant as a share of GDP. Even with the benefit of hindsight, it is not clear whether this would have been achieved. As for private sector employees, an INPS study (1993) projected that the equilibrium contribution rate (ECR)[11] would fall/rise from 42 per cent (and pension spending as a share of GDP from 7.7 per cent)

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[9] For example, well before the reforms, the CGIL criticised the government's generosity towards civil servants in terms of pension policy (*Financial Times*, 1 April 1992).
[10] Interview with CISL official, 12 October 2000, Rome.
[11] The ECR is defined as the contribution rate required for the various pension regimes to be in balance.

in 1992 to 40/47[12] per cent (and 6.8/8.0 per cent) in 2010 as a result of the reforms, rather than rise to an ECR of 54 per cent and pension expenditure of 9.2 per cent. The *Ragioneria Generale dello Stato* (1994 quoted in Commission of the European Communities 1996: 79), which had initially projected an ECR of 50 per cent (and pension expenditure of 8.8 per cent) in 2010, revised its estimates for private sector employee pension spending downwards. As a result of the reform, the ECR was expected to fall/rise to 36/46 per cent, while pension expenditure as a share of GDP was to decrease/increase to 6.2/ 8.0 per cent in 2010.

Similarly, the projections for central government and local authorities employees were revised downwards. The *Ragioneria Generale* (1994 quoted in Commission of the European Communities 1996a: 80) had projected an ECR of 73 per cent (and pension expenditure of 5.6 per cent) in the absence of reform, while with the reforms it projected an ECR of 46/55 per cent (and pension expenditure of 3.5/4.2 per cent) in 2010. The *Centro Europea Ricerche* (1994 quoted in Commission of the European Communities 1996a: 81) evaluated the effect of the reform on total expenditure of main schemes. It estimated that total pension expenditure of all main schemes as a share of GDP would rise from 12.4 to 13.0/14.9 per cent in 2010 as opposed to 16 per cent in the absence of reform. Other estimates calculated that the Amato reform would reduce *future* total pension expenditure commitments by about one quarter (Bank of Italy, *Abridged Report*, 2000: 112; see also OECD *Economic Surveys Italy* 2000: 112). Naturally these projections depend to a great extent on uncertain assumptions. Nonetheless, relevant projections at the time indicated a considerable *relative* improvement even if in a European perspective the situation still looked rather difficult.

With expected savings in the area of L11,000bn (1993), L15,000bn (1994) and L20,000bn (1995), the Amato reform undoubtedly contributed to short-term budgetary consolidation in the area of 0.8 per cent per year (*Servizio Bilancio del Senato* quoted in Cazzola 1995: 71). More importantly, it sent positive signals to international markets that the government was willing and able to achieve macroeconomic consolidation and tackle structural imbalances. Indeed, long-term interest rates, the exchange rate and the stock market showed encouraging signs

[12] The first figure assumes price indexation, the second wage indexation. The Amato reform even though it introduced price indexation, allowed for wage indexation to be introduced with the yearly budget.

towards the end of 1992 which are at least partly related to the Amato government's success in pushing through pension reform (Figure 4-3 above).

In sum, compared with previous reform efforts, the Amato government was able to overcome societal and parliamentary opposition and obstruction by staking its survival on the realisation of – among other things – pension reform in the context of what was widely acknowledged to be a 'national emergency'.[13] This allowed the government to prevail over potential opposition and obtain a delegation law, which subsequently offered the government a great degree of autonomy to determine the content of pension reform within the framework established by the delegation law and without undue interference and watering-down tactics by parliament. Similarly, unions - though broadly supportive of the aim of harmonising the pension system - did not like certain details of the reform (especially those attacking acquired rights). But due to the difficult economic and political situation unions were unwilling and unable to oppose the government.[14] Hence it is fair to say that: "The pension system was extensively reformed in 1992, under the pressure of the exchange rate crisis and the urgent need to curb the deficit" (Commission of the European Communities 1996a: 77). At the same, it is also true that "considering the unusual generosity of previous legislation and the fact that the changes adopted in 1992 were not enforced immediately, but were meant to be phased in over a fairly long period, the 1992 reform constituted only a very limited attempt to deal with a very serious problem in financing pensions" (Bonoli 2000: 155; Ferrera 1997; also Section 4.4).

Under the technocratic Ciampi government (1993-94) further changes to the pension system were introduced mainly by decree (Cazzola 1995; Corrente 1998). The changes introduced with the 1994 finance bill primarily concerned seniority pensions, especially the cumulation between income and seniority as well as stricter controls of the beneficiaries of disability benefits (law no. 537 in *Gazzetta Ufficiale*, No. 303, supplement no. 121; also Correnti 1998). In terms of their financial effect, these changes were worth about L4,000bn. As they largely concerned disability rather than old-age pensions, there does not seem to have occurred any major conflict between the government and the unions (Cazzola 1996).

[13] Some measures concerning seniority pensions were dropped after union opposition (Cazzola 1995: 55). However, interviews with union officials confirmed the strong position of the government and the grudging acceptance of the details of reform on the part of the unions, despite their overall agreement in principle.

[14] Interview with CISL official, 12 October 2000, Rome.

4.2 Failure and Success of Pension Reform under Berlusconi and Dini

In 1994, a centre-right majority consisting of three parties (*Forza Italia*, *Alleanza Nazionale* and *Lega Nord*) under Prime Minister Berlusconi won the general elections. Both the pension and the fiscal situation deteriorated rapidly, despite the 1992 reforms, and expenditure forecasts were substantially revised upwards. During the course of 1993-94, several new, revised projections of future pension expenditure raised the spectre of a contribution rate of around 50 per cent by 2010 instead of 2030 as originally forecast (Commission of the European Communities 1996a: 77). This clearly demonstrated the urgent need for further reform. At the same time, the pressure on the government to pursue budgetary consolidation was increasing (*cf.* Section 3.3). The 1994 budget target was set to overshoot. The external weakness of the lira not only created the possibility of a debt crisis but – through interest rate increases – also led to a worsening of fiscal position and to a loss of confidence by the international markets (Figure 4-3 above).

As Berlusconi had pledged not to raise taxes, the only other way to bring public finances under control was to cut expenditure. Welfare spending and more specifically pension spending were areas where important savings could potentially be made. Initially, the government discussed reform proposals with the unions (*Financial Times*, 14 September 1994). However, after the government was unable to strike a deal with the unions, it 'unilaterally' proposed changes to the pension system in the 1995 finance bill (*Financial Times*, 30 September 1994). Of the 27,000bn in spending cuts for 1995, L7,000bn-L8,000bn of savings were to come from pensions. The importance of the reform proposal did not so much regard actual short-term savings but rather its impact on long-term pension expenditure.

The most important of the proposed changes were: (1) acceleration of increase of retirement age from 56 to 60 for women and 61 to 65 for men; (2) the 'downwards' harmonisation of the rate at which pensions accrue annually from 2 to 1.75 per cent for both private and public employees; (3) penalisation measures for early retirement pensions (which would *de facto* have resulted in their abolition); (4) blocking of pension requests for four months; and (5) indexation of pensions on programmed rather than real inflation (Cazzola 1995: chapter 2; Castellino 1996).

This proposal was radical and strongly attacked acquired rights through rapid downwards harmonisation.

Not surprisingly, the plans met with considerable resistance. Under pressure from the unions as well as from within the coalition, the Berlusconi government agreed to several changes such as the easing of hardship cases (*Financial Times*, 27 October 1994). But the pressure on the government continued and came increasingly from within the majority. Thus the plan to index pensions on programmed inflation fell victim to intra-majority opposition (Cazzola 1995: chapter 2). The trade unions organised a national strike on 14 October and a demonstration on 12 November – the largest recorded in post-war Italian history with 1.5 million people in Rome alone (*Financial Times*, 16 November 1994). Clearly, the unions acted as defenders of acquired rights.[15]

Initially the prime minister vowed that the provisions would not be altered under any circumstances.[16] However, the weakening of Berlusconi's right-wing majority through the defection of the *Lega Nord*,[17] increasing criticism from *Alleanza Nazionale* and the other centre-right parties outside government as well as the prime minister's own political weakening due to his increasing involvement in the corruption scandal weakened the executive. In mid-October, *Lega* leader Umberto Bossi demanded the revision of the pension and health plans. Intra-majority opposition was even expressed in parliamentary voting. The defection of the *Lega*, for example, in a crucial vote in the Chamber on the government's proposal to reduce the accrual rate of pensions led to the defeat of this part of the reform (*Financial Times*, 19 November 1994). At the same time, the possibility of introducing a vote of confidence - Berlusconi was considering this to overcome parliamentary resistance - was received critically by parliament and, given *Lega* opposition, would hardly have succeeded.

The combination of intra-coalitional pressure and public and trade union opposition to the pension plans forced the prime minister to negotiate with the unions. An agreement was reached on 1 December where both the government and the unions accepted austerity measures in principle. Both sides agreed: (1) to make

[15] Interview with CISL official, 12 October 2000, Rome.
[16] "Not one, not 10 nor 100 general strikes will alter the budget" (*Financial Times*, 3 December 1994).
[17] The defection of *Lega* was at least partly caused by differences over welfare cuts (Cazzola 1995: chapter 2) which led *Lega* leader Bossi to believe that it would be more beneficial to leave the

the contributions paid by the individual more closely correlated to the benefits received; (2) to relate pension benefits to life expectancy at the date of retirement; and (3) to move towards equal treatment for the different categories of pensioners. It was agreed that pension reform should be negotiated with the unions setting 30 June 1995 as a deadline.

Thus the government was forced to withdraw the most controversial provisions and hence planned cuts were reduced to L4,000bn (*Financial Times*, 2 December 1994). The 'compromise' was thus estimated to have cost some L4,000bn (*Financial Times*, 3 December 1994). Of the original reform elements only the temporary freeze of seniority benefits and the acceleration of the retirement age survived. By contrast, the two-per cent accrual rate and the indexation on real inflation were maintained. In short, the government was forced to drop most of the provisions that attacked acquired rights in too radical a way.

Despite operating in a context of increased international pressure and a worsening domestic economic situation – the exchange rate against the German mark had worsened from L950 to almost L1,050 in the six months to December and the difference in long-term bond yields *vis-à-vis* benchmark-setting German bonds had increased (Figure 4-3 above; OECD *Economic Surveys Italy* 1996: 31-36) - the Berlusconi government was not able to introduce important change unilaterally as a result of strong trade union resistance and the crumbling of his parliamentary majority. This showed the limited strength of the Italian government. Executive weakness - embodied in the heterogeneity of the government coalition - was a crucial factor that led to the defeat of reform plans. Although Berlusconi vowed to take a strong stand and sought to force the issue, the fragility of the government coalition made it clear that this was impossible. In the end, it was both parliamentary and trade union opposition that prevented the government from realising pension reform and ultimately forced it to capitulate. It is fair to say that the government was too weak in terms of disciplining the majority parties to be able to push through a tough pension reform. (It would also be fair to say that Berlusconi as a newcomer sought to disregard the 'rules of the game', which required 'bargaining' rather than 'executive imposition', and that thus the institutional features of the system prevailed.)

alliance. The defection was also due to other intra-coalitional disputes, especially between the AN and the *Lega*.

Berlusconi resigned in December 1994 so that the task of reforming the pension system and achieving structural savings fell on his successor Lamberto Dini who took office in January 1995. As already pointed out, the Dini government was a technocratic government and as such did not have the support of a well-defined majority in parliament. However, the pressure on the government and unions to achieve reform increased in early 1995. On the one hand, the general economic situation and the latest projections of future pension liabilities released in 1995 projected a dramatic worsening of the financial sustainability of the pension system (for survey see Commission of the European Communities 1996a). At the same time, the overall pension deficit for 1995 was estimated to exceed L80,000bn - or more than 4 per cent of GDP (*Financial Times*, 19 May 1995). On the other hand, international financial markets became more nervous. The lira was weakening further, which led the Bank of Italy to raise interest rates, thus further increasing the pressure on Italian public finances. In March the value of the lira had fallen to 1270 lira per German mark. This represented a depreciation of 25 per cent over four weeks. Inflation was rising and the rise in the discount rate bore the risk of a solvency crisis. All this put pressure on domestic actors to achieve reform.

In conformity with the December agreement, the so-called Dini reform, negotiated with the union confederations throughout the first half of 1995 and adopted by parliament in August 1995, introduced several important changes (Bank of Italy, *Economic Bulletin*, 1995; Cazzola 1995: chapter 4; Fererra and Salvimini 1999; *Gazzetta Ufficiale*, no. 190, 19 August 1995, supplement no. 101). The main elements of the reform were the following (Corrente 1996):

- shift from an earnings-based system to one where benefits are linked to contributions paid over a life time period (capitalised on the basis of nominal GDP growth)
- adjust coefficients every ten years to take into account economic growth and demographic changes (with the first revision to take place in 1998 in case savings not as large as expected)
- link between benefits and residual life expectancy at retirement age (allowing flexible retirement between 57 and 65 years)
- phased increase from 35 to 40 years of contributions required for seniority pension
- ceiling on the incomes for which pension rights can be accrued
- creation of incentives for stimulating the growth of private pension funds

How was the pension reform possible from a political and an institutional point of view? With the 1 December agreement the unions had accepted the need to overhaul the pension system. The negotiations started from a union proposal that represented the common platform of the three major confederations. The proposal was based on the suggestions of the progressive faction of the CGIL (after prevailing over the communist one) and favoured a contribution-based system. CISL and UIL agreed to it, provided that the rights of workers with a seniority of more than 15 years (as of 1996) would be respected. Compared to 1992 and 1994, when unions were only marginally involved in the reform process, the 1995 reform was the result of extensive union-government consultations.[18]

After reaching an agreement, the unions submitted it to a referendum among their members and the government had to push it through parliament. The union leadership lobbied for acceptance of the reform (Braun 1996: footnote 29). The union referendum (29 May-1 June 1995) – in which both active workers and pensioners participated – accepted the government-union agreement with 65 per cent voting in favour of the reform. Given that a considerable part of trade union membership was made up of pensioners (Table 4-3), it was not surprising that the reforms largely maintained advantageous provisions for those already retired, while the main costs would fall on the currently active workers and primarily the young workers.

Table 4-3 Composition of Union Membership, 1995

(in million)

	CGIL	CISL	UIL
Active Workers	2.4	2.0	1.2
Pensioners	2.8	1.7	0.4
Total	5.2	3.7	1.6

Source: Cesos, *Le relazione sindacali in Italia: Rapporto 1995-96* (1998)

This explains partly why the unions fought so hard to retain the system - characterised by earnings-related benefits and seniority pensions - as much as possible by stretching transition periods in order to defend the interests of their constituencies. It is plausible to assume that a more extensive reduction of acquired rights would have resulted in the failure of the pension reform. This clearly limited possible reform outcomes.

As for the government, it submitted the proposal to parliament (Law no. 335 of August 8, 1995). In the Chamber, the proposal met with resistance and a great number of amendments, mainly by the RC, which alone tabled 2,700 amendments (*Financial Times*, 15 June 1995; Cazzola 1995: chapter 2). However, given the

[18] Interview with CISL official, 12 October 2000, Rome. Also Castellino 1996.

support the Dini government enjoyed from the centre-left parties and the co-operative attitude of *Forza Italia*, Dini was able to call a parliamentary vote of confidence after having reached an agreement that *Forza Italia* would abstain. By contrast, the AN announced that it would vote against the government. With three votes of confidence, the government was able to speed the passage through parliament and neutralise some 3,500 proposed amendments (*Financial Times*, 15 July 1995). The final margin secured by the government in the Chamber was comfortable with 284 deputies voting in favour and 147 voting against – with the centre-left parties and *Lega Nord* support and *Alleanza Nazionale* and (partial) RC opposition.[19] *Forza Italia* abstained. In the Senate the legislation enjoyed a much smoother passage (*Financial Times*, 14 July 1995; *Financial Times*, 4 August 1995).

Having reached an agreement with the unions, it was clear that the centre-left would not obstruct pension reform. As for *Forza Italia*, it initially criticised the pension reform as insufficient when it was announced. However, the centre-right appeared anxious to avoid being seen by the financial markets as 'irresponsibly blocking vital reforms' (*Financial Times*, 13 July 1995).[20] This was also the reason why *Forza Italia* was rather co-operative in that it only added amendments that were broadly in agreement with the government proposal (Cazzola 1995: 89). This makes it plausible that with continued international pressure the main political forces were not prepared to defeat the government on a bill that was seen as crucial for economic recovery and whose rejection risked triggering a financial crisis. Thus it is fair to say that the government's decisive action and the safe passage of the reform through parliament were the result of executive autonomy and the co-operative behaviour of the main political parties in parliament.

It was certainly also important that the reform was 'approved' by the trade unions before it was submitted to parliament. This is why the reform content was primarily determined at the negotiation stage between the government and the unions in which both in principle were co-equal partners, especially since it was hard to imagine that a technical government - relying on the support of the centre-left - could

[19] The RC split with the departure of 14 of the 39 deputies announcing that they would back the general line of the reforms (*Financial Times*, 15 June 1995).
[20] In addition to external pressure, there were also political-tactical reasons for *Forza Italia* to abstain: "Mr. Berlusconi appeared anxious to avoid being seen by the financial markets as irresponsibly blocking vital reform. At the same time, quick approval of the pension reform would help pave the way for an autumn general election which Mr Berlusconi has been pressing for" (*Financial Times*, 13 July 1995).

have credibly threatened to do what a centre-right majority had failed to do, that is, to introduce pension reform unilaterally. However, the consensual manner in which the reform had to take place had an effect on the outcome.

Not surprisingly, a rather critical view was expressed by the Bank of Italy which regarded the reform as insufficient and, in particular, too gradual (Bank of Italy, *Abridged Report*, 1996: 159-160). *Confindustria* rejected the reform outright and lobbied parliament hard for a shorter transition period (*Financial Times*, 19 May 1995). Even if these statements were politically motivated in the sense that neither central banks nor industry associations are ever satisfied with retrenchment policies, it is clear that the unions were able to defend their most important interests and especially the acquired rights of their constituency (that is, of their active and retired members).

The gradual character of the reform was the consequence of the lock-in effect and more specifically the result of the defence of acquired rights by the trade unions. This was reflected in the fact that the main issue of contention concerned seniority pensions (the government wanted 40 years of contribution, the unions insisted on 35 years), a low minimum retirement age (52 years with 35 years' contributions) and a very gradual rise in the minimum pension age to 57 by the year 2008 (*Financial Times*, 10 May 1994). The strong stance taken by the unions on acquired rights and especially workers with higher seniority was the reason why the transition to a pro-rata system would not be completed until 2013.[21] This was also acknowledged by the CGIL leader Sergio Cofferati: "Ensuring that *pensioni di anzianità* will not be abolished immediately was one of the hardest issues in the negotiations" (*Financial Times*, 28 July 1995).

However, while there were considerable safeguards and gradualism (as evidenced by the guarantees for workers with 15 years of seniority in 1993) as well as 'soft' eligibility requirements (as a result of a low retirement age), the introduction of a contribution-based system (in which workers eventually would receive only around 70 per cent of their earnings as compared to generally more than 80 per cent under the previous system) represented a major policy innovation. While this may seem surprising given the nature of the Italian policy-making system, from an institutional point view, this puzzle can easily be solved. Precisely because the system was unable to impose short-term costs and to infringe on acquired rights, the policy innovation was the only way to ensure medium-term stability by shifting 'costs' in terms of lower benefits to the future. This confirms the short-term character of pension policy, which tends to be more pronounced in Italy due to the presence of relatively strong trade unions and a weak government. The weakness can also be seen by comparing the Italian pension system after the Dini reform with those of other European countries. The Italian system is still characterised by a lower retirement age and a higher income replacement rate. It is also the only country with provisions for seniority pensions (Bank of Italy, *Economic Bulletin* 1995; for details see Brindisi 2000).

What about the reforms' financial effects? The reform was supposed to save L10,000bn a year over 10 years or 0.6 per cent of GDP per year, or 108,000n over 1996-2005 (OECD *Economic Surveys Italy* 1996: 49-55). Given that the unions had advocated proposals that would have achieved about L1,500bn over the next three years, while the government had initially pledged yearly savings of about L15,000bn over the same period, the reform clearly reflected a compromise. Although the government insisted that the original government target of saving L15,000bn over the three years between 1995-97 (and L10,000bn a year over a decade) would be met, *Confindustria* calculated there would be a shortfall of L4,500bn as a result of concessions to the unions (*Financial Times*, 9 May 1995). The INPS estimated savings to be L23,600bn by 1998. This indicates both the weakness to achieve wider reform and the need to pay lip service to placate financial markets (*cf.* Padoa-Schioppa Kostoris 1996a).

Although most observers estimated that the reforms would not be sufficient in terms of re-balancing the system (Bank of Italy, *Economic Bulletin*, 1995; Castellino 1996; Haman 1997), in terms of the long-term sustainability, equilibrium contribution rate and spending as a share of GDP, the reform was ambiguous. The *Ragioneria Generale dello Stato* (1995a) projected that the ECR for private employees' schemes (without adjustment of coefficients) would decline from 47.3 per cent (1995) to 40.3 per cent (2010) and spending as share of GDP from 7.3 to 6.3 per cent between 1995 and 2010. In the long term, the ECR would reach 47.7 per cent (2030) or 7.4 per cent of spending as a share of GDP and only decline

[21] An immediate change to a contribution-based system would have been perfectly possible and was in

afterwards. Relative to trend, which would have resulted in an ECR of 42.2 and expenditure of 6.5 per cent in 2010, this did not represent a major improvement in the medium term but would make expenditure more sustainable in the long term, and more specifically after 2030.

Accordingly, the Bank of Italy (*Economic Bulletin* 1995) took a rather critical view and considered it unlikely that private sector employees' pension expenditure would be reduced by the reforms. On the whole, it seems likely that the reform helped to make future pension expenditure more sustainable (OECD *Economic Surveys Italy* 1996: 49-55; OECD *Economic Surveys Italy* 2000; part III; *cf.* Figure 4-3 above).

In sum, the Dini reform was important in two respects: it achieved savings and it increased the confidence of international financial markets in the Italian economy by signalling its willingness to tackle the long-term unsustainability of the pension system (Regini and Regalia 1997). The reform was the result of a government driven by international financial pressure and the need to achieve savings. Unions – aware of their responsibility and the ultimate unsustainability of pension policy – were willing to negotiate reform. However, the reform outcome reflected and was right from the beginning circumscribed by the presence of relatively powerful unions and a weak government. Even though Dini claimed that the reform was "the maximum we could exact from this country at this time" (*The Economist*, 12 August 1995), it would be more accurate to say that it was the maximum that a weak government in the presence of reasonable co-operative unions could achieve within the constraints of the Italian political system and pension regime. That greater savings would have been possible was demonstrated by changes introduced two years later by the Prodi government (*cf.* Section 4.4).[22]

As for the unions, they accepted reform in principle as a result of the difficult domestic situation and continued external pressure (Figure 4-3 above). However, it is also fair to say that in a certain sense they were pushed to accept reform by Berlusconi's failed attempt to unilaterally impose reform. The fact that there were no reform proposals from the unions between 1992-94 indicates that the Berlusconi proposals were important in that they forced the unions to accept more fundamental

fact recommended by the 1997 Onofri Commission (see below).

[22] EMU was not even mentioned once in a two-hour discussion of the Amato and Dini reforms with a CISL official, 12 October 2000, Rome.

reform in principle: there certainly is a difference between agreeing that reform is necessary and the actual political readiness to achieve it. This was true for Italian trade unions in 1994-95. Braun (1996) has argued that the failure and success, respectively, of the Berlusconi and Dini reforms were due to the unions' defence of their co-decision making power. The analysis provided here suggests that the unions were only willing to accept systemic change in exchange for the large-scale preservation of acquired rights. The importance unions attached to acquired rights reflects the relevance of the 'lock-in' and policy feedback effects discussed in Section 2.3 - and hence the institutional effects of previous policy choices (that is, an earnings-related pay-as-you-go system). To the extent that these effects - in combination with a weak government and strong unions - precluded a truly radical reform, any reform had to be gradual.

Although unions acknowledged the importance of the long-term financial viability of the pension system, and although they were in favour of greater equity in terms of contributions and benefits, they nonetheless had a vested interest in defending acquired rights. On the one hand, the trade unions insisted on the preservation of acquired rights (such as seniority pensions). On the other hand, they accepted their responsibility for the long-term sustainability of the pension regime. This is precisely what made the relatively radical transition from an earnings-related to a contribution-based system possible. Hence a government unable to impose reform unilaterally and the lock-in effect of previous policy choices explain pension policy reform in 1994-95 well.

4.3 The Centre-Left and Pension Reform: The Prodi Compromise

In May 1996 a centre-left majority with Prime Minister Prodi took office with the declared goal of securing Italian EMU membership (Parker 1997). The economic situation had stabilised in terms of the valuation of the lira, economic growth and budgetary consolidation (OECD *Economic Surveys Italy* 1997). In November 1996 Italy returned to the ERM (*cf.* Chapter 6), the public deficit was decreasing and international markets had rediscovered their confidence in the Italian economy after the Dini pension reform - as reflected in long-term interest rates (Figure 4-3 above). In short, the threat of an imminent economic crisis had disappeared. After autumn 1996 Italian macroeconomic policy was exclusively concerned with meeting the EMU budget deficit criteria.

The Dini reform had determined that a review of the reform would not take place until 1998. Given that the INPS deficit was still widening, it was clear though that cuts in welfare spending and more specifically pension expenditure would be necessary at some point (*Financial Times*, 21 July 1997). The cabinet and the governing coalition were divided on further pension measures. As described in Chapter 3, in the initial mini-budget of 1996, pension policy remained untouched. Similarly, the 1997 budget did not contain any cuts in social welfare including pension spending (*cf.* Chapter 3). This was mainly the consequence of intra-majority division and the fact that the centre-left majority was hostile to further pension expenditure cuts after two pension reforms. In summer 1996, for example, Labour Minister Tiziano Treu ruled out an overhaul of the reform (*Financial Times*, 4 July 1996).[23] Similarly, Finance Minister Vincenzo Visco reiterated in November that the pension review should be conducted in 1998 rather than 1997 (*Financial Times*, 25 November 1996). However, due to the need to introduce structural savings with the 1998 budget and meet the sustainability criteria, Prodi - backed by Treasury Minister Ciampi - announced in October 1996 that the government wanted to bring forward a review of the country's pension system to 1997 (*Financial Times*, 28 October 1996).

Trade union opposition to further reform was strong. The general secretary of the CGIL, Sergio Cofferati, stated that there was no basis for concluding that the 1995 reform needed overhauling (*Financial Times*, 4 July 1996). The unions thus also opposed bringing forward the 1998 review of the pension reform agreed in 1995 (*Financial Times*, 28 October 1996). When the Prodi government called for an early national debate on the pension system, this met with immediate criticism from the unions, which called the government's stance on pensions 'masochistic' (*Financial Times*, 25 November 1996).

In early 1997 a government-sponsored report of the *Commissione per l'Analisi della Compatibillità Macroeconomiche della Spesa Sociale (Commissione Onofri* 1997) showed that significant savings could be achieved if: (1) the retirement age was raised; (2) early retirement pensions abolished; (3) the period of introducing the 1995 reforms accelerated; and (4) schemes for public and private sector employees harmonised. This put further pressure on all involved actors in view of continued budgetary consolidation, for not only did the need to achieve structural cuts impose

[23] Treu was quoted as follows: "It would be counter-productive to look at the reform again" (*Financial*

itself but the report also showed that further cuts were technically feasible. Undoubtedly, part of the reason why the government sponsored this report was precisely to increase the pressure on other actors, raise public awareness and mobilise public opinion, and thus enhance its bargaining position.[24] In combination with the continued need to achieve 'sustainability', this provided the government with a tactical advantage in the coming debate on pension reform.

In May 1997, projections showed that the deficit would reach 3.8 per cent of GDP. Given the need to meet the three-percent budget target, this increased the pressure to achieve further – if possible structural - savings. In order to bring the deficit down to 2.8 per cent, at the end of May, the government proposed fiscal measures worth L25,000bn of which L6,000bn-L7,000bn in spending cuts were to come from pension reform (*Financial Times*, 19 June 1997, 22 May 1997). Once more, pension reform was a response to international pressure. This time it was not so much the pressure of international markets (Figure 4-3 above) but rather the need to meet the three-per-cent deficit target in 1998. In short, EMU membership was directly at stake and because of this the government was able to impose its agenda on antagonistic actors.

This was clearly demonstrated by, for example, CGIL's change of position during the first half of 1997 when it declared that it would be ready to talk about reform, provided that all political parties backing the government endorsed reform (*La Stampa*, 17 April 1997; *Financial Times*, 14 May 1997) Whether this was a tactical measure in order to deflect growing pressure on the unions – hoping that the RC would not accept any further pension cuts – or not, the change of rhetoric shows the pressure prospective EMU membership put on domestic actors.

Nonetheless, in the context of the 1997 reform, the government encountered major opposition from both unions and its own (informal) ally, the RC, which made the negotiations between government and unions extremely difficult. Initially, seeking to reduce the various veto players' hostility to welfare cuts, the 1998 budget vowed to promote 'growth and jobs', which was clearly aimed at heading off a serious clash over reform. Of the L25,000bn of fiscal tightening, only some L5,000bn of cuts in welfare spending were eventually to be introduced with the 1998

Times, 4 July 1996).

budget, of which L4,500bn (as compared to the L6,000-7,000bn originally planned) were to come from reductions in pension outlays. More specifically, the Prodi government was eager to introduce the following modifications which mainly (but not exclusively) aimed at accelerating the phasing in of the Dini reform: (1) a new system for calculating pension benefits based on lifetime contributions to the state scheme rather than a (favourable) percentage of the final years' salary; (2) the accelerated introduction of a higher minimum retirement age bringing forward the minimum age of 57 (or 40 years of contributions) from 2006 to 2002; and (3) a freeze on early retirement pensions of public sector employees.

When the government introduced the finance bill in late September, government and unions were still negotiating the details of the pension package (*Financial Times*, 29 September 1997). Despite its readiness to negotiate and compromise, the government encountered stiff opposition from the RC which threatened to withdraw parliamentary support (*Financial Times*, 29 September 1997); at the same time, unions while not against reform in principle were opposing the type of large-scale reform envisaged by the government (*Financial Times*, 2 October 1997). Things came to a head between the government and the RC when, with a vote of confidence on the budget proposal scheduled in early October and with the government's refusal to make significant changes to the 1998 budget (including pension cuts), the RC announced that it would vote against the budget (*Financial Times*, 3 October 1997; Legrenzi 1998).

This led to the resignation of PM Prodi and the threat of new elections. However, due to strong pressure on the RC leadership from the media, public opinion, the rank-and-file and even the unions, the RC returned to the negotiating table and finally reached a compromise. In addition to the introduction of a 35-hour week, the RC obtained the exemption of blue-collar workers from the tightening of seniority pension rules - costing an estimated L500bn in 1998 (Financial Times, 15 October 1997).

After reaching an agreement with the RC on pension measures, the government had to win the approval of the trade unions in order to guarantee a safe passage through parliament (*Financial Times*, 29 October 1997). The CISL under D'Antoni

[24] This is consistent with the view that the creation of a government-sponsored expert commission that had been asked to produce a proposal for a definitive reform of the pension reform presented a change from a consensual towards a more technocratic style of policy-making (see Radaelli 2001).

was most strongly opposing the reform of early retirement pensions, which was not surprising given that the CISL was particularly strongly represented in the public sector. The ensuing discussion revolved precisely around the issue of seniority pensions. A final agreement was reached in early November, aiming to achieve 4,100bn in savings, and just in time to be introduced with the 1998 budget (*Financial Times*, 3 November 1997). Eventually the reform contained the following measures (D'Ercole and Terribile 1998):

- acceleration of the gradual harmonisation of public and private pension regimes (eligibility requirements, benefits and so on)
- increases in pension contributions paid by self-employed
- a more rapid increase in the minimum retirement age for seniority pensions
- temporary stop of access to new pensions
- temporary suspension of price indexation of highest pensions

However, important parts of the original reform plan – including the some of the proposals made by the Onofri Commission - fell victim to compromise as a result of the unions' defence of their members' 'acquired rights'. In addition to the exemption of blue-collar workers from some pension measures, a revision of the calculation mechanism was not achieved. Overall, the accelerated phasing-in of the Dini reform could have been quicker (*Commissione Onofri* 1997). The limited acceleration reflected the Italian government's need to accommodate domestic opposition. This resulted in short-termist policies and costly medium-term concessions.

The Prodi government did not achieve the initially intended structural reductions in long-term pension spending, even if it did achieve some structural cuts. The immediate financial impact was very modest, especially when compared to the previous reforms. In terms of its financial effect, the Prodi reform only achieved L4,100bn worth of savings in the 1998 budget. The pension savings amounted to about 0.22 per cent of GDP (*Presidenza del Consiglio dei Ministri* 1998). The L4,100bn of savings in the 1998 budget, for example, are less than half of what the government set out to achieve in early 1997 (Ferrera and Gualmini 2000: 257). The reform was the 'bare minimum' to ensure EMU membership (*Financial Times*, 4 November 1997).

In conclusion, the limited degree of the Prodi reforms was the result of a stronger-than-usual but still relatively limited executive strength: the government had to take into account the opposition and interests of other actors such as parties of the majority, the RC and the unions. The negotiation of the reform showed that reform was not unchallenged inside the cabinet. The reform was only possible after it was more or less impossible to avoid it, given the need to keep the 1998 budget deficit within the three-per-cent range. Even then the government had to make important concessions to win approval. At the same time, potential veto players had to accept reform in principle as the government coalition (at the beginning of 1997) and trade unions did (during the first half of 1997); or the acceptance was forced upon them (as in the case of the RC in October 1997).

Undoubtedly, it was impossible for major actors to reject pension reform outright in a situation where EMU membership was at stake. This obviously also reflected the extent and depth of support for EMU membership among the Italian public as well as among major societal and political actors. This also provides evidence for the continued importance of the weak government and lock-in effect of with regard to pension reform despite the presence of a *vincolo esterno*. The pension reform under Prodi clearly showed the importance of external pressure, and more specifically the need to reduce the budget deficit in view of meeting the Maastricht deficit criteria. But it also demonstrated the necessity for the government to tread carefully and shows that the government (and the prime minister) enjoyed only a temporary-tactical rather than a longer-lasting-strategic advantage. However, this temporary-tactical advantage was just about sufficient to overcome opposition to further pension cuts. Counterfactually, it is difficult to imagine how an Italian government could have achieved reform in the absence of the threat of EMU exclusion.

Once more, the gradual character of the reform and the issues of conflict clearly demonstrate the importance of the institutional characteristics of the Italian pension policy-making regime: a weak government and a strong lock-in effect, due to the existence of relatively influential trade unions and the issue of acquired rights, made more substantial reform practically impossible.

