

Macroeconomic co-ordination in the euro area: the scope and limits of the open method

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ABSTRACT A co-ordinated approach to fiscal policy in the euro area is desirable from a political economy standpoint if it protects against the harmful side effects which can arise from member states' fiscal policies. At the same time, however, closer economic co-ordination between national governments is perceived by some as a threat to the independence of the European Central Bank and with it the credibility of its price stability mandate. A variant of the open method, which is known as multilateral surveillance, has been assigned the unenviable task of minimizing the costs of macroeconomic co-ordination, while at the same time delivering the benefits. Whilst the open method poses little threat to the independence of the ECB, its effectiveness is contingent, in the absence of legal obligation and the threat of financial penalties, on the impact of peer pressure and consensus-building mechanisms. This paper assesses the potential of these mechanisms and then draws lessons about the scope and limits of the open method in the light of Portugal's recent breach of the Stability and Growth Pact.

KEY WORDS Consensus; economic and monetary union; open method of co-ordination; peer pressure.

INTRODUCTION¹

Henry C. Wallich, a former member of the Board of Governors of the United States Federal Reserve System, famously defined economic policy co-ordination as 'a significant modification of national policies in recognition of international economic interdependence' (Wallich 1985). He contrasted co-ordination with co-operation, with the latter defined in terms of information exchange and consultation amongst policy-makers. By this classification, early blueprints for economic and monetary union (EMU) in the European Economic Community (EEC) envisaged an advanced degree of co-ordination between monetary and fiscal policies. The Werner Report (CEC 1970) called for the creation of a supranational Centre for Economic Decision Making to give instruction to national governments on the conduct of their fiscal policies. When it comes to the final blueprints for EMU, however, the task of classification becomes more onerous. When EMU was eventually launched in the European Union

(EU) in 1999 it eschewed supranational institution-building in the fiscal sphere in favour of, what would later be known as, the open method of co-ordination (Hodson and Maher 2001). The open method was christened at the Lisbon meeting of the European Council in March 2000 and was defined as a 'means of spreading best practice and achieving greater convergence towards the main EU goals' (European Council 2000). The goal in this context is the medium-term budgetary position of close to balance or in surplus, which member states agreed to under the Stability and Growth Pact of 1997. The medium-term rule is designed as a counterweight to the excessive deficit procedure, which is a harder form of co-ordination (Wessels and Linsenmann 2002) that prohibits member states from running budget deficits in excess of 3 per cent of gross domestic product (GDP). While the excessive deficit procedure is enforced with the threat of financial penalties, the medium-term rule is enforced through a process of multilateral surveillance. This annual policy cycle begins in June of each year when the European Council presents conclusions on, and ECOFIN formally addresses, legally non-binding Broad Economic Policy Guidelines to member states and the EU as a whole.² Members of the euro area are then obliged to submit a Stability Programme to ECOFIN between October and December.³ These programmes cover the preceding, current and subsequent three years and contain an adjustment path towards the balanced budget objective and a critical account of underlying assumptions concerning expected economic developments. ECOFIN gives a formal opinion on each member state's programme before the end of February, highlighting any inconsistencies within the plan or between the plan and the Broad Economic Policy Guidelines. If inconsistencies are found, ECOFIN can issue legally non-binding recommendations for corrective action on the basis of a qualified majority vote. In contrast to harder forms of co-ordination, such as the excessive deficit procedure, the open method relies on neither legal obligation nor the threat of financial penalties but rather on the ability of member states to build consensus on the goals of policy and on the effectiveness of peer pressure as a sanction mechanism against non-compliance (Hodson and Maher 2001).

Does the open method correspond to Wallich's definition of economic policy co-ordination or is it closer in spirit to his idea of economic policy cooperation? For some commentators, the open method lacks the necessary firepower to co-ordinate fiscal policies within the euro area. Eichengreen and Wyplosz (1998) criticize the absence of binding measures in EMU's fiscal framework and warn that the consolidation of public finances that preceded the launch of the euro could soon unravel. The implication is that the design of multilateral surveillance owes more to the reluctance of member states to negotiate binding constraints on fiscal policy than it does to the potency of the open method. In opposition to this viewpoint, Hodson and Maher (2001) argue that the open method gives a new take on an old approach to economic policy co-ordination. In their view the open method can be seen as an attempt on the part of member states to balance the need for closer co-ordination with

concerns over the dangers of imposing a one-size-fits-all solution on diverse national economies. Multilateral surveillance, it is implied, is a conscious attempt to avoid the economic instability which could result when twelve heterogeneous economies follow a uniform fiscal policy.

