

The London School of Economics and Political Science

**Flirting with Disaster – Explaining Excessive Public Debt Accumulation in Italy  
and Belgium**

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**Declaration**

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## **Abstract**

The sovereign debt-crises that recently unfolded in Europe highlight how incompletely we understand why prosperous developed countries persistently accumulate debt even in the face of risk of fiscal turmoil. Scholarly research explored why countries run deficits, but it remains unexplained why countries fail to put their fiscal houses in order once public debt reaches potentially dangerous proportions.

This thesis argues that the key to the problem of excessive debt accumulation is the lack of compromise among powerful socio-economic groups within the polity about the distribution of the necessary fiscal sacrifices. As long as each group finds it expedient to resist spending cuts and tax increases that place part of the burden of consolidation on its members, stabilization is delayed and debt is allowed to grow. The readiness of groups to reach a compromise and accept a share of the fiscal pain is a function of the economic harm each suffers from the side-effects of fiscal imbalances, such as high inflation or declining international competitiveness. Therefore, the insulation of socio-economic actors from such side-effects delays stabilization. This perspective sheds new light on unintended consequences of EMU-membership.

This explanation is couched in a society-centred analysis of policy making. The thesis identifies coalitions of societal interest to explain policy choices, along the lines laid down in Gourevitch's *Politics in Hard Times* (1986) and it uses Alesina and Drazen's (1991) war of attrition model of delayed stabilization to analyse the costs and benefits for socio-economic groups of resisting fiscal pain. Using this approach, it provides theoretically guided historical analyses of Belgium's and Italy's experiences with excessive debt accumulation in the 1980s, consolidation in the 1990s and mixed results in the 2000s, demonstrating how the interests of societal groups shaped the politics of fiscal policy-making and investigating the effect of the EMU accession on fiscal outcomes.

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## **List of abbreviations**

AN	Alleanza Nazionale
Ameco	Annual Macro-economic Database of the European Commission's Directorate General for Economic and Financial Affairs
Cattaneo	Istituto Cattaneo
CGIL	Confederazione Generale Italiana del Lavoro
DC	Democrazia Cristiana
FI	Forza Italia
EMS	European Monetary System
EMU	Economic and Monetary Union
EU	European Union
IMF	International Monetary Fund
LN	Lega Nord
MSI	Movimento Socialista Italiano
OECD	Organisation for Economic Co-operation and Development
PCI	Partito Comunista Italiano
PLI	Partito Liberale Italiano
PRI	Partito Repubblicano Italiano
PSI	Partito Socialista Italiano
PSDI	Partito Socialista Democratico Italiano



## Chapter 1.

### Introduction: The politics of excessive indebtedness

Why do some countries flirt with fiscal disaster? Why do prosperous, advanced industrial states with democratic governments and reasonably well-organized bureaucracies keep borrowing in a time of peace and prosperity until they become excessively vulnerable to changing conditions in financial markets? The practical relevance of this question hardly needs to be emphasized today when a series of debt crises unfolds in Europe in front of our eyes. Several developed countries are currently struggling to secure financing to keep their state machineries going. Some of them would have already defaulted on their sovereign obligations, had the European Union (EU) and the International Monetary Fund (IMF) not come to their rescue. Even after receiving large bailouts on strict fiscal conditions, their situation is still precarious. The troubled countries' fiscal woes serve as a reminder of the risks entailed in persistent fiscal imbalances and the steady accumulation of debt, which becomes a ticking time bomb waiting to detonate if markets lose their nerve.

Greece, Portugal and Hungary were all forced to ask for multiple bailouts in the past two years. Italy has not needed urgent external help yet, but its situation is extremely fragile<sup>1</sup>. All of these countries had repeatedly been alerted to the risks generated by their fiscal policies as they got progressively mired in debt in the past decades. In the wake of the financial crisis and the global economic downturn, these risks suddenly materialized. The question is why and how these prosperous European states ended up in such difficult fiscal positions in the absence of major wars or economic cataclysms. Other countries that recently availed themselves of external financial help (like Ireland) or may do so in the near future (like Spain) are unlike these states in the sense that their fiscal disaster struck as a bolt from the blue due to imbalances in their private sectors despite a sound fiscal track record<sup>2</sup>. In these latter cases, the role of external

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<sup>1</sup> Most recently, the Italian government has attempted to secure a *quasi*-bailout from China by negotiating a deal with Chinese sovereign wealth funds. (See "Italy turns to China for help in debt crisis" Financial Times, September 12, 2011.)

<sup>2</sup> In Ireland, the efforts of the government to prop up the ailing Irish banking sector led to an extreme increase of the debt-to-GDP ratio within a very short period of time. Between 2007 and 2010, it grew from 25 per cent to 96 per cent. In November 2010, the government was forced to turn to the EU and the IMF for

forces in wreaking havoc in public finances is evident. The puzzle here is why the first group of countries allowed debt to gradually build up throughout the past decades and why they did little to mitigate the extreme vulnerability their high debts would create in periods of economic and financial turbulence. The role of past fiscal policies in generating exposure to changing market sentiments seems to be confirmed by Belgium's experience in the present crisis. Despite having a history of fiscal troubles and being similarly heavily indebted as Greece or Italy, Belgium has so far fared considerably better than these countries. Its insistence on fiscal rigour and its success in steadily decreasing its debt-to-GDP ratio in the past two decades has likely contributed to the fact that the country has been spared of the latest episodes of turmoil in the sovereign debt markets, even despite the manifest political instability that beset the country in the recent years.