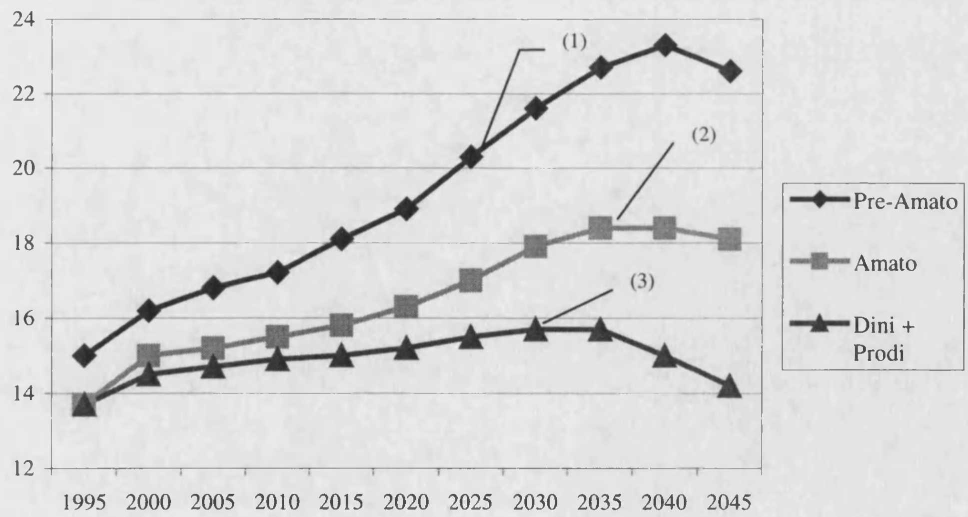
4.4 Conclusion: Domestic Institutions and Pension Reform

First of all, there is no doubt that pension reform contributed to Italy meeting the convergence criteria through relative to trend reduced pension spending and deficits. As described, the Amato reform led to L11,000bn (or roughly 0.8 per cent of GDP) in savings in 1993, the Dini reform to L10,000bn (or 0.6 per cent) in 1996, and the Prodi reform to about L4,000 (0.2 per cent) in 1997. All reforms were expected to bring about similar savings in the following years. Through their structural effect, the various measures also resulted in lower-to-trend spending in subsequent years (Figure 4-4 below). Second, by making future pensions spending more sustainable and thus calming international investors, pension reform also decreased the pressure on the exchange rate and especially interest rates and hence fiscal policy (Figure 4-3 above).

In the late 1990s, the *Ministero del Tesoro* (1998: 27-29) estimated that without pension reform pension spending as share of GDP would have reached 23.2 per cent (2040) before eventually declining. By contrast, with the reforms of the 1990s, it is now expected to peak at 15.8 per cent in 2032. This has put the future of Italian budgetary policy on a more sustainable path (*cf.* also ISTAT 1998: 87-90). In other words, pension expenditure is poised to increase slightly before it stabilises at around 16 per cent of GDP. Although some forecasts project rising pension outlays, it is clear that relative to trend the three pension reforms made the system more sustainable and made a considerable contribution to medium- term fiscal consolidation.

Figure 4-4 Pension Expenditure Projections

(as a share of GDP)



Source: OECD *Economic Surveys Italy* (2000: 112) based on *Ragioneria Generale dello Stato* (1999)

Key: (1) Peak in 2040: 23.3 per cent

(2) Peak in 2037: 18.8 per cent (except for indexation)

(3) Peak in 2032: 15.8 per cent (after 1992-1995-1997 reforms)

No doubt, by Italian standards, the changes of the pension system were unprecedented (*cf.* Annex C).

> In judging the current situation, the importance of the past reforms needs to be recognised. Available studies point to a significant improvement in the underlying situation. Treasury forecasts suggest that the increase in pension spending in the absence of reforms would have reached as much as 25 per cent of GDP around 2030. The increase in taxes necessary to balance the generational accounts on the basis of the pre-Amato system would have been 160 per cent rather than the current 5 per cent (OECD *Economic Surveys Italy* 2000: 113).

While it is certainly fair to say that the reform represented a major achievement, several scholars are sceptical of the long-term sustainability of the new pension regime.[25] A number of scholars tend to regard each of the three successive pension reforms as nothing more than short-term measures designed to confront the most pressing fiscal problems (Haman 1997; Gronchi 1996; Faustini 1996; Zaccaria 1998: 198; OECD 1996b; for variety of opinions see various contributions in Padoa-Schioppa Kostoris 1996a). In the medium term, and despite three reforms, estimated state financing of the pension deficit was still bound to increase from 3.9 (1993) to 4.2 (2010) (*cf. Ministero del Tesoro* 1998; Bank of Italy, *Economic Bulletin*, 1998: 36-43). Other simulations take an even less optimistic view of future pension expenditure (*cf.* Roseveare *et al.* 1996; OECD 1996b). Under the baseline scenario (excluding the Prodi reform), these simulations forecast a rise in Italian public pension spending from 13.3 per cent in 1995 to 20.3 per cent of GDP in 2030 (OECD 1996b: 38; for more detailed discussion in a comparative perspective see Section 7.2). Leaving the question of the long-term sustainability aside (a problem with which other stronger policy-making regimes such as the French and German ones are confronted as well), relative to trend the reforms had a major impact and were unprecedented in Italian pension policy-making (for a comparative perspective see Chapter 7).

[25] Note that the assessment by the OECD *Economic Survey* is exclusively based on Italian government projections that were published in the context of Italy's bid to become an EMU member (*Ministero del Tesoro* 1998; for updated projections see *Ragioneria Generale dello Stato* (1999, 2000)). This is not the place to evaluate these projections. However, given the continued criticism of actors such as the Bank of Italy, the conclusion that the Italian pension system will not need to undergo further reform should be evaluated carefully, especially since the tendency of the Italian government to downplay long-term problems is well known (*cf.* Section 2.3).

If this shows that pension reform made an important contribution to macroeconomic consolidation and hence to meeting the Maastricht criteria, the question from a political point of view is: how were the reforms of the pension system possible given unfavourable domestic policy-making institutions? A variety of explanations has been proposed, the majority of which point out the importance of corporatist decision-making and 'political exchange' (Ferrera and Gualmini 2000; Braun 1996; Castellino 1996; Ebbinghaus and Hassel 2000). None of them systematically includes the domestic-institutional conditions or 'rules of the game' under which reform was achieved. With the help of the concepts discussed in Section 2.3, the question is how the traditional obstacles to pension reform were overcome, namely, (1) the insufficient strength of the government, (2) strong unions acting as defenders of *status quo*, and (3) the lock-in effect of a pay-as-you-go pension system.

As has been confirmed in a recent comparative study of welfare reform in European countries, the government's capacity to intervene in welfare policy is a crucial variable in achieving successful welfare reform (Ebbinghaus and Hassel 2000). In the Italian case, an institutionally weak government was able to increase its autonomy and power, primarily as a result of external pressure. This made it possible to push both the unions and parliament to accept reform as well as to overcome traditional veto points. More specifically, the threat of a financial crisis as well as the concern for the long-run viability of the pension system in 1992 and 1995 and the need to meet the convergence criteria in 1997 strengthened the position of the executive relative to such veto players as unions, parliament and majority parties.

The history of pension reform demonstrated this. Relative to parliament and intra-executive dissent, the Amato and Dini government were able to act relatively autonomously. The Amato government was facing a major potential financial crisis and was able to push through reforms by way of a delegation law and subsequent decrees. While the imminence of crisis allowed the Amato government to impose reform, Dini had to reach an agreement with the unions in the context of continued economic pressure as reflected in interest and exchange rates developments. Thus both governments were also able to overcome otherwise likely parliamentary obstruction. By contrast, the Prodi government was to a much greater extent constrained to take into account intra-coalitional preferences and accommodate RC interests. But again, international pressure (represented by the convergence criteria) was a necessary condition both to prevail over domestic veto players and make intra-coalitional actors accept pension reform. The October 1997 crisis is just the most striking example how far the executive had to go in order to make veto players accept pension reform. However, the contrasting case of the failure of the 1994 Berlusconi reform shows that the government's bargaining position was only *relatively* stronger and that veto players inside and outside government were able to block reform.

Contrary to the government, the relative position of the unions - as the most influential defenders of the *status quo* - was weakened through external constraints and they were thus constrained to accept responsibility for the financial viability of the Italian economy and later Italy's success or failure regarding EMU membership. In the face of external pressures, the unions had no choice but to accept reform in principle. Thus they were willing to accept reform under a certain number of conditions (negotiated reform, greater equity between public and private sector, preferential treatment of the unions' main constituency and so on).[26] As described above, the reform outcomes strongly reflect the influential position of trade unions in the policy-making system (that is, formal institutions) as well as the character of the pension regime itself (that is, acquired rights).

To characterise pension reform as an exchange whereby the unions accepted reform for future benefits (Ferrera and Gualmini 1999; Ebbinghaus and Hassel 2000) seems incorrect. However, the future benefits were negligible at least in material terms. The few available resources that were allocated to employment creation and the *Mezzogiorno* through the agreements and legislation concerning Prodi's *Patto per il Lavoro* and D'Alema's *Patto Natale* (let alone their poor implementation so far) cannot be characterised as an exchange in terms of current sacrifices against future benefits. Essentially, Italian unions found themselves in an extremely defensive position and accepted the inevitable need to realise retrenchment in the face of international pressures or otherwise accept responsibility for a major financial crisis and EMU exclusion.

Nonetheless, the unions were potentially able to obstruct reform and thus shape its outcomes. While Amato pushed through pension reforms in the context of a national emergency, Berlusconi failed to realise his reform package under difficult

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[26] As suggested above, union preferences were strongly influenced by 'internal' distributional politics, notably by the fact that a considerable share of trade union members were retired (or about to retire) and were thus benefiting (or about to benefit) from acquired rights.

financial circumstances. Unable to push through a pension against the opposition of unions, the government was henceforth forced to accept the limits imposed upon reforms by unions. Both Dini and Prodi were forced to reach an agreement that was acceptable to the unions. In short, pension reform outcomes were determined by domestic as much as external factors, while the possibility of achieving reform emerged as a result of external constraints.

The importance of the institutionalist argument is also reflected in the following observations. First, the limited degree of reform in terms of *potential* financial savings, the extremely gradual transition period and the strong emphasis on temporary measures supports the institutionalist claims. Second, the gradualism of the reform was not only reflected in the fact that there were three reforms in only five years. It was primarily reflected in the long-transition periods with which certain changes were phased in (such as a higher retirement age in 1992 or the contribution-based system in 1995). The lock-in effect of a pay-as-you-go system limited the speed with which a transition can be phased in. Nonetheless, the fact that eventually an acceleration of the phasing-in of the Dini reforms was politically and economically feasible (seniority pensions under Prodi in 1997; also retirement age under Berlusconi in 1994) shows that the gradualism reflected political resistance and limited executive authority. Even though reforms in other countries were also gradual and piecemeal (*cf. Il Sole 24 Ore*, 23 October 2000), many countries were already characterised by stricter eligibility requirements and less dramatic pressure on pension spending (Brindisi 2000), thus potentially reducing the relative pressure to achieve reform. If Italy was not able to achieve a more sustainable policy despite greater external pressure, then this has to be attributed to the domestic factors discussed above.

Interestingly, in a comparative perspective, the 1995 reform was strikingly innovative and achieved what had been impossible in the preceding 25 years (Regalia and Regini 1997; Faustini 1996: 22). Especially the shift from an earnings-related to a contribution-based pension system represented much greater institutional innovation than anything that place in France and Germany during the same period where there was no shift towards a contribution-based system (see Chapter 7). Nonetheless, even this innovation had a limited effect because of the long transition period negotiated for phasing in the new system. This innovation is easily understandable. As a policy-making system with a low capacity for long-term policy, 'benefit gradualism' and 'pension innovation' were the only way to tackle long-term imbalances as they left the current situation essentially unchanged. Hence policy choice was restricted by the potential short-term effects of reform and by the inability of the executive to impose short-term costs on opposing groups.

In short, to the extent that the pension reforms were possible and to which they were successful, they were the result of international pressure; to the extent that the reforms were limited with regard to what could have been achieved, they reflected the institutional limits a weak executive faced in introducing more wide-ranging pension reforms. Pension reform outcomes were co-determined by the various institutional characteristics of the policy-making arena, while the possibility of successful reform depended on the *vincolo esterno*. This allowed weak governments to take decisive action in tackling the pension problem and more often than not forced other actors to co-operate.

What Cazzola (1995) observed with regard to the reforms between 1992 and 1995, namely that "*i governi politici non erano in grado di assumersi la responsabilità, in primo luogo perché non vi erano le condizioni di una maggioranza parlamentare sufficientemente adeguata [...] a sopportarne l'impatto sociale*"[27] (p. 132), reflects at best a part of the truth. Given the relative strength of unions and the relative weakness of the executive, the limited reform resulted from the *institutional* features of the Italian system of pension policy-making rather than an incapacity that resulted from *partisan-political* contingencies.

[27] "The political governments were not able to assume responsibility, in the first place because the conditions of a sufficiently large parliamentary majority, capable of withstanding the social backlash, did not exist."

5 THE POLITICS OF WAGE RESTRAINT

It is ironic that at a time when incomes policies are being abandoned in their Scandinavian homeland, they are being revived in Italy, a country with none of the institutional supports or legacies once deemed essential for such arrangements to succeed (Locke 1995a: 194)

Wage policy is a major factor influencing the level of inflation in an economy. If wage increases are above productivity increases, the price level in an economy will rise (so-called cost-push inflation). Hence a policy of wage restraint - imposed or agreed - can effectively contribute to lowering the inflation rate and improving the international competitiveness of an economy. Finally, wage restraint in the public sector also helps curb public expenditure and can thus have a positive effect on public finances as well as on price stability.

Historically, Italy suffered from relatively high inflation, mainly as a result of inadequate wage bargaining institutions and a weak government unable to control public wage expenditure (*cf.* Section 2.4). In the 1990s, Italy was able to overcome all these obstacles and successfully implemented a co-ordinated policy of wage restraint. This strongly contributed to Italy's good inflation and interest rate performance and thus helped Italy meet the Maastricht monetary criteria (*Presidenza del Consiglio dei Ministri* 1998).

The discussion in Chapter 2 demonstrated that Italian wage policy contributed to Italy's comparatively poor inflation performance. It also showed that these problems were the result of institutional deficiencies. First, while the 1980s and early 1990s were characterised by an 'implicit' incomes policy in the private sector (due to the external constraint), the confederal unions were nonetheless divided *and* had limited control over rank-and-file. In order to implement a policy of co-ordinated wage moderation, union confederations – in addition to overcoming their division - would have to assert control over lower bargaining units in order to prevent wage drift at the company and firm level. Second, the above-average levels of inflation during the second half of the 1980s were largely the result of the government's inability to control public wages,[1] which in turn was related to various institutional

[1] Public sector wage policy was important with regard to macroeconomic policy: public employment as a share of total employment in the 1990s was 23 per cent; public wage expenditure as a share of total public expenditure was 31 per cent (net of interest) (OECD 1998b: 11). Hence the inability to

weaknesses: the increasing fragmentation of trade unions in the public sector; a weak, accommodating government; and regulations encouraging union fragmentation and militancy. Third, the wage indexation mechanism was a problem in that it decreased wage flexibility and made disinflation harder to achieve.

This chapter is concerned with how these institutional deficiencies were overcome and neutralised. First, I analyse the institutional reforms of public and private wage policy-making during 1992-93. Then the policy and politics of wage moderation in both the private and public sectors between 1992 and 1997 are discussed. The final section examines why institutional reform was possible and to what extent it contributed to disinflation.

5.1 Reform of the Public Sector Wage Bargaining Regime, 1990-93

The Italian public sector wage determination system has been referred to by such terms as 'spoils system of pluralistic pressure' (Lange and Regini 1989) and 'distributive collusion'. This system pampered public sector employees in order to create party-political support for the government (Regalia and Regini 1998: 488). Reforms during the 1980s did not change this. After negative experiences with the 'legislative' regime (characterised by parliamentary authority over public wage determination, which tended to be uncoordinated due to the inability and unwillingness of the executive to control parliament) and even worse experiences with the 'mixed' regime[2] (where parliamentary intervention was accompanied by 'clientelistic' bargaining between the executive - and more specifically ministers - and their respective bureaucracies), reforms in the early 1990s introduced a 'bargained' regime, whose characteristics were described in Section 2.4.

A first major change to the system of public employment relations occurred in 1990 and hence well before TEU.[3] After previous attempts had failed, a major reform

control public wage policy had important inflationary effects for the economy as a whole. In fact, while in the 1970s the average public worker earned about the same as a worker in the private sector, by the end of 1980s the former earned about 25-30 per cent more than the latter (Lucifora 1999). This shows the extent to which public sector wage policy was out of line with the (exposed) private sector.

[2] In fact, the introduction of bargaining rights into public sector wage bargaining in 1983 contributed to the 'regime of double protection'. It thus indirectly contributed to public sector driven inflation. Moreover, parliament was still able to interfere in the wage setting process through legislative intervention.

[3] Although the 1990 reform took place before February 1992, it is discussed due to its relevance with respect to subsequent policy outcomes and in order to demonstrate the importance of international pressure with respect to the 1992-93 reforms.

was achieved with the introduction of law no. 146 of June 1990 that regulated strikes in 'essential public services'. Essentially this law required public sector trade unions and employers to agree on the level of public service to be maintained during strikes, the rules concerning early notification of strikes, the length and forms of work stoppages, and the definition of 'essential services'. The law introduced penalties in case of the violation of these rules and even threatened to deprive groups of their collective bargaining rights in case they disrespected the rules.

The purpose of reform was to limit the negative consequences of the 'regime of double protection' in both the public sector and public utilities. In other words, it was meant to limit the bargaining power of especially occupation-based unions whose strike actions tended to have highly disruptive effects (for example, air control). To monitor compliance with the law, the *Commissione di Garanzia dell'Attuazione della Legge sullo Sciopero nei Servizi Pubblici Essenziali* was created, consisting of nine experts nominated by parliament and the president (Napoli 1998: 84-93; *cf.* Salomone 1991: 51-52).

A second major reform took place during the Amato and Ciampi prime ministerships in 1992-93. The July 1992 agreement intended to bring about greater convergence in terms of pay determination in the public and private sectors (Lucifora 1999). The so-called 'privatisation' of public employment sought to bring the public sector in line with the private one in an attempt to bring public spending under control and to enhance efficiency (Napoli and Alessi 1996; Della Cananea 1997; Brunetta and Tronti 1993, 1998; OECD 1994c: appendix). Apart from increasing the efficiency of public services through changes of management guidelines, the 'privatisation' also brought about considerable change in the framework of public wage determination. The reforms relevant to wage determination were the following.

First, legislative changes in 1993 determined that public employment relations should entirely be regulated by collective bargaining, while the government retained unilateral pay determination for some parts of the public administration. Unilateral pay determination was retained for higher-level diplomats, state lawyers, judges, university teachers, the police corps and the armed forces – or a total of 0.6 million public employees. For the majority of public employees (3 million or 20 per cent of dependent employees) wages were to be determined through collective bargaining, excluding the privatised state railways and postal service (Bordogna *et al.* 1999: 96). Second, the reform foresaw that both the basic pay for different grades and the maximum amount that can be added to basic pay through the negotiations taking place at the decentralised or local level should be determined at the national level. This was meant to make the system of wage determination very centralised in the public sector and potentially increased executive control over public pay.

Another important change concerned the bargaining agents. The reform created an independent agency, the *Agenzia per la Rappresentanza Negoziale delle Pubbliche Amministrazioni* (ARAN), which negotiated on behalf of the employer, that is, central and sub-national governments and administrations, but had to follow government guidelines negotiated between unions and the government at the central level (Bordogna 1998). This was meant to do with away with 'clientelistic' bargaining (as represented by ministerial delegations) as well as to protect public wage negotiations from undue intervention by parliament or administrative courts. In short:

> The creation of an agency for compulsory representation of public administrations in collective negotiations at the national level (Aran) replaced a multiplicity of parties that previously intervened in the bargaining process, and helped to insulate collective negotiations from the political and parliamentary arena – at least to a much greater degree than in the past (Bordogna *et al.* 1999: 109).

According to the 1993 legislation, ARAN was to follow the guidelines laid down by the minister of public service. However, the 1992 agreement stipulated that the government link public sector pay to anticipated inflation (OECD 1994c: appendix).

A final important change was the result of the July 1993 agreement. The main trade union confederations and the government agreed that sectoral national collective agreements were to have a four-year duration with respect to normative issues, and a two-year duration for pay issues (Bordogna *et al.* 1999: 116) and that only performance-related pay would be discussed at the lower level. Moreover, only those unions that signed sectoral nation-wide agreements were recognised as representative in the relevant sector (including the confederations with which they are affiliated).[4] Sectoral agreements were to aim to preserve the real wage.

[4] Similar to the private sector, the introduction of a bargaining unit at the decentralised level (so-called *rappresentanze sindacali unitarie* [RSU]; for a detailed discussion *cf.* Section 5.3) was aimed at strengthening the confederal unions. In order to have the right to sign a national agreement, a union needs to gain five per cent of a combined average of RSU seats and votes. Even though these reforms led to a strengthening of the confederations (Interview with CGIL official, 11 October 2000, Rome),

To summarise, from an institutional point of view, the reforms resulted in greater centralisation and potentially greater executive control over public pay determination. The reform certainly strengthened the executive's potential control over wage expenditure and wage increases as a result of the exclusion of parliament and clientelistic ministers. The commitment to achieve real wage preservation at the sectoral level and to residual bargaining at the decentralised level committed the government (and the trade unions) to a policy of wage restraint. Like the French and German systems of public pay determination, the Italian system is among the most centralised (Perotti *et al.* 1998: 44; OECD 1997a; Dell'Aringa and Lanfranchi 1999).

As a result of the reforms, Italian public pay is negotiated in eight functional sub-sectors; levels and wage increases for all sectors are decided at the central level between unions and the government. The only minor element of decentralisation is the existence of performance-related pay, which however - at least formally - is under rigid control of central level (Dell'Aringa and Lanfranchi 1999: 38). Hence the Italian public sector wage bargaining regime can best be described as a regime of 'controlled decentralisation'[5] within which the government possesses strong formal means to control public wages.

The importance of the reforms is hence obvious. Most importantly, the reforms made bargaining more centralised. The creation of ARAN reduced the number of veto points. Moreover, the institutionalisation of a decentralised level of bargaining potentially increased the strength of confederal unions relative to the *cobas*. The question is then how these reforms were possible in a political system where the executive is weak and societal interests and parliament are usually strong enough to obstruct change?

The 1990 law on the regulation of strikes in the public sector was the outcome of widespread agreement between confederal unions and the government (*Gazzetta Ufficiale*, no. 137, 14 June 1990). Actually the legislation very much reflected the interests of the three confederations whose proposals on this matter strongly influenced the legislative process and the final legislative outcome (Treu 1991: 191). The union confederations actively demanded that the system of self-regulation based on an informal agreement be substituted by a system of legally binding rules in the

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this reform – contrary to the private sector – was of no importance with regard wage restraint in the public sector during 1992-97, as the first elections were not held until 1999.

[5] Term by ARAN official, 20 September 2000, Rome.

public utility sector (including postal service, banks, transport and so on).[6] While the introduction of self-regulation in 1983 primarily reflected the confederations' concern about their public image, the conversion of these rules into law had the explicit goal of extending the rules to the *autonomi* and *cobas*, which tended not to respect the rules. The re-assertion of control - stemming from the weakening of the non-confederal groups' bargaining power - was also driven by the wish to exercise greater control over wage bargaining in the public sector (Locke and Baccaro 1996: 296).[7] To this extent, the reform reflected the confederal unions' growing concern over national competitiveness and macroeconomic stability.

The government's interest in restricting strikes was even more obvious. Regardless of the potential clientelistic benefits political factions might derive from allowing anti-confederal groups to thrive, it was in the government's interest to strengthen its control over public sector wage expenditure and reduce the number of disruptions due to public sector strikes. These strikes were not only embarrassing, but they also made control over public wages - and indirectly over macroeconomic policy - difficult to achieve, not least because of the knock-on effect of public wage agreement in other sectors.

While the 1990 reform was the result of 'negotiated' legislation, the 1993 reform was characterised by greater unilateral executive action. The 1993 reform of wage bargaining arrangements and the acceptance of wage restraint in the public sector coincided with a major political and economic crisis (Della Cananea 1997). For the government the 1993 reform represented a means to reduce public expenditure and centralise decision-making and the bargaining process. The emergency situation helped strengthen the executive and neutralise opposition within the government coalition as well as from parliament. It also increased the power of the executive *vis-à-vis* trade unions. Having obtained a delegation law which foresaw the re-ordering of employment relations in the public sector, the government was in a position of strength *vis-à-vis* the union confederations, *cobas* and so on (*cf.* Section 3.2). In short, while previously executive weakness and a resulting unwillingness and inability to stir up confrontation with 'disruptive' unions and parliament had impeded

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[6] Interview with CGIL official, 27 October 2000, Rome. By enhancing the power of the *Commissione di Garanzia*, law no. 83 of 2000 continues this logic and indicates the importance attributed to it by the confederal unions.

[7] Member of the *Commissione di Garanzia*, 6 September 2000, Rome.

reform in this area, the crisis forced and allowed the executive to act forcefully and overcome potential opposition (*cf.* Carrieri and Tatarelli 1997: chapter 4).

Similar to the 1990 legislation on essential public services, the confederal unions acknowledged in principle the need to align the public sector to the private sector in order to avoid the problems of the 1980s as well as the need to strengthen their position *vis-à-vis* non-confederal groups in the public sector. Thus, the acceptance on the part of the trade unions that excessive public wage policy was a problem for both competitiveness and public finances led to a real re-orientation of trade unions' attitudes and the acceptance that wage moderation in the public sector can help achieve (or at least contribute to) lower inflation and other macroeconomic goals, such as competitiveness and stable public finances. This re-orientation of strategies and the change in attitudes reflected the increasing acknowledgement of the importance of the external constraint, that is, the need to converge on European standards and avoid a potential financial crisis. The guarantee to maintain real wages within the new bargaining framework is what made wage restraint acceptable to unions.[8]

There were differences in terms of the degree of support these reforms enjoyed. For example, the CGIL leadership was more strongly in favour of the reform than the CISL leadership, which largely reflected the greater presence of the CISL-affiliated unions in the public sector and the greater importance of the GGIL-affiliated unions in the internationally exposed manufacturing sector. But generally, both unions accepted the underlying necessity to bring the public sector in line with the private one in order to favour international competitiveness, domestic employment and financial stability. In short, the trade unions accepted the need for reform even if there were some objections to certain parts of the decree.[9] As for the *cobas*, they were not a party to the negotiations of the reforms of the early 1990s and were hence unable to prevent an agreement between the government and the confederal unions.

This clearly demonstrates that institutional reform was mainly driven by international pressure. The existence of an external constraint in the form of a hard currency policy and in the context of the increasing openness of the Italian economy forced the private sector to adapt. However, due to the institutional separation between private manufacturing and the public service sector, the latter had no

[8] Interview with CGIL official, 11 October 2000, Rome.

incentive to pursue a policy of wage moderation. With the government unable to resist pressure from public sector workers and unions, this situation became increasingly incompatible with an international context where above-average inflation resulted in decreased competitiveness and where devaluation was increasingly perceived to be a short-term instrument that could potentially trigger a financial crisis rather than a means to restore competitiveness in the long run. In short, the leadership of the confederal unions, acknowledging the existence of this external constraint, accepted the need for increased macroeconomic control.[10] This is not say however that change was easy or went unchallenged within the union movement.

Counterfactually, in the absence of an externally induced economic crisis, it is hard to imagine that, first, the Italian government would have been able to gain a position of strength and push through wide-ranging changes of public sector labour relations and, second, that the unions would have relatively willingly accepted the wide-ranging reform of public sector wage setting. At the very least, union-internal opposition to reforms would have been much stronger and would have probably prevented the confederal leadership from adopting an, on the whole, rather co-operative attitude. In this sense, the emergency situation was crucial in that it put the executive in a position of strength and the unions on the defensive - especially those groups within the union movement opposed to reform.

Nonetheless, it is important to distinguish contingent (that is, the emergency situation) from underlying structural (that is, the consequences of inflationary wage settlements in the public sector - and the subsequent loss of macroeconomic control - and international competitiveness) factors that induced the reform of public sector wage bargaining. In principle, the unions were in favour of reform and accepted the need for wage moderation in the public sector (as a result of structural, long-term constraints). In practice, an outright crisis was necessary for the government to take decisive action and for the unions to desist from forcing upon the government potentially acrimonious negotiations (and - not least of all - to prevail over union-internal opposition).

The crucial question with regard to Italian macroeconomic convergence is whether and why these reforms had the intended effect in terms of controlling public

[9] Interview with CGIL official, 11 October 2000, Rome.

sector wages and public wage expenditure. Before tackling this question, the institutional reforms of private sector labour relations, which were an integral part of the reform of the wage policy-making regime, are discussed.

5.2 Reform of the Private Sector Wage Bargaining Regime, 1992-93

Similar to public sector labour relations, wage bargaining in the private sector underwent considerable change during the first half of the 1990s. Agreements in 1992 and 1993 between unions, employers and the government led to substantial change of private sector bargaining institutions. Indeed, together with the reforms in the public sector, these reforms aimed at establishing the conditions for a national incomes policy. The reforms sought

> to reduce industrial conflict in the service sector, rationalise labour relations in the public sector, restructure collective bargaining arrangements at both the national and company levels, and re-establish tripartite, neo-corporatist 'concertation' between the social partners at the national level (Locke and Baccaro 1996: 290).

In what follows, the main institutional changes and the question of how these changes were politically possible are discussed. The 31 July 1992 agreement foresaw a programme of inflation reduction, the abolition of the *scala mobile* as well as a suspension of company-level bargaining in 1993 (Locke and Baccaro 1996).[11] Except for the abolition of the wage indexation mechanism, the 1992 agreement did not result in any permanent institutional change in the private sector. By contrast, a second agreement, reached on 3 July 1993, led to considerable institutional reform. The core element of the agreement was an incomes policy based on a joint but autonomous commitment to peg wage increases to the expected inflation rate in order to achieve currency stability and inflation convergence with other European countries (*Presidenza del Consiglio dei Ministri* 1993). On a more narrowly defined institutional level, the government, employers and unions agreed on the following features of the new bargaining regime:

> (1) introduction of a four-year national contract to regulate labour relations; wage increases were to be kept within the projected inflation rate and reviewed every two years in light of effective inflation;

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[10] Interview with ARAN official, 20 September 2000, Rome.
[11] It also included the non-renewal of civil service contracts until the end of 1993.

(2) individual companies were to raise wages only if they have made profits, and on the basis of productivity increases;

(3) government, employers and unions were to meet twice a year to define common objectives on inflation, GNP and employment levels;[12]

(4) once a national contract has expired - and in the period in which a new one is being negotiated - only limited increases will be allowed to compensate for inflation;

(5) *The scala mobile* was definitely abolished.

A separate inter-confederal agreement provided for the creation of the *rappresentanze sindacali unitarie* (RSUs). Compared to the pre-reform situation, which was characterised by a great heterogeneity of workplace representation, the RSU were to be recognised by all three confederal unions and the employers as legitimate bargaining agents at the company- and plant level (Regini and Regalia 1997). The agreement regarding the RSU also established electoral rules according to which two thirds of worker representatives were to be elected by all the workers and one third appointed by those higher-level industry union organisations that signed national-sectoral agreements. This was clearly aimed at weakening and delegitimising the *cobas*' claim to represent specific factions and was thus intended to increase the relative power of confederal unions. In fact, the reform resulted in the domination of confederal unions over company-level representation and hence the re-assertion of control over the rank-and-file.[13]

This brief overview of changes to the bargaining framework suggests that the importance of the 1993 agreement lies precisely in overcoming those institutional obstacles that had thus far made general wage moderation difficult. The re-assertion of control over the RSU would enable the confederal unions to gain loyalty of and greater control over plant-level bargaining and thus allow the unions to 'live up' to the agreements reached at the central and sectoral level; the agreement of all three union confederations to accept the content and framework of an incomes policy lessened inter-confederal competition; the agreement to abolish wage indexation

[12] Every year in May and June, prior to the presentation of the DPEF, which outlines budgetary policy objectives for three years in advance, government, employers and unions determine jointly agreed the targets for programmed inflation rates, GDP growth and employment. In September, during the preparation of the finance bill, the government consults the 'social partners' in order to define the practical measures to be included and to ensure consistency in the behaviour of the social partners (*Presidenza del Consiglio dei Ministri* 1993).

[13] The confederal unions achieved domination by winning about 90 per cent of RSU seats (Pellegrini 1998: 153).

would facilitate the process of disinflation. As the 1992-93 agreements paved the way for the subsequent implementation of wage moderation, it is important to explore how the agreement was made possible, especially since reforms had been blocked for such a long time (Ferner and Hyman 1992).

On one level, the 1992 agreement was the result of a 'national emergency' situation in which the government was able to push the social parties to agree on a number of stabilising measures. In summer 1992 the budgetary situation was getting out of hand, the pressure on the exchange rate led to increasing interest rates in a context of slowing growth, rising unemployment and diminishing competitiveness (also Chapter 6). The need to restore competitiveness, regain the confidence of international markets and avoid devaluation forced action on the social partners and the government. This is not the place to analyse in detail the bargaining strategies and the sense of political drama that surrounded the 1992 agreement: the CGIL almost split; its secretary (temporarily) resigned (invoking 'national interest' and referring to the on-going economic and political crisis); the prime minister threatened to resign; and wild-cat strikes opposing the agreement broke out in the North (Treu 1994; Locke and Baccaro 1996). This shows that neither the 1992 agreement nor the subsequent agreement of 1993 concerning the reform of the wage bargaining system was a foregone conclusion.

There was slightly less drama in 1993 (Locke and Baccaro 1996). Union leaders stressed the responsibility of the unions to help overcome political instability and economic crisis (CGIL official Cofferati in D'Agostino 2000: 14). What is true for the CGIL is certainly also true for the CISL and the UIL which had been more inclined to come to an agreement on abolishing wage indexation and co-operative bargaining all along. The confederal leaderships accepted that Italy needed to undergo major economic reform and that policy innovation was necessary.[14] Nonetheless, it would be too simplistic to regard the national emergency as the cause.

As suggested above, slowing growth and high (and rising) unemployment - to the extent that they were not already the reflection of increasing international pressure - and decreasing international competitiveness, especially during the early 1990s, demonstrated the importance of the international constraint and certainly weakened the ability and willingness of trade union confederations to put up strong

[14] Interview with CISL official, 26 October 2000, Rome; CGIL official, 27 October 2000, Rome.

resistance to reform. In 1992 alone, for example, 200,000 jobs were lost in industry, and unemployment as a whole rose to more than 10.5 per cent. The unemployment rate was expected to rise to more than 12 per cent by 1994 (OECD *Economic Surveys Italy* 1994).

At the same time, various other developments influenced the attitude of Italian unions. Union strength had been declining. Overall, union density had fallen from 49 to 39 per cent between 1980 and 1990. Moreover, the confederal unions were facing increasing competition from both rank-and-file organisations and independent unions especially in the public sector (Regalia and Regini 1998: 473). Under these circumstances the institutionalisation of bargaining rights as well as of a political role were certainly incentives to reach an agreement. Finally, it is true that, after the fall of the Berlin wall, the Italian union confederations re-oriented their strategies, with CISL 'pursuing social solidarity', UIL seeking 'represent workers as citizens' and CGIL aiming to create a 'German-style industrial democracy' (Mershon 1992; Ferner and Hyman 1992: 551).