This paper situates these concerns about the effectiveness of the open method within the context of political economy debates on macroeconomic co-ordination under EMU. This task is partly conceptual and partly empirical. As regards the former, the point of departure is that macroeconomic policy co-ordination is an inherently uncertain exercise, which entails costs as well as benefits. The open method, it is argued, provides a means to minimize the costs of co-ordination but it is doubtful whether it can deliver the benefits. This will depend in particular on whether consensus-building and peer pressure can have the desired impact on member states' budgetary decisions. The empirical dimension of the paper deals with developments in Portuguese fiscal policy since the beginning of EMU. In November 2002 Portugal became the first euro area member state to trigger the excessive deficit procedure following the revision of its budgetary balance for the previous year from -2.8 per cent to -4.8 per cent. The deterioration of Portuguese public finances in advance of ECOFIN's warning and the government's subsequent attempts to restore fiscal balance offers five broad lessons about the scope and limitations of the open method. First, willingness to co-ordinate at the political level cannot override the importance of domestic institutions and procedures in the formation of fiscal policy. Second, a willingness to co-ordinate for the sake of co-ordination is not always in the best interests of the member state's economy. Third, the uncertainty which surrounds the measurement of cyclically adjusted balances makes it more difficult to enforce the medium-term fiscal rule. Fourth, the ability of peer pressure to generate debate at the domestic level provides no guarantee that this debate will support compliance with EMU's fiscal provisions. Fifth, the impact of peer pressure as a sanctioning mechanism is undermined when doubts arise about the credibility of the sanctioning body.

The remainder of this paper is divided into four sections. The first begins with a broad-brush overview of the pros and cons of fiscal policy co-ordination under EMU and then investigates the rationale for the open method. The second concentrates on the effectiveness of the open method and reviews the political economy of using peer pressure as a sanction mechanism and promoting consensus over macroeconomic policy. The third section gives an account of Portuguese fiscal policy between 1999 and 2002 and draws lessons for the effectiveness of the open method as an instrument of economic policy co-ordination. The fourth section concludes.

1. THE POLITICAL ECONOMY OF THE OPEN METHOD

In political economy debates, co-ordination is beneficial when the autonomous actions of individuals generate spillover that is harmful to the welfare of others (Mooslechner and Schuerz 1999). Although economists generally agree that

EMU creates fresh channels of fiscal spillover, there has been considerable uncertainty over the merits of macroeconomic policy co-ordination within the euro area. Three sources of uncertainty stand out in particular.

First, there is diagnostic uncertainty over the exact nature of fiscal spillover within the euro area and hence over the form that macroeconomic co-ordination should take. For instance, Buti *et al.* (2001) focus on the negative spillover between member states' budget deficits and the stance of European Central Bank (ECB) monetary policy. Excessive borrowing in one member state will act as a spur to aggregate demand and push output above its natural rate. In the case of larger member states or a group of small member states this will generate higher average inflation in the euro area and thus force the ECB to increase the short-term interest rate. The fact that all member states suffer a higher interest rate because of the actions of one government is taken as a basis for imposing constraints on government borrowing within the euro area. An alternative strand of the literature focuses on the spillover between unsustainable debt and inflation. Eichengreen and Wyplosz (1998) warn that the accumulation of unsustainable debt by one member state will put pressure on the ECB to undertake a bail out so as to protect the stability of the euro area's banking and financial system. A bail out, they imply, will generate inflationary pressures in the euro area as a whole, thus punishing all member states for the profligacy of one national government, while encouraging others to run higher debts in the knowledge that the ECB will come to their rescue. The implication of this viewpoint is that fiscal policy co-ordination should focus on the sustainability of member states' debt rather than government borrowing *per se*.

Second, there is prescriptive uncertainty over whether macroeconomic co-ordination is an appropriate cure for the problem of fiscal spillover. Artis and Winkler (1997) argue that fiscal co-ordination will safeguard the credibility of the ECB by preventing excessive debt accumulation and removing imbalances from the macroeconomic policy mix. In contrast, Alesina *et al.* (2001) argue that a co-ordinating agreement between national governments and the ECB could compromise the credibility of the latter's commitment to price stability. Similarly, Catenaro and Tirelli (2000) argue that a central bank's independence is greater when fiscal sovereignty is dispersed over a large number of small authorities. From this perspective, macroeconomic co-ordination amounts to a pooling of fiscal sovereignty by national governments, which would increase their bargaining power over the ECB.

Third, there is substantive uncertainty over the definition of the medium-term target. For Artis and Buti (2000), a medium-term budgetary position of close to balance or in surplus will reconcile the need for greater fiscal stabilization under EMU with the risks posed by harmful fiscal spillover. They argue that if a member state obeys the balanced budget rule this will allow its budgetary stabilizers to operate in the event of an economic downturn without breaching the excessive deficit ceiling. As the Commission (CEC 2002a) admits, however, the measurement of medium-term budgetary balance is an

uncertain exercise because we cannot directly observe the economy's natural rate of output and no one econometric method can provide an irrefutable estimate. Traditionally, economists have used the Hodrick–Prescott filter to identify fluctuations in the path of economic growth around a statistical trend. A more popular, but by no means unassailable, alternative nowadays is the production function method, which takes concepts like potential productivity and the non accelerating inflation rate of unemployment (EMU) into account when assessing the economy's productive potential.