While the fiscal disaster now engulfing ever more European countries is a shock that has been unprecedented since the Second World War, the underlying problem is nothing new. It has been at the forefront of attention for decades now. "Fiscal discipline" (or rather, the lack of it) has been a dominant theme in European policy discourse since the early 1990s, due to the constantly increasing rate of indebtedness of many countries and due to the tying together of the fates of countries in the Economic and Monetary Union (EMU). The adoption of fiscal criteria for EMU-accession in the Treaty of the European Union in 1991 amounted to an official declaration that certain member states of the European Union pursue budgetary policies that make them too much of a potential liability to be included in monetary integration. Since then, repeated attempts have been made to create a system of rules, surveillance and sanctions that effectively forces member states to deal with their fiscal imbalances.

These endeavours seem to have made little difference for the majority of the countries with grave fiscal problems, even though they voluntarily signed up to these schemes and repeatedly committed to correction programmes and deadlines. Despite initial compliance with the Maastricht treaty, Italy was in excessive deficit for five years and Portugal for seven years in the past decade. In Greece's case, even the apparent initial compliance with the rules has been discredited by subsequent audits of the country's

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a bailout package as financing from the financial markets dried up. (See "Ireland Gets \$113 Billion Bailout as EU Ministers Seek to Halt Debt Crisis" Bloomberg, November 29, 2010).

In Spain, the sharp end to the housing boom put great stress on the financial sector as well as on public finances and many observers expect the country to need external help soon. (See "Portugal bailout: Spain could be the next to fall" The Guardian, April 7, 2011 or "Spain PM told unions country was close to bailout" Reuters, September 6, 2011)

fiscal figures. Hungary has been unable to correct its excessive deficit and to fulfil the criteria for joining the common currency ever since it acceded to the EU in 2004. Belgium and Spain were exceptional among countries with long-standing fiscal troubles in firmly maintaining the improvements they had achieved in the run-up to the euro. The poor performance of the other fiscally troubled countries seems to have been impervious to the European attempt at institutionalizing fiscal discipline. The limited success of the European efforts to put an end to the mounting of debt in most member states further underlines the puzzling stubbornness of the problem. At the same time, the improvement of the fiscal performance of a handful of countries since the introduction of the European fiscal surveillance suggests that there are ways to address even deeply entrenched fiscal troubles, adding to the intricacy of the issue.

Excessive indebtedness – besides being a burning practical problem – also represents a major theoretical puzzle. This thesis argues that resolving this puzzle requires an approach that substantially differs from earlier ways of studying fiscal policy making. It proposes a theory that focuses on the socio-political context of fiscal decisions and explains excessive debt accumulation by analysing the policy preferences and the sources of policy influence of different groups within society, whereas existing literature on fiscal performance mostly concentrates on the institutional environment of fiscal policy making,

This introductory chapter is aimed at specifying the theoretical puzzle and placing it into the context of past research on fiscal policy making. The next section explains why the issue of excessive debt is theoretically puzzling. It contends that it is far from obvious why policy makers would keep borrowing when the outstanding debt stock is relatively high or why the electorate would tolerate such policies in view of the disproportionately high costs and risks of further debt accumulation beyond a certain level. The third section reviews the existing rich literature on the determinants of fiscal performance, and argues that the puzzle of dangerous debt accumulation remains in a blind spot for theories that aim at explaining general cross-national and cross-temporal variation in fiscal outcomes. While these theories provide several reasons why governments might fail to stay within their budgetary limits from one year to the other, they do not address the issue why governments do not stop borrowing once the cumulative effects of deficits – the escalating risks and the growing costs of debt – start to make persistent borrowing truly deleterious. It is this latter question this thesis is interested in. Therefore, the last section concludes by proposing a new approach to

studying fiscal policy-making that focuses on societal constraints on policy makers' ability to carry out radical adjustment in the policy course in order to break the inertial forces driving debt growth and reduce the increasing risks. It also lays out the plan for developing and evaluating such a theory in the rest of the thesis.

### **The puzzle of risky debt accumulation**

Beyond its immediate practical relevance, the issue of enduring fiscal imbalances and excessive borrowing is fascinating from a theoretical perspective, too. It is puzzling why excessive deficits are allowed to persist. High and growing debt constrains governments' room for manoeuvre in managing the economy, it potentially retards growth and undermines price stability<sup>3</sup> and it gives rise to abruptly and swiftly increasing risks. It exposes countries to unpredictable and uncontrollable developments on the financial markets, by making them highly vulnerable to changes in interest rates and investor sentiments. Debt also entails risks of major economic – and potentially social and political – disruptions if investor confidence wanes and the country is forced to default on its obligations. Finally, even if the worst scenario is avoided, a high outstanding debt stock and a large interest burden foreshadow ever more painful adjustments in the future. Therefore, the premise of this thesis is that continued borrowing in the face of these costs and risks is an anomaly waiting to be explained.