In short, both international economic pressure and domestic changes coincided and undoubtedly contributed to wage bargaining reform. Above all, though, it was the systemic constraint resulting from the increasing openness of the Italian economy that helped bring about a major re-orientation of confederal trade union strategy. The main unions came to accept the external constraint and recognised the potential threat of the inflationary consequences of currency depreciation and hence the need to stabilise the lira - not least because high inflation rates and continued devaluations meant the erosion of workers' real wages.[15]

In fact, the crucial role played by long-term international pressure is indicated by the fact that the 1992 agreement was in a sense the result of a process that had started in the late 1980s[16] when the increasing loss of international competitiveness[17] and increasing unemployment had induced both employers and unions to search for an anti-inflationary pact (Ferner and Hyman 1992; Somaini 1998). As the abolition of wage indexation was a taboo, partly because of the high symbolic importance that was attached to it by the strongest and traditionally most militant private-sector

[15] Interview with CGIL official, 27 October 2000, Rome.
[16] That is, with the switch to a hard currency and anti-devaluationist policy.
[17] Between 1987 and 1992, the cumulative inflation differential between Italy and Germany was more than 18 percent, and more than 8 percent relative to EU countries as a whole (OECD *Statistical*

industry union FIOM, unions and employers entered into negotiations seeking to reduce labour costs and thus re-establish competitiveness by focusing on social security contributions and taxes. From this perspective, it is fair to say that the deteriorating domestic and international economic situation of 1992 was the event that 'triggered' the parties to accept the 1992-93 reforms. Tellingly, the December 1991 protocol, which preceded the 1992 and 1993 agreements and was signed by the unions, recognised the importance of a wage policy that would aim at a structural decrease of the inflation rate, the reduction of the inflation differential relative to the other major European countries, the defence of competitiveness and exchange rate stability (Negrelli 1994: XV). The official name of the 1992 accord made this even more explicit as it was called 'Protocol on Incomes Policies, the Struggle against Inflation, and the Cost of Labour'. In short, this indicates that the 1992 crisis had a 'trigger' effect but that the willingness of the different actors to reach an agreement has to be seen in the light of long-term external constraints on domestic wage policy.

Talani (2000) argued that "the trade unions, given the extent of their internal divisions, were not in a condition to resist the pressures that the government was exerting on them by continuously underlining the negative effects of the labour costs issues on the Italian economic and financial situation" (p. 197). Although this is true, it does not - as just argued – do justice to the fact that the strategies and goals of the larger part of the Italian unions had already changed by the early 1990s.[18]

What about executive strength? There is general agreement that the government in the context of fiscal consolidation did not have sufficient resources to 'exchange' in order to secure wage moderation (Treu 1994).[19] It is true that the government introduced a number of reforms demanded by the unions. But these reforms had nothing to do with the 'exchange' of classical incomes policy. Thus, at best, the government was instrumental in bringing about reform by way of the Amato and Ciampi governments threatening to resign in case an agreement would not be reached (*Financial Times*, 28 June 1993; Treu 1994). By shifting responsibility to the societal actors under conditions of economic emergency, unions and employers were

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Compendium 1999). This suggests how severe the external competitiveness constraint was for the trade unions (and employers).

[18] This view is supported by both various interviews with union officials (see footnote 14) and the strategic re-orientation of the CGIL during the 1991 congress (Mershon 1992).

[19] As in other European countries, the government was simply not capable of offering much in exchange for wage moderation except the 'institutionalisation' of wage bargaining rights (Pochet 1998; IMF 1998: 41).

pushed to reach agreement by the two governments. This should however only be regarded as having facilitated agreement. The underlying factors are to do with external long-term pressure as explicated above. In short, executive strength with regard to changes in the private sector wage policy regime was negligible and thus reflected its relative irrelevance. This was also reflected in the voluntary character of the incomes policy in that the executive was reliant upon the social parties reaching an agreement. This contrasts with reforms in the public sector where the government was able to re-order employment relations unilaterally on the basis of the delegation law.

In sum, the 1992-93 agreements resulted in a fundamental reform of private sector employment relations and bargaining institutions. While the reforms of public sector wage bargaining were largely the result of the re-assertion of government policy authority in context of an economic emergency, the reforms in the private sector were the result of an agreement between unions and employers. The government - except for the formal recognition of the 'concertation function' of unions and the threat to shift the blame to unions and employers by resigning - did not make any substantial contribution to private sector bargaining reform. Reform was mainly the result of long-term international pressure and the resulting acceptance of the international economic constraint by (relatively encompassing) unions and more specifically by the recognition that repeated devaluations did not represent a long-term competitive strategy in the context of increasing economic integration.[20] The primacy of the long-term, systemic constraint over other potential factors, such as the possible need to meet the Maastricht criteria, was also reflected by the fact both reforms were at the time regarded primarily as an Italian problem. It was in the words of a trade union official an issue '*tutto italiano*'.[21] In short, the long-term competitive constraint in combination with the immediate political and economic emergency situation were the factors that made successful reform possible.[22]

If the rationale for the confederal union leadership was clear, that is "the three confederal unions [...] exchanged income protection for their commitment [...] to support the government's austerity policy, and thus engage in self-restraint in terms

[20] Interview with CGIL official, 18 October 2000, Rome. This is not to say that policy-makers were unaware of the Maastricht criteria and what this would entail for Italian macroeconomic policy. Nonetheless, policy reform was above all driven by the need to confront the long-term, systemic pressures and the economic emergency situation.
[21] Interview with CGIL official, 11 October 2000, Rome.

of both bargaining and industrial conflict" (Locke and Baccaro 1996: 292), the question still remains as to how wage moderation was sustained beyond the context of emergency. In short, given that previous emergency responses (in the 1970s) were of a short-lived nature, the successful implementation of the agreements requires an explanation.

5.3 Wage Policy in the Public and Private Sectors, 1992-97

After having explained why the unions and the government managed to *agree* on major institutional reform, the critical question with regard to inflation control is how the agreement was maintained and the related measures implemented. More specifically, the question is how the government was able to keep its promise to restrain public wage growth in the face of potential trade union and party-political pressure, and how the confederal unions were able to control rank-and-file and managed to avoid intra-union competition.

First of all, Italian macroeconomic figures undoubtedly establish that public and private wage restraint did take place and was indispensable in bringing about good inflation performance and reduce pressure on public finances (*Presidenza del Consiglio dei Ministri* 1998; Pellegrini 1998; Negrelli 1998). As a quantitative description does not indicate why the agreements held up, a qualitative approach is necessary. Due to lack of space, the complexity of wage bargaining, the great number of sectors and bargaining rounds, the analysis will have to be confined to pace-setting metal-sector negotiations in the private sector. Due to the lack of detailed studies of decentralised public sector wage bargaining (Ruffini 1998: 16), an explanation will be provided on the basis of interviews with trade union and government officials.[23]

Wage Policy in the Public Sector (and in the Public Utilities)

A purely quantitative analysis shows that public sector wage moderation was considerable after 1992. After overruns in 1988-90 and a watered down public wage freeze in 1990, the freeze on public sector pay, and the abolition of wage indexation

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[22] See above for official statements by unions leaders referring to political and economic instability.

[23] See Cesos [various years] and Bank of Italy, *Abridged Report* [various years], *Ministero del Bilancio, Relazione generale sulla situazione economica del paese* [various years] and ARAN [various issues] for a more complete assessment of Italian industrial relations and wage bargaining during the 1992-98 period.

in 1992 contributed to the considerable decline in real wages during 1992 and 1995 (*cf.* IMF 1998: 37; Table 5-1).

Table 5-1 **Real Wage Growth, 1990-1997**

(annual change in per cent)

	1990	1991	1992	1993	1994	1995	1996	1997
Agriculture	-1.41	-0.52	5.49	0.29	-3.43	-3.21	-1.77	-0.88
Industry	0.30	3.00	1.04	-0.94	-0.73	-1.96	-0.55	1.67
Services								
- Financial Services	1.10	0.94	0.96	-2.27	-3.70	1.83	1.90	1.60
- Transport & Communication	0.93	1.80	0.30	-1.38	-3.00	-1.13	-1.11	-0.76
Public Administration	3.89	2.73	-2.66	-3.50	-3.63	-3.59	1.36	4.25
General	0.98	2.61	-0.03	-1.65	-2.03	-2.12	0.14	2.16

Source: IMF (1998: 37)

Certainly, the inflationary wage agreements of the previous decade had created room for a downward adjustment. In 1992 public sector contracts were not renewed, the *scala mobile* was abolished and the 1993 budget froze almost all wage components in response to the dramatic economic situation. This was the result of strong government action in the face of impending crisis. However, with falling inflation and the attempt to achieve compensation for the real wage loss, national agreements in the various sectors led to a recuperation of the initial loss in 1996-97 and thus introduced compensation for the decline in real wages that had resulted from repeated the inflation overshoots between 1992-95. Thus after an initial decline in real wages public sector workers achieved real wage preservation over the 1993-97 period (Table 5-2).

Table 5-2 **Wage Increases in Public Sector, 1994-1997**

(annual change in per cent)

	1994	1995	1996	1997	CUMULATIVE INCREASE 1994-97
Contractual wages	0.9	2.6	5.6	3.7	-
Supplementary components		-	0.1	0.8	-
Total	1.8	3.7	5.8	4.5	16.8
Target inflation rate	3.5	2.5	3.5	3.0	13.1

Actual inflation rate	3.9	5.4	3.9	2.7	16.9
Industrial earnings	3.7	3.9	5.1	5.0	19.0

Source: OECD *Economic Surveys Italy* (1997: 99)

Wage moderation in the public sector has also been confirmed by econometric studies. Evaluating the effect of the 1990 and 1993 reforms, La Valle found that the reforms were coincided with wage moderation in all sectors - except transport (La Valle 1996). The quantitative analysis thus indicates that not only wage moderation was a crucial factor in bringing down inflation, easing interest rates and reducing the public deficit but that wage moderation coincided with institutional changes of 1990 and 1993. Even if real wage growth accelerated after 1995, the wage increases were in line with the 1992-93 agreements. In short, institutional reform coincided with policy reform: the reform of public sector labour relations coincided with a sharp decline in conflict as well with a remarkable degree of wage moderation (Bordogna *et al.* 1999).

Clearly, wage moderation was negotiated at the 'political level' between government and unions in preparation of the yearly budget with the explicit goal of maintaining real wages. ARAN only conducted negotiations within the limits agreed upon by the major trade unions and the government. Given that there was overall substantial agreement at the formulation stage between the union confederations and the government, the implementation was on the whole rather smooth,[24] at least once the targets had been determined.

This is not to say that wage determination was conflict-free. On several occasions, tensions rose after the government conceded generous wage agreements to some militant non-confederal groups in the transport sector (*Financial Times*, August 1994).[25] Moreover, the repeated overshoot of the inflation target and especially the increase in inflation of up to 5.8 per cent in 1995 resulted in severe union criticism of government policies (as well as of employers' pricing policies). Interestingly and ironically, there was pressure from the confederal unions on the government to resist excessive wage settlements in the (non-ARAN managed) public utilities. This reflected unions' worries regarding a potential knock-on effect in the public sector

[24] Interview with ARAN official, 20 September 2000, Rome.
[25] Note however that the transport sector does not fall under the authority of ARAN.

(*Financial Times*, 7 July 1994) and thus interest of the confederal leadership to avoid above-inflation-target wage increases in other sectors.

In addition to concerns that this violated the agreement, this also reflected the worry of the confederations about keeping lower level unions organisation in line. Otherwise rank-and-file would certainly have been difficult to control and convince of the continued need for wage moderation (*Financial Times*, 9 July 1996). With the confederal unions - as relatively encompassing unions - recognising that low inflation was important, this shows how the 1993 agreement created what could be called a 'low-inflation pact' in which the confederations had a crucial part to play in terms of linking wage policies across the various sectors of the economy. It also demonstrates that the acceptance of the need for wage restraint on the part of the confederal unions was an integral part of the success of wage policy during this period.

Data and anecdotal evidence suggest that overall wage restraint was less successful and conflict greater in the transport and public utility sector (La Valle 1996; *Financial Times*, 27 September 1995; Bordogna and Provasi 1998).[26] This indicates the importance of the crucial role the structure of union representation in the various sectors and hence the co-operation of confederations played with respect to achieving wage moderation in the public sector as opposed to the largely 'non-public' utility sectors and especially the transport sector: non-confederal groups in the public utility sectors tended to be less willing to accept wage restraint, while the relatively encompassing confederations in public administration were willing to accept greater wage restraint and influence lower level units in this sense.

Hence the distinction between the public sector (under the responsibility of ARAN and dominated by unions associated with the three confederations) and the public utility (not ARAN-managed and characterised by a strong presence of non-confederal and hence non-encompassing groups) suggests the important role confederal unions played with regard to wage moderation in the public sector. On the whole, once an agreement was reached between the confederal unions and the government at the formulation stage at the central level, ARAN - immune at that stage from party-political interference - simply implemented it within the limits

[26] The figures in Table 5-1 suggest that even though real wages declined (for communications and transport), wage restraint in this sector was relatively weaker than in the public administration sector, thus supplementing the anecdotal evidence provided above.

determined by prior agreement and within budgetary constraints, while the confederal unions enforced their obligations with regard to rank-and-file.

In sum, with regard to public wages (excluding public utilities) "wage increases negotiated at national level have remained within the planned inflation rates fixed by the budget laws of the state, without the excesses often witnessed in the 1980s, when such ceilings were often ignored, not least by the ministers responsible for the negotiations" (Bordogna *et al.* 1999: 118). The repeated overshoot of the inflation target was on the whole recuperated and hence the agreement fulfilled (Ruffini 1998: 25).[27] Wage restraint was possible because of institutional reform and primarily as a result of the strengthening and the co-operation of confederal unions rather than the increase of executive strength (as continued executive weakness in the public utilities suggests). Economic conditions played a less important role, as the incentives for unions in the public sector to exercise wage restraint was not directly affected by decreasing international competitiveness. To the extent then that public sector wage increases were moderate they certainly reflected the interests of relatively encompassing unions and the greater centralisation and isolation of bargaining from party-political interference rather than a newly gained executive-domination of the wage determination process. The economic emergency situation certainly reinforced the incentives for the executive to control public wage but their ability to achieve control was equally dependent on the co-operation of the confederal unions.

Thus the wage determination system in the public sector introduced between 1992-93 worked well in that it achieved its aims during the 1992-97 period. Given that private sector wages had scope for increases in the aftermath of the 1992 devaluation, wage restraint in the public sector was a pre-condition for successful wage restraint in the private sector, since private sector employees could hardly be expected to exercise restraint while public sector employees were enjoying above-inflation-target wage increases.

[27] Interview with CGIL official responsible for public sector, 11 October 2000, Rome.

Wage Policy in the Private Sector

Similar to the public sector, the incomes policy accord whereby national-industry-level wage increases would be linked to the official inflation forecast were largely respected by the unions.

> The employment relations system has performed surprisingly well. Major national agreements were concluded and made a large contribution towards lowering inflation. When the currency came under downward pressure, unions were helpful in restoring international confidence by making major concessions. At lower levels, industry agreements were reached in accordance with established procedures and wage increases were at levels compatible with the goal of lowering inflation (Pellegrini 1998: 165).

The figures confirm this evaluation. Econometric studies for the first half of the 1992-98 period indicate that the 1993 agreement on wages and inflation had a positive effect on inflation performance independent of economic conditions (La Valle 1996; Table 5-3).[28]

Table 5-3 Wage Policy in Private Sector, 1993-1997

(total increase over duration of contract, in per cent)

	FIRST ROUND					SECOND ROUND			
	Effective Date	Target Inflation	Nominal Wage Increase	Actual Inflation		Effective Date	Target Inflation	Nominal Wage Increase	Actual Inflation
Paper	Jul-93	7.3	7.5	8.7		Jul-95	7.4	7.9	7.9
Chemicals	Jan-94	6.1	7.9	9.5		Jan-96	6.6	8	5.8
Petroleum	Jan-94	6.1	6.7	9.5		Jan-96	6.6	7.9	5.8
Banking	Jan-94	6.1	9.1	9.5		Jan-96	6.6	7.7	5.8
Insurance	Jan-94	6.1	5.9	9.5		Jan-96	6.6	7.9	5.8
Metal	Jul-94	5.3	7.6	9.8		Jul-96	4.6	8.6	n/a*
Tourism	Jul-94	5.3	7.2	9.8		Jul-96	6.1	9.2	n/a*
Publishing	Oct-94	5	6.1	9.8		Oct-96	5.5	7.5	n/a*
Trade	Jan-95	4.6	8.3	9.5		Jan-97	5.1	9.1	n/a*
Food	Jun-95	7.6	7	8.3		Jun-97	4	4.5	n/a*
Textiles	Jul-95	7.5	8.6	7.9		Jul-97	4.7	5.3	n/a*

Source: IMF (1998: 36-37) * not available at time of publication in 1998

[28] This econometric study only covers the period until 1996 during which inflation targets were repeatedly overshot. It is true that after 1996 wage moderation was less pronounced. But this largely reflected the catching-up of nominal wage increases with higher than expected inflation throughout the previous periods.

As the metalworkers sector, characterised by the strongest unions, traditionally set the benchmark sectoral agreement that the other 14 sectoral trade unions tend to follow, the analysis focuses on private sector wage bargaining in this sector during 1992-97. The first round of wage bargaining took place for the 1994-95 contract period. The agreement for the 1994-95 period was reached without any strikes or substantial conflict for the first time since 1945. This was certainly partly due to the difficult economic situation as reflected in continuous pressure on the exchange rate and long-term interest rates (*cf.* Figure 4-3). Although the 1992 devaluation theoretically offered the opportunity for wage increases from a sectoral point of view, national-sectoral agreements were by and large in line with programmed inflation (IMF 1998: 16-17; Table 5-3; Rossi 2000: 104-109).[29] Tellingly, there was no attempt to fully recover the loss in earning power at the sectoral level that had resulted from the 1992-93 recession. However, workers in the metal sector were compensated by year-end productivity and profitability bonuses (*Financial Times*, 7 July 1994).

While the 1994-95 agreements had been easy to achieve, the renewal of the pace-setting metalworker contract for 1996-97 was characterised by a much higher degree of conflict and was not concluded until February 1997. The metalworkers demanded at least a 3 per cent rise plus recovery of part of what they have lost in real terms over the 1994-96 periods as a result of the continued inflation overshoot (*Financial Times*, 9 July 1996; *cf.* Table 5-3). *Federmeccanica*, the metal-sector employer association, refused to simply add-on the difference between actual and projected inflation demanded by the unions and claimed that the sector's industrial prospects be taken into account in determining the wage increase for the period ahead. It also argued that the increase demanded by the unions did not take into account the element of inflation that was imported in the wake of the lira devaluation (*Financial Times*, 15 October 1996). (The 1993 agreement did indeed allow for some interpretational scope regarding this point.)

After a period of increased conflict, a compromise was reached in spring 1997 involving the extension of the pay award of L200,000 a month over 30 rather than 24 months (*Financial Times*, 4 February 1997). This compromise clearly demonstrated that although the conflict showed considerable differences - and even differences

[29] The difference between target inflation and nominal wage increase reflects the catch-up element.

regarding the very core of the new bargaining regime (especially whether or not to compensate workers for past inflation overshoot), the final agreement reflected the respect of the 1993 accord as well as the importance both sides attached to the maintenance of the agreement. The 1993 reforms were regarded as too important by both sides as to risk their unravelling.[30]

In addition to the interest in preserving the system, it is clear that the repeated threats by the Bank of Italy, which had constantly argued that an inflationary wage agreement would not be compatible with continued disinflation, to raise interest rates also had an impact on the position of the bargaining parties. The Bank also argued that the loss in real wages had already been compensated by wage increases at the decentralised level (*Il Sole 24 Ore*, 1 November 1996). This indicates the institutional influence of an independent central bank on the wage bargaining process.

In sum, wage moderation in the private sector was quite successful. The unions fulfilled their promise regarding wage restraint, despite the fact that inflation rates repeatedly overshot the agreed inflation target. Wage moderation was achieved despite the scope unions had to increase their wages in the aftermath of the lira devaluation. Thus, the incomes policy resulted in wage moderation, preserved the competitive advantage of the Italian economy in the wake of the 1992 devaluation and more importantly allowed the Bank of Italy to bring down interest rates as well as prevent an inflationary upsurge in the wake of the substantial depreciation of the lira. In short, wage policy was a crucial element in achieving disinflation in the 1990s (*Presidenza del Consiglio dei Ministri* 1998).

It is true that company-level bargaining in the private sector during the period immediately preceding the reforms had been largely consensual (Regalia and Regini 1998). However, the Italian private wage bargaining regime in the 1980s was characterised by an 'implicit' incomes policy in which three bargaining levels were involved (that is, confederal, national-industrial and company levels). This type of 'uncoordinated' wage bargaining however was unlikely to have resulted in the same level of wage moderation, especially after the 1992 devaluation and the abolition of the *scala mobile*. Co-ordination within the private sector as well as between the public and the private sectors was crucial with regard to achieving wage restraint,

[30] In fact, *Confindustria* had submitted a request to the president of the Republic before the general

especially given the presence of medium-strength unions capable of using the space opened for upward wage adjustment by the lira devaluation.

This suggests that the co-operation of the confederations and their affiliated industry unions was also important. In the private sector, initially, union division was overcome because none of the actors wanted to be responsible for causing an economic crisis. Subsequently, wage moderation was maintained, which to a considerable extent reflected a re-orientation of strategy on the part of the confederal leadership. Contrary to the 1970s and 1980s, even the FIOM, as the traditionally strongest and most militant union, came round to accepting wage moderation. This reflected the increasing importance of international competitiveness for exposed sectors and hence the effects of economic internationalisation. The union confederations and the most important (exposed) industry unions accepted their responsibility for disinflation in exchange for the preservation of real wages.[31]

As regards the issue of control over lower level units, a comparison of public utilities and private industry is revealing. Wage moderation worked much better in the ARAN-managed public and the private sectors than in the transport sector, where confederal unions were weaker (*cf.* Table 5-1). This reflected both the organisational strengthening through the introduction of the RSU[32] as well as a general consensus within the confederal unions as to the desirability of wage moderation and real wage preservation.[33] Through the introduction of unified workplace representations, lower level units were linked to confederations in a more consensual way; it also well as strengthened the confederations (and industry unions) relative to the rank-and-file.[34] In short, a combination of consensus, international pressure and institutional change was responsible for an overall successful policy of wage moderation in the private sector. What this means with regard to institutionalist approaches to wage bargaining and policy is discussed in the following section.

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elections of 1994 demanding the maintenance of the 1993 agreement.

[31] This responsibility was not least of all the consequence of the trade unions' commitment to EMU membership which was regarded as favouring economic development (Interview with CGIL official, 27 October 2000, Rome).

[32] This is only true for the private sector, as the RSU were not formally in place in the public sector until 1997.

[33] Interview with CGIL official, 18 October 2000, Rome.

[34] Interview with CGIL official, 18 October 2000, Rome.

5.4 *Conclusion: Employers, Unions, the Italian Government and Incomes Policy*

The Italian system of labour relations underwent dramatic institutional and policy change in the 1990s. The policy of wage restraint in both the public and private sectors agreed in 1992-93 turned out to be successful in that wage moderation contributed to disinflation and monetary convergence - something that Italy had failed to achieve since the mid-1960s. In the context of a considerable depreciation of the lira and nervous international markets, the importance of public and private wage moderation cannot be overestimated. Without a policy of wage restraint, the devaluation would have resulted in much higher inflation. Ford and Krueger (1995), for example, find that their econometric model overpredicts Italian wage and price inflation in the wake of the 1992 lira devaluation (also La Valle 1996). The authors attribute this to the changes in labour market institutions (that is, abolition of *scala mobile* and so on).[35]

Counterfactually, it is hard to imagine that Italy could have achieved the same level of disinflation in the absence of a policy of public and private wage restraint. First of all, the 1992 exit from the ERM softened the external constraint and hence the 'implicit' incomes policy of the 1980s. As already noted, in the absence of a policy of wage restraint, the lira devaluation offered space for wage increases without the risk of running into the competitiveness constraint in the short term. The agreement to keep wage increases in line with inflation was hence crucial to achieving lower interest rates and preserving the increased competitiveness resulting from the lira devaluation. Second, the abolition of the *scala mobile* was equally instrumental in lowering inflation. The continuation would have created a drag especially in a situation when inflation would have picked up as a result of higher import prices and inflation. Disinflation would have been much more difficult to achieve. Finally, in the context of jittery financial markets, considerable wage increases would have likely resulted in an even greater depreciation of the lira, thus contributing to higher inflation.

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[35] Another - admittedly extreme comparison - illustrates the importance of wage restraint. While in the wake of the devaluation in the early 1970s unit wage labour costs in industry increased by 96 per cent between 1972-76, they rose by only 2 per cent between 1991-95 (Rossi 2000: 109).

Having established the importance of wage moderation, the question is how wage moderation was possible. Previous attempts to implement a policy of wage restraint as well as the institutional characteristics of the Italian private and public wage bargaining regimes did not bode well (Golden 1988; Regini 1984, 1997). Talani (2000), for example, explained the 1992-93 labour market reforms in terms of distributional politics taking place in the context of increasing international economic integration. Increasing unemployment and shrinking profit margins and market shares gave employers the upper hand and forced reforms on confederal unions, which were themselves divided over the issue. While domestic distributional politics are no doubt important, it does not explain how the domestic institutional problems were overcome and how the agreement was upheld in the medium term.

As suggested above, while the crisis was the 'trigger' factor and long-term competitive pressures represented the underlying 'cause' of institutional and policy reform, the co-operation of the confederal trade unions was also partly induced by prospective EMU membership. Although initially the 1992-93 reforms were primarily regarded as an exclusively Italian problem (*cf.* Section 5.3), it is true that there was an awareness of the need to converge with other European countries in order to remain a full participant of the European integration process (*Presidenza del Consiglio dei Ministri* 1993). This can be interpreted as follows. While the 1992-93 reforms were above all a response to the impending crisis and the long-term competitive pressures that Italy endured as a result of ERM membership, the trade union leaderships' commitment to make the agreement work in spite of the short-term economic costs endured has also to be seen in the context of wider economic and social goals that the confederation regarded as being tied up with EMU membership.[36] In this sense, wage policy after 1992-93 certainly represented a 'consensual' response to external pressure and can explain how trade union division was initially overcome (*cf.* 1970s crises discussed in Chapter 2). However, this would still not explain how the leadership was able to control lower level bargaining. In fact, the renewal of the wage contract in 1996 demonstrated that industry unions in the metalworkers' sector were prepared to potentially risk the breakdown of the 1992-93 agreements and thus potentially cast into doubt Italy's commitment to meet

[36] Interview with CISL official, 26 October 2000, Rome; Interview with CGIL official, 27 October 2000, Rome.

the Maastricht criteria. A more detailed discussion of the post-1992 wage bargaining regime is therefore warranted.

Put in terms of the theoretical concepts discussed above: how were domestic-institutional obstacles to an incomes policy overcome: that is, in the private sector, (1) the division of confederal unions, (2) the weak authority of union leaderships over lower levels, and (3) a weak government unable to fulfil its promises (Regini 1997); and in the public sector, (1) the fragmentation of union representation, (2) the absence of international competitive pressure, and (3) a weak government unable to control public wages.

First, how were union division and fragmentation overcome?[37] The willingness of employers and unions to agree on the abolition of wage indexation can in fact be understood in terms of the negative distributional consequences resulting from increasing international constraints. Employers wanted a reduction in labour costs in the face of increasing international competition. Confederal unions (or at least their leadership) were willing to accept wage restraint in exchange for real wage preservation in the context of rising employment. Hence it is fair to say that both parties accepted the external constraint and agreed on the need to a system-stabilising response. In addition to the evidence provided above (see footnote 14), this suggests that there has indeed emerged 'a shared vision of national competitiveness' in the private sector (Dore 1994; Katzenstein 1985). As already suggested, even though it is essential that actors possess a 'shared vision',[38] it is only likely to be shared – and capable of being implemented - under certain institutional conditions.

In this sense, trade union division was neutralised - both of which helped to overcome the private/ public sector dualism (Cella 1995). This suggests that a limited degree of confederal fragmentation can be overcome through co-ordination especially in the presence of an international constraint such as a hard currency regime (*cf.* Section 2.6).

Second, the willingness of the union leadership to accept institutional and bargaining reform does not explain how the confederations were able to make lower units accept an arrangement that demanded short-term sacrifices for the sake of long-

[37] During the 1990s, the fragmentation of the employer side was also reduced with the unification of various employer federations such as *Asap*, *Intersind* and *Confindustria* (Lanzalaco 1998). Employers have not been the focus here as the analysis focuses on the demand-side.

[38] This conception of 'shared competitiveness' is not simply cognitive but reflects primarily a change in attitude, strategy and goals as a result of international competitive pressure.

term benefits, such as systemic stability and international competitiveness. How were the unions able to control rank-and-file despite considerable resistance to this policy? Regini (1997) has suggested that 'legitimacy', achieved through workplace representation in the form of the RSU, acted as a functional equivalent to the (neo-corporatist) triad of centralisation-autonomy-control of the confederal leadership: "the potential crisis of representation has been channelled and controlled not by securing a legal monopoly of representation but by mechanisms for the articulation of 'voice' within, rather than outside the trade unions" (p. 270). While this is plausible, it is equally clear that the strong position of confederal unions and their affiliates in the workplace following the 1993 reforms discussed above also provided the leadership with greater control and influence over lower-level company wage bargaining.[39] Non-institutional factors such as rather unfavourable economic conditions during 1992-97 also helped prevent wage drift at firm level and thus contributed to the acceptance of wage restraint by lower-level actors. However, the fact that wage moderation continued, despite the catching-up from 1996 onwards, suggests the importance of the domestic-institutional change.

Hence, on the one hand, the 1993 reform seems to have been instrumental in ensuring wage moderation at the national and rank-and-file levels in that it enabled greater control of confederal unions over company-level wage bargaining and thus prevented potential wage drift. On the other hand, it seemed acceptable to the majority of workers to exchange real wage preservation in the context of a national economic crisis and the continued presence of external constraints. The CGIL, the confederation most hostile towards bargaining concertation, for example, held a union-internal consultation in which members voted in favour of the institutional changes, thus indicating the importance of consensus.[40] This was true for the majority of workers, with the exception of the leftist faction within the CGIL. However, this consensus should not be overestimated. While there existed a certain degree of consensus (especially in the presence of the threat of economic crisis in 1992 and to a lesser degree in the following year), the conflicts of 1996-97 in the private sector also indicated a certain degree of fragility.

In short, in the absence of detailed studies of collective bargaining rounds, it is difficult to evaluate the relative importance of institutional reform, economic crisis

[39] Interview with CGIL official, 20 October 2000, Rome.

and consensus, even if a comparison with the similarly structured German system suggests that the new bargaining arrangements are conducive to low inflation and competitiveness (*cf.* Streeck 1994; Dustman and Von Soest 1999). Industry unions and workplace representations are linked; and the latter are in fact dominated by the main confederal unions (or at least their affiliated industry unions). Within the private sector, the internationally exposed metalworkers traditionally set the pace-setting agreement with which most of the other private sectors fall in line. The competitiveness constraint and an inflation-averse central bank, which can credibly threaten to tighten monetary policy in case of above-productivity wage increases, also affects wage policy. This suggests that the Italian system of private sector wage determination has moved from a system of uncoordinated bargaining characterised by confederal, national and company-level wage agreements to a 'coordinated system' - and indeed a 'Germanic'-style system of co-ordinated industry bargaining (*cf.* Section 7.4), where export-oriented unions dominate wage-setting in the private sector through a system of wage leadership and control over company-level bargaining.

A third problem with regard to wage moderation has been identified as the 'weak executive'. However, the 1992-93 reforms represented neither a political nor an economic exchange between the trade unions and the government. The role of the latter was not very relevant with regard to private sector wage bargaining. The issue of executive strength is however important as regards public sector wage policy-making.

The reform of public wage bargaining was undoubtedly a response to international economic and domestic financial crisis. Control of public wages was important not only in order to keep inflation under control but also to prevent private-sector employees from demanding higher wages in turn. In the public sector, the government was able to increase its authority in the area of public wage policy by introducing a number of institutional changes. While the reforms were introduced in a more or less unilateral way in the wake of an economic emergency, the successful implementation of wage moderation also depended on the co-operation of union confederations that had an interest in restraining public wage growth and in re-asserting their influence in the public sector, where it had been severely undermined

[40] Interview with CGIL official, 11 October 2000, Rome.

as a result of the emergence of occupation-based anti-confederal unions. As suggested in Section 5.2, the role of the core executive with respect to public sector wage bargaining was strengthened, the authority of the confederal unions enhanced, and the power of *cobas* (and of clientelistic ministers) weakened. This strengthening has partly to be àttributed to domestic-institutional reform.

While the government was strengthened in that it centralised public sector wage bargaining within the executive and increased its transparency, it would be exaggerated to speak of a 'depoliticisation'. After all, the formulation of guidelines is still subject to union (and coalitional-political) pressure as the conflicts over inflation targets in the 1990s demonstrated. Nonetheless, once decided, ARAN negotiated and concluded contracts within the guidelines set at the 'political' level. But it was clear that the control of wage bargaining was enhanced as a result of strengthened confederal unions and the weakening of the *cobas*. Similarly, the creation of the *Commissione di Garanzia* in 1990, which was successful in reducing strike activity in most sectors (except transport), also increased the 'bargaining' position of the executive relative to disruptive groups in the public sector (*cf.* Bordogna and Provasi 1998). In short, the lesser vulnerability of the executive, the greater centralisation of bargaining under the auspices of the prime minister and ARAN (and the greater bargaining co-ordination of the various parts of the public sector that this allowed) as well as the reduced influence of *cobas* and the resulting stronger position of the more encompassing confederal unions all contributed to more responsible wage policies in the public sector.

In sum, there is no doubt that international pressure induced reform as much as domestic factors shaped the outcome and nature of reforms. The institutional reform of 1992-93 removed some obstacles and introduced new rules of the game that made a policy of wage restraint possible. The successful policy of wage moderation in both the public and private sector also depended a great deal on the co-operation of the three union confederations. Yet the ability of the confederation to co-operate successfully was in turn the result of institutional reform. The importance of domestic institutions with respect to wage bargaining reform is also reflected in the fact that it took 10 years to abolish wage indexation (1983-93) and to institutionalise a system of private and public wage setting consistent with the external constraint:

> L'incapacità per un lungo periodo successivo di superare una forma di centralizzazione impropria (automatica ed inerziale e non finalizzata e strategica) ha determinato il

> prolungarsi più che in qualsiasi altro paese avente analogo livello di sviluppo, di disfunzioni (alta inflazione ed elevata disoccupazione) (Somaini 1998: 401).[41]

This incapacity was due to the importance and inertia of domestic institutions.[42] A weak government and a medium-strength, ideologically divided union movement were not able to achieve adequate change of the wage policy regime. To the extent that medium-strength unions and an uncoordinated bargaining system are regarded as institutional features, the policy change in Italy was path-dependent rather than purely functional (*cf.* Section 1.4). Not only can the delayed adjustment and policy reform be attributed to the domestic-institutional obstacles (weak executive, strong unions), but also bargaining decentralisation was not an option in the context of medium-strength unions. Hence for a weak government - unlike the British government in the late 1970s or the French government in the early 1980s – as well as for employers, the only solution consisted of convincing the unions to accept wage restraint in exchange for bargaining reform and real wage maintenance. The introduction of a system of 'controlled decentralisation' (Traxler 1995, 1996) rather than complete decentralisation was the only realistic way to achieve wage moderation. This further indicates that domestic institutions are in fact an intervening variable that mediate between external-international and domestic-societal pressures and thus limit possible outcomes.

In a comparative-institutional perspective, it is fair to say that Italy had the 'misfortune' of being a large country with a low degree of openness, medium-strength unions and weak government that after the oil shocks of the 1970s became an increasingly 'small country' in terms of economic openness.[43] Institutions such as the *scala mobile* persisted despite their apparent inadequacy in relation to a changing international context and their resulting dysfunctional character. The government was more often than not unable to control public wage expenditure, despite its

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[41] "The inability, for a long period of time, to overcome a form of inappropriate centralisation (which was automatic and inert and not goal-oriented and strategic) was responsible for the persistence – longer than in any other country with a similar level of development – of dysfunctions (high inflation and high unemployment)."

[42] Rhodes surprisingly calls this 'societal effect' which is defined as "the complex relationship between the key elements of national economic systems which make them resistant to change and critical in the mediation of any external pressures" (1997: 4).