In the burgeoning literature on the open method, opinions are divided over policy-makers' true motivations for choosing this particular mode of governance at this particular time. For De Búrca and Zeitlin (2003: 3) the value of the open method 'lies not simply in its general usefulness, efficiency, and flexibility as an instrument of EU policy-making' but also in the fact that it 'is particularly well suited to identifying and advancing the common concerns and interests of the member states while simultaneously respecting their autonomy and diversity'. In contrast, Chalmers and Lodge argue that the open method

developed in the context of one particular economic policy coalition that (a) required a 'modern' sounding set of instruments to overcome potential hostility to a US-type economic policy reform agenda, that (b) wanted to displace the Commission as the central standard-setting organization and that (c) was not overly appreciative of the institutional complexity of EU policy and law.

(Chalmers and Lodge 2003: 17)

From a political economy perspective, the open method offers a pragmatic reading of the uncertainties surrounding macroeconomic policy co-ordination under EMU and a conscious attempt to minimize the associated costs. First, the open method minimizes the risk of imposing the wrong model of the economy on EMU's macroeconomic architecture. Instead, it embodies a radicalized application of the principle of subsidiarity (Hodson and Maher 2001), which sets out broad guidelines for the EU and then allows individual member states to meet these demands in a manner than best suits the specificities of their own economies. This recognizes the diagnostic uncertainties of policy co-ordination and affords member states the opportunity to gain more information about the workings of the euro area economy and the nature of fiscal spillover. The self-critical nature of the open method encourages member states to exchange instances of best policy practice and to build consensus over the goals of macroeconomic policy. Furthermore, the emphasis on soft law measures in the application of the open method rather than hard law bargains gives greater scope for future reform, as witnessed in recent debates over the reform of the Stability and Growth Pact (see Hodson and Maher 2003). Second, the decentralized nature of the open method minimizes the risk that macroeconomic policy co-ordination will compromise the independence of the ECB. This recognizes the prescriptive uncertainties of policy co-ordination and ensures that the credibility of monetary policy remains

paramount under EMU. The corollary, however, is that the open method is primarily focused on the adherence of national governments to the goals of the ECB rather than on the creation of common goals between fiscal and monetary authorities. The (not undisputed) assumption here is that the ECB's behaviour is consistent with stated objectives and such objectives are optimal (Allsopp and Artis 2003). Third, the codification of the medium-term budgetary target in soft rather than hard terms minimizes the risk that macroeconomic policy co-ordination will miscalculate member states' cyclically adjusted balances, and thus enforce a fiscal stance that is either too strict for the member state in question or too loose for the rest of the euro area. This recognizes the substantive uncertainties of co-ordination and gives member states some discretion over the enforcement and interpretation of the medium-term rule.

The fact that the open method is more attuned to the costs of macroeconomic policy co-ordination is, of course, no guarantee that it can deliver the benefits. The central criticism of the open method in this regard is that in the absence of legal obligation and the threat of financial penalties, it lacks the necessary means to discipline errant member states. In other words, while the ambiguity of soft co-ordination allows for agreement to be struck in an area that is not suited to harder forms of co-ordination, it also provides a readymade escape clause for profligate member states. The following two sections take a closer look at the channels through which the open method is designed to operate. The first is consensus-building and focuses on the deliberation between member states over the goals of macroeconomic policy. The second is peer pressure and concerns the use of legally non-binding recommendations to name, shame and blame errant member states in the eyes of national parliaments, the media and financial markets.

2. CONSENSUS-BUILDING AND THE OPEN METHOD

Consensus-building between member states over policy objectives plays a crucial role in the workings of the open method. At the Lisbon European Council in March 2000, the Heads of State and Government (HOSG) identified a number of weaknesses in the EU economy: unemployment, the underdevelopment of the skills sector, the widening skills gap and the need for economic and social reform. As a proposed solution to these problems, the HOSG agreed on a new 'headline' goal to make the EU economy 'the most competitive and dynamic knowledge based economy in the world by 2010 capable of sustainable economic growth with more and better jobs and greater social cohesion' (European Council 2000). A similar logic underpins multilateral surveillance. As noted by the European Commission (CEC 2002b: 5), '[w]ith the exception of binding rules on deficits, macroeconomic co-ordination within the euro area is generally based on dialogue and consensus.' A guiding principle of policy co-ordination, it argues, is that '[p]olicies are not imposed but an effort is made to convince member states to apply the policies' (CEC 2002b: 32). The Broad Economic Policy Guidelines play a key role in

this process by 'forming policy views and generally yield[ing] consensus that is codified in the final document. Policy consensus, in turn, is the basis for exerting peer pressure and essential for successful co-ordination' (CEC 2002b: 11).