This point of departure differs from the commonly held approach to public borrowing and fiscal consolidation in political economy. The lack of corrective action to stem deficits is often considered rational, because borrowing is associated with political benefits, whereas the political costs of fiscal tightening are assumed to be very high. There are, however, both empirical and theoretical reasons to depart from these assumptions, especially when indebtedness has already reached proportions that make the risks and costs of further borrowing more pronounced. In empirically investigating what they call the “textbook view” of the political economy of fiscal stabilization, Alesina, Perotti and Tavares (1998) found no evidence that governments that carry out fiscal tightening suffer a fall in popularity or are penalized at the ballot box. In some cases, there is even evidence of an electoral reward for consolidation. Similarly, Brender and Drazen (2008) find across a large sample of countries that deficits do not help incumbents to stay in power. In fact, they find that deficits reduce the

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<sup>3</sup> On the negative effects of a large debt stock on growth and inflation, see Reinhart and Rogoff (2010).

government's chance to be re-elected. These results confirm the insights of earlier studies conducted on smaller samples<sup>4</sup>.

From a theoretical perspective, it is possible to identify several strong incentives that could induce policy makers to adjust fiscal policy and close the fiscal gap as soon as possible once debt accumulation starts to reel out of control. First, the costs of a default are massive in political terms, if the blame for it is attributed to a given political force. Second, even if explicit default can be avoided, a debt crisis triggers immensely difficult policy problems that the government in power will need to deal with. Third, even when a debt crisis is not yet imminent, a grave fiscal problem is likely to receive considerable public attention and its handling becomes an important issue on which policy makers' performance is evaluated. Fourth, delay in the inevitable stabilization is only likely to make things worse, escalate the pressure on public finances and face policy makers with an ever more daunting task in the years to come. Hence, policy makers – ministers, parties in the government or individual political personalities – with reasonable chances to stay in the political race for future government positions should feel under great and increasing pressure to stop the escalation of debt.

Furthermore, it is puzzling why policy makers who allow an alarmingly large debt stock to grow further get away with pursuing such a dangerous policy course electorally. Why the public would care about looming fiscal disaster and penalize policy makers who fail to deal with the threat goes without saying. It is an open question to what extent the electorate in different countries is aware of the risks. However, the example of the last British elections shows that the promise to stave off an imminent fiscal spiral and prevent a perceived crisis can be a very powerful political message. Therefore, it is likely that in countries with sizeable fiscal problems, political forces in opposition should find it useful to educate the public about the risks of the country's debt and campaign on the pledge of solving the issue. Even in countries where debt has accumulated over the decades – rather than in a frightening surge as in Britain recently – the public seems to attach high significance to the state of public finances. The 2006 riots and waves of demonstrations in Hungary revealed immense public anger over the deterioration of the debt position<sup>5</sup>. In this case, the opposition did not focus on debt as a campaign issue, but the confession about the real state of public finances led to

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<sup>4</sup> See for example Peltzman (1992) and Kraemer (1997)

<sup>5</sup> Admittedly, the public mood was made no brighter by the fact that the prime minister himself said in a private but secretly taped and subsequently leaked conversation that he and his government "lied morning noon and night" about the country's fiscal situation during his previous term in office. (See "Hungary parliament condemns riots" BBC.co.uk September 19, 2006)

months of demonstrations, long before any concrete austerity measures were announced. These examples suggest that the public does have some degree of awareness of the dangers of large debt and is ready to act upon it.

Why, then, do some countries expose themselves to the vagaries of financial market sentiments? Why does excessive debt accumulation occur among rich, democratic, highly developed states – and with such relatively high frequency? Why did the European system of rules and surveillance fail to leave an imprint on the policies of most of the countries that created and joined it to deal with their persistent problems? Why do policy makers make their own lives harder by procrastinating fiscal adjustment and why does the electorate let them continue to do so?

This thesis explains this puzzle by focusing on the societal conflicts of interests in the background of fiscal policy making. It argues that since eliminating a large structural gap in public finances involves considerable changes in the existing arrangements for redistribution among different sections of society, understanding the delay or absence of fiscal stabilization requires exploring under what conditions the redistributive *status quo* can be changed in the given polity. Both the actions of policy makers and the attitude of different sections of the electorate towards fiscal stabilization should be explored in light of the redistributive consequences of fiscal adjustment. Meaningful fiscal stabilization will be delayed as long as influential societal groups are determined and able to block momentous spending cuts and tax increases that would restore the balance of public finances at their expense. Debt accumulation will only be stopped if at least one large group within society acquiesces in or can be forced to accept taking a share or all of the necessary fiscal sacrifices. In other words, the thesis interprets the lack of stabilization as a sign of the inability of societal actors to decide who is to pick up the bill of painful adjustment. Until the societal conflict over this issue is resolved – either by compromise or by the ascendancy of some groups over the others – closing the fiscal gap is impossible even if policy makers in decision-making position are bent on eliminating the problem.