[43] By contrast, Germany had a stronger government, an inflation-averse central bank and a medium-strength union movement that was more homogenous and was dominated by the export-oriented metal sector (Scharpf 1991). France had a strong government able to control both fiscal and monetary policy

obvious incompatibility with intensifying international constraints. The crises of the early 1990s just provided the focal point, and triggered institutional reform and a corporatist response to international pressure that other, smaller countries had experienced before (Maier 1984; Katzenstein 1984, 1985). In sum, it is fair to say that a combination of external pressure and domestic institutional reform led to a policy of wage restraint. This made it possible for Italian inflation to converge to the level of the best-performing European countries.

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and - after the turmoil of the late 1960s - unions unable to push up inflation (*cf.* Table 7-1 in chapter 7).

6 MONETARY AND EXCHANGE RATE POLICY: THE POLITICS AND CONSEQUENCES OF CENTRAL BANK INDEPENDENCE

> *La giustificazione dell'autonomia della banca centrale dal Tesoro si troverebbe in tal caso nel postulare una maggiore 'lungimiranza' della autorità monetaria rispetto alla visione tendenzialmente* short-sighted *delle autorità di governo* (Arcelli 1992: 11)[1]

In 1991-92, Italian inflation and long-term interest rates were high. Italian consumer price inflation stood at an annualised 6.5 per cent in 1991, which was well above the EU-15 average of 5.2 per cent. Long-term interest rates were far above the European average. The average annual nominal long-term interest rate in 1991 was 13.1 as against a rate of 8.5-9.5 per cent in most other EU countries.

As pointed out, given Italy's monetary performance in the second half of the 1980s and early 1990s, the prospects of Italy achieving monetary convergence were not promising (Table 6-1). Nonetheless, despite losing the external stability anchor of ERM membership in September 1992 and despite considerable depreciation of the lira (of up to 25-30 per cent against the currencies of its major trading partners), Italy was actually able to reduce domestic inflation from 5.3 per cent in 1992 to just under 2 per cent in 1998. Moreover, Italian long-term interest rates were brought down from an annual average of over 13.3 per cent in 1992 to 4.9 per cent in 1998. Both monetary indicators were below the respective reference values. As for the exchange rate, after rejoining the ERM in November 1996, the lira had not been subject to severe tensions and its parity did not have to be re-adjusted during the period until May 1998 (*Presidenza del Consiglio dei Ministri* 1998). Thus Italy managed to satisfy all three monetary criteria in time.

Table 6-1 Consumer Price, 1982-1992

(in per cent)

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Inflation	16.4	14.9	10.6	8.6	6.1	4.6	5.0	6.6	6.1	6.5	5.3

Source: OECD Economic Outlook [various years]

[1] "The justification of the central bank's autonomy from the Treasury would in this case be found postulating a greater far-sightedness of the monetary authority, compared to the often short-sighted vision of government authorities."

Institutional change, that is, the granting of independence to the Italian central bank in 1992 and 1993, was a major factor contributing to Italy's monetary performance. Theoretically and empirically one would expect central bank independence to matter (Goodman 1992; Effijinger and De Haan 1996; Chapter 2). In order to establish that central bank independence made a major contribution to Italy's good monetary performance, I show that at various points of time the central bank pursued stability-oriented policies *despite* major opposition from domestic political and societal actors.

In this chapter, I first discuss influences and interests in Italian monetary and exchange rate policy leading up to the 1992 EMS crisis. A detailed analysis of the 1992 crisis is important because it radically transformed the context in which monetary policy was to be conducted, and because it allows for an understanding of the interests of the various actors regarding monetary and exchange rate policy thereafter. Second, the process of central bank reform in 1992-93 is examined. Third, monetary policy and decision-making under a floating regime are analysed. Fourth, the reasons for the 1996 ERM re-entry and the politics of monetary policy thereafter are discussed.[2] The final section provides further evidence regarding the importance of central bank independence for greater price stability after the 1992-93 reforms.

6.1 EMS Crisis and Regime Change

The modification of the domestic-institutional framework (April 1992, November 1993), that is the granting of increased independence to the central bank, roughly coincided with the change of the international framework (September 1992) of Italian monetary policy. International regime change is analysed first to gain an understanding of the interests of the actors involved.

After 1987 successive Italian governments had clearly shown a desire to avoid devaluation. In January 1990 the lira joined the narrow fluctuation band and despite the lira's persistently worse inflation performance relative to other European currencies and the concomitant loss of competitiveness, the Italian authorities ruled out devaluation (*Financial Times*, 8 February 1991, *Financial Times* 29 August 1992). Eventually the 1992 EMS crisis forced Italy to devalue and ultimately leave

[2] The analysis will mainly focus on the central bank's discount rate policy since this was the single most important instrument of which the Bank of Italy made use in conducting monetary policy. Moreover, the discount rate was the primary cause of conflict over monetary policy.

the ERM. The ERM exit had considerable consequences for future Italian monetary and exchange policy in that it removed the exchange rate constraint on the conduct of domestic monetary policy. Another consequence was that by leaving the ERM Italy was potentially not meeting the exchange rate criteria and would hence need to re-enter the exchange rate system at some later stage.

Domestic and international factors contributed to the unsustainability of Italian ERM membership. The three major underlying causes of the EMS crisis in 1992 are well known and are only briefly reviewed here (Ungerer 1997: chapter 22; Delli Gatti *et al.* 1995; Busch 1994). First, the weakness of the U.S. dollar and high interest rates in Germany led to an appreciation of the German mark within the ERM and a weakening of the other currencies. From the beginning of 1992 to July 1992 the *Bundesbank* raised its discount rate several times (to counteract the inflationary consequences of economic policies resulting from German re-unification). High German interest rates forced other ERM member states to raise their interest rates, even though these were gradually moving into recession.

Second, part of the tensions within the ERM were essentially due to insufficient economic convergence among ERM member states. Italy in particular had not been able to achieve a sufficient degree of macroeconomic convergence. Italian inflation had consistently been above the ERM average and public debt increased rapidly due to persistent public deficits. A combination of slowing growth, rising unemployment and increasing current account deficits made the high interest rate policy - aimed at defending an overvalued lira - increasingly incredible and thus eventually unsustainable. Italian authorities sought to shore up the exchange rate through high interest rates. However, this 'buying of credibility' finally failed when market expectations concerning the creation of EMU were cast into doubt.

This happened as a result of the third condition which was triggered by the uncertainties resulting from the rejection of the TEU in a referendum in Denmark on 2 June 1992 as well as from the uncertainties surrounding the French referendum on the same issue due to take place at 20 September. The change in market expectations exposed what has been called 'undeserved credibility' (Artus and Bourginat quoted in Ungerer 1997: 262).

These pressures affected Italian monetary policy. Clearly Italian monetary policy faced a difficult situation in the early 1990s. Since the second half of 1989 the Italian economy had experienced relatively low growth. Already high interest rates to counteract domestic inflation were pushed even higher by the attempt to defend the external value of the lira. A persistent inflation differential led to an effective real appreciation of the lira in the ERM and the loss of competitiveness (Table 6-2). At the same persistent wage pressures and considerable increases in real wages fuelled domestic consumption (OECD *Economic Surveys Italy* 1992: 19-23). The Bank of Italy sought to counteract these inflationary consequences by pursuing a high interest rate policy (Bank of Italy, *Abridged Report*, 1993: 158).

Table 6-2 Italian Cumulative Inflation Differentials, 1987-1992

(annual change in per cent)

	1987	1988	1989	1990	1991	1992
Vis-à-vis Germany	4.4	8.1	11.9	15.3	18.2	18.4
Vis-à-vis EU-15	1.6	3.2	4.8	5.5	7.1	8.1

Source: OECD *Statistical Compendium* 1999

Attacks against the lira (among others) began in the second half of August 1992, after the Danish referendum and remarks by *Bundesbank* president Helmut Schlesinger concerning a possible realignment in the ERM, (Micossi and Padoan 1994). Despite massive intervention by both the Bank of Italy and the *Bundesbank* and a total increase in the Italian discount rate by 1.75 points to 15 per cent between 4 August and 4 September, the lira remained below its floor. In the context of slowing growth and rising employment this was clearly an unsustainable policy stance.

The dilemma that the Bank of Italy confronted had been reflected in the cut in interest rates in August 1992. In a desperate attempt to balance domestic and international pressures, that is, weakening growth which demanded lower interest rates and the defence of the lira which required higher interest rates, the Bank of Italy lowered both of its rates by half a percentage point following the agreement to abolish the wage indexation mechanism (*Il Sole 24 Ore*, 4 August 1992; *cf.* Chapter 5). Domestically strong opposition to the high interest (and thus implicitly exchange rate) policy came from industry. In fact, the situation was perceived to be so dramatic that *Confindustria* publicly asked the government for an emergency meeting (*Il Sole 24 Ore*, 4 September 1992). It also published a report talking of the 'unbearable cost of money and de-industrialisation' (*Il Sole 24 Ore*, 5 September 1992; *Il Sole 24 Ore*, 9 September 1992).

After further increases in interest rates and massive but unsuccessful intervention[3] by both the *Bundesbank* and the Bank of Italy, the EC Monetary Committee was convened and Germany agreed to a moderate easing of its monetary policy in exchange for 7 per cent devaluation of the lira on 12-13 September 1992. Despite the realignment, the attacks on the lira continued which finally led the Italian government to suspend ERM membership on 17 September. In the meantime, the president of *Confindustria*, Luigi Abete, called for lower interest rates in the aftermath of the devaluation (*Il Sole 24 Ore*, 15 September 1992).

Retrospectively the Italian ERM exit may look inevitable. Even though it is plausible that the devaluation was inevitable once the markets doubted that EMU might come into existence, this does not yet explain why Italy decided to leave the ERM altogether. After all, other countries such as Spain and Portugal devalued (repeatedly) without leaving the ERM. What then were the actors and interests behind Italy's ERM exit? While initially the Bank of Italy had been cautious towards ERM membership, it gradually came to favour it because it helped impose monetary discipline on the Italian economy (Epstein and Schor 1989; Walsh 1995).

> The steady real appreciation of the lira within the EMS was an essential part of Italian exchange rate policy. It helped bring Italian inflation down towards the European average and spurred firms and unions to conclude agreements that safeguarded competitiveness by containing costs and raising productivity (Santini quoted in Walsh 1996: 298).

If ERM membership in combination with a not fully accommodating exchange rate policy had been an integral part of the Bank of Italy's anti-inflation strategy in the early 1980s (Bank of Italy, *Abridged Report*, 1987: 164; Oatley 1997: chapter 5), the Bank had certainly realised that the exclusive reliance on an external anchor was not sufficient to achieve monetary convergence with Europe's best-performing countries.

However, when pressures on the exchange rate increased in summer 1992 the Bank of Italy resisted devaluation. Ultimately, it was the government that was responsible for determining exchange rate policy and hence membership in exchange rate systems. As for the Bank, it certainly feared the loss of hard-earned credibility (Bank of Italy, *Abridged Report*, 1993: 158-160) and the start of a devaluation-

[3] At the end of September 1992, net currency reserves had fallen to their lowest since 1978, that is,

inflation cycle that might only be avoided by even higher interest rates, unless decisive domestic policy measures were taken to regain the confidence of the markets. For example, the head of the Bank of Italy's foreign department thought that it would be disastrous to devalue before the 1993 budget was approved (*Financial Times*, 4 August 1992). However, running low on reserves and with Italian public finances in a state of crisis, devaluation became inevitable. With devaluation and the resulting loss of credibility, bank officials probably considered it more prudent to urge the government to leave the ERM and pursue a policy of price stability outside a fixed exchange rate system, especially since the Bank had gained increased independence in April 1992. In other words, while initially the Bank certainly sought to save its credibility by trying to 'ride out the storm', it is plausible that it actually favoured exiting the ERM since this would allow it to pursue a low-inflation policy in the new context of increased domestic independence and increased external flexibility.[4] Although the ERM had served as an external anchor to impose disinflation on the domestic economy in the early 1980s, during the second half of the 1980s, the adherence to a fixed parity became a problem more than a solution in view of the aim of achieving inflation convergence.

> The Italian experience in the EMS, however, made it clear that running a monetary policy independent of exchange rate policy is an almost impossible task. In the very period in which it was acquiring greater formal independence, the Bank of Italy was in fact losing actual autonomy because of the determination of the government to defend the position of the national currency inside the EMS (Graziani 1998: 177).

In short, with the 1992 reform in place and the 1993 reform in sight, full independence offered the Bank the prospect of controlling monetary policy more successfully outside the ERM. Thus the Bank certainly had no objections to being

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L32,917bn as against L108,581bn a year earlier (*Financial Times*, 15 December 1992).

[4] No central bank officials were available to confirm this. As exchange rate policy is under the authority of the government, Bank of Italy publications do not reveal where the Bank stood on the issue of devaluation and ERM membership. But even if it were the case that the Bank of Italy was a staunch defender of ERM membership, this does not affect the general argument defended here, namely that not all major actors were in favour of a hard-currency policy or ERM membership. Nonetheless, it is plausible that the Bank was at least not opposed to leaving the ERM or devaluing the lira. This is also the sense one gets from the formulations used by the head of the Bank of Italy's research department (Rossi 2000: 93-99) in describing the events of 1992 such as "*questo si traduce, per la Banca d'Italia, nell'impegno alla difesa della lira*" (p. 97) ["for the Bank of Italy this translates into a commitment to defend the lira"] or "*la Banca d'Italia adempie al dovere di difendere il cambio della lira*" (p. 98) ["the Bank of Italy abides by the duty to defend the exchange rate of the lira"].

liberated from the exchange rate constraint and pursue disinflation in the context of increased policy flexibility.

The Italian government had consistently rejected a realignment prior to the crisis (*Financial Times*, 8 February 1991) and only once it had become clear that the peg was unsustainable for both economic as well as domestic political reasons did it decide to devalue and then abandon the ERM. Still in late August, Treasury Minister Barucci declared: "The government will adopt any measures that may become necessary towards maintaining the current central rate of the lira within the European Monetary System" (*Financial Times*, 29 August 1992). Similar to the Bank, the government was hoping to ride out the storm. But it is also equally clear that there were strong incentives for devaluation. On the one hand, the loss of competitiveness since 1987 as a result of persistently higher inflation certainly required a downward adjustment of the exchange rate (Table 6-1). On the other hand, slowing growth and growing unemployment made a continuation of a high interest rate policy politically difficult to sustain. Eventually market pressures overwhelmed whatever resistance there was on the part of the Italian government and the government requested a general re-alignment of ERM currencies. Once credibility had been lost and the turmoil and pressure on the lira exchange rate continued, the prospect of further maintaining or even increasing interest rates to defend the newly adjusted external value of the lira certainly provided the government with a major incentive to float the lira.

After leaving the ERM, the government repeatedly professed its willingness to re-enter the ERM as soon as possible (*Financial Times*, 15 December 1992, 19 January 1993). However, the assertion to re-join as soon as possible was more rhetoric than a serious commitment. This was reflected in the fact that the government did not lay out any timetable for future re-entry (*Financial Times*, 26 November 1992). Furthermore, the fact that the lira only re-entered the ERM four years after its exit also casts doubt on this declared intention. It is hence plausible to assume that the considerable depreciation of the lira suited the government. After all, the pursuit of a beggar-thy-neighbour policy, made possible through the ERM exit, contributed to domestic recovery through higher exports. It also gave Italy time to tackle its economic problems.

As pointed out above, industry and more specifically its political representation, *Confindustria*, had been complaining about the loss of competitiveness from at least 1990 onwards (Walsh 1996: 287). High interest rates were criticised in the run-up to the crisis (*Il Sole 24 Ore*, 5 September 1992: 76; *Il Sole 24 Ore*, 9 September 1992). When confronted with rising interest rates and an economic slowdown in 1992, the opposition to interest rate rises became stronger. It is true that the official anti-devaluationist stance of both the government and the Bank of Italy was not questioned publicly by *Confindustria* (*Financial Times*, 14 September 1992). But if industry publicly never quite came out in favour of devaluation or exit from the ERM, it was clear that it preferred a devaluation of the lira to restore competitiveness and lower interest rates in order to stimulate domestic economic activity.[5] In particular, there was considerable pressure from the small- and medium-sized export-oriented firms of Northern Italy to bring about a considerable adjustment of the lira exchange rate (Graziani 1998: 177). Similarly, the banking sector - due to its strong relationship with industry through loan exposure - was also concerned about national competitiveness and favoured devaluation (if not a float) in order to restore competitiveness of the manufacturing sector, provided of course that the low inflation policy would not be jeopardised (Walsh 1998: 109-114; Talani 2000: chapter 4).

Unions were also concerned about the high interest rates but do not seem to have publicly expressed any strong view concerning ERM membership or the future international framework of Italian monetary policy as such. On the one hand, high unemployment and slowing growth should have led one to expect that unions would favour devaluation. On the other hand, as a result of these external pressures as well as domestic pressure from employers, the unions accepted a policy of wage moderation and thus co-operated – or were forced to co-operate - in an effort to save the exchange rate peg through the Amato protocol of July 1992. However, on the whole, the unions were agnostic towards devaluation since on the one hand devaluation held the prospect of increased competitiveness and employment; on the other it was seen as potentially provoking a vicious cycle that could possibly lead to even higher interest rates.[6]

Taken together the analysis of the interests of domestic actors suggests that there was - in addition to the eventual inevitability of the devaluation - considerable domestic pressure on the government to devalue if not to leave the ERM altogether.

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[5] Interview with CGIL official, 27 October 2000, Rome.

This would provide time to solve the most severe economic problems, restore competitiveness and even provide greater internal and external monetary flexibility. The Bank of Italy and the government hoped to be able to avoid devaluation in an attempt to save 'earned' credibility.[7] However, once this credibility had been lost, it was difficult to find a lobby in favour of preserving the exchange rate peg.

In short, Italian monetary policy in the wake of the signing of the TEU was primarily oriented towards defence of the exchange rate peg. With the government in charge of determining the exchange rate regime, the Bank of Italy policy was obliged to defend the lira. In terms of executive strength and central bank independence, the evidence suggests that the government was able to defend the exchange rate peg and ERM membership against strong pressure from industry until the government was finally overwhelmed by external economic pressure. The central bank's control (since April 1992) over discount rate changes was of limited importance because of the massive external pressure and a difficult domestic economic situation that would have overwhelmed even the most independent central bank. Furthermore, greater central bank independence did not matter since it was the government that had legal authority over exchange rate policy.

Thus the analysis of domestic political conflict over devaluation showed that there did not exist an unambiguous position towards monetary and exchange rate policy. While the government certainly sought to avoid devaluation and ERM exit, the Bank of Italy might have secretly favoured exit in order to be in a better position to pursue a low inflation policy. *Confindustria* very likely favoured devaluation hoping to restore competitiveness and achieve lower interest rates, while the unions on balance held a relatively agnostic position, even though they certainly favoured lower interest rates as the 1992 agreement with industry demonstrated. It is important to keep in mind the position of the various domestic actors in order to understand the politics of monetary and exchange rate policy between 1992-98.

6.2 The Politics of Central Bank Independence

One actor was going to dominate monetary policy after 1992: the Bank of Italy. The relative strength of the Bank of Italy with respect to monetary policy and hence with

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[6] Interview with CISL official, 26 October 2000, Rome.

[7] This consideration had also played an important role in British exchange rate policy and sterling devaluation (Thompson 1996; Stephens 1996).

regard to monetary outcomes was considerably strengthened as a result of domestic institutional change. While the ERM exit removed the external constraint on monetary policy, domestic-institutional changes increased the authority of the Bank over monetary policy decisions. In order to account for improved monetary performance, it is important to explain institutional change rather than to regard it as exogenous.

During the 1980s and 1990s the Italian monetary and financial regime underwent dramatic change both on a technical and political-institutional level (Sarcinelli 1995; Passacantando 1996). As described in Chapter 2, after the 1981 reform there were still plenty of ways in which the government could potentially influence monetary decisions. The government still retained ultimate authority over monetary policy decision-making: discount rate changes had to be approved by the Treasury; reserve ratios were determined by the *Interministerial Committee for Credit and Savings*; it was still possible to finance the government budget deficit through the 14 per cent overdraft facility as well as through a parliamentary vote for extraordinary advances. All these features of the Italian monetary policy-making regime limited the central bank's control over the conduct of monetary policy.

Despite these institutional features, which suggest a rather limited degree of central bank independence, there is also evidence for a relatively higher degree of *de facto* central bank independence. First, Sarcinelli (1995: 412) claims that discount rate changes proposed by the governor were never rejected by the treasury minister. Second, although the overdraft was *de jure* not abolished until 1993, according to central bank governor Fazio, it had not been used during the early 1990s (*Financial Times*, 10 December 1993). Even if this is true for the early 1990s, empirical evidence for the 1980s at least confirms the view of the Bank of Italy as being *de facto* constrained in its decision-making. For example, in the first half of the 1980s, the stock of the overdraft facility rose from 24.5 per cent to 45.8 per cent of the central bank's total assets (Passacantando 1996: 87). Furthermore, Goodman (1992: chapter 5) cites various instances in the early 1980s where the Bank accepted to monetise government deficits – either in response to severe pressure by the government or after a parliamentary vote on advances.

Hence even if there were no visible instances of government interference with central bank policy in the early 1990s, it is plausible to assume that the central bank was sensitive – if not responsive – to government pressure. For instance, arguably, a fully independent Bank of Italy would have been able to raise interest rates further to stamp out inflation during the second half of the 1980s even if this would have conflicted with the exchange rate constraint. Aware of its legal-political status and of the domestic opposition such a move would have provoked, the central bank presumably felt that it was not in a position to pursue this option (*cf.* Section 2.6).

In any case, the modification of the central bank's legal framework during the early 1990s undoubtedly increased the Bank's independence considerably. In accordance with the TEU, which stipulated that national central banks had to be given independence, parliament approved a number of important legal-institutional changes concerning the relationship between government and central bank.[8]

Reform concerning central bank independence took place in two steps. In February 1992 law no. 82 of 1992, which entered into force in April 1992, was passed. This law attributed the exclusive right to set the discount rate to the Bank of Italy. Previously, discount rate changes had to be approved by the finance minister who acted upon a proposal from the central bank. Following the February 1992 legislation, law 483 of November 1993 further increased the Bank of Italy's independence from political authorities (Bank of Italy, *Abridged Report*, 1993: 85). First, it assigned the power to vary reserve requirements, which had been a prerogative of the *Interministerial Committee for Credit and Savings*, exclusively to the Bank of Italy within the limits established by the law.[9] Second, the government's overdraft facility with the Bank of Italy was abolished and advances of any kind by the Bank of Italy to Treasury were prohibited. The outstanding credit of the overdraft facility was converted into bonds with an average maturity of thirty years (Passacantando 1996: 98, appendix I). These reforms put the Bank into a position to control effectively the monetary base.

The Bank of Italy thus obtained a high degree of political and economic, as defined in Chapter 2. With respect to the statutory task or, alternatively, the freedom to choose monetary policy goals, it is true that neither the Constitution nor the central bank statute specify the objective of monetary policy, and therefore the objective of price stability is implicit at best. Moreover, the government retained the right to set general guidelines concerning macroeconomic goals. Indeed, both the absence of a

[8] For chronology of technical changes see Passacantando (1996: appendix II).

statutory task and the right of the government to set general macroeconomic goals were regarded by the *Maastricht Watch Report* as problematic:

> In generale mentre in alcuni Paesi è in atto una revisione normativa che dia indipendenza di diritto e di fatto alla banca centrale, in Italia la convergenza si limita a eliminare le norme in contrasto con la lettera del Trattato, senza risolvere il dissidio tra l'ampio grado di indipendenza di fatto della Banca d'Italia e l'incertezza della situazione giuridica sottostante (quoted in *Il Sole 24 Ore*, 20 December 1993).[10]

By contrast, other observers regarded this less of a problem and suggested that in institutional terms the Bank enjoyed a degree of independence similar to the *Bundesbank* (*Financial Times*, 10 December 1993). While it may be difficult to determine the exact degree of independence relative to other central banks based on these indicators, it is uncontroversial that the Bank of Italy was more independent in determining and controlling monetary policy than it was before the 1992-93 reforms (OECD *Economic Surveys Italy* 1996: 29-31). In short, the changes arising out of the institutional changes would lead one to expect to find a more stability-oriented monetary policy and *ceteris paribus* better monetary outcomes in terms of price stability.

Before demonstrating the importance of the tight monetary policy pursued by the Bank of Italy with regard to achieving the monetary criteria, it is necessary to analyse how and why central bank independence was possible. Given executive weakness, it is interesting to analyse how the government was able to overcome opposition, especially since granting full independence to the central bank would result in a relative weakening of other actors such as industry, unions and the government and certainly reduce their (indirect) influence on monetary policy.

The reform concerning discount rate changes[11] was introduced in September 1991. Treasury Minister (and ex-central bank governor) Guido Carli presented a bill

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[9] The new law set an upper ceiling of 22.5 per cent. The Italian minimum reserve ratio at the time was higher than in other European countries. This meant that there was space for downward adjustment. The upper ceiling was hence of no practical importance.

[10] "In general, while in some countries legal changes have been enacted that grant the central bank *de jure* and *de facto* independence, convergence in Italy is limited to the elimination of those laws that contradict the 'letter' of the [Maastricht, MJ] Treaty, without resolving the discrepancy between the Bank of Italy's high degree of *de facto* independence, and the uncertainty resulting from the current legal situation."

[11] Article 104 (1) of the TEU (in conjunction with related articles) stipulated that governments abolish the possibility of monetary financing of government deficits during stage 2 (1994-1996/98). Art. 107-

to parliament to grant the Bank of Italy full discretion over the discount rate. As a member of the technocratic elite and former Governor of the Bank of Italy, Carli had favoured greater central bank autonomy for a long time (*Il Sole 24 Ore*, 24 April 1993, 12 November 1993). The law was quickly approved in *sede legislativa* by the Senate (13 November 1991) and in session by the Chamber (30 January 1992) (*Gazzetta Ufficiale*, no. 37, 14 February 1992). Even though the Chamber, on the suggestion of the president of the Commission for Constitutional Affairs, Silvano Labriola (PSI), affirmed the responsibility of the government for guidelines concerning general economic policy, the assignment of full discretion over both interest rates found full approval (*Il Sole 24 Ore*, 31 January 1992). To the extent to which this reflected a cautious attitude towards full central bank independence among the Socialist party, it also reflected the importance of the general consensus regarding EMU among all parliamentary parties (*Il Sole 24 Ore*, 19 January 1992). The re-affirmation in the form of an *ordine del giorno* was not considered by the government to infringe upon central bank independence in any way (*Camera dei Deputati, Discussioni*, 30 January 1992).

Judging from the debates in both houses, the importance of short-term capital movements, the institutional convergence with other European countries, and the legal obligation to introduce an institutional framework consistent with the TEU obligations, were the most important reasons for the smooth adoption of the reform (*Senato della Repubblica, Commissione XI*, 13 November 1991; *Camera dei Deputati, Discussioni*, 30 January 1992). The fact that TEU obligations[12] were mentioned in the parliamentary debates indicates that both the government and parliament were aware of the legal obligation to change the central bank law.

The reform concerning reserve requirements and overdraft facility that resulted in law 483 of November 1993 went equally smoothly (*Gazzetta Ufficiale*, 1 December 1993, no. 282). The bill was presented by Treasury Minister Barucci on 19 March 1993 and was approved with minor amendments (regarding the upper ceiling of the reserve requirement ratio) in *sede legislative* by both Senate (6 June 1993) and Chamber (11 October 1993). Except for the opposition from the

108 of the Treaty (in conjunction with the Art. 7 and 14 of the Statute of the European System of Central Banks (ESCB) [Protocol no. 3 annexed to the Treaty]) determined that national central banks had to be granted full discretion over the setting of the discount rate and reserve requirements.

[12] The TEU was only agreed upon in December 1991, but its content regarding central bank independence were already known during the parliamentary debates on central bank reform.

Communists, there was general approval of the changes (*Senato della Repubblica, Commissione VI*, 6 October 1993; *Camera dei Deputati, Commissione X*, 11-13 November 1993). Similar to the preceding reform, the importance of institutional convergence with other European countries as well as the need to meet the TEU requirements were emphasised in the parliamentary debates.

While it is true that Italy was not obliged to introduce changes at such an early stage, it was clear that these legal changes had to be implemented at some point, as the failure to do so would have resulted in EMU exclusion. The fact that changes were introduced rather early almost certainly reflected external economic pressure and hence the advantages that could be derived from making the Bank more independent. With TEU in place (or about to be in place), the government was in a much better position to overcome potential opposition to greater independence. There has always existed a large consensus among Italian political parties with regard to the desirability of European integration, including monetary integration. All parties – with the exception of those at the far end of the party spectrum - welcomed the TEU (*Istituto Affari Internazionali* 1993: 128; *cf.* Chapter 1). As a result, opposition to central bank independence was weak and marginal and never serious enough to obstruct it.

Why was an in principle rather fundamental reform approved with visibly no serious challenge? Before dealing with this question, the interests and attitudes of the major societal actors are evaluated. On the whole, trade unions should have been expected to oppose central bank independence. However, given that a relatively hard currency policy was already a reality and that trade unions had consistently supported European political and monetary integration,[13] there was virtually no debate among unions. The trade unions kept a low profile. This was similar to the absence of union views regarding the 1981 reform (Epstein and Schor 1989).

Confindustria did not voice any opposition against central bank independence either. The export-oriented part of the manufacturing industry at the time was certainly more concerned about the exchange rate regime and high interest rates than central bank independence. Even though industry criticised the high interest rate policies of the Bank of Italy in the early 1990s and complained about the loss of competitiveness incurred through a policy of non-devaluation (Walsh 1996: 287), it had never questioned the desirability of either ERM or EMU membership and hence the resulting commitments such as granting full independence to the Bank of Italy.

The Bank of Italy had been in favour of greater independence for some time. Successive central bank governors had demanded the institutional separation of the monetary and fiscal policy-making authority. Famously, Ciampi first expressed these demands in the governor's annual *Concluding Remarks* in 1982 where the Bank of Italy demanded full autonomy over monetary policy as a precondition for monetary stability (Bank of Italy, *Abridged Report*, 1982).

In short, and contrary to what should have been expected, there does not seem have been much public debate about changes to the status of the central bank. Several reasons can explain why there was neither much public discussion nor controversy: the obligatory, EMU-related nature of central bank reform; its technical character; the absence of immediate distributional consequences; and the *de facto* existence of an already relatively independent central bank.

In short, the 1992-93 central bank reform granted the Bank of Italy a degree of independence comparable to the one enjoyed by the most independent central banks. Central bank reform – though reflecting the requirements determined by the TEU - seems to have enjoyed a wide consensus among political and societal groups, or at least, there was no opposition to it worthwhile mentioning. Reform was largely uncontested. Other factors also help explain the relative ease with which the 'weak' Italian government was able to achieve reform. The reform certainly increased the autonomy and independence of the Bank beyond the relatively high degree of *de facto* independence (Nardozzi 1992). While these factors may have played a role, it seems that the relative high degree of independence was the result of two factors. On the one hand, the independence from both parliament and factional interests lies in both the limited use factional and micro-sectional interests such as political parties and interest groups can make of monetary policy. As discussed in Section 2.5, the distributional consequences of monetary and exchange rate policy are difficult to evaluate, in practice and in theory, at least as compared to budgetary policy. On the other hand, increasing international pressure in terms of confidence crises (as experienced in the 1970s), which were reinforced by capital account liberalisation, made the manipulation of monetary policy by the executive a 'risky business'. Hence

[13] Interview with CISL official, 26 October 2000, Rome; Interview with CGIL official, 27 October

not only were there other, more suitable means of distributing benefits to clientelistic interests; the risks of triggering a major crisis was simply too great a risk to take. All these factors made it relatively easy for the government to achieve the 1992-93 reforms.

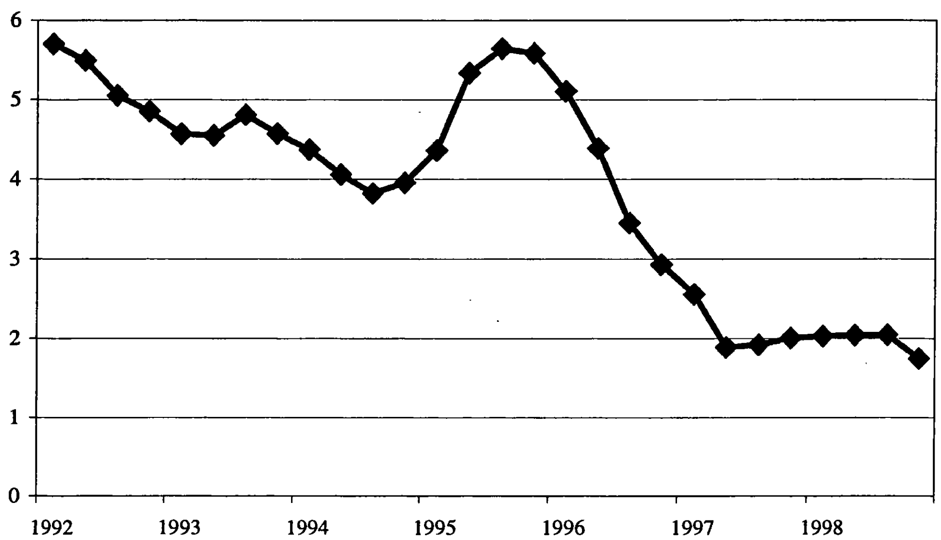
6.3 Monetary and Exchange Rate Policy outside the ERM, 1992-1996

The exit from the ERM in September 1992 changed the framework of Italian monetary policy. Instead of achieving domestic price stability by pegging the lira to a strong currency, Italian monetary policy-makers found themselves managing a float. Similar to 1979-81, the change of the international framework coincided with domestic monetary reform. While the floating regime gave the Bank of Italy greater flexibility with regard to both interest rates and the external value of the lira, it certainly increased the risk of instability in terms of exchange rate volatility and at various points posed the risk of a depreciation-inflation cycle.

However, having gained full independence between April 1992 and late 1993, the Bank of Italy was able to pursue a cautious monetary policy unresponsive to more or less explicit calls from politicians and societal actors to ease monetary policy in order to boost growth and curb the public debt burden.[14] The tight monetary policy was a major reason why, despite a considerable depreciation of the lira, Italian inflation fell from 5.3 per cent in 1992 to around 3 per cent by the time the lira re-entered the ERM in November 1996 (Figure 6-1; Bank of Italy, *Abridged Report* 1997: 87).

Figure 6-1 Consumer Price Inflation, 1992-1998

(annual change in per cent)

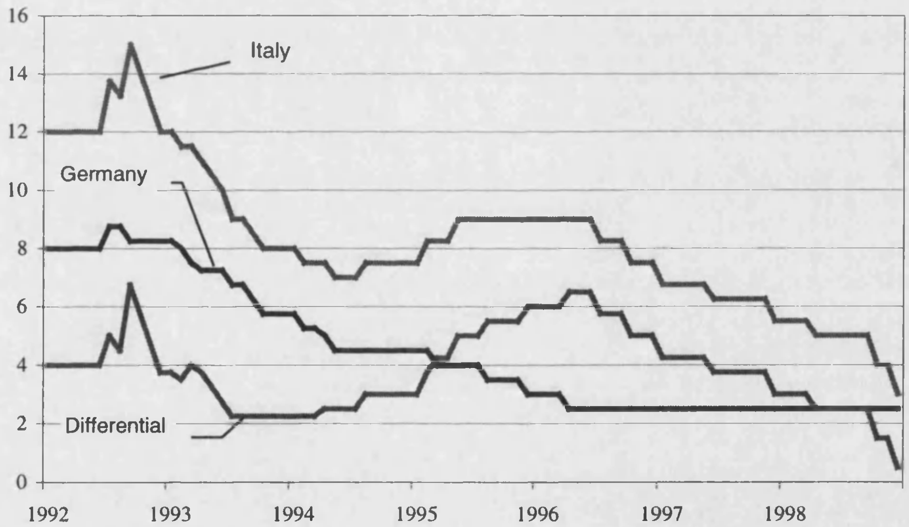


Source: *Statistical Compendium – Main Economic Indicators* 1999

As a consequence of slowing economic growth, rising unemployment and the loss of international competitiveness, annualised consumer price inflation had dropped to below 5 per cent by September 1992. There was clearly space to adjust Italian interest rates downwards. During the last quarter of 1992 Italy experienced negative growth, resulting in higher unemployment (which increased by nearly 2 percentage points between first and the last quarter of 1992). With exclusive control over the discount rate, the Bank lowered rates in a gradual and cautious way from a peak of 15 per cent in September 1992 to 8 per cent in October 1993 (Figure 6-2).