The idea that consensus brings value added to the macroeconomic policy mix is implicit in the work of Kydland and Prescott (1977) and Barro and Gordon (1983), which identifies disagreement between policy-makers over their desired end goals as an important cause of co-ordination failure. Dixit and Lambertini (2003) use a variation of the Barro–Gordon model to show that, under certain assumptions, consensus between fiscal and monetary authorities leads to a convergence of inflation and output towards their desired targets. Buti *et al.* (2001) find that when fiscal authorities fail to agree with the central bank on the importance of counter cyclical stabilization, the latter will choose higher interest rates so as to contain inflationary pressures.

In political economy debates deliberation is assigned an important role in consensus-building, with the former seen by some commentators as a means to build agreement over desired end goals by means of discussion between free and equal group members (Gambetta 1998). It offers an alternative to voting and bargaining as solutions to resolve disagreement between group members. If voting attempts to aggregate the preferences of group members and bargaining attempts to trade one set of individual preferences over another, consensus-building attempts to transform these preferences 'through rational deliberation' (Elster 1998). Deliberation works in principle by compelling group members to justify their reasons for holding certain preferences and to understand why their peers hold different ones. In so much as an individual member state may lack an incentive to be unduly critical of its own preferences, the same member state will have every reason to be highly critical of the preferences of its peers not least in the presence of harmful spillover. This civilizing force of hypocrisy, as Elster (1998) calls it, can be an important mechanism for generating agreement between group members.

There are strong deliberative undertones to economic policy co-ordination under EMU not least in the work of the Eurogroup (Puetter 2003). In the view of the former French Finance Minister, Dominique Strauss-Kahn, the idea of the Eurogroup arose because 'here was a clear need to create something more informal than ECOFIN where there were as many as 100 people between ministers and advisers.' The presence of one minister and one adviser from each member state, he argues, allowed for a 'real exchange of views'.⁴ Puetter (2003: 100) describes the Eurogroup as a form of deliberative intergovernmentalism, which allows ministers to develop a shared understanding of the current economic situation and to discuss economic policy options. This role is facilitated, he argues, by the fact that meetings are held in the strictest confidence, allowing ministers to step back from their negotiating positions in ECOFIN and to 'think aloud' (Puetter 2003: 117). This view is shared by Collignon (2001: 21) who recalls from his time on the Eurogroup that '[t]he brightest and best-trained ministers often dominate the debate. The dreary

reading of prepared speaking notes is less common in the Euro-group than in Ecofin meetings where ministers speak under the scrutinizing eyes of their top civil servants.'

The idea that pure deliberation can overcome the problem of fiscal spillover within the euro area is an intellectually alluring one but it is subject to three decisive criticisms. First, deliberation is not necessarily democratic. The open method is arguably closer to the non-democratic strain since its deliberative mechanisms are designed to encourage a debate amongst members of the policy-making community, rather than the wider public. Cohen and Sabel (2003: 367) put this less politely and more succinctly when they write of 'cloistered bodies that make fateful choices, but are inattentive to the views or the interests of large numbers of affected parties – without being connected to open public debate and practice'. Second, deliberation does not necessarily produce agreement. Deliberation can accentuate points of disagreements between policy-makers, polarize opposing viewpoints, compound the existing co-ordination failure and even hinder policy reform. Sabel (1994: 137) emphasizes this last point when he writes of the need to reconcile 'the demand of learning with demands of monitoring'. It is easier, in other words, to enforce a co-ordinated agreement when each member state commits to one and only one course of action. The third and most compelling criticism of the purely deliberative approach is that, by assuming that political willingness to co-ordinate is a sufficient condition for policy co-ordination, it ignores the role of domestic budgetary institutions and procedures in the formation of a member state's fiscal policy. The point of departure for this institutionalist reading of fiscal policy is that deviations from cyclical smoothing arise because the government agencies with responsibility for formulating government expenditure fail to take into account the effect of their decisions on the overall tax burden (Hallerberg 2003). For von Hagen and Harden (1996) there are two ideal ways to overcome this common pool resource problem (Hallerberg 2003). The first is delegation, which gives power to the Finance Minister to take a strong grip on the formation of the budget. The second is commitment, which entails the signing of a fiscal contract to keep budgetary decisions within predetermined parameters. In a study of national fiscal policy in the EU over the period 1990–94, Hallerberg and von Hagen (1997) find that member states, which had fiscal contracts or a high degree of delegation, enjoyed a significantly lower budget deficit. An important implication of this finding is that a deliberative approach to policy co-ordination, which generates consensus at the political level, will come to nought unless the desired course of action is consistent with domestic budgetary procedures and institutions.