In other words, this thesis approaches the political economy of excessive public debt from a societal angle. It draws on the insights of Peter Gourevitch's *Politics in Hard Times* (1986) in exploring the politics of fiscal policy making by looking at the "politics of support for different economic policies" (p19). It combines this approach with Alesina and Drazen's (1991) war of attrition model of delayed fiscal stabilization in an

effort to understand how and under what conditions the necessary societal support can be generated for successfully implementing a far-reaching fiscal stabilization programme.

The next section reviews the results of existing scholarship on fiscal discipline, to show that focusing on the societal context of fiscal policy making represents a novel theoretical approach to fiscal performance and to argue that pursuing such a new direction is necessary to fully disentangle the conundrum of excessive debt accumulation. The existing literature concentrates exclusively on the governmental-parliamentary sphere and locates the reasons for borrowing in the institutional and party-political characteristics of fiscal decision-making. It explores in detail the correlation between fiscal results and the institutional context in which budgetary decisions are made, and places special emphasis on the institutional dispersion of decision-making authority among actors directly involved in the policy-making process and on the way the latter process is structured. However, by investigating the factors behind public borrowing in general, the literature on fiscal discipline concentrates on a substantively different issue than the one targeted in this thesis. Therefore, while the insights of this literature provide some important clues for exploring the question asked here, they cannot be directly extended to explain why borrowing continues even when the debt is already large, because this literature does not take into consideration the strong motivations of policy makers for fiscal retrenchment that arise when indebtedness reaches dangerous proportions.

### **The literature: Fiscal governance and fiscal discipline**

Fiscal imbalances are not a new issue. Especially from the second half of the 1970s, budget deficits started to be a significant policy problem in several developed countries. In line with its increasing practical relevance, the question why countries spend beyond their means at times and accumulate debt has received growing scholarly attention. A wide range of theories has been proposed to explain the phenomenon. One group of theories claim that governments have an interest in running deficits to increase their chances of re-election. The public choice school, political business cycle models and electoral spending cycle models suggest a number of ways in which overspending can help governments to stay in power. The other group of theories argue that governments may run deficits even without a specific intention to do so. They focus on the collective action issues entailed in democratic decision

making and contend that governments slip into borrowing whenever they have trouble collectively setting and controlling spending and taxation. Some of these theories are based on common resource pool models of public spending, others on veto actor models of governmental decision making, but they all investigate how the institutional context of fiscal policy making and party political factors influence the severity of collective action problems involved in deciding on the budget. This section reviews these two main branches of the literature on fiscal discipline in search of clues for understanding the puzzle of why some countries borrow until they are in the danger of going bust.

### *Borrowing for electoral advantage*

Governments might be tempted to intentionally let expenses exceed revenues for several electoral reasons. The public choice school suggests that governments expect the electorate to appreciate the ability to consume more today at the expense of tomorrow. This can be the case if the electorate suffers from “fiscal illusion” and is therefore unable to recognize the costs that extra consumption in the present will have in the future (Buchanan and Wagner 1977) or if it wants to transfer the costs of its present overconsumption to later generations (Cukierman and Meltzer 1989). Political business cycle models contend that incumbent governments want to reinforce their image as competent managers of the economy and of public finances. They can do so by generating an artificial economic upswing via spending more and taxing less and by providing more public goods from the same amount of tax revenues (Nordhaus 1975, Rogoff and Sibert 1988, Franzese et al. 2008). Finally, electoral spending cycle theories suggest that the incumbent political actors want to remind their supporters – and potential supporters – who they should vote for by pleasing them with new targeted spending measures or tax cuts before the elections (Tufte 1978, Alesina et al 1997). These motivations – on their own or in combination – could be strong forces behind borrowing.

The empirical evidence on the relevance of such electoral motivations for fiscal results is mixed. On the one hand, Alesina et al.’s (1998) and Brender and Drazen’s (2008) results (quoted above) show that loose fiscal policies tend not to yield the electoral advantage that these theories attribute to them. On the other hand, incumbent policy makers might still be tempted to try their luck with such fiscal manipulation. Empirical work on the presence of electoral effects on fiscal policy variables suggests that they



sometimes do. In reviewing a wide range of empirical studies, Alt and Rose (2007) point out that most of these studies find some evidence for electoral cycles in fiscal policies in different datasets, although the correlation between elections and loose fiscal policies seems to be limited to specific countries, specific periods or specific areas within fiscal policy.

Despite the documented empirical relevance of these theories in certain contexts, the hypothesized electoral motivations for overspending or undertaxation do not help to dispel the puzzle of why borrowing continues even in the face of rising costs and risks from a large outstanding debt stock. Opportunistic, office-seeking political actors – individual policy makers as well as parties – with time horizons that stretch beyond the next elections can be expected to take into consideration the costs of allowing an already high debt stock to grow even further. Long-term political damage from being associated with a crisis or with painful emergency measures needed to avert default is likely to be massive. The greater the chance that these costs arise already in the coming electoral term – i.e. the greater the debt – the stronger the incentives should be for incumbent policy makers to refrain from fiscal electioneering. Furthermore, the erosion of the room for policy manoeuvres to manage the economy and to maintain price stability foreshadows policy problems for the coming governmental term and therefore carries additional political costs for later elections. Finally, if one assumes that a large outstanding debt stock makes borrowing a salient policy issue, fiscal electioneering might backfire already in the current elections. In light of these considerations, the motivations of policy makers to subject their spending and taxation decisions to short-term electoral targets should be progressively outweighed by the risks and costs of such a strategy as indebtedness reaches alarming proportions. Therefore, instead of resolving the puzzle, focusing on the electoral motivations of incumbent governments raises the question what forces can counterbalance the political risks entailed in continued deficits when the debt stock is large.