Figure 6-2 Discount Rates, 1992-1998

(in per cent)



Source: OECD *Statistical Compendium - Main Economic Indicators* 1999

Hence it is fair to say that:

> Italian monetary policy was directed initially towards defending the lira's central rate in the Exchange Rate Mechanism; from mid-September onwards, when this objective had to be abandoned owing to the pressure on the lira, the actions of the Bank of Italy were aimed at countering the inflationary implications of the devaluation while at the same time permitting a gradual restoration of more relaxed monetary conditions (Bank of Italy, *Abridged Report*, 1993: 77).

Similarly, "the central bank pursued its immediate aim of steering high interest rates gradually down to levels more commensurate with the steady decline in inflation and the weak state of the economy" (OECD *Economic Surveys Italy* 1994: 33). The cautious monetary stance was reflected in the gradual character of the downward trend in official interest rates and in the number and size of the cuts as well as the temporary suspension of downward cuts between March and August 1993 when a weakening of the lira and political instability risked to re-kindle inflationary tensions (Figure 6-1).

Economic recession made the voices demanding a faster easing of monetary conditions to boost growth even more audible than during the high interest rate period preceding the EMS crisis. Ever since the exit from the ERM individual industrialists as well as *Confindustria* had been calling for large and swift rate cuts (*Il Sole 24 Ore*, 24 October 1992; *Il Sole 24 Ore*, 12 December 1992; *Il Sole 24 Ore*, 28 January 1993). The Bank of Italy argued that due to the external weakness of the lira and its possible effects on domestic prices the stance had to remain tight and that the easing was going to remain gradual (*Il Sole 24 Ore*, 20 March 1993). Even as the economy gradually started to recover, there was hardly a month where the representatives of industry did not call on the Bank to cut interest rates (*Il Sole 24 Ore*, 1 April 1993; *Il Sole 24 Ore*, 1 July 1993; *Il Sole 24 Ore*, 10 September 1993; *Il Sole 24 Ore*, 24 October 1993). Despite considerable pressure, the Bank was able to persist in its policy of cautious easing which was consistent with its price stability orientation.

After negative growth in 1993, the Italian economy started to pick up again in 1994 reaching almost 3 per cent in the third quarter of that year. At the same time inflation was continuously decreasing, falling below 4 per cent in June. The easing of monetary policy continued in the face of these trends. Following German rate cuts, the Bank lowered its discount rate from 8 to 7.5 per cent in February 1994. A further cut took place in May 1994 with the lowering of the discount rate to 7 per cent, thus implementing the twelfth cut since the exit from the ERM in September 1992. All these cuts were taking place in a relatively favourable environment characterised by falling inflation (Figure 6-1).

At first sight, it may seem that the decrease in the discount rate between September 1992 and early 1994 was dramatic and that this might this might suggest an overly loose monetary policy, and possibly an accommodating stance on the part of the Bank of Italy. However, Italian discount rates in September 1992 were (from a domestic point of view) unnecessarily high as a result of the attempts to try to maintain the lira parity. Moreover, the monetary easing throughout this period took place in the context of minimal growth and at times outright recession (Table 3-2). Finally, interest rate decreases took place in an environment of falling inflation. All this strongly suggests that the Bank of Italy did act in a sensible manner given general economic conditions. And even if it may be argued the Bank underestimated the potential threat to price stability that resulted from the considerable depreciation of the lira, this would still not demonstrate that the Bank was re-acting to domestic political pressure (for a more detailed discussion see Section 6.5).

However, after July 1994 there were signs of accelerating inflation. Furthermore the combination of the lira depreciation, which had reached 25 per cent over two years to August, and accelerating domestic economic expansion which reached almost 3 per cent during the third quarter of 1994 further contributed to the decision by the Bank of Italy to raise the discount rate by 50 basis points to 7.5 per cent in August 1994 – the first increase in the discount rate since September 1992 (Bank of Italy, *Abridged Report*, 1995: 83). This was consistent with the officially announced central bank goal of protecting price stability and ensuring that inflation would not return as the domestic recovery strengthened. The Berlusconi government was not happy about the increase, especially since it worsened the fiscal situation by increasing interest payments. This added to the already tense relationship between the Bank of Italy and the government (*Financial Times*, 24 November 1994).

Judging from press coverage, there was little public criticism from societal actors of the central bank's policy during 1994. This was probably due to the acceleration of economic growth and a relatively stable inflation rate of around 4 per cent which left everyone satisfied: industry and unions enjoyed the benefits of growth, the Bank kept inflation under control and the government received higher revenues.

In 1995 the Italian economy experienced continued expansion of a yearly average of 3 per cent. The acceleration of growth put pressure on prices. Inflation increased from just below 4 per cent in early 1995 to a peak of 5.7 per cent in August. While yearly inflation had declined from 4.6 per cent in 1993 to about 4 per cent in 1994, it rose to 5.2 per cent in 1995 on a year-on-year basis. In addition to the inflationary pressures stemming from higher growth, higher import prices and an indirect tax hike (as a result of March 1995 Dini mini-budget) led to a higher year-on-year inflation rate (OECD *Economic Surveys Italy* 1996: 29-36).

Increasing inflation and increases of the discount rate were responsible for increased conflict in terms of increased criticism of the Bank's policy in 1995. The three major trade unions, CGIL, CISL and UIL, and especially, *Confindustria* criticised the raising of lending rates by commercial banks, visibly trying to avert the Bank of Italy to follow suit (*Il Sole 24 Ore*, 13 January 1995). The pressure had no effect on the Bank's policy stance. In a situation of lira weakness, the lira had just reached L1,100 per German mark, and accelerating inflation, which had increased from 4.0 to about 4.2 per cent in February, the Bank of Italy raised the discount rate by a considerable 75 basis points to 8.25 per cent in February 1995 (*La Stampa*, 22 February 1995). Even the trade unions – usually more cautious than industry on these occasion – expressed the view that the Bank should have waited before raising interest rates, while *Confindustria* expressed fear that the rate increase might damage the real economy (*Il Sole 24 Ore*, 22 February 1995).

Even though the *Bundesbank* lowered interest rates in April 1995, the Bank of Italy raised interest rates once more by three quarters of a point to 9.0 per cent in May after an acceleration of producer and consumer prices, the latter increasing to over 5 per cent in April and May. Naturally neither unions, which called for a resumption of concertation, nor business were happy about the move in interest rates (*La Stampa*, 27 May 1995). *Confindustria* regarded the interest rate move as unnecessary, arguing instead that the inflationary tendencies were mainly due to the external weakness of the lira rather than domestic reasons.

Despite widespread criticism of the interest rate rise, in his annual address in May, Governor Antonio Fazio warned that the Bank would be ready to raise interest rates further if necessary and announced an inflation target of 4 per cent for 1996 and set a 1995 target 4.5 per cent - net of the effect of increases in indirect taxes (Bank of Italy, *Abridged Report*, 1995: 78; *Il Sole 24 Ore*, 1 June 1995; *Financial Times*, 1 June 1995). In mid-1995, the Italian lira weakened further reaching almost L1,200 per German mark. Fearing a rise in interest rates due to a weakening of the lira and persisting inflationary tensions, *Confindustria* president Abete warned against an increase in interest rates, again arguing that lira weakness was the main cause of the inflationary tensions (*Il Sole 24 Ore*, 7 July 1995).

In August 1995 international monetary conditions eased with the *Bundesbank* cutting its discount rate further. But with inflation still running at 5.6 per cent in July, after hovering around the same value in June, the Bank of Italy excluded an easing of its monetary stance. *Confindustria* however kept up pressure, claiming that German interest rate cut would provide space for a reduction of rates (*Il Sole 24 Ore*, 25 August 1995).

Given the persistence of inflationary tensions and continued quarterly growth of about 2.6 per cent in 1995, the Bank left interest rates unchanged. In November, the president of *Confindustria* stated that it would be a 'mistake' if the Bank of Italy raised interest rates and demanded instead that the emphasis should be laid on wage and fiscal policy (*Il Sole 24 Ore*, 24 November 1995). A month later, Abete explicitly demanded the lowering of interest rates (*Financial Times*, 30 December 1995), despite the fact that annualised inflation rate had remained largely unchanged. In the presence of stable monthly inflation rates of 5.5-5.7 per cent, the Bank however left interest rates unchanged.

The strong growth in 1995 was followed by a sharp cyclical downturn during the first half of 1996 as a result of weak domestic demand and decreasing exports, which were partly the result of the strengthening of the lira. The downturn led to an increase in unemployment, which rose to a record level of 12 per cent. This contributed to an easing of inflationary tensions, and inflation for 1996 fell below 4 per cent.

A combination of lower prices of imported inputs, an appreciation of the lira, which rose by 10 per cent in real effective terms in 1996, and hence lower import prices, continued wage restraint, productivity growth and higher unemployment contributed to this achievement. Despite rapidly falling inflation and an economy that was sliding into recession, the Bank maintained a tight monetary stance.

> To ensure that the external price impulses stemming from the undervaluation of the lira were not transmitted to domestic markets via rising inflation expectations, the Bank of Italy left its two key lending rates, the discount rate and the rate on fixed-term advances, unchanged at 9 and 10.5 per cent respectively from May 1995 to July 1996, the longest period of interest-rate stability in many years (OECD *Economic Surveys Italy* 1997: 3-4).

The pressure on the Bank, under conditions of slowing growth and falling inflation, was quite considerable. Again *Confindustria* was the most vociferous among the voices calling for a loosening of monetary policy (*Il Sole 24 Ore*, 21 January 1996; *Il Sole 24 Ore*, 24 April 1996). However, the Bank of Italy reiterated its prime goal of reducing the difference between Italian inflation and inflation in the main competitor economies as well as that of meeting the inflation target of 4 per cent. With annual inflation running at 5.2 per cent in 1995 as compared to around 2 per cent in other European economies, a tight monetary policy was necessary indeed (Bank of Italy, *Abridged Report*, 1997: 87).

In the course of the year, pressure increased massively. In March 1996 the *Osservatorio Monetario* expressed its view that rates could be lowered (*Il Sole 24 Ore*, 27 March 1996). After a cut in German rates in April, the pressure on the Bank of Italy to cut its interest rates increased even further (*Il Sole 24 Ore*, 19 April 96). The press started to talk of the 'tough line of Via Nazionale' and *Confindustria* even called the Governor 'obstinate' and accused the Bank of 'slowing down the economy' (*La Stampa*, 24 April 1996).

During 1996 even the government joined those demanding rate cuts. Prime Minister Prodi, obviously concerned about cutting the budget deficit, implicitly threatened the Bank by declaring in an interview that if the rates did not come down it would not be possible for Italy to become an EMU member (*La Stampa*, 24 April 1996). Given the eagerness of public opinion to join EMU, this represented severe criticism indeed. With the threat of a major financial and currency crisis passed and with the new centre-left government eager to respect the convergence criteria, it was understandable that the government was trying to exert pressure on the central bank to reduce interest rates as this would have greatly helped to reduce the deficit (*cf.* Section 3.4).

Committed to achieving the announced inflation target, the Bank of Italy continued its cautious monetary policy. In order to gain and retain credibility in the eyes of international financial markets, the Bank of Italy was not willing to relax its policy, even when this resulted in considerable domestic criticism. Obviously, the continued resistance on the part of the Bank of Italy to cut the discount rate until inflation was set to reach the 4 per cent target increased the pressure on the government to pursue a tighter fiscal policy than would have been necessary otherwise (*Financial Times*, 26 April 1996).

In May pressure on Bank grew even further. In addition to industry, ex-Treasury Minister Mario Arcelli criticised the Bank of Italy as being too cautious and even trade unions joined industry in demanding an easing of monetary policy (*La Stampa*, 19 May 1996). In short, during this period the criticism of the Bank was massive. However, the Bank persevered and indicated that future interest rate moves would depend on tight budget and moderate wage agreements following the expiration of the freeze of public salaries at the end of June (*La Stampa*, 19 May 1996; *La Stampa*, 1 June 1996). Despite continued criticism and pressure on the Bank to lower interest rates, the Bank announced an even more stringent inflation target for 1997 of less than 3 per cent. The Bank also reaffirmed its commitment to meeting the inflation target of 4 per cent for 1996 (Bank of Italy, *Abridged Report*, 1996: 86-87, 166-67).

Economic indicators continued to improve. Inflation fell below 4 per cent in June and the lira continued to strengthen, which naturally increased the pressure put on the Bank by domestic actors (*Il Sole 24 Ore*, 26 June 1996). In response to reports that annualised consumer price inflation had dropped to below 4 per cent, the central bank finally lowered the discount rate by three quarters of a point to 8.25 per cent in July. However, immediately after the rate cut, industry was criticising it as insufficient (*Il Sole 24 Ore*, 24 July 1996).

In the meantime, growing confidence in economic stabilisation by international markets led to capital inflows and the nominal exchange rose by roughly 9.5 per cent in 1996, further contributing to an easing of inflationary tensions (Figure 6-1 above). Notwithstanding considerable criticism from industry and falling inflation, the Bank left lending rates unchanged for another two and a half months until October when it lowered the discount rate by 0.75 percentage points to 7.5 per cent. By then consumer price inflation had fallen to 3 per cent and the Bank was on its way to meeting the 4 per cent target for 1996 (Bank of Italy, *Abridged Report*, 1997: 91-92). Again despite the size of the cut, industry demanded further cuts pointing to the real interest differential with regard to other EU countries as providing space for cuts in Italian rates (*Il Sole 24 Ore*, 24 Oct 1996).

The view that the Bank was under severe pressure to lower interest rates was shared by others at that time. "Mr Antonio Fazio, governor of the Bank of Italy, has been under strong pressure to bring Italian rates more into line with its EU partners but he has obstinately resisted, insisting inflation must come down to 3 per cent" (*Financial Times*, 24 October 1996). Hence the cut in October turned out to be consistent with the Bank's inflation target, even though it caught some observers by surprise.[15]

Thus, in 1996 the Bank of Italy pursued a very tight and cautious monetary policy in the context of low growth and in the face of strong domestic pressures to ease monetary policy by industry, trade unions and the Italian government. Despite these pressures and calls for a less restrictive policy stance the Italian central bank persisted and thus achieved its inflation target of 4.0 per cent for 1996.

To summarise, under the floating regime Italy was able to reduce inflation. Despite a major depreciation of the lira after 1992, inflation dropped from 4.9 per cent in September 1992 to 2.9 per cent in November 1996. Long-term interest rates fell from 12 to 8 per cent over the 1992-96 period, reflecting greater confidence in the Italian economy as a result of macroeconomic consolidation to which the Bank of Italy's cautious monetary policy certainly contributed (Figure 6-3). Clearly the Bank acted in a very independent manner pursuing and realising its primary aim of meeting its announced inflation target. When after the 1993-94 disinflation period inflationary pressures became visible in 1995-96, the Bank did not hesitate to raise interest rates and then maintain a tight anti-inflationary stance by leaving the interest rates unchanged between May 1995 and July 1996, that is, until the inflationary consequences of the lira depreciation started to subside.

Figure 6-3 Long Term Interest Rates, 1992-1998

(in per cent)

[15] The decision came as a surprise to some observers, as it was widely expected that the central bank would not lower interest rates until early November when the producer inflation data for October would be available. It was suggested that the Bank acted in the face of indications that economic growth was slowing to no more than 0.8 per cent in 1996 (*Financial Times*, 24 October 1996).

Source: Datastream

As for the exchange rate, it experienced a considerable depreciation of temporarily up to 30 per cent compared to its value in September 1992. During the second half of 1995 the lira appreciated considerably and in 1996 it further appreciated by 6.9 per cent. It is certain that an institutionally dependent Bank of Italy would not have regained the same degree of confidence of the international financial markets and would very likely have pursued a less strict monetary policy – if only because it would not have had the legal mandate to pursue such an independent policy (*cf.* Chapter 2). This is so because on the one hand financial markets would have been less assured of the continuation of a tight, anti-inflationary policy and would have demanded higher interest rates reflecting the higher risk. On the other hand, the government had every incentive to pressure the Bank for a quicker downward adjustment of interest rates, as this would have lightened the burden of fiscal adjustment. In short, central bank independence was a major factor in bringing about rapid disinflation during 1992-96. This created the conditions for a return of the lira to the ERM.

6.4 Re-Entry and the Final Move towards EMU

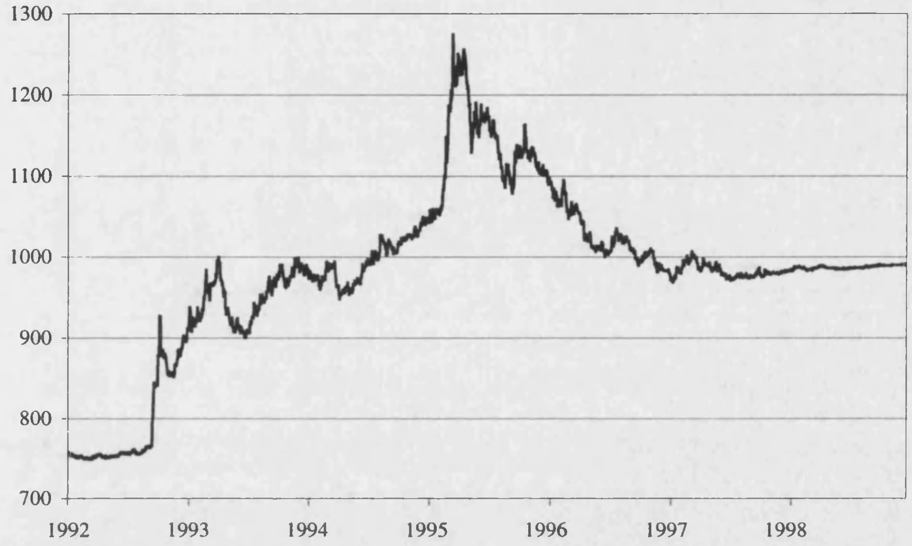
Despite repeated affirmations by successive Italian governments that Italy would re-enter the ERM after the exit in September 1992, Italy did not do so until November 1996. The Maastricht exchange rate criteria stipulated "the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other member state" (TEU, Article 109j, 7 February 1992). Put differently, if 1 January 1999 was the latest possible starting date for EMU, November 1996 was the penultimate month to re-join the ERM if Italy wanted to remain eligible for EMU membership.

General economic conditions in late 1996 were relatively favourable for ERM re-entry. Between early and mid-May 1996 the lira had appreciated by 7.4 per cent in effective terms proving the renewed confidence of the markets (Figure 6-4). Inflation was gradually coming down from 5.5 per cent in January to just above 3 per cent in October. The 1997 budget had won final approval in mid-November (*Financial*

Times, 23 November 1996). On 25 November 1996 the Italian lira re-joined the ERM four years after it had left.

Figure 6-4 Lira-German Mark Exchange Rate, 1992-1998

(Lira per German mark)



Source: Datastream

The Prodi government had the greatest interest in re-joining the ERM. It was the government's declared goal to become a founding member of EMU and thus it staked its reputation on the realisation of this goal. Retaining responsibility for exchange rate policy and the choice of the exchange rate regime, the government initiated re-entry negotiations. There does not seem to have been any opposition to government policy. The most contentious issue was the exchange rate level. The government preferred L1,000 but finally had to settle for L990 per German mark as a result of opposition from its European partners. Prodi expressed satisfaction with the entry rate.

Industry was less upbeat as it had preferred an exchange rate of L1,050 or at least L1,000 and had expressed worries about the strong valuation of the lira and pointed to problems of competitiveness (*Financial Times*, 25 November 1996; *Il Sole 24 Ore*, 26 November 1996). Unions, on the other hand, responded more favourably to the entry rate and expressed their hope for a 'more courageous' interest rate policy (*Il Sole 24 Ore*, 26 November 1996). The unions approved of re-entry as a necessary step towards EMU membership.[16]

The Bank of Italy was not thought to have been particularly happy about the ERM re-entry in general as long as the inflation differential was still high (*Financial Times*, 22 June 1996). This was probably due to the fact that the Bank was afraid that the defence of the exchange rate might compromise the price stability objective or compromise its interest rate policy, especially in a context where political events might lead to speculative attacks on the lira exchange rate. The 1992 crisis was presumably still looming large in the Bank's memory. However, with the government committed to EMU membership and responsible for international monetary policy and with the deadline for re-entry nearing, neither the Bank nor the other actors had any choice but to go along with government policy, whatever the Bank's preferences.

The Bank claimed that the re-entry of the lira into the ERM did not change its monetary stance (Bank of Italy, *Abridged Report*, 1997: 92). The Bank maintained its tight monetary stance and the pursuit of independently chosen inflation targets. Whereas central banks had often used the joining of the ERM as an opportunity to cut interest rates, the Bank of Italy resisted doing just that in November 1996, even though the lira had been enjoying renewed confidence of international markets and had been performing well (Figure 6-4).

The economy was dipping into recession during the last quarter of 1996. During this period pressure grew – especially from the government that was eager to reduce interest payments - for a further easing of monetary policy. For example, Prime Minister Prodi stated that if he had been in charge of monetary policy, he would have already cut interest rates and that there would be a 'future without the madness of interest rates that kill you' (*Il Sole 24 Ore*, 26 November 1996).

Despite negative GDP growth in the last quarter of 1996 and inflation moving towards the Bank's inflation target, the lowering of interest rates did not take place until January 1997 when the Bank cut rates by three quarters of a point to 6.75 per cent (*Il Sole 24 Ore*, 22 January 1997). It is true that the cut in the discount rate coincided with stalled negotiations in the metal-sector which had been going on for more than eight months (*Financial Times*, 23 January 1997). But it is also clear that

[16] Interview with CISL official, 26 October 2000, Rome; Interview with CGIL official, 27 October 2000, Rome.

decreasing inflation and a stagnating economy allowed for this considerable decrease in interest rates without endangering the inflation target.

With negative GDP growth of almost 1 per cent during the first quarter, the voices for a further easing of monetary conditions became louder. The pressure on the Bank to cut interest rates intensified. *La Stampa* wrote in April 1997:

> Al governatore della Banca d'Italia Antonio Fazio, perché si muova, si appellano un po' tutti. Lo fa forse con un pizzico di rancore il ministro degli Esteri Lamberto Dini, lo fa per dovere di ruolo il ministro dell'Industria Pierluigi Bersani, lo fa naturalmente la Confindustria e le altre associazioni imprenditoriali, lo fanno i sindacati (*La Stampa*, 22 April 1997).[17]

In addition to the constant pressure from industry (*La Stampa*, 8 May 1997), pressure from the government increased further during this period. The government was desperate to boost growth and reduce debt payments in its attempt to meet the 3 per cent deficit target for 1997 (Chapter 3). In May 1997 a meeting between Prodi and Fazio took place. According to *Il Sole 24 Ore*, there existed a cold climate between the Bank and the government (*Il Sole 24 Ore*, 15 May 97). Despite considerable pressure on the Bank, Fazio announced an even more ambitious inflation target of 2 per cent for 1998 in May (Bank of Italy, *Abridged Report*, 1997: 215).

In June pressure on the Bank of Italy was growing as the government suggested that in the face of decreasing inflation there was 'room for the reduction of the cost of money'. *Confindustria* official Innocenzo Cipolletta claimed that a further delay in the reduction of interest rates would create risks for the economy (*Il Sole 24 Ore*, 22 June 1997: 2). The so far rather implicit government pressure also increased further. Probably the clearest criticism from the government came during the G-7 summit in Denver in June where the three most important members of government more or less overtly demanded a lowering of interest rates. Prodi spoke of 'extremely high interest rates' and Treasury Minister Ciampi – more diplomatically - stated that he would like to see an inflation rate of 1.8 rather than 1.5 per cent. Foreign Minister Dini expressed the view that the 'official rates were very high with respect to market rates and that the inflation as well as the return on treasury bills was decreasing, thus

[17] "More or less everyone is appealing to the governor of the Bank of Italy, Antonio Fazio, to do something. The Foreign Minister Lamberto Dini does so with a little rancour perhaps; Industry

making it a question of time until official rates would fall' (*Il Sole 24 Ore*, 22 June 1997). This overt criticism was easy to understand given that it was more than uncertain whether Italy would meet the three-per-cent deficit target by the end of the year (*cf.* Section 3.4). Decreasing interest rates would give a necessary boost to reach this objective.

Finally, at the end of June with year-on-year inflation below 2 per cent for the second month in a row, the Bank reduced the discount rate by 0.5 points to 6.25 per cent (*Il Sole 24 Ore*, 28 June 1997). It did not take long however until in the face of weak growth and the need to reduce public debt, criticism of the Bank's tough monetary stance intensified (*Il Sole 24 Ore*, 15 November 1997). Similar to the period preceding the interest rate cut in June, more or less explicit government pressure was also a constant feature of public speeches and announcements throughout this period. For example, Treasury Minister Ciampi pleaded for 'more flexibility or otherwise the growth will slow' and Prime Minister Prodi 'predicted' a decrease of short-term interest rates (*Il Sole 24 Ore*, 20 November 1997). Given the need to achieve the three-per-cent deficit target for 1997, increased criticism did not come as a surprise. Again, despite this pressure, the Bank of Italy did not decrease its discount rate until late December when it was lowered by 0.75 points to 5.5 per cent (*La Stampa*, 24 December 1997). The interest rate cut was a response to inflation reports that predicted an annualised inflation rate of just 2 per cent. Thus the Bank undershot its three-per-cent target for 1997 by one percentage point.

The conditions for a fall in inflation were rather favourable in 1998. In the context of a stable lira, a deficit-reducing fiscal policy and moderate domestic growth of 1.5 per cent in 1997, there emerged room for further cuts in interest rates. However, the Bank of Italy lowered official rates gradually, being visibly concerned with the domestic inflation target and possible speculative attacks on the ERM in the wake of continued international financial turmoil (that is, South-East Asian crisis). The tightness is reflected in the real short-term interest rate differential with regard to other European economies despite almost identical inflation rates (Figures 6-2 and 6-4 above). Nonetheless, the Bank left rates unchanged until April 1998 when the Bank of Italy cut the discount rate to 5.0 per cent. On 3 May 1998, the Council of the European Union deliberated that Italy fulfilled the convergence criteria (*Financial*

Minister Pierluigi Bersani does so out of duty; Confindustria and other employer associations do so

Times, 4 May 1998). With inflation just around 2 per cent, long- and short interest rates below respective reference values and a stable lira exchange rate, Italy fulfilled the monetary criteria. Thus Italy became one of eleven founding members of EMU.[18]

In short, monetary policy after the ERM re-entry in November 1996 remained very tight. The Bank gave priority to meeting its announced inflation target and did not respond to domestic pressure. The detailed examination of discount rate policy demonstrates this. Hence it is justified to claim that an independent central bank was instrumental in bringing about disinflation and meeting the monetary criteria as laid down in the TEU.

6.5 Conclusion: Central Bank Reform, Monetary Policy and Monetary Outcomes

To appreciate the importance of central bank independence it is useful to recall the interests of the most important actors with regard to monetary policy as evidenced during the 1992-98 period. The unions were certainly not in favour of an overly tight monetary policy but they accepted the need to achieve inflation convergence and meet the convergence criteria, not least because any positive difference between actual and programmed inflation would mean a temporary loss of real wages. Even though this did not prevent the unions from criticising the Bank of Italy occasionally, on the whole, they abstained from exercising pressure.[19]

By contrast, *Confindustria* and - especially from 1996 onwards - the government[20] sought to put public pressure on the Bank of Italy in order to achieve lower interest rates. This reflected industry's concern for growth and the government's role as a debtor and its eagerness to alleviate the burden of fiscal consolidation in view of the need to meet the three-per-cent target by the end of 1997. This indicates that the most important political and societal actors by no means

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naturally; trade unions do so as well".

[18] The conservative policy of the Bank was also clearly reflected in the discount rate policy after Italy had become a member of EMU. Even though after the decision on EMU membership the likelihood of attacks on the exchange rate had hugely decreased, Italian monetary policy remained very cautious. It was not until December 1998 that the Bank of Italy allowed the discount rate to converge fully on the European level (Bank of Italy, *Abridged Report*, 1999: 120-121).

[19] Interview with CISL official, 26 October 2000, Rome.

[20] Judging by press reports, political parties kept a very low profile in the debates surrounding monetary policy during the 1992-98 period. This is consistent with the discussion above according to which monetary policy does not lend itself well to the pursuit of micro-distributional and clientelistic goals.

favoured an uncompromising hard-currency policy as pursued by the Bank of Italy. In the absence of complete central bank independence this would have likely resulted in less complete monetary convergence.

As for the Bank of Italy, its position on price stability was absolutely clear. Its primary and sole objective was the achievement of price stability and convergence on the best-performing countries in terms of inflation performance and not - at least explicitly - the meeting of the Maastricht criteria more generally. Practically of course, these two goals coincided. Nonetheless, both the Bank's rather reserved attitude towards re-joining the ERM in 1996 and its uncompromising position on interest rates, which potentially threatened the objective of fiscal convergence, indicates that its primary aim was price-stability rather than the pursuit of wider political goals such as EMU.

On a more general level, several problems arise in validating the proposition that Italian central bank reform in 1992-93 had a decisive impact on both monetary policy and monetary outcomes. First, a simple reform of the legal framework should not necessarily be expected to have an immediate effect on policy and policy outcomes (Passacantando 1996: 99). This is even more true since the Bank of Italy had enjoyed a certain degree of *de facto* independence even before the 1992-93 reforms. As far as the institutionalist argument is concerned, a second difficulty arises out of the fact that it can be difficult to tell whether in a given situation a central bank cut interest rates as a result of pressure or in response to prevailing economic conditions. As pointed out above, a third difficulty has to do with the possibility that the relationship between price stability and central bank independence might be spurious.

The empirical evidence provided in this chapter largely refutes these three possible objections and corroborates the institutionalist argument. First, central bank policy after the exit from the ERM did reflect greater political independence from the government relative to previous periods. For example, the Bank of Italy reacted immediately to signs of rising inflation by tightening its policy.

> It is [...] hard to deny that greater central bank independence did improve the performance of monetary policy in some specific respects. The reforms greatly enhanced the flexibility of short-term interest rates and the ability of the central bank to steer them ... [T]he increase in the discount rate in response to inflationary pressures

> was much swifter and faster in 1994 than in previous turning points of inflation (Passacantando 1996: 100; similar Bini 1998).

This also supported by quantitative evidence.

> Comparison of the movements in official rates and short-term interest rates at the time of the last three upturns in consumer price inflation [...] shows that the tightening of monetary policy was timely last year [...]. In 1979 the increase in interest rates occurred almost a year after the rise in inflation [...]. In 1986-87 there was a delay of around four months between the reversal of the trend in inflation and that in Treasury bill rates [...]. In 1994 the increase in official rates and Treasury bill rates occurred before consumer prices accelerated (Bank of Italy, *Abridged Report*, 1995: 84-85).[21]

It may be possible to pinpoint instances where retrospectively the central bank does not seem to have been 'tough' enough. It may be claimed that the Bank of Italy lowered interest rates too much in 1994 and that it did not raise interest rates sufficiently to prevent the surge in inflation in 1995. However it would be wrong to assume that this was due to a lack of independence. On the one had, the monetary stance and monetary outcomes disconfirm that the Bank of Italy was responsive to domestic pressure. On the other hand, the Bank did raise interest rates three times during this period: in August 1995 immediately after the emergence of increasing inflation, and in February and May 1996 when interest rates were raised by 0.75 respectively. If the Bank did not raise interest further, then this was primarily due to economic rather than political considerations. Since the higher inflation was the result of one-off measures such as a VAT increase and the effect of lira weakness, the Bank was presumably cautious about not tightening its policy too much since the inflationary pressures in the economy were expected to be only temporary.

Indeed political pressure during the 1994-95 period did not seem particularly strong at least compared to periods of slow or negative growth. Thus the Bank certainly had fewer 'incentives' to loosen policy than for example during the low-growth period of 1996 and early 1997. All this supports the claim that the Bank behaved in a much more independent and hawkish manner than before. Indeed, even *The Economist* acknowledged that Governor Fazio had established an international

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[21] The greater efficiency of banking and financial markets that resulted from various 'technical' reforms increased the speed with which market rates react to changes in official rates. This also contributed to the central bank's increased ability to control of inflation (Eizenga 1993; Passacantando 1996).

reputation as an inflation hawk (*The Economist*, 8 November 1997) – a rare compliment indeed.

As regards the second objection, the preceding detailed analysis of monetary policy shows that decisions on monetary policy were above all concerned with price stability and were rather unresponsive to domestic political pressure. Certainly, there is some interpretational scope with regard to whether individual monetary policy decisions reflected political pressures - even after accounting for the presence of objective macroeconomic circumstances and projections. However, in addition to the historical analysis, which on the whole indicates how the Bank resisted domestic political pressure, probably the most convincing indicator of the central bank's independent policy stance was reflected in its ability to announce an annual inflation target and meet it.

Moreover, Italian monetary policy even met the government inflation targets as laid out in the long-term financial programme four out of six times between 1992 and 1998 as compared to once out of seven times between 1984-91. Certainly, favourable fiscal and wage policies facilitated the realisation of these targets after 1992. However, the Bank met *its* inflation target three out of four times (Table 6-3). This indicator is particularly revealing, especially as the central bank – relative to the second half of the 1980s – faced massive political pressure to ease monetary policy.

Table 6-3 Inflation Targets and Actual Inflation, 1984-1998

(in per cent)

YEAR	GOVERNMENT TARGET	ACTUAL INFLATION	YEAR	GOVERNMENT TARGET	CENTRAL BANK TARGET	ACTUAL INFLATION
1984	10.0	10.8	**1992**	4.5	---	5.3
1985	7.0	9.2	**1993**	4.5	---	4.6
1986	6.0	5.9	**1994**	3.5	---	4.1
1987	4.0	4.7	**1995**	4.7	4.5*	5.2
1988	4.5	5.0	**1996**	3.9	4.0	4.0
1989	4.0	6.3	**1997**	2.5	3.0	2.0
1990	4.5	6.5	**1998**	1.8	2.0	2.0
1991	5.0	6.3				

Source: Bank of Italy, *Abridged Report* [various years]; OECD *Economic Surveys Italy* [various years]

* net of the effect of indirect tax increases

With regard to the third possible objection according to which the more conservative monetary stance might just be a reflection of a cultural change or underlying domestic societal and political coalitions, the above analysis has amply shown that the central bank was criticised and urged to pursue a less stringent monetary policy by all important domestic groups and actors, including the government. Not only did the Bank of Italy not give in to demands from industry and trade unions, but it was also unresponsive to more or less explicit criticism from the government and its leading members. Thus in defiance of all those forces, the central bank successfully pursued and achieved its price stability objectives. Hence the relationship between central bank independence and monetary policy is not spurious and the restrictive central bank policy was anchored in institutional change, thus confirming the institutionalist argument.