3. PEER PRESSURE AND THE OPEN METHOD

In his seminal work on the organization of groups, Olson (1971) demonstrates that in the absence of persuasive economic incentives, large groups with common interests are unlikely to act in their collective self-interest. Olson

(1971: 60) recognizes, however, that 'people are sometimes also motivated by the desire to win prestige, respect, friendship and other social and psychological objectives.' Peer pressure – or social pressure and social incentives, as he refers to it – 'are among the kind of incentives that may be used to mobilize a latent group' (Olson 1971: 61).

Peer pressure will, Olson implies, depend to a large degree on the size of the group in question. 'In general, social pressure and social incentives operate only in groups of a smaller size, in the groups so small that the members can have face-to-face contact with one another' (Olson 1971: 62). He cites the comparison between competitive and oligopolistic market structures as a case in point. When there are a large number of small firms, an entrepreneur who cuts prices to capture a greater share of the market is unlikely to provoke a negative reaction from his or her peers. The actions of the individual firm are simply too small in the competitive world to matter. The situation under oligopoly is quite different, however. When there are a small number of firms, an entrepreneur who cuts prices will capture extra market share at the direct expense of his or her peers. It is highly likely that this will provoke a strong and negative peer rebuke. According to Olson (1971) a variant of social pressure can be found through the use of mass media. If members of the group are continuously encouraged through the media to co-operate, or are publicly named and shamed when they defect, this may generate sufficient pressure to enforce the provision of the collective good. Olson (1971: 63) argues, however, that the use of mass media in this manner can be achieved only by a pre-existing group and not by a latent one.

As we move from a theory of how individuals interact to the study of the fiscal policies of EU member states, Olson's assumption that peer pressure operates through social and psychological channels only is no longer tenable. In particular it fails to account for the role of market sentiment and political credibility in the economic policy-making process. When these factors are considered, peer pressure can be understood as a sanction mechanism, which is designed to increase the reputational costs of political opportunism, policy reversal and policy non-implementation. In each of these cases, policy-makers fail to deliver their promised policy goals for reasons of strategy or incompetence. A key aim of the open method is to encourage member states to publicly pre-commit themselves to a medium-term plan for economic policy. If a member state defects from these plans then its peers can publicly acknowledge this fact. First, naming and shaming provides political ammunition to opposition political parties and the media alike. The timing of a peer rebuke to coincide with an election campaign, for instance, has the potential to severely damage a government's credibility in the eyes of the electorate. Second, a public rebuke can result in a loss of credibility for national economic policies in the eyes of financial markets. If hard co-ordination demonstrates the advantages of tying oneself to the mast then soft co-ordination shows the value added of nailing one's colours to the mast.

Hodson and Maher (2003) list four factors which will influence the

effectiveness of peer pressure as a sanction mechanism. First, the obligation that peer pressure enforces must be precisely drawn so as minimize the possibility of counterclaim in the event of a censure. As was already argued, this point is problematic in relation to multilateral surveillance since errant member states can exploit the uncertainty which surrounds the measurement of the medium-term fiscal position in pleading their case. Second, member states must have due respect for the rule of law, which in this case means that they must consider a peer rebuke over public finances to be costly. There is always a risk with peer pressure that national governments can use criticism from 'Brussels' as an opportunity to gain domestic support for their defence of the national interest. Third, the sanctioning body must have credibility. The fact that ECOFIN enjoys a degree of discretion over the exercise of peer pressure raises doubts about whether it will enforce the fiscal rules of EMU consistently over all member states. The Commission's concerns over this point are apparent from its non-paper submission to the Convention on the Future of Europe, Penelope, which argued that the Commission should be given the power to issue recommendations directly against errant member states without the consent of the Council of Ministers (Commission Group of Experts 2002: 70). Likewise, peer pressure assumes that financial markets look favourably on the overall aims of co-ordination. If this assumption fails, we could expect financial markets to react favourably to non-compliance by member states. Indeed, such a reaction occurred during the speculative attacks against the exchange rate mechanism (ERM) in 1993 when financial markets lost faith in the system's ability to reconcile fixed exchange rates with domestic demands on national monetary policies (De Grauwe 2000). Finally, the sanctioning body must be willing to reprimand errant member states. The risk for multilateral surveillance is that member states will be less inclined to sanction a fiscally profligate member state when they themselves might encounter difficulties in meeting EMU's fiscal rules at a future date. This raises the risk of collusion between member states not least when several member states face the threat of sanction at once.

4. PORTUGUESE EXPERIENCES OF OPEN CO-ORDINATION

The deterioration in public finances

In November 2002, Portugal became the first member state to trigger the excessive deficit procedure after its budget deficit for 2001 reached 4.2 per cent. The problems of Portuguese fiscal policy arose, or perhaps it is more accurate to say were discovered, when the Social Democrat government of Jose Manuel Durao Barroso took office in April 2002. This new administration revised its predecessor's estimate of the general government balance for 2001 from -2.8 per cent to -4.8 per cent, thus pushing it well above the excessive deficit ceiling.