#### *Borrowing and the intra-governmental collective action problem*

While the above theories assumed that deficits are intentional and serve the electoral objectives of the incumbent political forces in various ways, the other significant group of theories contend that fiscal imbalances can also occur as an undesired side effect of collective decision-making within the government (Grilli et al 1991). Unintentional, undesired deficits arise from the collective action problem that governments face in

trying to reconcile the public interest in a balanced budget with the particularistic interests regarding spending and taxation that different actors within the government represent. Deficits are a “residual source” of financing when decision makers cannot agree on the different spending items and taxes so that revenues and expenditure balance (Grilli et al 1991). This reasoning focuses on the dispersion of decision-making authority between several actors – ministers within the cabinet, coalition parties within the government and members of parliament – that are assumed to represent the spending and taxation preferences of different groups of voters or lobby groups.

The collective action problem involved in budgetary decision-making has been approached from two different angles in the past, but both approaches arrive at essentially the same conclusions. One set of theories investigate the question what motivates different participants of the policy making process to increase spending or to cut taxes beyond a level that would allow for a balanced budget. In other words, it asks how deficits are *actively created*. The other approach looks at why participants of the policy making process would be against cutting spending or increasing taxes when the budget that they inherit is in deficit. In other words, this approach seeks to explain the *passivity* of policy makers in the face of a persistent problem. Consequently, the “active” approach argues that the public harm of deficits is generated by the pursuit of particularistic benefits (of higher spending and lower taxes), whereas the “passive” approach contends that the public good of balanced budget remains elusive because of the difficulties entailed in inflicting particularistic harm (spending cuts and tax increases).

Common resource pool models take the “active” approach. They understand deficits as an externality problem. Budgetary processes may separate spending decisions from the ones on taxation, and spending that is specifically targeted at well-delineable groups is usually paid for by the electorate as a whole, either in the form of higher taxes or in the form of increasing public indebtedness. Therefore, individual decision makers do not fully internalize the costs of additional spending benefiting their voters and are excessively keen to increase spending directed at their constituencies. The seminal model that gave rise to this family of models was developed by Weingast, Shepsle and Johnsen (1981) to explain the size of pork-barrel spending directed at geographically concentrated interests in the US legislature. Von Hagen and Harden (1996) and Hallerberg (2004, 2009) then applied this idea to targeted spending in general. These models do not explicitly investigate the revenue side of the budget and the incidence of

taxes on different groups. In fact, they implicitly assume that taxes are general. Therefore, they treat the deficit problem as a spending control issue. However, their logic can be easily extended to tax cuts, exemptions and rebates which are often quite clearly aimed at specific groups and thus create the same sort of externality as targeted spending. Therefore, it is possible to argue that the pursuit of particularistic benefits not only bloats spending but also erodes revenues and can thus contribute to unwanted deficits through two channels.

The “passive” approach concentrates on the conflicts of interests that arise when the budget needs to be adjusted in order to eliminate existing imbalances. Roubini and Sachs (1989) argued that even if the government aims at stabilizing public finances, this objective might be undermined if parties constituting the coalition try to shield their own constituencies from spending cuts and tax increases. In effect, coalition parties are tempted to secure a “free ride” for their own constituencies by vetoing measures that place part of the burden of consolidation on them, hoping that other retrenchment measures will pass and their voters can benefit from fiscal stabilization without having to contribute to it. If each of the parties takes an intransigent position, a prisoner’s dilemma ensues, and stabilization might not be launched at all in the coalition’s entire lifetime or might be insufficient, even if all of the parties are otherwise committed to stemming debt growth<sup>6</sup>.

The “active” and the “passive” models reflect different implicit assumptions about the nature of budgetary policy making. The “passive” approach takes into consideration the inbuilt inertia of fiscal policies, the fact that in most developed countries a large part of the budget is predetermined by laws and past commitments (Wildavsky and Caiden 2004). It acknowledges that deficits might be inherited from the past, in which case restoring the balance of public finances requires active tightening in the present. The “active” approach, on the other hand, operates as if all items of the budget were subject to current decisions. Consequently, the two approaches concentrate on different institutional sources of power: “passive” models focus on veto points in the decision making process, whereas “active” approach is interested in how the budgetary process formally provides access of different actors to influence decisions<sup>7</sup>. However, despite these differences, the two approaches are conceptually identical in the sense that they both describe a situation in which the balance of public finances is the function of a

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<sup>6</sup> See also Spolaore 1999

<sup>7</sup> See also Cox (2008)

political agreement between representatives of particularistic interests to restrain those interests for the sake of fiscal equilibrium.