Counterfactually it is difficult to imagine that the Bank would have been unresponsive to societal pressure, and in particular to politicians' criticism in the absence of the 1992-93 reforms. On the one hand, there was a general consensus regarding ERM membership during the second half of the 1980s and early 1990s, which was shared by both the Italian government and the Bank of Italy and which was part of the reason why the government did not interfere with central bank policy. On the other hand, though, Italian monetary policy under a floating regime certainly left a much greater scope for debate and conflict. Had the central bank not been independent, monetary policy and monetary outcomes would very probably have been different. Even if the government was unlikely to question the objective of inflation convergence in principle, the government would have been tempted to lower interest rates in order to relieve the burden of fiscal adjustment and ease fiscal convergence or – not being able to deflect domestic criticism of monetary policy – would have been inclined to give in to industry and trade union pressure.[22] This would have had an effect on the Bank's policy stance. Either way it would have resulted in a less restrictive monetary policy and higher inflation. Hence the institutional separation of monetary and fiscal policy removed the temptation of the government to resolve the tension of achieving simultaneously disinflation and a reduction of the debt burden.

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[22] Judging from press coverage, the unions seem to have been much more cautious about criticising the Bank of Italy than industry. There were two reasons for this. On the one hand, the unions' commitment to an incomes policy meant that higher-than-programmed inflation would result in the erosion of real wages. On the other hand, they had a strong commitment to joining EMU and hence to achieving inflation convergence. This is why trade union criticism of interest rate policy was far more moderate than the criticism voiced by *Confindustria* (Interview with CISL official, 26 October 2000, Rome; *cf.* Chapter 5).

Hence institutional reform introduced a policy of greater far-sightedness than would have been case in the absence of institutional reform. Moreover, although this cannot be measured, the increased credibility of Italian monetary policy - after granting formal independence to the central bank - certainly decreased the nervousness of international financial markets and *ceteris paribus* had a positive effect on monetary performance (that is, interest rates and the exchange rate).

What does the above analysis suggest with regard to the concept of executive strength? By transferring decision-making responsibility to an independent central bank, the Italian executive paradoxically increased its autonomy and strength. At least this is true in the context of European monetary convergence and the specific goal of Italian monetary policy to achieve monetary convergence and price stability. In other words by granting the Bank of Italy full discretion over the conduct of monetary policy, the Italian government succeeded in 'tying its hands'. Similar to the decision to join the ERM in 1979, the transfer of monetary policy responsibility away from the (weak) government to an independent agent allowed the Italian government to deflect pressure and criticism with regard to the conduct of monetary policy (Oatley 1997: chapter 5). This certainly increased the government's strength – at least in terms of achieving its long-term objectives (that is, inflation convergence).

Moreover, central bank independence was also important with regard to its ability to affect the behaviour of other actors in the areas of wage, fiscal and pension reform. In the absence of central bank independence, the government would have been tempted to press the Bank of Italy to pursue a less tight monetary policy in order to compensate for the inability of a weak government to implement policy reforms in other areas. This temptation would have been particularly strong in the absence of a direct external constraint after 1992. In short, domestic-institutional reform - and more particularly the greater independence of the central bank - was instrumental with regard to achieving monetary convergence.

7 DOMESTIC INSTITUTIONS, EXECUTIVE STRENGTH AND MACROECONOMIC POLICY

The proper study of politics is not man but institutions (John Plamenatz quoted in Sartori 1997 [1994]: IX)

In this concluding chapter the results of this study are summarised and discussed. Then the Italian case is contrasted with the French case to demonstrate the wider applicability and heuristic utility of the domestic-institutional approach. The following section places this study in the context of the current academic debate on economic internationalisation and domestic politics and suggests aspects for further study. Finally, the sustainability of Italian EMU membership is evaluated.

7.1 The Institutional Determinants of Macroeconomic Policy and a Changing International Environment: The Case of Italy

As pointed out in Chapter 1, a purely historical approach is rich in detail but generally not comparative. This study has sought to combine cross-national statistical, comparative and case study methods in order to understand how Italy was able to achieve major macroeconomic reform in the 1990s and meet the Maastricht convergence criteria. By doing so, it demonstrated how institutional factors that had strongly influenced Italian macroeconomic policy up to the early 1990s were overcome and macroeconomic convergence achieved.

The Italian economy had entered the 1990s with relatively high inflation, excessive public debt, and an institutional framework characterised by executive weakness, an unsustainable pension regime, wage indexation, uncoordinated private sector wage bargaining and limited central bank independence. During the 1990s, substantial *policy* reform in all relevant areas took place. What makes the policy adjustment particularly impressive is that it happened during a period of recession and sluggish economic growth and in the absence of any substantial *institutional* strengthening of the executive. Given that the Italian political system and the economic policy-making regime were still characterised by a high degree of internal fragmentation, the diffusion of responsibility and a great number of veto points, successful macroeconomic convergence was surprising indeed.

What clearly emerged from the analysis of Italian macroeconomic policy is the crucial role played by external pressure. However, despite the importance of international pressure, this study has argued that Italian macroeconomic convergence cannot be properly understood without taking into account the role played by domestic institutions. On the whole, institutional obstacles were overcome thanks to the reluctance of various political and societal actors to be regarded as responsible for causing a financial crisis or Italy's failure to join EMU. This enhanced both the autonomy and the power of an otherwise weak executive and thus created a window of opportunity to achieve policy reform. However, the executive's autonomy and power were still strongly circumscribed.

In addition to international market pressure, Italian economic policy has also to be seen in the context of an overwhelming and almost all-encompassing consensus regarding the desirability of EMU membership. All major political parties were characterised by pro-European attitudes (*Istituto Affari Internazionali* 1993: 44-46). All relevant interest groups were publicly in favour of EMU, if for different reasons: industry and finance were pro-EMU because of the effect convergence and monetary union was going to have on monetary policy and public finance; trade unions favoured EMU because of the social policy and political goals related to EMU (Talani 2000: chapter 6).

Besides the attitudes of economic and political elites, public opinion showed considerable enthusiasm – indeed the greatest support among all European countries for most of the 1992-98 period - for European integration as well as EC and EU membership (Commission of the European Communities 1998). Moreover, Italian public opinion in favour of EMU was by far the strongest among all European countries, even in the face of the major sacrifices that resulted from economic reforms. In 1996, for example, after three years of restrictive macroeconomic policies, 78 per cent of Italians were in favour of EMU, while only 9 per cent were opposed to it. This made Italian public opinion the most pro-EMU by far (see Figure 1-1).

At the same time, Italians have always displayed the highest level of dissatisfaction with their own political system and government. In 1994 only 19 per cent of Italians were satisfied as against 77 per cent dissatisfied (Commission of the European Communities 1994). Under these circumstances, assuming responsibility for either a financial crisis or for the failure to join EMU was something none of the major political and societal actors were willing to risk. This was so despite the fact that macroeconomic adjustment imposed considerable short-term costs on Italian society (Brunetta and Tronti 1995; Simonazzi and Vianello 1998).

The emphasis on domestic institutions does not imply that individual leadership was unimportant. It certainly was in the cases of the Amato, Ciampi and Prodi governments. Nonetheless, personal leadership was circumscribed by institutional constraints (as Berlusconi experienced). On various occasions, these constraints were softened thanks to international pressure. Nonetheless, institutions were constraints on actions and tended to circumscribe (though not in an absolute way) potential outcomes. Although the underlying institutional logic characterising Italian macroeconomic policy was partly weakened by international pressure, the results of policy reforms provided ample evidence for the continued influence of domestic institutions - if not in terms of obstructing policy reform – then at least in terms of shaping reform outcomes. This demonstrates that the interplay between external pressure and domestic institutions is central to an understanding of reform:

> The effectiveness of government strategies and the opportunities provided by broad currents of public opinion will always depend to some extent on contingent aspects of the political and economic situation. Nonetheless [...], both distributive conflicts and the possibilities for sustained adjustment will depend heavily on more institutionalized patterns of political representation (Haggard and Kaufman 1992: 30).

The study also suggests that Italian macroeconomic 'politics' can be categorised in terms of 'normal' and 'revolutionary' politics (*cf. Financial Times*, 27 October 1995). Put more concisely, under 'normal' circumstances (that is, permissive international environment) the logic of domestic institutions prevails, while under 'extraordinary' circumstances (that is, restrictive international environment) other influences override domestic politics and institutions to bring about policy results that could not have been achieved in normal times. However, crisis and international pressure have always to be analysed in the context of agency and, above all, the constraining effect of domestic institutions.

> Crisis is clearly neither a necessary nor a sufficient condition to initiate reform. It has nevertheless often played a critical role in stimulating reform. In extreme cases [...] the crisis of the ancient regime may be so profound as to create an opening for [...] 'extraordinary politics' – a widespread willingness to suspend the usual political rules (Williamson and Haggard 1994: 565).

In the Italian context, this meant that executive weakness, *partitocrazia* and veto power of societal interests were 'suspended', or - to put it more conceptually - veto points (and institutional obstacles) were 'neutralised', even if only temporarily and to varying degrees. This suspension of rules had an important effect on executive strength and autonomy.

Extraordinary circumstances created both greater consensus and provided the government with greater autonomy to initiate and achieve policy reform. It is fair to say that institutionally speaking the Italian political system - characterised by a weak executive, strong parliament, medium-strong societal actors - is a 'system of bargained pluralism' (*cf.* Chapter 2) in which the executive is but one actor among many. Extraordinary circumstances tend to increase the relative 'bargaining position' of the executive and suspend to a certain degree the 'rules of the game' and thus make it possible to achieve policy innovation. On those occasions, to paraphrase Allum (1973), one may actually talk of a 'republic with a government'.

My contention is then that the interaction between international pressure and underlying institutional conditions tended to make Italian macroeconomic policy move in cycles - with 'state' autonomy as an important intervening variable. This is also consistent with the observation in Chapter 2 according to which Italian policy is to a very high degree of a reactive type (*cf.* Dente 1990). The lack of executive autonomy and fragmentation of decision-making in macroeconomic policy-making prevents the imposition of coherent, long-term, sustainable policies. The inability to produce goal-directed, anticipating policies is the reason why macroeconomic policy responds to domestic factors during 'normal times' but to international factors during 'extraordinary times'. 'Revolutionary politics' and reform take place during the latter. Once the situation stabilises and international pressure becomes weaker, the domestic consensus breaks down and the logic of domestic institutions re-emerges. Politics will revert back to 'normal' politics. This results in a cyclical pattern of policy that remains nonetheless re-active at all times. It is certainly no coincidence that the Prodi government fell after Italy had achieved EMU membership. The fact that the 1999 budget, which was the issue over which Prodi was forced to resign, contained the smallest fiscal adjustment in years further corroborates this view (*Financial Times*, 21 September 1998). (To what extent this domestic-institutional logic may have been modified as a result of the 1992-98 reforms in the various relevant policy areas will be discussed below.)

Hence in terms of the classical distinction between international, societal, domestic-institutional and cognitive-ideational factors (Hall 1997), this study emphasises the importance of domestic institutions for a proper understanding of Italian convergence. As for societal explanations, Walsh (1999) suggests that Italian macroeconomic adjustment can be understood as a result of distributional-societal politics in which the victory of a 'exposed sector coalition' (including employers and unions in these sectors) made possible the transition from a purely monetary-based to a comprehensive macroeconomic adjustment (including fiscal policy). Interestingly, Walsh (1999) considers the potential relevance of domestic institutions:

> Italy experienced little change in the institutions governing politics, the labour market, and the financial system from the late 1970s to the early 1990s. The only leverage over institutional effects is the case of electoral and party institutions. An electoral system based on proportional representation and a political system with many parties, are often seen as the underlying causes of Italy's series of short-lived coalition governments, but these institutionally derived characteristics had little effect in the timing and content of macroeconomic adjustment (p. 81).

This reveals a rather narrow – deterministic - view of institutions. I agree that the 'political-institutional' changes were of limited importance with regard to policy change. It is also true that contingent circumstances (such as the weakening of traditional parties, technocratic governments) played a role in bringing about macroeconomic adjustment. However, neither of these contingent circumstances can explain policy reform during the 1992-98 period in its entirety. Not only did institutional change take place in other areas and was important with respect to policy change (for example, monetary policy), but a purely societal interpretation - like the one proposed by Walsh - discounts the possibility that executive strength can vary as a result of external pressure (for theoretical implications see Section 7.3 below). In particular, the societal approach neglects the government's scope for autonomous action, especially in a crisis situation. To give an example: as described in Chapter 3, in 1996 prominent voices among the economic-financial elite took a rather cautious attitude towards the strong fiscal adjustment proposed by the government in view of meeting the convergence criteria. Nonetheless, the government, and more specifically the prime minister and the finance minister, forced the issue and pursued fiscal tightening in order to meet the 1997 deficit criteria. Similarly, Chapter 4 demonstrated how the government was able to set the agenda and 'force' trade unions to accept further pension cuts as a result of increasingly powerful external constraints: in 1992, Amato was able to override potential trade union and parliamentary opposition; in 1995, the Dini government pushed the rather reluctant unions to accept pension reform; in 1997, the Prodi government once more pushed the unions to accept further reform. Clearly, the trade unions were not enthusiastic supporters of these reforms. Chapter 6 showed that there was considerable societal opposition to the Bank of Italy's monetary policy. It was only in the wage policy area, as demonstrated in Chapter 5, that the unions changed their position quite considerably. But even in this area reform was not uncontested. In short, the 1990s did not bring about a major re-alignment of the trade unions as the most important interest groups. As demonstrated, the domestic-institutional-*cum*-external-constraint approach provides a much better explanation.

Finally, some accounts have emphasised the importance of ideas (McNamara 1998). This study has not dealt with ideational factors in detail - other than suggesting that the presence of a pro-European attitude in Italy was very important. The importance of other ideational factors such as ideology and discourse seems to have been spurious, or at least dependent on the presence of external pressure.

First, it has been acknowledged that 'ideas' changed (for example, among the trade union leadership with regard to wage policy). This change of ideas, however, was mainly induced by external pressure (such as capital mobility, exchange rate instability and loss of international competitiveness). Something similar is certainly true with respect to pension reform where trade unions came to accept a contribution-based system as a result of the obvious unsustainability of the earnings-related system and the pressing need to achieve reform - rather than a new-found enthusiasm for a contribution-based system and the introduction of complementary private pensions. These examples suggests that the independent causal influence of ideas on macroeconomic policy change was marginal at best. Second, one might argue that discourse (that is, the self-conscious use of symbolisms, appeal to identity of actors rather than their material interests) can explain macroeconomic policy reform. It is certainly true that the government used discourse to overcome potential opposition to its policies. Between 1992-95, Italian government appealed to societal and political actors to help overcome the political and economic crisis Italy was facing by appealing to their sense of responsibility and the need to achieve a national consensus. After 1996, the government invoked the need for Italy to join EMU and thus continue to be at the forefront of European integration. The government thus appealed to Italians' self-identity and thus appealed to various societal and political actors to overcome narrow partisan interest for the benefit of the country. Nonetheless, the importance of 'discourse' was still limited in an explanatory sense.

While government appeals to societal and political actors and its attempt to 'sell' policies were clearly important in mobilising support and overcoming traditional institutional obstacles, this kind of discourse could only be effective in the presence of a *real* external constraint. Put differently, in the absence of the economic and political crisis and the EMU constraint, appeals to the national interest would hardly have been successful. This suggests that, on the whole, ideational accounts do not perform as well as the institutionalist-*cum*-external constraint account. Discourse – however exaggerated at times – always also reflected the existence of real external constraints. In other words, for discourse to be effective, an external constraint had to exist.

To speak of institutional learning – thus invoking the dynamic aspect of institutions – seems by and large unsatisfactory. This study has argued that politics is about power, and power is to a very high degree determined by domestic institutional arrangements. All four analysis chapters provide plenty of evidence that policy reform was about the executive trying 'get its way' in the face of opposition from a variety of political and societal actors. Moreover, the uneven course of reform during the 1992-97 period (and the post-1997 experience) showed the domestic-institutional logic that dominated Italian politics re-emerged, if indeed, it had ever disappeared. However, if learning is a gradual, cumulative process, then an explanation of Italian economic policy reform in terms of learning is not satisfactory.

More generally, had a major realignment of interest groups occurred, had ideational factors been crucial, or had learning occurred, the history and nature of Italian policy reform should have been much more continuous and progressive – and even easier to achieve. However, the fact that government stability increased and the reform of budgetary and pension policy slowed down after 1997 (that is, after the relaxation of the external constraints) strongly suggests that the domestic-institutionalist-*cum*-external-constraint framework provides the most adequate explanation for Italian macroeconomic policy reform in the 1990s.

Similarly, a purely international, systemic-functional approach (such as the capital mobility hypothesis, the optimal currency theory, or trade integration) interprets Italian adjustment as a simple response to international pressure and disregards the importance of domestic-institutional factors. By constrast, this study argued that in order to account for the nature of adjustments as well as for the nature of institutional changes, it is necessary to take into account domestic institutions. In any case, the case study of Italy shows that domestic politics interfered with a 'natural' tendency towards functionally efficient adjustment. For example, with regard to the belated budgetary policy reform, the pension problem or the problems related to wage policy, it is clear that domestic institutions mattered.

While neither approach can explain Italian policy reform entirely, the domestic-institutional-*cum*-international-constraint approach performs best. No doubt, other factors affected economic policy at times – but only in a contingent way. This is entirely consistent with the historical-institutionalist framework adopted in this study. In short, there was no major re-alignment of interest groups; ideational factors were only effective due to the presence of considerable international constraints; institutional learning cannot explain the uneven nature of policy reform; a pure systemic-functional approach cannot explain the difficulties economic policy reform encountered (nor why it was so slow and insufficient at times). In short, a historical-institutionalist with a special emphasis on international constraints seems to be the most appropriate way of understanding Italian macroeconomic policy and policy change in the 1990s.

7.2 Extending the Argument: The Strong French 'State' and Macroeconomic Convergence in the 1990s

The argument so far has primarily relied on counterfactual reasoning before a background of institutionalist hypotheses that found a certain measure of confirmation in statistical and comparative studies. In methodological terms, this study represents a 'deviant' case study in the sense that it examines a case that did not fit the predictions of institutionalist theory. Contrasting the weak Italian with the strong French 'state'[1] thus represents a further test of the institutionalist argument.

[1] A comparison of Italy with another parliamentary regime might seem more interesting than a comparison with the French semi-presidential regime. However, the point that I would like to make is that what matters is executive strength and executive autonomy. The executive can be strong or weak

The French Political System: Institutions and Actors

A sketch of French institutions and policies offers interesting insights concerning the institutionalist approach to macroeconomic policy. Traditionally the French 'state' represents the ideal-type of a strong 'state'. Cultural as well as historical factors have contributed to this: (1) an absolutist, centralised 'state' and bureaucracy dating back to the 17th century; (2) an ideology that emphasised anti-corporatism; and (3) the glorification of the 'state' and individualism (Ehrmann 1983: 182-183). The constitution of the Fifth Republic of 1958 certainly put into place institutional structures that reflect these traditions and created an 'executive-dominated' political system.

Studies have confirmed the importance of 'state'-centred policy networks in France that affect both content and continuity of various economic policies (Katzenstein 1976; Zysman 1977a, 1977b; Zysman 1977b; Hall 1986). A highly centralised, unified and powerful executive relative to decentralised and divided societal actors tends to produce coherent and consistent policies with little interference from societal actors or parliament (Simonian 1985; Kaltenthaler 1997; Josselin 1997; Walsh 1994; Goodman and Pauly 1993; Cerny 1989; Loriaux 1991; Hayward 1986). Even though some studies critique the 'strong state' thesis, mainly by pointing out that the French government's capacity to implement policies should be distinguished from its autonomy to formulate them (Feigenbaum 1985; Milner 1987, 1988), the evidence overwhelmingly suggests that policy in France is characterised by executive-domination. This 'strength' and 'autonomy' have their roots in the institutional characteristics of the French political system. A brief sketch of the institutional features that underpin executive strength will have to suffice here.

On the political-institutional level, the French government is undoubtedly strong. The French government has wide-ranging powers with regard to intervention in parliamentary deliberations and adoption of legislation. In fact, its proposal and decree powers place the executive in a dominant position with respect to the legislative process. The government has considerable powers with regard to determining agenda items and their order of consideration and can demand 'package

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with regard to macroeconomic policy-making in both parliamentary and presidential systems (for example, UK, USA). Clearly, a comparison of two parliamentary regimes would more clearly underline the importance of the features of the electoral system. A stylised comparison with the German and British parliamentary systems is suggested in Table 7-1 below.

votes' and declare a vote of confidence. Parliamentary committees cannot block the final consideration of legislation by not reporting it. Parliament's amendment powers are very limited. The government proposes and accepts amendments. The government can even issue decrees that permit it to modify laws. Furthermore, the constitution allows a vast domain to be regulated by executive decrees. The strong position of the executive relative to the legislature is the reason why the French parliament has been described as an 'arena legislature' as opposed to a 'transformative legislature' (Polsby 1975). In the former, the executive largely controls the outcomes of the legislative process. In the latter, parliament puts its own imprint on legislation by originating, modifying or even 'killing' legislation. While the Italian parliament is of a 'transformative' type in that it possesses considerable influence on the final legislative outcomes, the French parliament is primarily a body that enacts government proposals and is hence of an 'arena' type.

The executive is powerful not only because it has many tools to intervene in the legislative process but also because it is largely independent from parliament. The French president is directly elected for a seven-year term and has extensive powers, especially concerning the nomination of the prime minister and the dissolution of the *Assemblée Nationale* (National Assembly) - *cohabitation* excepted. Ministers are responsible for the various policy sectors but they have only limited power (unlike in Italy). This is so because "[t]he Prime Minister of the Fifth Republic is not simply a *primus inter pares*. He or she can impose decisions, take strong measures and force a recalcitrant Minister to submit or to resign" (Mény 1996: 129-130).

Finally, the electoral system of the National Assembly is a two-ballot majority system (*uninominal à deux tours*). This system tends to produce bi-polarisation as it forces parties to seek alliances. However, contrary to the British first-past-the-post system, the French system has resulted in a system of multi-party bi-polarity. The multi-party aspect is - contrary to Italy - not a problem as the majority tends to be relatively cohesive as a result of the overwhelming powers of the executive. This aspect means that a comparison of the French and Italian electoral systems is only of limited usefulness to the extent to which the Fifth Republic is a semi-presidential regime and in that the parliament, on which the executive depends, finds a counterweight in the president. Hence to attribute executive strength solely to the bipolar tendency of the electoral system would certainly underestimate the importance of the strong position the prime minister has as a result of its (generally) close relationship with the president. In fact, the post-1994 Italian experience suggests that bipolar multi-partyism results – or at least can result - in 'weak' executives. Nonetheless, it is clear that the French electoral regime of the Fifth Republic has resulted in a bipolar structure that is characterised by greater coherence than a purely proportional electoral regime.

The most outstanding feature of the French political system relative to the Italian one is the position of the executive *vis-à-vis* parliament (Suleiman 1980). On balance, the executive's power of dissuasion (dissolution of parliament) is more powerful than parliament's power of dissuasion (vote of no confidence), which in combination with the extensive powers of the executive to interfere in the legislative process gives rise to a strongly executive-dominated regime. Hence it is fair to say that the Fifth Republic combines the virtues of both presidential and parliamentary regimes. As a semi-presidential system (except for periods of *cohabitation*), the French system combines the independence of the executive (typical of presidential systems) and the control over parliament (typical of parliamentary regimes - at least those with a low degree of parliamentary fragmentation). Very clearly, the French government is extremely strong, autonomous and centralised in terms of the decision-making process. In short, "the executive of the Fifth Republic is at the heart of the political system [...]. Efficiency, governmental solidarity, concentration of power and the authority of the leader take priority over pluralism, debate and a system of checks and balances" (Mény 1996: 137).

In addition to the institutional characteristics of the French 'state', the weakness of societal interests in France, which tend to be weakly organised and fragmented along ideological – rather than functional - lines, further enhances the government's strength (Wilson 1987; Labbé 1994). If the executive has traditionally been strong, societal interests have traditionally been weak. This weakness is of course partly the result of such features as the high degree of centralisation of decision-making and the weak position of parliament - both of which reduce the number of access points for societal groups.

All this demonstrates the considerable difference between the French and the Italian political systems in terms of executive strength. To evaluate the executive strength and institutionalist argument, it is necessary to establish how strong the executive is in the areas of budgetary, pension (and welfare), wage and monetary policy and to analyse how this strength affected policy outcomes. This will also allow for an evaluation of the importance of the other institutional characteristics that have been found to be important with regard to Italian macroeconomic policy.

Budgetary Policy-Making

The control of fiscal policy has never represented a serious problem in France. This was largely the result of a political system that is characterised by a powerful, cohesive and centralised executive and a weak parliament. The political-institutional features and budgetary institutions suggest that the French budgetary system comes close to being an ideal-type of a centralised, hierarchical and executive-dominated budgetary policy-making regime (Lord 1973; Le Cacheux 1994; OECD 1995a: 109-13; Von Hagen 1992). For example, all finance laws are reserved to government initiative. Parliament is prohibited from initiating increases in public expenditures or reductions in government revenues. Combined with the features of executive dominance, a high degree of prime-ministerial authority within the cabinet, the centralisation of the budgetary process and the power and prestige of the finance ministry (Mamou 1988), the French executive is extremely powerful and is able to pursue and impose its preferences without undue interference from other actors.

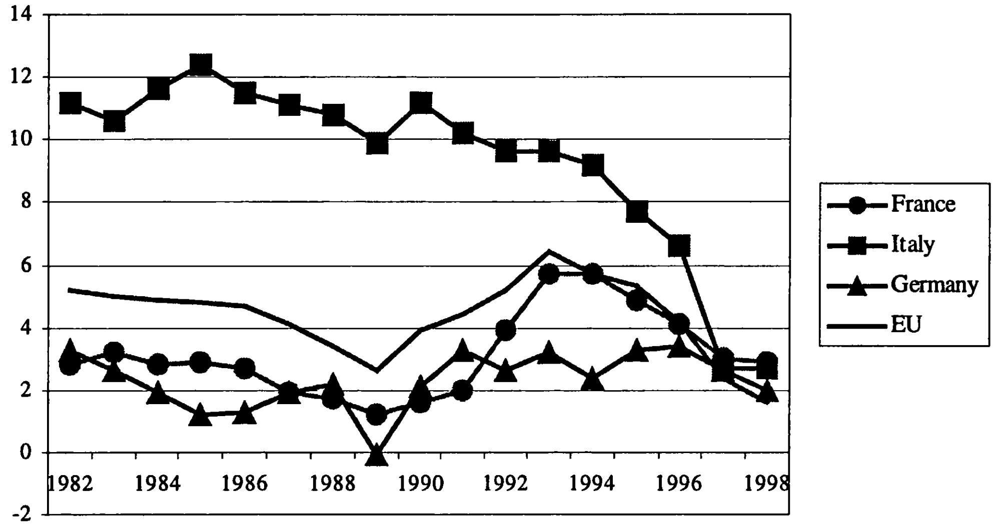
> Not only does the constitution forbid parliament to increase costs or decrease public revenue, but the government is reluctant to accept proposals affecting its own plans, even when they imply no extra cost, or would bring in extra revenue in ways unacceptable to the Minister of Finance. This curtailment of powers is considerable by comparison with Italy or the United States, where the assemblies have sizeable prerogatives over revenue and expenditure (Mény 1996: 120).

The French executive enjoys insulation and is in a dominant position *vis-à-vis* parliament in terms of political-institutional and budgetary-procedural characteristics. The contrast with Italian fiscal policy-making could not be greater (*cf.* Section 2.2).

France was never close to experiencing excessive fiscal deficits and public debt comparable to Italy in the 1980s and early 1990s (Figures 7-1 and 7-2).

Figure 7-1 General Government Net Borrowing, 1982-1998

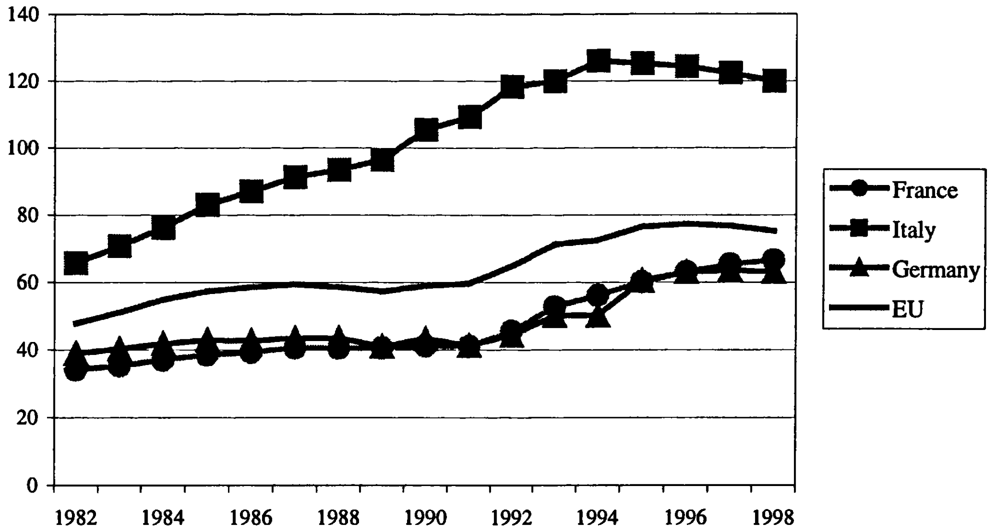
(as share of GDP)



Source: OECD *Economic Outlook* [various years]

Figure 7-2 General Government Gross Financial Liabilities, 1982-1998

(as a share of GDP)



Source: OECD *Economic Outlook* [various years]

After the 1982-83 reversal of budgetary policy, the French government achieved fiscal consolidation with relative ease during the 1980s (Virard 1993; Muet and Fonteneau 1990; Walsh 1994; Le Cacheux 1994). The increase in the budget deficit between 1992 and 1994 reflected a looser fiscal policy stance in response to stagnating growth and an extremely restrictive monetary policy that aimed at defending the parity with the German mark rather than domestic inflation. The relative looseness of fiscal policy was has to be regarded as a conscious response to economic pressure rather than as an inability to control budgetary policy.

This - and hence the 'executive dominance' argument – is supported by events after 1994 when subsequent French governments that were elected on the promise to pursue (expenditure-increasing) employment policies were able retract on their promises and pursue policies of fiscal consolidation instead. Thus the Juppé (1995-97) and the Jospin (1997-) governments achieved fiscal convergence with relative ease. Admittedly, the 1995 strikes in response to the Juppé government consolidation policies led the government to accept negotiations with the trade unions. But these negotiations primarily concerned pension reform and the government was still able to achieve the larger part of its intended budgetary savings from health reform (see next section). On the whole, there can be no doubt that despite considerable resistance to fiscal austerity from unions, public opinion, voters and opposition parties, successive French governments were able to pursue sustainable and long-term-oriented budgetary policies (Cameron 1996).

Welfare and Pension Reform

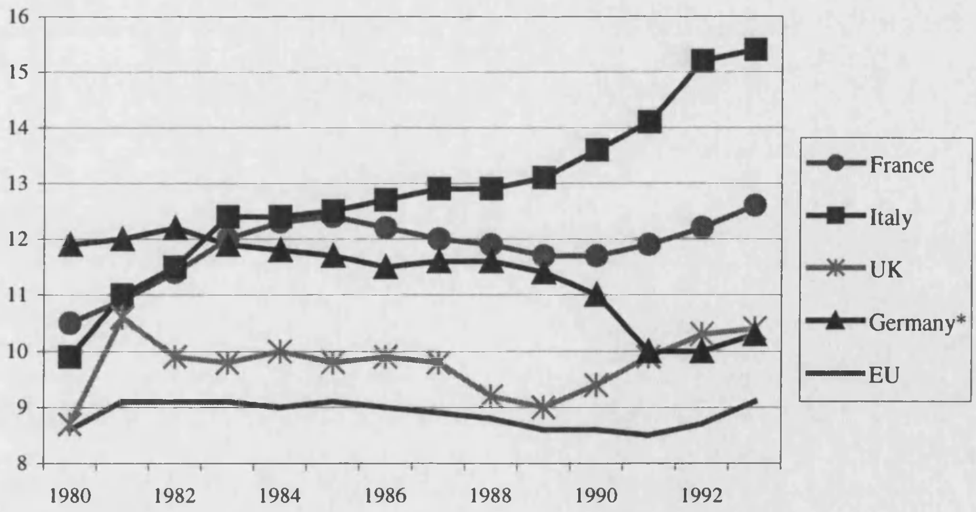
Compared to budgetary policy, the position of the French government in (welfare and) pension policy is less strong. On the one hand, the French pension policy-making regime is characterised by a strong, insulated executive with considerable control over the legislature. Furthermore, trade unions, the traditional defenders of the welfare state, are rather weak. This gives the executive - at least from an institutional point of view - a strong ability to formulate, legislate and implement reform. On the other hand, the French pension system is primarily Bismarckian: it has a compulsory pay-as-you-go pension system financed out of contributions which - similar to the Italian system of the early 1990s - is characterised by great complexity and fragmentation (that is, *régime général*, *régimes complémentaires*, *régimes spéciaux*); the latter regime covers mainly public employees in public companies and utilities (such as railway and postal service). Employees in these sectors generally enjoyed special privileges (Darnaut 1997; Taylor-Gooby 1999; Bonoli and Palier 1996; Bonoli 1997; for detailed description see Brindisi 2000: 95-109).

In the early 1990s, there clearly was a need for social expenditure and more specifically pension reform (Beduc 1993). In general, French social security accounts of the general scheme began to be characterised by deficits. In 1993 borrowing reached more than FRF100bn (or 1.4 per cent of GDP) and remained at a level of around 1 per cent in 1995 (Darnaut 1997: 209-211; OECD *Economic Surveys France* 1997: 47). The major sources of this financial imbalance were the health and old-age functions. In 1995, for example, the deficit of the general pension scheme was FRF39.5bn (see Bonoli 2000: 130).

Clearly, any comparison with Italy faces limits as both countries face slightly different employment patterns, rates of demographic change and so on. However, on the traditional criteria for evaluating sustainability, the Italian situation was much more dramatic than the French situation - both in terms of the impact of the pension regime on the public deficit and in terms of spending as a share of GDP (Bonoli 2000: 131; Figure 7-3) and especially regarding future expenditure trends (see Franco and Munzi 1997). The contribution rate to finance the increase in expenditure was projected to rise from 18.9 (1990) to 30.9 per cent (2040) in the best-case scenario and to 41.9 in the worst-case scenario (Bonoli 2000: 130).

Figure 7-3 Old-Age and Survivors' Expenditure, 1980-1993

(as a share of GDP)



Source: Eurostat 1996b * West Germany

Interestingly it was in the pension policy area where the French government encountered considerable difficulties in bringing about reform and reducing the negative impact of pension spending on public finances (Le Cacheux 1994; Commission of the European Communities 1996a: 60-65).