The deterioration of public finances in Portugal during the initial years of

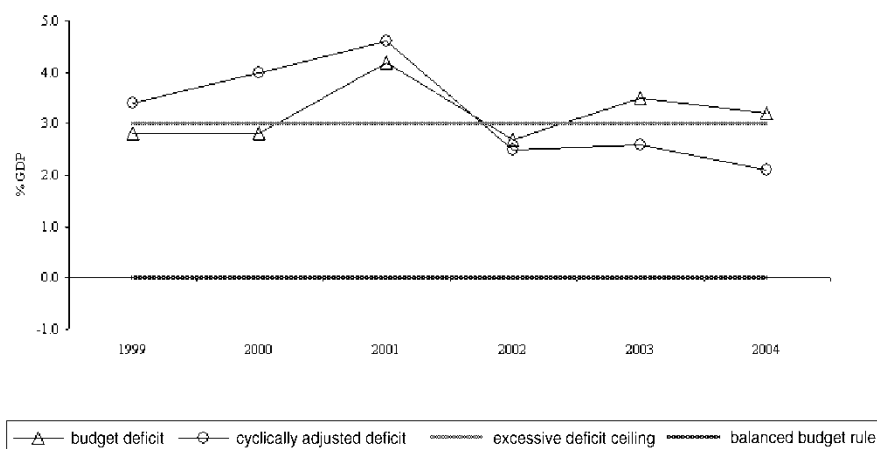


Figure 1 General government borrowing in Portugal, 1999–2004

Source: Commission of the European Communities (2003) 'Spring economic forecasts, 2003', *European Economy*, No. 2.

EMU can be traced back to two root causes. The first consists of a failure to consolidate public finances during a period of economic upswing and the second concerns the deficiencies in the collection of budgetary statistics. The Portuguese economy grew by an average of 4 per cent in nominal terms between 1998 and 2001. As is evident from Figure 1, however, this period of growth coincided with a deterioration in public finances rather than an improvement as the budget deficit rose from 2.8 per cent in 1999 to 4.2 per cent in 2001. The picture is bleaker still when it is viewed in cyclically adjusted terms. According to this measure, the underlying budget deficit increased from 3.4 per cent in 1999 to 4.6 per cent in 2001. Figure 2 reveals that the deterioration in the budget deficit can be attributed to sluggish growth in total government revenue, coupled with a sustained increase in total government expenditure. The former remained fairly constant at around 42 per cent of GDP between 1999 and 2001. During this period total government expenditure rose from 45.2 to 46.3 per cent of GDP. Pizarro (2003) places more emphasis on the effect of the former, arguing that weaker than expected government revenues account for 2.8 percentage points out of the 3 per cent revision of the expected budget deficit. The OECD (2003) attributes the shortfall in government revenue to the fact that policy measures to tackle tax evasion were less successful than had been expected and because of a weakening in economic activity. It explains the rise in expenditure in terms of excessive increases in primary spending, not least on wages and salaries in advance of the general election.

Turning to the second point, Courela (2002: 4) is critical of the inaccuracy of budget forecasts in Portugal, which he attributes to a failure of co-ordination between the Directorate-General (DG) for Taxes and the DG for the National

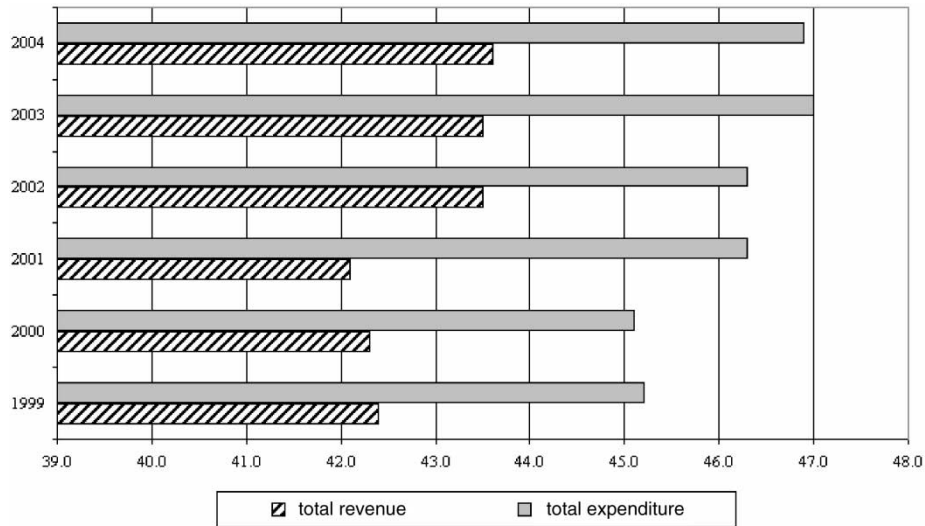


Figure 2 Total government expenditure and revenue in Portugal, 1999–2004
 Source: Commission of the European Communities (2003), 'Spring economic forecasts, 2003', *European Economy*, No. 2.