In line with their conceptual congruence, the empirically observable implications of the two approaches are the same. These concern institutional and party-political aspects of decision-making that determine both the severity of the collective action issue and the available mechanisms to deal with it. First, institutional settings that disperse decision-making authority over fiscal matters among a large number of actors are expected to be associated with greater difficulties in maintaining or restoring budgetary discipline (Roubini and Sachs 1989, Grilli et al. 1991, Alesina and Perotti 1996). Second, institutional mechanisms that foster coordination between the different actors and provide incentives and constraints that help them to overcome their collective action problems are expected to lead to better budgetary results (von Hagen 1991, von Hagen and Harden 1994, Hallerberg and von Hagen 1997). Third, party-political factors influence the intensity of the conflicts of interests between the different actors with access to the decision making process. Consequently, they determine the likelihood that these actors reach compromises over how to fit their spending and taxation priorities into a balanced budget. Countries where the party system exhibits large polarization between powerful parties or party-blocs are expected to suffer from greater fiscal imbalances (Balassone and Giordano 2001, Hallerberg 2004, Hallerberg, Strauch and von Hagen 2009).

These predictions of the theoretical approach focusing on intra-governmental collective-action issues provide promising clues for resolving the puzzle of why countries might fail to balance their budgets even when further borrowing is risky and costly. In countries where the budgetary decision-making process is excessively fragmented, intra-governmental coordination mechanisms are missing and/or political polarization among actors involved in the policy making process is significant, governments are expected to face especially great challenges in remaining within their budgetary limits. These challenges might frustrate efforts to stem debt growth even when indebtedness reaches alarming proportions. The rest of this section reviews studies focusing on the institutional and party-political aspects of the collective-action problem entailed in budgetary decision making in order to get a clearer picture of the conditions under which these aspects can explain the puzzle investigated here.

The institutional implications of the collective-action models have been thoroughly explored empirically. One group of such studies<sup>8</sup> investigate how electoral institutions affect fiscal outcomes. Electoral institutions are expected to influence the severity of the collective action problem through determining the dispersion of policy-making power among different party-political actors. Roubini and Sachs (1989), Grilli et al. (1991), Alesina et al. (1998) find that countries that have proportional electoral systems – and that are, therefore, governed by multiparty governments most of the time – are likelier to run deficits and are less likely to be able to successfully consolidate the budget after a shock to public finances. Padovano and Venturi (2000) and Balassone and Giordano (2001) also claim that government fragmentation – measured by the number of parties in the governing coalition – seems to be the strongest factor behind debt accumulation.

Other studies<sup>9</sup> explored the fiscal effects of specific rules regulating the budgetary decision-making procedure itself<sup>10</sup>. Some budgetary institutional features – for example hierarchical decision-making between different levels of government or the centralization of decision-making in the hands of a strong finance minister – determine the spread of decision-making authority among different office holders and different entities (such as different ministers within the cabinet, between the cabinet and the parliament, among parliamentary committees etc.). Other features – such as spending and deficit rules or commitments to budgetary targets etc. – provide mechanisms to overcome the collective action issue. The empirical results show that limiting the dispersion of power between decision makers by procedural regulations improves budgetary outcomes (e.g. Alesina and Perotti 1996, Hallerberg and von Hagen 1997). Truly binding spending and deficit rules as well as fiscal targets and credible penalties for defection from pre-agreed objectives are also associated with better fiscal performance (e.g. Hallerberg and von Hagen 1997, Hallerberg et al. 2009).

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<sup>8</sup> Roubini and Sachs (1989), Grilli et al. (1991), Alesina et al. (1998), Padovano and Venturi (2000), Balassone and Giordano (2001)

<sup>9</sup> Von Hagen and Harden (1996), Hallerberg and von Hagen (1997), Perotti and Kontopoulos (2002), Hallerberg (2004), Lagona and Padovano (2007), Hallerberg and Yllaoutinen (2008), Hallerberg, Strauch and von Hagen (2009).

<sup>10</sup> For a comprehensive list of the possible institutional factors that can come into consideration, see Lagona and Padovano (2007).

These results strongly highlight the role of institutions – both electoral and budgetary – in determining a country’s ability to maintain and restore fiscal equilibrium. At the same time, they also raise fundamental questions. Alesina and Perotti (1996), Poterba and von Hagen (1999) and Hallerberg et al. (2009) et al. – among others – point out that understanding why certain countries adopt certain budgetary institutions would be crucial for capturing what it is about countries that explains the great variation in their fiscal performance. Since certain budgetary institutions<sup>11</sup> have been shown to successfully mitigate the potential negative effects of electoral institutions on fiscal outcomes, it is the combination of the two sets of institutions that matters for fiscal performance. While the choice of electoral institutions in a given country is determined by a complex set of socio-political and historical factors and is unlikely to be subjected completely to the requirements of fiscal discipline, budgetary institutions can in principle be tailored more freely to improving the collective efficiency of policy making. The question is therefore why some countries forego the benefits of better institutions and of stronger coordination among different actors involved in decision-making. This question is especially important for the puzzle at hand here. Would growing pressure from mounting debt not force the actors involved in budgeting to find a coordination mechanism to overcome their collective action problem? If it is possible to limit the budgetary harm of collective decision making through the adoption of rules and the adjustment of procedures, why would policy makers not avail of this option to avert a looming fiscal crisis?