In 1993 a reform that exclusively concerned the basic pension schemes, which accounted for 42 per cent of pension spending, took place. The pension reform under the Balladur government foresaw a 'pension recovery plan' which increased the general solidarity tax for a pension liability fund and introduced price indexation for pensions[2] as well as a gradual extension of the contribution period. Although there was not as much opposition to the reform as in 1995, the government succeeded in making the social parties sign a tripartite protocol after threatening to regulate by decrees (Ebbinghaus and Hassel 2000). This indicates that the introduction of these changes was relatively easy. The most important elements were the following (Commission of the European Communities 1996a: 61):

- pension adjustments were to be based on price dynamics rather than on wage dynamics
- basic pensions were to be calculated on the 15 best-paid years.
- the number of years required for the payment of a full pension was gradually raised from 27.5 to 40
- a new *Fonds de Solidarité Vieillesse* was created in order to transfer from the pension schemes to the central government the responsibility for welfare pension expenditure

The financial impact of the 1993 reform was largely due to the switch to price indexation. While in the absence of reform the ECR of the *Caisse Nationale pour l'Assurance Vieillesse* (CNAV) would have increased from 18.5 (1995) to 24.5 per cent (2010), with the reforms it was projected to reach 22.5/19 per cent[3] (Commission of the European Communities 1996a: 61). As a result, the General Planning Committee (1995) estimated that the deficit would remain stable until 2005. In the longer term, the General Planning Committee expected an increase in the ECR of 5 points until 2015 and 14 points until 2040 instead of 9 and 20 points respectively. Confirming these projections, the OECD (*Economic Surveys France* 1995: 31-44) estimated that the 1993 reform would keep the general pension scheme close to balance until 2010 and that it would rapidly deteriorate thereafter, reaching a deficit of 4 per cent of GDP in 2030 (for similar results *cf.* Briet 1995). In short, the 1993 reform guaranteed financial sustainability in the medium term (*cf.* Bonoli 2000: 141).

[2] Since 1986 parliament decided on an annual basis whether to index pensions on wages or prices. *De facto* pensions had been indexed on prices since 1987.
[3] The first figure represents the projection on the basis of wage indexation, the second figure on the basis of price indexation.

> Until 2005, and conditional on a favourable macroeconomic environment, the social security system should not be subject to significant pressures. Until this time, the social security net borrowing would result mainly from the health insurance system, whereas the pension scheme, due to the effects of the July 1993 reform, would not as a whole experience financing difficulties (Darnaut 1997: 232).

Considerable savings could have been achieved if the 1993 reform had been extended to the special schemes. The 1995 reform precisely sought to extend 1993 reform to the special pension schemes (affecting primarily workers in the public sector) in order to achieve short-term savings as well as to pre-empt major imbalances that were expected to result from this scheme after the year 2000 (Briet 1995).

In June 1995 the government laid out a timetable that foresaw a reduction of the budget deficit from 5 per cent of GDP in 1995 to 4 per cent in 1996 and 3 per cent in 1997. The reform of social security was to make a major contribution to achieving this goal. The 1995 reform concerned mainly health insurance.[4] It also foresaw the reform of the special pension schemes. While the health reform was implemented by decree, the pension reform had to be postponed due to major strikes and societal opposition (Darnaut 1997: 219). Announced by the Juppé government in November 1995, the pension reform proposal provoked the largest protest and strike movement since 1969. More specifically, the pension part of the Juppé plan foresaw the reform of the special pension schemes (*régimes spéciaux*) by harmonising (downwards) benefit formulas and entitlement conditions of employees in the public sector, covered by *régimes spéciaux*, with those of private sector employees, covered by the *régime général*.

[4] The 1995 reform aimed at: (1) emergency measures to bring social accounts back to balance by 1997; and (2) structural reforms aiming to constrain durably social and more specifically health expenditure. Among other measures, it created the *Caisse d'Amortissement de la Dette Sociale* (CADES) which was to be financed through a special tax in order to pay back social security debt that was accumulated between 1995-1998 (ca. □34.15bn or around 3 per cent of GDP). The reform also increased contribution rates in order to check the negative impact of the social security deficit on public finances (Brindisi 2000: 97; OECD *Economic Surveys France* 1997: 48-49). The accumulated social debt was to be funded by a new broad-based income tax (*remboursement de la dette sociale* or RDS), introduced in February 1996, which foresaw a 13-year amortisation period. In terms of public finances, in 1995 social security borrowing amounted to 0.8 per cent of GDP. The health reforms are estimated to have contributed 0.6 (1996) and 0.9 per cent (1997) to fiscal consolidation (p. 221), while the 0.7 (1996) and 0.9 per cent (1997) were raised through the RDS. These reforms made a substantial contribution to budgetary consolidation (Darnaut 1997; OECD *Economic Surveys France* 1997: 48-49).

The main opposition was concentrated almost exclusively in the public sector and in particular in a certain part of it, that is, public transport and utilities where unions had a high degree of disruptive power. The demonstrations also showed though that there was considerable support from the wider public. Due to massive protests, the government finally accepted to negotiate with the unions, and the plans for public-sector pension reform (as well as for restructuring of railway and postal service) were withdrawn.

At first sight, this seems to suggest that the strong French government could not do what the weak Italian government was able to do. It also seems to suggest that the institutionalist approach is inadequate. However, one needs to bear in mind that all three Italian pension reforms took place under radically different external circumstances. Unlike in Italy, without the threat of an impending fiscal crisis or EMU membership at stake and hence without regarding pension reform as absolutely necessary, the inclination to compromise on the part of French unions as well as the incentives for the French government to push through extremely unpopular reforms were less strong. It is also noteworthy that the French government was able to bring about 'structural-institutional change' in the social security area[5] where changes were simply introduced by decree.

The French government's failure to introduce reform in the pension area also shows that executive strength should not be over-estimated but needs to be analysed in its wider situational context. In terms of the theoretical concepts discussed above, the French government encountered the lock-in (or acquired rights) effect that was transmitted by highly mobilised groups in the public sector with a high degree of disruptive power.[6] By contrast, the 1993 reform that only concerned the private sector passed without major problems. This was primarily due to the lesser union strength in the private sector. Nonetheless, whether due to executive strength or the weakness of unions in the private sector, on the whole, it is clear that the French government was more successful in controlling pension spending than the Italian one. French pension spending and its impact on public finance were relative to Italy at a sustainable level throughout the 1990s (Figure 7-3 above). Comparative OECD

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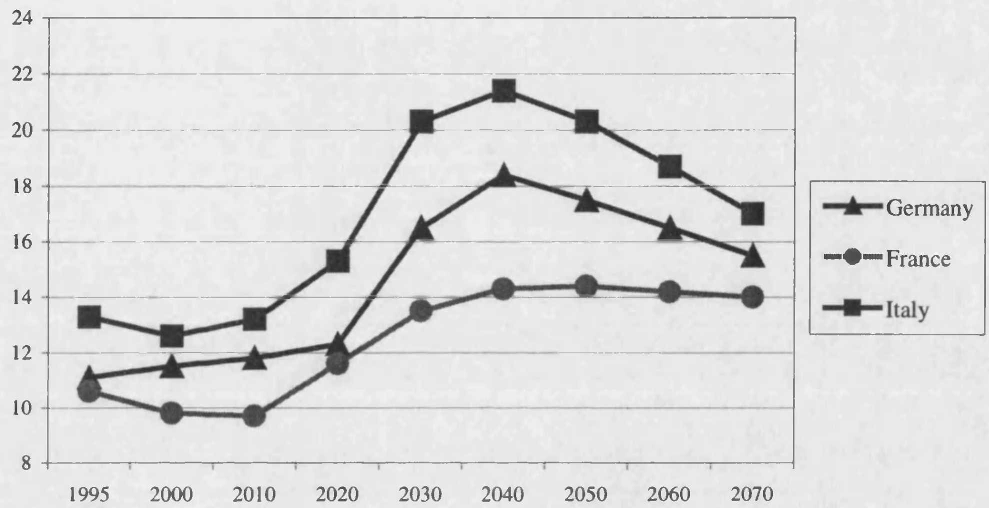
[5] In February 1996 parliament decided wide-ranging changes of the general orientations and political objectives of the social security system, such as administrative change in health care, changes in the constitution of social security boards, shift towards taxes rather than contributions (Taylor-Gooby 1999: 8).

studies also suggest that French policy is on a more sustainable path than the Italian one (Roseveare *et al.* 1996; Figure 7-4).[7] In short, even though the French government failed to implement pension reform in 1995, French public pension policy is far more sustainable than the Italian one, thus suggesting the overall usefulness of the executive strength argument.

Figure 7-4 OECD Pension Expenditure Projections (baseline scenario)

(as a share of GDP)



Source: OECD (1996b: 38)

Private and Public Sector Wage Policy

The French industrial relations system in the private sector is characterised by a high degree of government involvement, mainly because of the weakness of French unionism (Van Ruysseveldt and Visser 1996; Goetschy and Jobert 1998). Unions have traditionally been divided along ideological lines and have tended to oppose co-operative relations with employers. Trade union weakness is reflected in terms of low union density, absence of access to policy-makers, limited financial resources and so on. Similarly, for a variety of reasons, employers have been paternalistic and reserved towards co-operation with the unions. Collective bargaining mainly takes place at the decentralised level, even though national-industry agreements – if they exist at all - are automatically extended by the French government to the whole

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[6] The retreat of the French government in spring 2000 on the issue of the harmonisation of public and private pension schemes corroborates this view.

[7] The definition of pension expenditure used by various studies differs slightly. But this does not affect the argument regarding pension expenditure trends, as the 1996 OECD study used identical definitions for standardised simulations (*cf. Ministero del Tesoro* [2000: 28-30]).

sector. Overall, though, the existence of a weak, divided and declining union movement in the private sector was not able to create substantial wage-push inflation[8] once the French government had decided to switch to a hard currency policy after 1983.

The dominance of the French government in wage policy is also evident in the public sector. A dominant 'state' with tight control over an economy-dominating public sector, the "collapse of union opposition" (Soskice 1990: 47; Boyer 1994) and the practice of extending wage hierarchy and settlements from the public to private sector results in a system of wage formation that is "highly institutionalized and centralized under the auspices of the state" (Boyer 1994: 55). Due to the weakness of trade unionism, the French government can moreover intervene in the private sector with relative ease in terms of job security legislation, unemployment benefits and minimum wages.

To the extent that the resurgence of Italian inflation after 1985 was the result of public - rather than private - sector wage policy (*cf.* Section 2.4), the difference in executive strength was a crucial factor. Contrary to the Italian government, the French government was able to control public wages thanks to its dominance over the wage-setting process. Given that public sector wage determination affects almost 5 million people or almost a quarter of the French labour force (OECD 1997a: 52), public wage policy has a huge impact on economy-wide wages and inflation. The government unilaterally determines public sector wages within budgetary constraints. The national budget fixes the number of jobs per administrative department and sets limits to the increase of the total wage bill. And even though collective wage bargaining was formally introduced in the public sector in 1983 which formalised the right of trade unions to negotiate with the government nationally over pay, this did not undermine the ability of the government to set or freeze wage rates unilaterally in the public sector because if agreements are reached at all they are not legally binding. Moreover, negotiations are highly centralised for the entire public service conducted by the minister of public service - who is subject to the direct authority of the prime minister (Mosse and Tchobanian 1999). Finally, public sector strikes are strictly regulated and there exists an obligation to provide a minimum service and a ban on certain kinds of (disruptive) strikes.

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[8] Violent strikes are not uncommon in France and not infrequently force the government to

The strong position of the executive in the wage determination process explains how the French government was able to do what the Italian government failed to do in terms of re-orienting macroeconomic policy towards further disinflation after the mid-1980s (Virard 1993; Muet and Fonteneau 1990; Onofri and Tomasini 1992; Walsh 1995). The importance of a strong and autonomous executive is further corroborated by the fact that French wage bargaining exhibited tendencies similar to Italy. Union density was much higher in the public than in the private sector; confederal unions were less and less capable of controlling occupational unions (so-called *co-ordinations*); and conflict in the private sector had been declining since the 1970s.

Despite these unfavourable characteristics, in terms of controlling public wages, the French government (in 1983) was able to index public sector wages on the official inflation target with no automatic clause for adjustment in case actual inflation overshot the forecast inflation rate.

> Wages were not to be indexed to past inflation. Minimum wage increases were slowed. Severe wage guidelines were set for the public sector and nationalized firms in order to initiate wage moderation to be diffused to the whole private sector. Job security legislation was relaxed. Welfare payments, including unemployment benefits, were slimmed (Boyer 1994: 59).

As regards French wage policy, after a relatively lax public wage policy in the early 1990s, which aimed to offset the rather tight monetary policy oriented towards the maintenance of a stable exchange rate with the German mark, the French government – seeking to reduce the public deficit – tightened public wage policy. The government decided that no negotiations would take place between 1995 and 1998 and unilaterally decreed a nominal wage increase to maintain civil servants' purchasing power (Eliot *et al.* 1999; Guillotin and Meurs 1999). In sum, both the 1980s and 1990s demonstrate that the French government had sufficient institutional strength to control public wages effectively (Figure 7-5). Ultimately, this strength is grounded in the French executive's tight control over public sector wages, its ability to intervene in private sector wage policy-making (Redor 1997), and its strong position relative to parliament and trade unions more generally.

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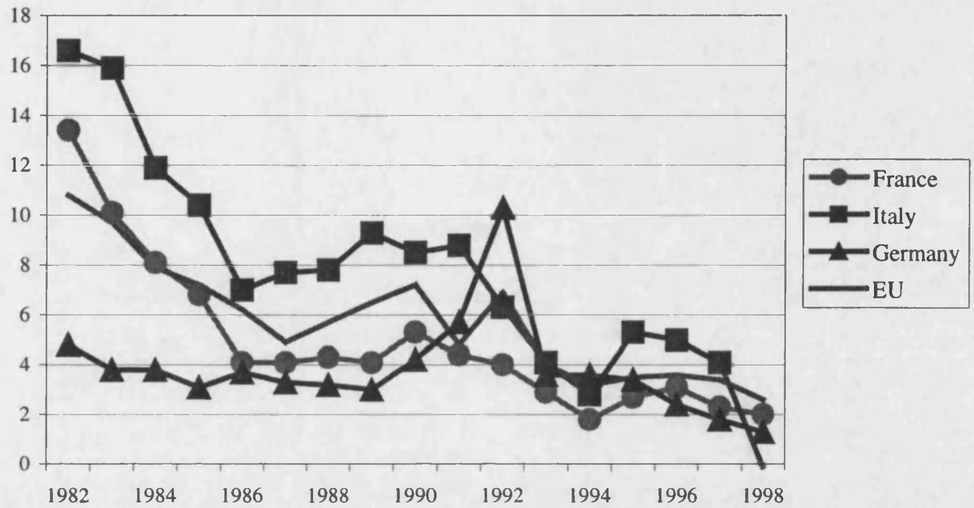
compromise (especially farmers, truckers). These strikes rarely affect wage issues though.

Figure 7-5 Compensation per Employee in the Business Sector, 1982-1998

(annual change in per cent)



Source: OECD *Economic Outlook* [various years]

Monetary Policy

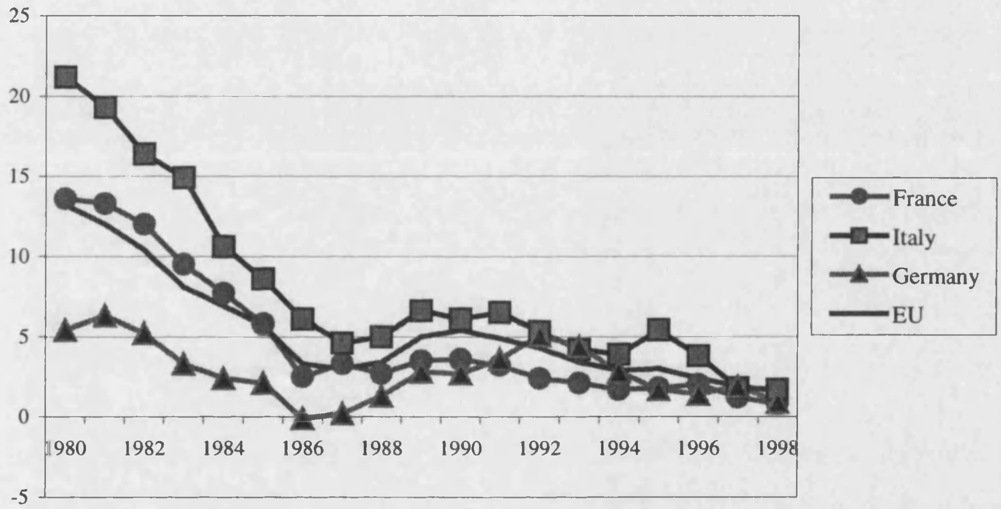
Traditionally, monetary and exchange-rate policy-making in France was dominated by the executive in all relevant respects, such as the financing of government deficits, the control over interest rates and exchange rates, and in terms of the nomination of central bank decision-makers (Elgie and Thompson 1998: chapter 6; Goodman 1992: chapter 6; Cukierman *et al.* 1994).

In January 1994, a major institutional change took place when the Bank of France was transformed from an extremely dependent into a highly independent central bank. The *Rassemblement pour la République (*RPR) - *Union pour la Démocratie française* (UDF) majority proposed central bank reform in March 1993. This was partly a response to the commitment undertaken in the TEU concerning central bank independence. Partly it was due to the desire to strengthen the credibility of French monetary policy in the face of jittery international financial markets and in a context where the French government had already largely renounced an independent monetary policy as a result of ERM membership. Whatever opposition there may have been at the time (especially from the *Direction du Trésor*, political parties) the government proposal was adopted with minor but insubstantial amendments against the votes of the *Parti communiste français* (PCF), the *Parti socialiste* (PS) and over fifty majority MPs (Elgie and Thompson 1998: 132). Despite this opposition, the reform was never in danger of not being enacted.[9] The reform granted the Bank of France both economic and political independence (see Elgie and Thompson 1998: 134) and demonstrated the ease with which the government was able to implement reform.

What effect did the 1994 reform have subsequently on monetary policy? French monetary policy did not significantly change after the reform, as successive French governments had already been pursuing a successful low inflation policy (Figure 7-6).

Figure 7-6 Consumer Price Inflation, 1980-1998

(annual change in per cent)



Source: OECD *Economic Outlook* [various years]

It is true that the Chirac government (1986-88) was less ‘anti-devaluationist’ than the various Socialist governments before and after (Cameron 1995, 1996). However, both under Bérégovoy (1992-93) and Balladur (1993-95), the French government’s eagerness to cut interest rates more often than not prevailed over the concerns of the central bank. For example, after coming to power in March 1993, the Balladur government decided a gradual reduction in interest rates against the opposition of the Bank of France. The fact that this policy was reversed from August 1993 onward reflects the government’s wish to maintain the stable exchange rate

[9] Given that it was above all the French government that fought hardest for the creation of a politically dependent central bank, one might have expected greater resistance to central bank reform (see Mazzucelli 1997).

with the German mark. This demonstrates that the conflict between government and central bank was over how to achieve the goal of preserving the exchange rate peg rather than the goal itself. Nonetheless, after the new central bank law had entered into force, a more cautious monetary policy prevailed (Aeschimann and Riché 1996).

This leads to the following conclusion: executive dominance (in terms of internal cohesion and insulation from outside pressure) can to a large extent serve as a substitute for central bank independence (similar Walsh 1994). Far from undermining the institutionalist argument, it actually demonstrates the importance of analysing different institutional variables in conjunction with one another. Hence central bank autonomy seems to be a more helpful instrument for weak governments than for strong ones in their pursuit of price stability. This can help explain why the Italian government 'delegated' monetary policy-making to the Bank of Italy in the early 1980s and subsequently abstained from interfering with its decisions. Had the Italian executive been stronger, the *de facto* delegation of monetary policy to the Bank of Italy would not have been necessary. It remains though that French central bank reform did have a visible effect on monetary policy, that is, it became more cautious.

Implications for the Institutionalist Argument

This admittedly brief and stylised history of the French politics of macroeconomic policy convergence corroborates the institutionalist argument overall: economic policy is to a high degree constrained and facilitated by domestic institutions; economic policy is particularly affected by executive strength (Table 7-1 below).

The French government's institutional strength has been demonstrated after 1982-83 as well as during the 1990s. This was why France never had to face a situation as dramatic as Italy in the early 1990s. If it is borne in mind that there was considerable opposition among public opinion, political parties and scholars to EMU as well as opposition to the government's restrictive economic policies (Guyomarch *et al.* 1998: chapter 3; Fitoussi 1995), and that the economic consequences of these policies were partly responsible for the successive electoral defeats of various governments, then this indicates that French policy-makers had to face more adverse conditions in terms of public opinion than their Italian counterparts. This is illustrated by a few figures. In terms of the attitude of the electorate towards TEU, a majority of RPR supporters opposed Maastricht (67 per cent), which outweighed the pro-TEU attitudes of the UDF (58 per cent). The electorate of the left was broadly in favour of the TEU. The parties themselves exhibited similar attitudes towards TEU and hence by extension to EMU (*cf.* Guyomarch *et al.* 1998: chapter 3). At the same time, French public opinion towards European integration and EMU was far less positive than the Italian one (see Figure 1-1). While the average support for EU membership among EU countries was on average around 50 per cent during the 1990s, support in France decreased from a about 60 per cent in 1992 to below 50 per cent in 1996 and 1997. By contrast, support in Italy hovered around 70 per cent during the 1990s and actually increased to 75 per cent in late 1996. While support in France reflected the European average, Italian support for EU was consistently above the EU average (Commission of the European Communities 1998).

Table 7-1 Comparison of Institutional Characteristics of 'Big Four'

	EXECUTIVE	BUDGET POLICY	WAGE POLICY	PENSION POLICY	MONETARY POLICY
France	Executive dominance	Executive regime	Tight control of public wages/ private sector dominated by state (companies)	Influential unions in public sector only/ lock-in effect	(until 1994) dependent central bank
Italy	No executive dominance	Parliamentary regime	Uncertain control in public sector/ industry bargaining 'controlled decentralisation' in private sector dominated by export-exposed metalworkers	Influential unions/ lock-in effect	(until 1993) partly dependent central bank
Germany	Executive dominance*	Parliamentary regime with strong executive prerogatives	Tight control over civil servants (less control over public employees); industry bargaining and 'controlled decentralisation' in private sector dominated by export-oriented industry unions	Influential unions/ lock-in effect	Independent, inflation-averse central bank
United Kingdom	Executive dominance	Executive regime	De-centralised bargaining in public sector within budget limits/ de-centralised bargaining in private sector	Executive dominance/ weak lock-in effect	(until 1997) dependent central bank

* Germany is certainly characterised by a strong executive (even if less strong than the British of French executives)

It is true that French policy-makers justified the *franc fort* policy as well as convergence with a strategy of so-called 'competitive disinflation'. At least initially, this strategy had limited effects (Blanchard and Muet 1993; Fitoussi 1993). The policy was certainly not conducive to electoral success. Consecutive governments suffered dramatic defeats. This further corroborates the institutionalist argument. It was precisely its institutional capability that allowed the French government to pursue long-term pro-active policies, while the Italian government's institutional weakness resulted in re-active and short-term policies.

It might be argued that the right's overwhelming majority during the 1993-97 legislative period was more important than the institutional factors underpinning executive dominance. But the relative continuity of monetary, public wage and budgetary policy under four different parliamentary majorities since 1983, including a minority government in 1986-88, suggests that the institutionalist approach provides a better explanation.

To sum up, consistent with the approach to institutions taken here, neither the pursuit of convergence policies nor the 1982-83 policy reversal was *inevitable*. This is also reflected in the fact that the French policy reversal of the early 1980s and the convergence policies of the 1990s have received widely differing explanations (Cameron 1995, Oatley 1997; Loriaux 1991; Aeschimann and Riché 1996; Védrine 1996). This is consistent with the historical-institutionalist argument defended in this study. As repeatedly pointed out, the 'capability' to act does not prejudge what *kind* of policy governments will pursue. However, if the government realises that policies will run into an international constraint at some point and if it is in a position to prevent this, then it seems likely that the government will pursue system-conforming policies. Successive Italian governments – quite apart from their willingness – never had the ability to do this. The comparison of Italian policies and institutions hence confirms the usefulness of the institutionalist approach.

7.3 Historical Institutionalism, Institutional Convergence and Directions for Future Research

Having provided further evidence for the heuristic usefulness of the historical-institutionalist approach, it is necessary to discuss the implications of this case study for theory. The results of the case study also provide further insights into current academic debates concerning economic internationalisation and domestic convergence.

Historical Institutionalism, Executive Strength and Macroeconomic Policy-Making

Historical institutionalist analysis is based on a few claims, namely,

> that political processes can best be understood if they are studied over time; that structural constraints on individual actions, especially those emanating from government, are important sources of political behavior; and that the detailed investigation of carefully chosen, comparatively informed case studies is a powerful tool for uncovering the sources of political change (Pierson 1993: 596).

This is exactly what this study sought to do. The most important claims of the historical-institutionalist approach regarding institutional change are neatly summarised in the following quote:

> Institutional structures do not respond in any rapid and fluid way to alteration in the domestic or international environment. Change is difficult. Incongruence between the needs and expressed demands of the state and various societal groups is the norm, not the exception. Institutional change is episodic and dramatic rather than continuous and incremental. Crises are of central importance (Krasner 1984: 234).

All of these claims have generally been confirmed by this study. First, Chapter 2 argued at length that various domestic institutions had an independent effect on policy outcomes in the past. In Section 7.1 it was argued that, even though the logic of domestic institutions was overridden by external pressure, domestic institutions still had an impact on the content and nature of policy change. This shows that institutions are more than just simple epiphenomena, that is, they are not only the mere reflection of the domestic balance of power between competing groups or of the pressures of economic internationalisation. Second, institutions were also shown to be inert, that is, they were to a certain degree resistant to change despite domestic and international pressure. The continued executive weakness in fiscal policy-making is only the most striking example. Third, institutional change is sporadic (rather than continuous), usually takes place in response to crises and – when it does happen – tends to be circumscribed by pre-existing institutions. This study of Italian macroeconomic reform demonstrated that increasing international pressure had to be supplemented with outright crisis in order to bring about the institutional reform of, for example, the wage bargaining and pension regimes. As argued in Chapters 4 and 5, in both cases, pre-existing institutions limited possible institutional outcomes. The (failed) reform of formal-political institutions also clearly exhibited the importance of pre-existing institutional configurations. It seems however that the monetary policy area, where the central bank had gradually increased its *de facto* independence before being granted full independence, is the exception that confirms the rule with respect to *institutional* change, which usually is gradual and path-dependent. On the whole, though, the prediction that institutional change proceeds through 'punctuated equilibria' rather than in a gradualist fashion was confirmed (Krasner 1984: 240-44).

The study also confirmed the path-dependent character of institutional change. An understanding of institutional change required more than a purely actor-oriented or systemic-functionalist analysis.

> An institutionalist perspective regards enduring institutional structures as the building blocks of social and political life [...]. Historical developments are path dependent; once certain choices are made, they constrain future possibilities. The range of options available to policymakers at any given point in time is a function of institutional capabilities that were put in place in some earlier period, possibly in response to very different pressures (Krasner 1988: 67).

Italian macroeconomic policy during 1992-97 confirms this view. A weak government was not able to transform itself into a strong one; a universal pension system could not be transformed into a private, purely contribution-based system; the industrial relations regime could not be changed to a decentralised regime due to the existence of medium-strength trade unions. It was only in the area of monetary policy where institutional change was relatively easy. This was due to the already greater insulation of monetary policy-making as well as due to the uncertainty regarding distributional consequences resulting from institutional change, especially for interest groups (for theoretical argument see Gowa 1988) and especially in a context of increased economic openness.

In short, the changes in Italian macroeconomic policy and policy-making institutions in the 1990s are on the whole well explained by historical institutionalism in that the latter emphasises the importance of pre-existing domestic political and economic institutions (independent influence, inertia), the nature of change ('punctualist' change) and even the direction of change (path-dependent change).[10]

As regards the central concept of executive strength, the study provides a differentiated picture. A common criticism directed against the 'state' strength approach is that it does not precisely define the basis of 'state strength'.

> If statist approaches are to avoid the tautology of defining capacity in terms of the ability to realize objectives, they must be able to specify ex ante the state structures that are associated with successful reform. What are the organizational bases of state autonomy? (Haggard and Kaufman 1992: 20).

This problem was addressed by drawing on the results of statistical and comparative studies that specified the institutional conditions for successful macroeconomic performance in the various policy areas and by analysing in a case-sensitive manner how and why certain Italian institutions were associated with unsatisfactory macroeconomic performance.

Nonetheless, the study strongly suggests a differentiated view of executive strength according to which a government is not strong *per se* but its strength is co-determined by the specific characteristics of the policy areas (*cf.* Section 1.4). Moreover, executive strength can vary within a given policy area (for example, budgetary policy in 1993 as against 1995). All this suggests the need for a historically sensitive and differentiated approach to executive strength. Executive strength and autonomy are not absolute but should be regarded as structural potential that can however vary across areas *as well as* across time. As Skocpol (1985) put it:

> '[S]tate autonomy' is not a fixed structural feature of any governmental system. It can come and go. This is true not only because crises may precipitate the formulation of official strategies and policies by elites or administrators who otherwise might not mobilize their own potentials for autonomous action [...]. It is also true because the very *structural potentials* for autonomous state actions change over time [...]. Thus, although cross-national research can indicate in general terms whether a governmental system has 'stronger' or 'weaker' tendencies toward autonomous state action, the full potential of this concept can be realized only in truly historical studies that are sensitive to structural variations and conjunctural changes within given polities (p. 14).

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[10] It should be noted that on the whole strategic elites (mostly prime minister and technocrats) were the *agents* of change and that Italian macroeconomic reform was a top-down reform in that other

By analysing 'structural variation' and 'conjunctural change', this study confirmed the necessity of not reifying the *institutionalist* basis of executive strength. Although institutional factors structure social life and processes and hence are important, they do not do so in an absolute way (Katzenstein 1977a, 1977b). The case study of Italian macroeconomic reform was a case in point, as it demonstrated how 'state' strength was affected by international constraints and pressure and how it varied across policy areas and time.

Further Implications for Institutionalist Theory

The above discussion suggests some interesting theoretical implications. Institutionalist theory and studies should not so much ask 'whether institutions matter', but rather 'when and how institutions matter' (Weaver and Rockman 1993; Kent 1993). This is where the issue of causal complexity and relations arises. This study demonstrated that the nature of institutional effects is potentially affected by the presence or absence of other institutional as well as the non-institutional factors. In other words, it demonstrated that there often is no simple one-to-one relationship between institutions and policies.

It is true that, statistically speaking, certain institutions have 'on-average' effects. For example, for the reasons discussed in Chapter 2, central bank independence does on average lead to lower inflation. This is en empirical fact (and a very plausible one too). The same is true for other institutions, such as the budgetary policy regime, the wage bargaining regime, and the pension regime in relation to respective policy outcomes. However, in a specific case, the presence of a specific institution does not necessarily lead to the occurrence of an 'average' policy effect. This is so because the effects of other intervening factors are not averaged out as in the case of large-sample statistical studies. This makes it possible that institutions have differential effects depending on the presence or absence of other factors. Hence the question 'when and how institutions matter' (that is, under what circumstances) arises. The analysis of Italian macroeconomic policy provides sufficient evidence in this respect.

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actors (parliament, parties, public employees, trade unions) were forced to respond to the government's agenda setting.

For example, on average it is certainly true that a dependent central bank is more conducive to higher inflation than an independent central bank. However, the analysis of French monetary policy showed that a strong, autonomous government can act as a 'compensating factor' that reduces the effect central bank dependence would normally have. By contrast, the Italian experience suggests that a weak government does not 'compensate' for central bank dependence. In fact, it is plausible to assume that government weakness magnifies central bank dependence through the inflationary effects government weakness creates in other areas, such as budgetary and public wage policy. In fact, it could even be argued that – at least under the relatively permissive international conditions Italy faced during the 1970s – central bank dependence created a disincentive for the (weak) Italian government to control budgetary policy more tightly. This is due to the fact that successive Italian governments were aware that their control over monetary policy would eventually allow them to reduce government debt with the help of a loose monetary policy - rather than having to pursue politically difficult debt reduction. This suggests the existence of an 'enhancing' interaction effect: the presence of a weak government reinforces the causal impact central bank dependence has on inflation, while a strong government reduces this impact. In other words, the strength of one variable (central bank dependence) is enhanced or reduced depending on the presence of another factor (government strength).

Similar observations can be made with regard to the effects of wage bargaining institutions. The nature of the monetary regime strongly shapes the effects wage bargaining institutions have on wage outcomes. While 'intermediate' industry-level bargaining can be expected to lead to competition between industries (and possibly different groups within industries), the German – and recently the Italian - experience suggest that a hard-currency regime modifies the effect wage bargaining institutions have on medium-term wage policy. Indeed, as indicated in Chapter 5, highly centralised collective bargaining arrangement may even be *more* inflationary under a hard-currency regime than co-ordinated, intermediate industry bargaining. In the absence of a hard currency regime, the opposite situation may occur: the centralised system may perform better than the industry bargaining system (see Iversen 1999). Again, the Italian case shows that private sector wage bargaining arrangements, which would not normally not be deemed to be conducive to a moderate wage policy as a result of the relatively high level of fragmentation, were very effective in producing low inflation under a hard-currency regime (as it emerged after the 1992-93 central bank reforms).

Finally, the presence or absence of non-institutional factors can also affect the kind of effect institutions have on policies. The increase of executive strength in various policy areas as a result of international political and economic pressure is only the most striking example. Similarly, the relative *de facto* increase in central bank autonomy in the 1980s was both the result of Italy's ERM membership and a decreasingly permissive international economic environment. Even though from a purely institutional point of view the Bank of Italy was still dependent on the government (and the government itself was weak), the institutional effect of central bank dependence with respect to inflation was subdued relative to what it would have been in the presence of a more permissive international environment.

In short, these examples show that case-oriented institutionalist studies need to take into account the varying causal effects institutions can have under varying circumstances – whether these circumstances result from institutional or non-institutional factors. A whole variety of varying causal relationships (such as interaction effects, spurious relations, mutually reinforcing effects, and so on) can exist among different individually relevant institutional (and non-institutional) variables. Hence, especially when the objective is to understand one specific case, it is imperative to check for the existence of these effects, rather than dismiss the importance of domestic institutions outright. This theoretical implication leads to a practical implications: case-oriented studies need to be sensitive to the potential existence of complex causal relations between institutional and non-institutional variables; and research – rather than dismissing the importance of institutions when the actual effects of the latter seem to contradict the predictions made by statistical studies – would therefore be well advised to consider likely causal complexity, and allow for the possibility that there does not exist a simple one-to-one relationship between independent (institutional) variables and dependent (policy) variables. Hence this study also serves as a reminder that social reality is complex, but not inexplicable; rather, its sometimes apparently inexplicable nature may be the result of our limited understanding of complex causal relationships.

Current Academic Debates and Italian Macroeconomic Policy Convergence

Recent academic debate in International Political Economy has paid a great deal of attention to how economic internationalisation affects domestic politics, policies and institutions (Berger and Dore 1996; Keohane and Milner 1996; Garrett 1998). In particular, a debate has revolved around whether economic internationalisation leads to institutional convergence.[11] On the one hand, there is the systemic-functionalist argument according to which similar international pressures lead to policy as well as institutional convergence - and the emergence of a best-practice model (Dore 2000; Boyer 1996; Boltho 1996; Regini 2000; Crouch and Streeck 1997; Rhodes and Apeldoorn 1997; Berger and Dore 1996). On the other hand, the institutionalist approach holds that policy and institutional change will differ due to the existence of pre-existing domestic institutions and that institutional change is at least partly limited by path dependency (*cf.* Scharpf 1991; Ikenberry 1988).

The question is then to what extent Italy experienced convergence of its economic policy-making regime in the 1990s. Rhodes (1997), for example, has argued that under pressure from the new international economic regime introduced with EMU (that is, no devaluation *vis-à-vis* main trading partners, inflation-averse monetary policy), EMU member countries have converged on a German-Dutch-Austrian model of 'competitive corporatism'. By contrast, at least with respect to labour relations and pension policy, Regini (1999), though acknowledging that there are centripetal-functionalist forces towards greater homogeneity, argues that the closer a country gets to the convergence point the more indeterminate and less predictable future policies and institutional change become.