Budget and to the fact that fiscal policy was not prepared on the basis of a multi-annual plan. The OECD (2003) adds a number of points to this list, including delays in the introduction of a new public accounting system, the absence of multi-annual expenditure ceilings, the inadequacy of external auditing procedures, and a lack of fiscal accountability over local authorities. In the light of these developments, the Commission made a recommendation to ECOFIN in January 2002 that an early warning procedure be issued against Portugal (ECOFIN 2002a). One month later, ECOFIN concluded that Portugal had 'effectively responded to the concerns expressed in the Commission's recommendation', thus rendering the early warning procedure unnecessary (ECOFIN 2002a). In November 2002, however, ECOFIN reversed this decision and launched the excessive deficit procedure against Portugal. In its public recommendation ECOFIN (2002b) called 'for the Portuguese government to take all necessary measures to bring the excessive deficit to an end'. ECOFIN was also critical of the collection of public finance statistics in Portugal and called on the new government 'to take steps to improve the reliability and timeliness of budgetary data used in the multilateral surveillance process'.

The fiscal adjustment programme

The Portuguese government responded to its breach of EMU's fiscal provisions by devising an austere programme of budgetary adjustment, coupled with a

number of institutional and procedural reforms in fiscal policy-making. As can be seen from Figure 1, Portugal's budget deficit fell by 1.5 percentage points in 2002. Although it is forecast to rise above the excessive deficit threshold again in 2004, the latest update of Portugal's Stability Programme envisages a near balanced budget by 2006 (Portuguese Ministry of Finance 2002). The decline of government borrowing is more acute in cyclically adjusted terms, with the deficit set to fall from 4.9 per cent in 2001 to 2.1 per cent in 2004. Once again, the Portuguese Stability Programme envisages a position of near balance by 2006. Figure 2 reveals that budgetary adjustment will chiefly be borne by an increase in government revenue, which is forecast to rise from 42.1 per cent of GDP in 2001 to 43.6 per cent in 2004. By contrast, the share of government expenditure to GDP is forecast to remain fairly constant over this period. This reflects a wide range of budgetary changes, which include an increase in the rate of VAT from 17 to 19 per cent, a reform of capital gains tax to target speculative gains only, and the introduction of strict measures to combat tax evasion. The government has also devoted a considerably greater share of the receipts from its ongoing process of privatization towards the reduction of public debt. In the budget for 2003, some 1.150 million euro of the receipts from privatization in the energy, transport, environment and natural resources sectors were earmarked for this purpose as compared with figures of 281 and 398 million euro for 2001 and 2002 respectively (Portuguese Ministry of Finance 2003: 29). The centrepiece of the government's procedural reform is the Budgetary Stability Law of 2002 (Portuguese Ministry of Finance 2002: 4). Under the terms of this law, public administration bodies must abide by three principles. The first is budgetary stability, which is defined as a commitment to a budgetary position of balance or in surplus. The second principle refers to reciprocal solidarity, which means that all government subsectors are liable to contribute towards budgetary stability. The third is the principle of budgetary transparency, according to which public entities must disclose certain information on their activities before they are entitled to transfers from the state budget. In a series of related measures to improve the quality of budgetary statistics, the government also agreed to extend the scope of the Public Official Accounting Plan and to implement a new Revenue Management System. The official statistical agency (INE) has also committed to publish General Government Quarterly National Accounts from 2003.

Lessons from the Portuguese case

The failure of multilateral surveillance to forestall the deterioration in Portugal's public finances, and the nature of its response to ECOFIN's warning, point towards a number of weaknesses in the operation of the open method in general and the impact of consensus-building and peer pressure in particular.

First, the discrepancy between Portugal's fiscal plans and fiscal policies serves as a reminder of the link between consensus-building over fiscal policy at the EU level and the process of domestic policy formation at the national level. It

reveals that a commitment to a medium-term budgetary target is more easily agreed than delivered under circumstances when there is a shortfall in government revenue, and when a pending election places upward pressure on the government expenditure commitments. It demonstrates that weaknesses in the collection and presentation of budgetary statistics can obscure the true state of public finances and undermine the stability of budgetary plans. The fact that the current Portuguese government has begun to redress these deficiencies will improve its chances of meeting the fiscal provisions of EMU in the future (OECD 2003).