#### *Intra-governmental decision-making and party politics*

The question of the endogeneity of budgetary institutions turned the attention of scholars to the previously under-researched party-political aspects of the collective action problem of fiscal decision-making. Recent scholarship takes into consideration the intensity of the conflicts of interest present in the decision-making forums, not just the dispersion of decision-making authority. In answering the question why some countries have the right, others the wrong fiscal institutions, Hallerberg and others (2009) argue that the type of coordination mechanisms that policy makers can adopt depends strongly on the strength of party-political conflict present in the policy making sphere<sup>12</sup>. They contend that the degree to which coalition partners are willing to limit their own scope of action and to compromise their particularistic interests for the sake

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<sup>11</sup> Or in Hallerberg et al.’s terminology certain forms of “fiscal governance” (2009, p 5).

<sup>12</sup> See also Hallerberg and von Hagen 1997, Hallerberg 2004.

of a balanced budget is a function of the polarization of ideologies between the different parties and the chances that they will run together or against each other in subsequent elections. For example, the authors show that budgetary discipline can be enforced by a strong finance minister only if the government is unified, because parties in a heterogeneous coalition will not surrender control over spending and taxation completely to a minister from another party. Fragmented coalition governments will instead have to agree on detailed fiscal contracts in the coalition-formation phase in order to commit themselves to a specific strategy that all of them find acceptable for achieving fiscal balance. Consequently, their ability to overcome collective action issues in budgeting will be subject to successfully negotiating a no-deficit contract.

However, Balassone and Giordano (2001) show that such a contract will be unachievable if the policy preferences of the possible coalition partners strongly differ and they have evenly distributed bargaining power (arising either from the number of votes a party can muster in the legislature or from a *de facto* veto connected to a party's pivotal significance to the viability of the coalition). In such a situation, it might not be possible to put together a coalition that can agree on a programme of spending and taxation that ensures the balance of the budget, even if individually all the parties are otherwise keen on avoiding deficits. Furthermore, Balassone and Giordano note that even a single-party government might be similarly unable to commit to a no-deficit plan, if it consists of several strong factions with differing constituencies and divergent fiscal preferences. In such a case, conflicts of interests between factions make the delegation of authority to a strong finance minister equally unlikely as in the case of a coalition government.

These results suggest that some conflicts of interests between parties or policy makers might simply be too stubborn to handle even by negotiations and institutionalised commitment devices. If the different spending and taxation preferences represented in the policy making process diverge very strongly, the trade-off between compromising these interests and the benefit of consolidating public finances is very steep. In such a situation, the willingness of policy makers to put the particularistic interests of their constituencies ahead of the goal of fiscal stabilization might be more than just an opportunistic impulse arising in the decentralized process of budget management, which can be reined in via the necessary coordination mechanisms. It might in fact be at the heart of policy makers' political strategies, perceived to be the key to their electoral survival. In such a situation, the adoption of budgetary institutions that

enforce self-restraint on the representatives of particularistic interests is unfeasible. Therefore, in a policy space populated by actors of matching strength representing strongly polarized interests, balancing the budget will be particularly hard, possibly even once debt accumulation starts to reach dangerous proportions.

Furthermore, Balassone and Giordano's observation about internally factionalized single-party governments implies that the emergence of such a situation is independent of the primary characteristics of the party-political landscape (such as fragmentation or concentration), because the same strong conflicts can arise within as among parties. It is the degree of divergence of spending and taxation preferences between crucial, electorally significant constituencies that matters, rather than how they are distributed among parties. Moreover, Hallerberg et al.'s (2009, p205-208) results in connecting fiscal outcomes to institutions of social partnership and to the presence of social pacts shed light on the importance of non-party political representatives of interests of different constituencies in the policy making process. Their findings indicate that a full analysis of how conflicts of interests between different constituencies influence fiscal outcomes cannot stop at the exploration of party strategies, but has to take into consideration a broader set of interest-representing actors and the way their survival and success is connected to the protection of particularistic preferences.

These results shed new light on the determinants of fiscal performance and suggest that the institutional factors that empirical studies found to be so closely correlated with fiscal outcomes might be only intervening variables between underlying structural factors – such as the constellation and conflicts of interests of different political constituencies – and fiscal problems. The greater the urge of actors with significant influence on policy making – such as parties, factions within parties, possibly trade unions and employers organizations – to safeguard the strongly divergent interests of their constituencies, the more challenging it is to overcome the collective action problem of having to reconcile and restrain those interests for the sake of fiscal equilibrium.

In the context of the puzzle at hand, these findings identify a potentially significant force that could drive governments – and therefore countries – towards borrowing even in the face of an alarmingly large debt stock. But does it mean that countries where the interests of the constituencies of different powerful political organizations



strongly diverge are meant to never resolve their fiscal problems and borrow unflinchingly until they go bust? After all, political actors bent on pleasing their constituencies cannot infinitely ignore the accumulation of debt. Under what conditions are the costs and risks associated with high and growing debt likely to outweigh the collective action problem generated by the conflicts of interests? Conversely, under what conditions are the conflicts so strong that they push the country to the edge of fiscal disaster? This is the question that this thesis attempts to answer.