Prima facie the convergence thesis is eminently plausible. Empirically, it was primarily countries that had not been part of the German-mark zone but were eager to join EMU that adopted 'national pacts' and underwent the greatest degree of institutional change in the 1990s (Pochet 1998). No - or much less - reform took place in countries that had already been members of the German-mark zone (such as the Netherlands or Austria) and in Germany itself of course (Thelen 2000). Similarly, change in 'opt-out' countries (Denmark, Sweden, UK) was also limited, at least

[11] As regards Italian monetary and fiscal policy, *policy* convergence was of course required by the TEU.

during the 1990s. Theoretically,[12] it makes sense to expect that the institutionalisation of a hard currency and hard fiscal regime (see discussion of Stability Pact below) will require a re-orientation of economic strategy towards an export-oriented policy based on 'competitive disinflation' as well as an adjustment of domestic institutions in order to cope with the new constraints.

This is of course an old argument. Katzenstein (1984, 1985), in his seminal work on small, open European economies, demonstrated that domestic institutions and policies were historically evolved responses to the pressure of the international economic environment and especially trade integration. Small, open economies (such as Austria, Switzerland, the Netherlands and the Scandinavian countries) were subject to much greater international constraints than larger, more closed economies (such as France, Italy, the UK and Germany). Therefore, the former tended to develop a set of domestic institutions that allowed these countries to thrive in the face of international constraints. However, today the large European economies are characterised by a degree of economic integration similar to the one of smaller European economies in the 1950s and 1960s. Hence it is fair to say that "[a]ll European economies are now subordinate to international markets in a way that has long been the case for the Belgians and Danes" (Crouch 1994: 194). It might even be argued that, as a result of financial liberalisation in the 1980s, the large European economies are subject to even greater constraints than the small, open economies in the decades before. Hence it is not surprising to expect that large, soft-currency countries would have to adapt to the functional pressure stemming from greater economic integration.

The case study of Italian macroeconomic policy and more particularly of domestic-institutional change in the 1990s makes it possible to make some observations concerning the validity of convergence theories. Budgetary *policy* reform was 'imposed' by both international markets and the Maastricht criteria. If the institutional reform of the monetary regime was stipulated by the TEU, this was not the case with regard to the budgetary policy *regime*. Undoubtedly, though, substantial institutional change would have been difficult to realise as a result of the micro-distributional character of budgetary policy and due to executive weakness. As

[12] As already pointed out, a number of studies have demonstrated that - under conditions of a hard currency regime - a system of industry-level bargaining that allows for co-ordination across sectors

argued in Section 3.1, there were no substantial reforms of the budgetary policy regime in the 1990s in terms of modifying the crucial executive-legislature relationship. This means that on an institutional level Italy has certainly not experienced a convergence on the better performing budgetary regimes, such as the French, German or British ones. As pointed out, this was mainly the result of the path-dependent character of domestic-institutional change.

With regard to pension policy, the Italian system should have been expected to produce a very gradual evolution in terms of both policies and institutional change. Interestingly the most fundamental institutional change took place in this area with the switch from an earnings-related to a contribution-based system and the introduction of complementary pensions. Other European countries also underwent change in terms of the homogenisation of pension schemes for public and private employees, the rise in retirement age and complementary pensions (*Il Sole 24 Ore*, 23 October 2000). However, at a moment when other European countries were searching for an institutional equilibrium (like France and Germany in 2000), it is hard to talk of convergence as this precisely implies the notion of 'institutional equilibrium'. However, the (gradual) change towards a contribution-based system in Italy makes the Italian pension system different from at least the other two big continental European economies. In short, so far institutional changes in the pension area point towards divergence rather than convergence.

Public and private wage policy also underwent important changes. Similar to other European countries (Pochet 1998), Italy has adopted a system of 'organised decentralisation' as opposed to a system of 'disorganised decentralisation' (Traxler 1995).[13] The institutionalisation of a national incomes policy in Italy seems surprising. However, to the extent that change was necessary, it was clear that private sector company-level and decentralised public pay bargaining was unlikely to emerge in Italy, given the existence of relatively strong but divided confederal unions in both the private and public sector. The unions would never have been prepared to give up the *scala mobile* in favour of decentralised bargaining.[14] Overall, it is fair to say that the Italian system of 'organised decentralisation' of the mid-1990s – despite formal differences (such as explicit inflation targeting) - largely resembles the system

leads to better inflation outcomes than centralised peak-level bargaining (Iversen 1999, 2000; Pontusson 2000; Soskice 2000; also Chapter 4).

[13] Also described as 'centralised decentralization' (Visser 1997).

of (less formally) co-ordinated industry bargaining that characterises most of the other hard-currency countries.[15]

As for public sector wage bargaining, the Italian regime evolved towards greater centralisation of *bargaining* (through the creation of ARAN) and preserved the centralisation of *wage setting* (that is, essentially the national level) and thus continues to represent the continental European type of public sector wage determination (OECD 1997a). In terms of the two models, that is, Anglo-Saxon-Scandinavian decentralisation versus continental-European centralisation, the latter has prevailed. However, there certainly has not been full convergence on the 'stronger' French or German models within the group of centralised regimes (Table 7-1). More specifically, despite the high degree of centralisation, Italy did not develop the same degree of formal (let alone practical) executive dominance as exists in France and to a lesser degree in Germany (Elliot *et al.* 1999; OECD 1994c). The existence of a weak executive largely precluded the development towards a 'strong' continental model, while the relative strength of confederal unions would have made it difficult to introduce an Anglo-Saxon- or Scandinavian-style decentralised system. Thus, despite attempts to achieve it, institutional convergence on the 'stronger' continental models was limited.

With respect to the monetary policy regime the Italian experience provides perhaps the most limited insights as the direction and nature of institutional reform was largely pre-determined by TEU. The more general tendency to grant independence to national central banks in an age of increasing capital mobility seems to have been at work in Italy even before Maastricht. Nonetheless the Italian experience is instructive in that (apart from the 1981 reforms) independence was not established through legislation until 1992-93. An already relatively high degree of *de facto* central bank independence and uncertain distributional consequences of

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[14] Interview with CGIL official, 18 October 2000, Rome.

[15] Recent studies have talked of 'dual convergence' or 'co-convergence' in this area (Iversen and Pontusson 2000: 3), meaning that the wage-bargaining-monetary regimes of the advanced capitalist countries are presently converging on two models. While (in Soskice's terms) 'co-ordinated market economies' converge towards a model of 'organised decentralisation' (Traxler 1995), the 'liberal market economies' converge towards the U.S. model of decentralised bargaining. This suggests a 'modified' convergence thesis according to which there is a "trend toward convergence on the German model of coordinated industry-level bargaining among the coordinated market economies [...] and, similarly, a trend towards convergence on the dual American model of firm-level bargaining and a large non-union sector among the liberal market economies" (Iversen and Pontusson 2000: 7). The Italian experience of the 1990s certainly fits this pattern by falling into the category of co-ordinated market economies.

monetary policy and hence the limited use partisan interests can make of monetary policy also make this policy area qualitatively different (Gowa 1988). This made central bank reform and institutional convergence relatively easy to achieve politically. Even a weak government like the Italian one was able to bring about quite substantial institutional change with relative ease – at least relative to other areas such as pension and budgetary policy. In short, with regard to monetary policy, there has been both institutional and policy convergence.

What then does the case study of Italy contribute to the convergence debate? Italy went some way in terms of convergence towards the Germanic model[16] of 'competitive corporatism' in the 1990s. Convergence was most pronounced in the private sector wage bargaining and monetary policy regimes. There was much less convergence with respect to the public wage bargaining and budgetary policy regimes, while with regard to pension policy there was in fact divergence. Revealingly, where *institutional* convergence was achieved (monetary and private wage bargaining), executive strength did not matter very much, and where convergence was limited (budgetary and public wage bargaining), this reflected the relevance of path dependency and more particularly the pre-existence of a weak executive.

In short, this suggests that while external pressures did exercise a certain functional logic, a high degree of institutional convergence did not take place, largely as a result of the importance of pre-existing institutions (and especially a weak executive). The Italian case thus at best provides limited support for the convergence thesis.

Future Directions of Research

In order to test the argument proposed here in terms of the relevance of domestic institutions and its interaction with international pressure in the context of 'normal' and 'extraordinary' politics, it would be interesting to conduct a study of comparative crisis-decision-making where two or more 'weak states' are compared (such as Greece, Italy and Belgium) – rather than a weak with a strong one as in this study. This would make it possible to test to what extent the insights of this study can be

[16] This model is under attack itself and is subject to change. Note also that there are of course various combinations of domestic institutions that are compatible with a hard-currency strategy (*cf.* France and Germany; Table 7-1).

extended to other cases. Furthermore, it would be interesting to analyse systematically cases that share at least some of the features of the Italian system but have fared much better in terms of macroeconomic performance, such as the relative pluralist party systems in Denmark and the Netherlands (*cf.* Commission of the European Communities 1995; Iversen and Thygesen 1998; Visser 1997). These different comparative strategies - if successful - would improve the explanatory scope of the arguments advanced in this study.

Another interesting direction concerns the possible importance of ideas broadly speaking and a possible 'marriage' between ideas and institutions (Adler and Haas 1992; Hall 1993, 1997; Keohane and Goldstein 1993). From Banfield's 'amoral familialism' (1958) to Putnam's examination of 'civic culture' (1993), various authors have argued that culture matters in Italian economic and political development. Indeed, some might argue that certain features of Italian politics exhibit continuity across time and are therefore better explained with reference to 'culture'. The tradition of *trasformismo*,[17] which was an important characteristic of both the Liberal state (1860-1922) and arguably the First Republic (Clark 1996; Smith 1997), and the history of high public debt and inflation in periods preceding the First Republic (Fratianni and Spinelli 1997), could be cited as examples.

However, that 'culture' should be so pervasive and important a phenomenon sounds implausible. Moreover, on an anecdotal level, comparisons within 'cultures', such as between the Weimar Republic and the Federal Republic of Germany or the 4th Republic and the 5th Republic in France, suggest that institutions make a difference. Nonetheless, without a historically detailed inquiry into, for example, the causes of high debt and inflation under varying political regimes in Italy, the 'culture-matters' hypothesis cannot be convincingly discarded. Despite the notorious difficulty to 'capture' them (Ross 1997), both culture and ideas certainly deserve greater scholarly attention (Jacobsen 1995; Blyth 1997; McNamara 1998).

Finally, the focus of this study has been on how institutions structure political conflict over both policies and institutional change. The institutionalist approach addresses the *capacity* of 'states' but not their *motivations*. Undoubtedly, even though policy preferences are not exclusively determined by institutions, they are

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[17] *Trasformismo* is a practice whereby the government manages to stay in office by distributing favours and patronage to political parties and societal groups. This practice emerged under the Liberal

certainly influenced by them. A more detailed theoretical and empirical analysis of exactly how and why institutions structure and provide incentives for a certain course of action deserves greater theoretical attention beyond what has been proposed here in terms of concepts such as encompassingness, centralisation, hierarchy, strength and autonomy.

7.4 The Question of Sustainability: Prospects and Challenges

After having discussed the theoretical implications of the results this study has generated, I will allow myself to make a few observations concerning problems and prospects of institutional reform and their possible implications for the future of Italian economic policy. If the thesis according to which Italian macroeconomic policy moves in cycles and is strongly determined by domestic institutions is correct, an analysis of Italian policy-making institutions should provide clues as to whether Italy is about to move towards a new macroeconomic cycle or – this time – is bound for more sustainable macroeconomic development (see Section 7.1).

There is not enough space to evaluate in detail whether current policies will guarantee the sustainability of Italian macroeconomic policy and EMU membership (see Spaventa and Chiorazzo 2000: chapter 4; *Presidenza del Consiglio dei Ministri* 1998; Reviglio 1998). Hence only a brief discussion of various possible scenarios will be provided. Primarily, sustainability will be discussed under the aspect of the conduciveness of domestic institutions to sustainable macroeconomic policies in the context of EMU membership and economic internationalisation. Other important socio-economic and political factors (such as labour market reforms other than wage bargaining, investment and technology policies, efficiency of public administration and so on) that will certainly influence sustainability cannot be analysed here.

Political Institutions

This study suggests that executive strength is central for achieving sustainable, long-term macroeconomic policies. As pointed out, in parliamentary political systems, electoral system, executive dominance, parliamentary strength, government longevity and government stability tend to be associated with each other (Lijphart

State and, despite major constitutional changes over the past 140 years, has – arguably - not disappeared to this day.

1999). In particular, executive weakness has been related to fragmentation. Moreover, 'strong' political-institutional features tend to be associated with 'strong' budgetary rules (Hallerberg and Von Hagen 1999). This suggests that weakness reinforces weakness, while strength increases strength. This is easy to understand as a strong executive can change budgetary procedures with relative ease, while strong parliaments (and hence weak executives) tend to prevent such a strengthening of the executive in parliament-dominated systems.

As for Italy, moderate centre-right and moderate centre-left coalitions emerged after the 1993 electoral reform. However, this is unlikely to suffice as these coalitions are highly heterogeneous and thus make the Italian political system still resemble more closely an assembly government than a working government type (Sartori 1997 [1994]: chapter 6; *cf.* Chapter 2), even if the new system allows for alternation and greater competition. The analysis of budgetary politics and policies between 1992-98 suggests that the institutional capacity of the executive is unlikely to be sufficient to produce responsible, long-term-oriented budgetary policies. At the same time, it is very unlikely that Italy - in the absence of yet another crisis - will implement sufficient (constitutional) political-institutional change as political actors (mainly parties) have largely regained control of the political agenda and Italy has returned to 'normal politics' as defined in Section 7.1.

This is not the place to delve into the politics of political-institutional reform. However, with the reduced usefulness of referendums in bringing about constitutional-institutional change (Donovan 1998) and with the lack of will on the part of the political parties to realise reforms (failure of *Bicamerale* in June 1998), neither institutional[18] nor electoral[19] reform is likely to take place (Bardi and Rhodes

[18] In addition to the practical problems of realising reform towards a more 'reductive' electoral system, some analysts have cautioned as to the practical relevance of electoral reform (Gambetta and Warner 1995). On this account, problems primarily relate to: (1) a transitional period and a lagged effect; (2) the claim that 50 years of *party-cratic* domination can be eliminated by simple institutional tinkering; and (3) the raising of unrealistic hopes. While it is certainly justified to caution against a quick 'fix-everything', this study suggests that electoral reform and the resulting strengthening of the executive not only lies at the very heart of 'responsible' macroeconomic policy but also that under present circumstances it is the only realistic way to improve the current policy-making system. This is especially true in that it is quite plausible that multi-partyism is incompatible with a presidential system in terms of producing sustainable and co-ordinated policies (*cf.* Sartori 1997 [1994]: chapter 6 and section 11.2). This would preclude wider constitutional reforms as a way forward, regardless of the practical difficulties involved in achieving such a change.

[19] Any compromise that would substantially reduce the number of parliamentary parties would be unlikely. If fragmentation is crucial in determining executive strength, then the majority bonus - as discussed, for example, in autumn 2000 - would not result in the strengthening of the executive, as it is not the *size of the majority* that counts but its *fragmentation*.

1998; Gilbert and Pasquino 2000). The continued presence of small parties and the need to secure intra-coalitional compromise make the likelihood of achieving a more 'reductive' electoral system remote.

What is true for the change from a proportional to a majoritarian regime also tends to be true for any electoral reform that directly or indirectly aims at restricting the number of effective parliamentary parties. Hence it is not surprising that under a proportional electoral system "[f]undamental changes are rare and arise only in extraordinary historical situations" (Nohlen 1984b: 218). Only those changes that will not diminish the electoral fortunes of the political parties can be expected to find the approval of parliament. In the absence of further electoral reform, the pursuit of long-term, sustainable policies in areas such as budgetary, public wage and pension policy (that is, where a strong executive is important) seems difficult to achieve.

Budgetary Procedures

A second area of institutional reform relevant to fiscal performance concerns budgetary procedures (Milesi-Ferretti 1997). The implications of the theoretical and empirical arguments are clear. Centralisation, greater hierarchy and transparency of the budgetary process are all conducive to greater executive control of budgetary policy. There have been quite a number of proposals in this respect.[20] Nonetheless, only little reform was achieved.

The strengthening of the executive in budgetary policy-making, especially through the reforms of the early 1990s (Verzichelli 1999a; Felsen 1999), has undoubtedly resulted in a greater rationalisation of the budgetary process at both the formulation and parliamentary stage. Nonetheless, the detailed historical analysis of budgetary policy-making in Chapter 3 suggests that it was primarily external pressure that strengthened executive control and power.

In May 1997 another reform took place. With law no. 94 of 1997 (introduced with 1998 budget) the budget was divided into a political and an administrative budget with the aim of re-orienting parliamentary approval towards broad functions and objectives of economic policy. New basic accounting rules were introduced and the budget preparation procedures tightened. This would leave the government and

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[20] See proposals by the *Commissione per la Riforma dei Balanci Pubblici* (1994) and by academics such as Alesina *et al.* (1998), Von Hagen and Harden (1994).

ministries free to allocate items within limits determined by parliament. It also foresaw the centralisation of budget responsibility through the merging of the *Ministero del Tesoro* and the *Ministero del Bilancio*. This reform certainly increased the transparency, efficiency and autonomy of the budgetary process (Felsen 1999). The greater centralisation at the formulation stage and the greater transparency at the parliamentary stage will allow programme-based (in place of incremental) budgeting as well reduce opportunities for lobbying - both of which should facilitate the realisation of budget targets. Another recent reform introduced in 1999 similarly sought to alleviate some of the procedural problems regarding the budgetary process (*cf.* Degni 1999: 48; *Gazetta Ufficiale*, No.151, 30 June 1999). Both reforms though left untouched the issue of executive-legislature relations in budgetary policy (especially non-amendability).[21]

However, given the results of this study, it seems that the 'political' strengthening of the executive is crucial and prior. As discussed above, for rules to be effective, the strengthening of the executive relative to parliament and parliamentary (majority) parties is required (*cf.* De Ioanna 1993: chapter 16). In other words, rules at the parliamentary and implementation stages will only give the executive greater potential greater control over budgetary legislation and outcomes if it is strengthened politically. This is so because the ability (and willingness) to use procedural means will ultimately depend on the willingness of the executive to discipline its parliamentary majority; and this would presumably require that all majority parties regard their interests as being bound up with the government's electoral fortunes (like in Germany or the UK). This leads back to the question of political-institutional reform discussed in the previous section. Once more this does not bode well with regard to future financial discipline. It is however possible that external pressure in the form of the Pact for Stability and Growth[22] will permanently

[21] In fact, the *relatore* pointed out that the reform would not only increase the initiative power of the executive but also the amendment power of parliament (*Senato della Repubblica, Resconti dell'Assemblea*, 19 November 1996). Also, the number of amendments to the various budget documents between 1997-99 was 17.751, that is, 10.254 in commission and 7.497 in *aula* (Degni 1999: 64). This shows the relative weakness of the executive relative to parliament and makes the amendability issue extremely important.

[22] The Stability Pact came into force on 1 January 1999 and is meant to ensure the long-term sustainability of fiscal policies under EMU. The Stability Pact foresees financial sanctions for countries with budget deficits larger than three per cent, unless there has been a decline in real GDP of more than two per cent over the preceding year. (If there has been a decline of more than 0.75 per cent but less than two per cent, the Council of Ministers decides on the basis of the suddenness of the decline in economic growth relative to earlier trends whether to impose sanctions or not.) Decisions

compensate for executive weakness and lead to more sustainable budgetary policies (see below for more detailed discussion).

Pension and Welfare Policy

As regards the sustainability of the current Italian pension regime, the judgements of observers differ (Gronchi 1996; Pizutti 1998; Cazzola 1999; for a more upbeat assessment see OECD *Economic Surveys Italy* 2000: part III). At the very least, social welfare and in particular pension expenditure will be a critical factor in determining Italy's medium to long-term budgetary performance. Indeed many industrialised economies will face this problem. However, in the continued absence of political-institutional reform (and more specifically in the absence of a considerable strengthening of the executive), further pension reform in Italy will be difficult to achieve unless there is concrete international pressure. In the meantime, the tendency to downplay problems and the temptation of multi-party coalition governments to delay incisive reform is likely to prevail. Hence reform will be difficult to achieve and, if achieved, is likely to be gradual in its effects. Policy reform is hence bound to remain intermittent, gradual, piecemeal and reactive. This is the result of the Italian government's lack of institutional strength necessary to pursue long-term, anticipatory policies and the result of the presence of relatively strong trade unions that act as defenders of acquired rights.

Public and Private Wage Policy-Making

As for industrial relations, a number of issues need to be addressed with regard to competitiveness (internal labour market issues, adoption of new technology, investment in employee skills and so on). However, given that in the absence of the exchange rate tool, wage policy is literally the only instrument to influence economy-wide price levels, wage policy will remain more important than ever with regard to inflation and international competitiveness.

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will be taken with a qualified majority. If a country concerned is found to have an 'excessive' deficit, the Council can call on that country to take effective measures within four months.
The sanctions comprise an interest-free deposit of 0.2 per cent of GDP that will be payable in the first year; 0.1 per cent of GDP is payable every year for each percentage point above the three-per-cent mark. If the budget deficit is still above three-per-cent after two years, the non interest-bearing deposit automatically becomes a fine (*cf.* Gros and Thygesen: 341-346).

As regards private sector wage policy, the policy of wage restraint of the 1990s was quite successful in reducing inflation and preserving competitiveness in the wake of the 1992 devaluation. As Iversen (1999) has convincingly argued, industry unionism – if dominated by manufacturing sector unions – is the system most conducive to moderate wage policy in the presence of a non-accommodating monetary policy. The German regime of flexibly co-ordinated wages, for example, is characterised by the long-established wage leadership of the internationally exposed metalworker sector, by workplace representative bodies that are effectively controlled by the confederal unions and by the institutionalisation of monetarism through the *Bundesbank* (Streeck 1994; Crouch 1990).

Italy hence already possesses all the features that are likely to lead to responsible wage policies. In the private sector, wage bargaining is dominated by the (internationally exposed) metalworkers' union, workplace representations are dominated by confederal unions, and the European Central Bank (ECB) has institutionalised monetarism permanently. Confederal division is not likely to matter as the international constraint imposes a limit on what unions can demand, and the strengthening of the confederal unions at the company-level in the private sector should allow avoiding excessive wage drift. Wage pressure and inflation are hence unlikely to emerge from the private sector. The only problem may be the transport sector where the continued strength of non-confederal groups may result in excessive wage increases. Wage policy in this area will be strongly influenced by the ability of the government to control wages.

As for public sector wage bargaining, all the institutional mechanisms are certainly in place (centralisation of bargaining, exclusion of parliament and administrative courts, and so on). Should it turn out that the confederal unions are unable to bring the *cobas* into line and dominate public sector wage bargaining, then the control of public sector wages will depend on the ability (and willingness) of the Italian government to keep public pay growth under control. Whether the 'bargained' system will achieve this is an open question, especially since the government is weak. Compared with the capacity of the French and German governments to control public wages (Bordogna 1992; Dustman and Van Soest 1999), the Italian system - despite the relatively high degree of centralisation – appears weak. While the exclusion of parliament and courts from public sector wage bargaining should allow the executive to control wages if it is *willing* to resist political and societal pressure, in practice it may be unlikely to do so. Given the continued fragmentation and weakness of the Italian executive, moderate public wage policy is hence far from certain.[23]

Overall Evaluation of Policy Sustainability

Studies evaluating whether or not Italy's EMU membership will be sustainable, given current policies, provide a mixed picture with some commentators being optimistic (Spaventa and Chiorazzo 2000; *Presidenza del Consiglio dei Ministri* 1998) and others pessimistic (Cazzola 1999; Reviglio 1998). Based on the above discussion, this study suggests a differentiated view, according to which Italy is likely to experience more difficulties in respecting the fiscal criteria rather than experiencing difficulties on the monetary side.

The transfer of monetary and exchange rate policy to the European Central Bank (ECB) has not only removed these policies from domestic influence but they have also created the impossibility of competitiveness-restoring devaluations and thus the need for Italy to achieve average European inflation rates. Given the strong presence of confederal unions in the exposed manufacturing sector and given the recognition of the external competitiveness constraint, both private and public wage policy can be expected to stay broadly in line with the evolution of wages in other EMU countries. As just argued, this will however be contingent on whether or not the confederal unions are able to keep their public sector affiliates in line. Given the relatively strong position of confederations at the RSU level (in both the private and public sector), and hence the confederations' ability to function effectively as a link between the public and private sectors, continued wage restraint is possible.

As regards fiscal policy, the Stability Pact imposes long-term, quantitative constraints. Hence, the question is whether current policies are on a sustainable course. An important factor with respect to budgetary sustainability is the composition of public debt. Although it is true that Italy was able to increase medium-and long-term debt as a share of total debt throughout the 1990s, Italy - compared to other European countries – still has the highest percentage of short-term debt (OECD *Economic Surveys Italy* 1999: 59-60). This makes Italy more vulnerable to interest rate increases. If current objectives can be realised, Italy will achieve a

[23] The continued debate on future reform - even after the introduction of a new law on public service

cyclically adjusted budget balance in 2003 and a 60 per cent debt-to-GDP ratio sometime after 2010. This will require, however, sustained primary surpluses in the area of 5 per cent of GDP (OECD *Economic Surveys Italy*, 1999, 2000). Given the institutional weaknesses analysed in the previous section, whether or not these targets can be achieved is an open question.

In terms of long-term spending commitments, the future evolution of pension expenditure will also be of crucial importance with respect to fiscal sustainability. Provided that the most recent projections by the *Ragioneria Generale* are correct (see Section 4.4), the effect of future increases of pension spending will be moderate and should not cause too many problems (for more critical view see OECD 1996b; Cazzola 1999). However, given that these projections tend to be subject to major revision, especially in the face demographic changes, which are the most adverse in Italy among all European countries (Commission of the European Communities 1996a), it is clear that the continued domestic-institutional weakness of the Italian government in conjunction with strong unions, which will continue to act as defenders of acquired rights, will make further pension retrenchment difficult from a domestic-institutional point of view.

In sum, if the arguments put forward in this study are correct, one would expect Italy to face considerable problems with regard to the continued respect of the budgetary constraints imposed by the Stability Pact. With regard to inflation and competitiveness in a single-currency area, Italy should be expected to do much better as a result of confederal unions that are more than ever before capable of implementing wage moderation and that are indeed interested in preserving the competitiveness of the Italian economy within the new framework established by EMU.

Final Remarks

In recent contributions Fabbrini (1999, 2000) argued that, due to the failure to bring about substantial institutional change of the political system, Italian politics is poised to revert back to 'normal'. In a detailed analysis of core executive decision-making during 1992-98, the author finds that this period was indeed a transition period characterised by a relatively high degree of executive autonomy and a strengthening

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strikes (law no. 83 of 21 April 2000) - indicates the continued relevance of the problem.

of the position of the prime minister relative to political parties and parliament. Policy reform was possible thanks to increased executive autonomy and power which in turn was the result of external pressure rather than fundamental institutional-constitutional change (similar Hine and Vassallo 1999; Gilbert and Pasquino 2000). Hence a reverting back to the 'normal politics' of *trasformismo*, *frazionismo* and *partitocrazia* should be expected.

More specifically, the fall of the Prodi government in October 1998 signalled the re-assertion of party-parliamentary control. The circumstances surrounding the formation of the D'Alema II government and its fall in December 1999 further confirms this view. With the concomitant transfer of legitimacy from the electorate to parliament, the transition from a *governo governativo* to *governo partico* was realised (Hine and Vassallo 1999; Fabbrini 1999: 147). The less central place of the executive in relation to parliament, less collegiality and lower collegial responsibility at cabinet level and the transition from a electoral mandate towards post-electoral legitimacy indicate this reversal.

This view is consistent with the argument advanced in this study with regard to macroeconomic policy. However, with regard to macroeconomic policy, two caveats are in order: executive strength and its importance with regard to policy outcomes varies across policy sectors; and executive strength is not the only feature that matters with regard to policy outcomes. Hence, on the basis of the detailed empirical analysis of policy and institutional change undertaken in the previous four chapters, this study suggests that the evaluation by Fabbrini - though broadly correct - has to be more differentiated if one is to draw conclusions concerning future macroeconomic performance and possible macroeconomic cycles (see previous two sections).

Nonetheless, executive strength - or rather its absence in the Italian case - remains a crucial feature of the macroeconomic policy-making regime. In budgetary, pension and public wage policy a strong, autonomous government is necessary to resist societal demands and political pressure and, if necessary, to implement adequate reform. While consensus may function as a functional equivalent to executive power, the relatively high level of conflict in Italy suggests that an autonomous and strong executive is central for the sustainability of future macroeconomic policies. As repeatedly argued, budgetary rules may increase an executive's procedural power in budgetary policy-making but is unlikely to be made use of if there is fundamental disagreement within a heterogeneous cabinet at the formulation, ratification and implementation stages. Similarly, low inflation and international competitiveness will depend on the executive's ability to control public sector wages. Finally, a sustainable pension policy would be facilitated by the presence of a strong homogeneous executive able to formulate and implement coherent, long-term-oriented pension reform.

What does this mean with regard to the question of sustainability? EMU membership and the Stability Pact have institutionalised macroeconomic constraints that Italy has to respect. However, if the argument defended in this study is correct, Italy should be expected to experience considerable difficulties in achieving sustainability (especially with regard to budgetary, pension and - to a lesser degree - public wage policy) and certainly much greater difficulties than countries with strong policy-making regimes. Nonetheless, it is possible that the political legitimacy Italian EMU membership enjoys among the Italian public and the Italian elite will help overcome those institutional biases that otherwise would tend to make medium-term macroeconomic policies unsustainable. To this end, Italian macroeconomic policy will continue to be determined by the interaction between a domestic institutional logic and international constraints that tend to clash. Hence a proper understanding of future Italian macroeconomic policies will continue to require the historically and institutionally informed judgement of the observer.

ANNEXES

Annex A: Structure of the Budgetary Process

Table 1 Structure of Government Stage

	Type of Procedure		
	1. Strategically centralized	**2. Decentralised guided**	**3. Decentralised**
Event		**Participants**	
Budget targets and guidelines	Prime Minister (PM) or finance minister (MF)	Cabinet on proposal by MF	Cabinet
Budget bids		Spending ministries	
Compilation of draft	MF, in bilateral negotiations	MF, serving as intermediary between ministers and cabinet	MF, simple collection of bids
Reconciliation	PM or senior cabinet committee	Senior cabinet committee or cabinet	Cabinet
Finalization		Cabinet	

Source: Von Hagen and Harden (1994: 336)

Table 2 Structure of Parliamentary Stage

	Type of Procedure		
	Restrictive	**Intermediate**	**Open**
Scope of amendments	Amendments cannot increase spending or reduce revenues, or certain amendments are not receivable	Amendments cannot change overall balance	No limits on amendments
Relation of upper and lower house	Upper house has no budgetary powers	Lower house has prerogatives over upper house	Lower and house have equal rights
Relation of government and parliament	Government can call vote of confidence, can impose voting procedure on parliament, amendments require consent	Amendments may cause fall government	No special stipulations

Source: Von Hagen and Harden (1994: 338)

Table 3 **Characteristics of the Implementation Stage**

	Type of Procedure		
	Restrictive	**Intermediate**	**Open**
Expenditure Management	Disbursement approval required, spending departments subject to cash limits, MF can block expenditure	Disbursement approval required, and-or spending departments subject to cash limits	Disbursement approval or full authority of spending departments
Transfers of appropriations	Within chapters only	Within chapters unrestricted, between chapters upon approval by MF	Unrestricted
Substantive revisions	By new law and rarely used	By new law, commonly used	By approval of MF

Source: Von Hagen and Harden (1994: 339)

Annex B: Budgetary Policy Measures

Table 1 Annual Budget Bills, 1992-97

FINANCIAL BILL	GOVERN-MENT	DATE OF ADOPTION	STATE SECTOR TARGET IN % OF GDP*	STATE SECTOR OUTCOME IN % OF GDP*	NEW REVENUES (IN BN OF LIRA)	EXPENDITURE CUTS (IN BN OF LIRA)	TOTAL (IN BN OF LIRA)
1992	Andreotti	31.12.91	8.5	10.5	36.500	25.000	61.500
1993	Amato	22.12.92	9.6	9.8	49.500	43.500	93.000
1994	Ciampi	22.12.93	8.7	9.5	3.500	28.000	31.500
1995	Berlusconi	23.12.94	8.0	7.4	21.000	29.000	50.000
1996	Dini	28.12.95	5.8	7.4	17.900	14.600	32.500
1997*	Prodi	23.12.96	3.0	2.7	25.500	37.000	62.500
1998*	Prodi	23.12.97	2.8	2.7	10.000	15.000	25.000

Source: Verzichelli (1999b: 53); OECD *Economic Surveys Italy* [various years]; Bank of Italy, *Abridged Report* [various years]

* refers to general government

Table 2 Mini-Budgets, 1992-97

BUDGET YEAR	GOVERN-MENT	DATE OF ADOPTION	NEW REVENUES (IN BN OF LIRA)	EXPENDITURE CUTS (IN BN OF LIRA)	TOTAL (IN BN OF LIRA)
1992	Amato	July	21.800	8.200	30.000
1993	Ciampi	May	6.800	5.600	12.400
1994	---	---	---	---	---
1995	Dini	February	15.600	5.200	20,800
1996	Prodi	June	5.000	11.000	16.000
1997	Prodi	March	11.100	4.400	15.500

Source: OECD *Economic Surveys Italy* [various years]

Annex C: Changes of the Pension System

Table 1 Changes of the Italian Pension System between 1992 and 1998

	UP TO 1992	1998	STARTING 2000-08	AFTER FULL IMPLEMENTATION
Requirements for elderly pension	60 years of age (M) 55 years of age (W)	63 years of age (M) (1) 58 years of age (W) (1)	starting 2000 65 years 60 years of age (W)	65 (M/W) years of age Early retirement is allowed if age is not lower than 57 years with benefits inversely related to retirement age according go an actuarial correction
Requirement for seniority pension eligibility - private sector employees	35 years of contributions at any age	35 years of contributions and 54 years of age or 36 years of contributions (3)	starting in 2002, 35 years of contributions and 57 years of age or 37 years of contribution (40 years starting in 2008)	
- public sector employees	20 years of contributions at any age	35 years of contributions and 53 years of age or 36 years of contributions (3)	starting in 2004 same conditions required for private sector employees	
-self-employed	35 years of contributions at any age	35 years of contributions and 57 years of age or 40 years of contributions (1)	starting in 2001: 35 years of contributions and 58 years of age or 40 years of contributions	
Indexation	consumer price index (two annual revisions) and real wage changes (one annual revision)	pre-determined benefit in percentage points of reference wage per year of contribution	same as before	same as before
Benefits determination Elderly employees (4)	pre-determined benefit in percentage points of reference wage per year of contribution	gradual extension career period to calculate reference wage (1)	predetermined benefits in percentage points of reference wage per year of contribution	
- reference wage	last 5 years wage (private sector) final wage (public sector) same as before	2 percentage points of reference wage for all categories (2)	same as before	
- percentage points of reference wage	2 (or more for special categories) percentage points of reference wage	2 percentage points of reference wage for all categories (2)	same as before	
Middle-aged employee (5)		combination between predetermined benefit and contribution-based system benefit	same as before	

		calculation using a 'pro-rata' scheme according to the number of working years before and after 1996 (3)		
Young workers (5)				contribution base benefit: according to lie expectancy and to the overall amount of contributions capitalised at the rate of growth of nominal GDP

Source: *Presidenza del Consiglio dei Ministri 1998*

Key: (1) process starting in 1993
(2) process starting in 1995
(3) process starting in 1996
(4) elderly workers: 18 or more years of contributions in 1995
(5) middle age workers; less than 18 years of contributions in 1995
(6) young workers: new workers since 1996

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