Second, the severity of the Social Democrat fiscal programme indicates that a willingness to co-ordinate at the EU level for the sake of co-ordination may not always be in the best interests of the domestic economy. The OECD (2003) supports the firm commitment of the Portuguese government to redress its budgetary imbalances but implies that 'emergency measures', which are designed to restore consistency with the fiscal provisions of EMU, could have perverse side-effects. For instance, implementing expenditure cuts in relation to infrastructural investment may have helped to eliminate the excessive deficit in the short run at the cost of jeopardizing the productive potential of the economy over the long run.

Third, the uncertainty over Portugal's medium-term fiscal position points towards the weakness of peer pressure as a sanction mechanism when the obligation that it enforces is imprecisely defined. Table 1 records the Commission's estimates and forecasts of Portugal's cyclically adjusted deficit for the years 1999–2001 over the period 1999–2003. It is evident that the deficit was gradually revised upwards as the true state of Portugal's public finances became apparent. In November 1999, the Commission forecast a cyclically adjusted deficit of 1.7 per cent in 2000. By March 2003, the estimate for 2000 was revised to 4 per cent. The fact that the cyclically adjusted fiscal position is a moving target inevitably makes it harder to enforce the medium-term rule.

Table 1 Cyclically adjusted budget deficit, Portugal, 1999–2001

| <i>Date of forecast/estimate</i> | <i>1999</i> | <i>2000</i> | <i>2001</i> |
|----------------------------------|-------------|-------------|-------------|
| March 1999 | 1.9 | 1.7 | n/a |
| November 1999 | 1.2 | 1.3 | 1.4 |
| March 2000 | 1.8 | 1.5 | 1.6 |
| October 2000 | 2.1 | 2.1 | 1.6 |
| April 2001 | 2.2 | 2.0 | 1.7 |
| November 2001 | 2.6 | 2.5 | 2.5 |
| April 2002 | 2.7 | 2.6 | 3.2 |
| November 2002 | 3.0 | 4.0 | 4.3 |
| March 2003 | 3.4 | 4.0 | 4.6 |

Source: European Commission Macroeconomic Forecasts 1999–2003.

Fourth, the intensity of public reaction in Portugal to ECOFIN's censure reveals that peer pressure can be an effective communication strategy but that communication is no guarantee of compliance. Pizarro (2003) records that ECOFIN's censure of Portugal in November 2002 generated considerable interest in media debates and amongst politicians as, inevitably, did the negotiation of the Budgetary and Stability Law. Courela (2002) observes, however, that national politicians were largely in favour of these changes, while their local counterparts were generally opposed. This conforms to the earlier notion that peer pressure can provoke mixed reactions within domestic arenas.

Fifth, the reluctance of ECOFIN to endorse the Commission's censure of Portugal in February 2002 raises concerns about the consistency of peer pressure as a sanction mechanism. The fact that ECOFIN failed to launch a similar action against Germany at this time raised suspicions that a German government facing a general election was being treated leniently. The implication was that Portugal was able to piggy back on this leniency (Buti and Giudice 2002: 841). In a later opinion on strengthening the co-ordination of budgetary policies, the Commission (2002c: 2) recognized 'a number of difficulties with the implementation of the SGP [Stability and Growth Pact]' and criticized the 'reluctance on the part of member states to enforce the SGP (in spirit and in letter)'.

CONCLUSIONS

This paper began by asking whether the open method is closer to Wallich's definition of economic policy co-ordination or co-operation. Within the context of EMU, the variant of the open method known as multilateral surveillance is designed to be closer to the former. More specifically, the open method offers a pragmatic response to the costs of macroeconomic policy co-ordination which attempts to insulate the ECB from unwanted political influence, while at the same time protecting member states from harmful fiscal spillover within the euro area. Whether the open method can deliver more than economic policy co-operation in practice, however, depends on the effectiveness of consensus-building and on the impact of peer pressure as a sanction mechanism. Developments in Portuguese fiscal policy since the launch of EMU confirm the limitations of a purely deliberative approach to policy co-ordination and ignore the institutional and procedural determinants of fiscal policy-making. The fact that Portugal reached consensus with other member states on the importance of achieving medium-term budgetary balance could not override the fact that domestic fiscal institutions and procedures hindered the achievement of this goal. The Portuguese experience also reminds us that the impact of peer pressure as a sanction mechanism requires an obligation that is precisely drawn, a credible sanctioning body that is ready, willing and able to perform its functions, and a member state that has respect for the rule of law. The substantive uncertainty of the medium-term budgetary target, the reluctance of ECOFIN to apply peer pressure against Portugal

and Germany, and domestic opposition to the Portuguese fiscal adjustment programme raise concerns on all three counts.

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NOTES

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- 2 For a detailed description of EMU's macroeconomic architecture, see Commission (2002b).
- 3 Member states that are not part of the euro area submit Converge Programmes, which are qualitatively similar to the Stability Programmes but contain additional information on, *inter alia*, inflation convergence and exchange rate developments.
- 4 The *Financial Times*, 12 February 1999, quoted in Puetter (2003: 114).

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