### *Conclusion – the neglected puzzle*

The general feature of the literature on fiscal deficits reviewed here is that it takes as its point of departure the “textbook view” of the political economy of fiscal discipline and fiscal stabilization. The theories described above only concentrate on the possible political downsides of fiscal rigour and fiscal tightening for policy makers. None of them take into consideration that in certain situations it is borrowing and fiscal imbalances – rather than fiscal restraint – that are likely to become ever more costly politically for the policy maker. This is equally true for theories that see borrowing as a conscious decision of the government and for ones that consider deficits an undesired side effect of collective decision-making. Therefore, these theories are “blind” to the puzzle entailed in continued imbalances in the face of alarming levels of debt. They are interested in explaining the variation in deficits across countries and periods, but see nothing fundamentally puzzling in relentless debt accumulation. This “blindness” is not too surprising given the low empirical relevance of the issue of potentially dangerous indebtedness in most of the post-war period. It is only recently that in the developed world fiscal problems reached proportions that generate potentially large and growing costs for a significant number of countries. Previously, the assumption that deficits are costless for policy makers held for the large majority of countries. Since it “assumes away” the factors that make the phenomenon of risky debt accumulation puzzling, the existing literature does not directly provide an answer to the question asked here.

At the same time, this literature does offer clues to identifying the forces behind the phenomenon of excessive debt accumulation. The next, concluding section proposes a theoretical framework that is based on the same basic intuition as the theories about unintentional deficits described in this section. It focuses on the conflicts of particularistic interests of different constituencies within the polity and on the difficulties in restraining and reconciling these interests for the sake of regaining fiscal

equilibrium. However, the proposed new framework differs from the literature reviewed here in two crucial aspects.

First, while the theories described here concentrate on the problems entailed in collective-decision making in the narrowly-defined policy making forums, the theoretical framework proposed below broadens the scope of investigation beyond the governmental and parliamentary sphere, to encompass a more complete set of forces that have an influence on policy outcomes. On the one hand, this broadening of the scope of analysis incorporates the newest results of Hallerberg and others (2009) and the insights of Balassone and Giordano (2001) about the need to take into consideration actors other than parties when explaining fiscal outcomes. On the other hand, it goes beyond exploring the role of previously neglected actors in policy making – like trade unions, employer organizations or influential factions within parties – and seeks to encompass every possible political force that affects fiscal outcomes.

Second, the proposed new framework seeks to capture more accurately the tension between the public good and particularistic interests of different sections of the population and to incorporate the structural factors that influence the levels of conflicts of interest between different groups within a polity. The government-centred common resource pool and veto actor theories use this tension as the centrepiece of their models, but never explicitly investigate it. The theories reviewed here assume that different political actors stand for different sets of interests, but – apart from sporadic attempts to proxy the conflicts of interests by measures of ideological polarization<sup>13</sup> – they do not actually investigate the divergence of preferences and how exactly it interferes with promoting the public interest in fiscal stability. The proposed theory explores the strength and the nature of conflicts between the different constituencies of different political actors in order to better understand the reasons why policy makers might be unable to stem debt growth and steer the country away from fiscal disaster.

### **The argument in brief and plan of the thesis**

The review of the literature on the determinants of fiscal performance throws into relief the necessity to study the substance rather than just the mechanics of fiscal policy making when it comes to accounting for the phenomenon of risky debt accumulation in certain countries. In other words, it suggests going beyond institutional analyses of

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<sup>13</sup> E.g. Grilli et al. (1991), Hallerberg et al. (2009)

policy formation and focusing more on structural factors shaping the nature and intensity of political conflict surrounding fiscal decisions in a polity. Therefore, this thesis develops a theoretical framework that explains how the underlying socio-economic characteristics of a given polity influence fiscal policy making and determine the likelihood that the country goes down the path of excessive debt accumulation.

This theoretical framework places less emphasis on how and why fiscal imbalances originally arise. Instead it concentrates more closely on how borrowing can be stopped – or not – once it becomes obvious how explosive the fiscal path is. Public finances can be pushed out of balance by economic, financial or societal shocks that policy makers have no control over – such as the slowing of growth, a permanent rise in unemployment, population aging or a jump in the interest rates on outstanding public debt etc. – or by earlier policy mistakes that present generations need to address. It is arguably not the original source of the problem that matters for debt accumulation, but the ability of the country to adapt its fiscal course to restore fiscal balance and stem further borrowing.

Since a major adjustment in fiscal policy – a substantial growth in taxes or large cuts in expenditure – necessarily upsets the redistributive arrangements present in the given country, choosing a specific path towards consolidation is likely to be a highly contentious matter politically. Different groups within society are likely to mobilize their resources and form political coalitions in defence of their long-term fiscal interests. As long as all groups find it expedient to use their political influence to veto stabilization plans that would restore the balance of public finances at their expense, policy will be impossible to adjust and the persisting gap in the budget will keep feeding the debt stock despite the growing costs and risks of further debt accumulation.

Therefore, the chances of stabilization depend on the calculus of resistance for different groups. As long as defending their redistributive interests trumps the urge to eliminate the costs and risks arising from the ever-higher debt stock, groups will form and maintain political coalitions that allow them to resist tax increases or benefit cuts that harm their interests and channel their political resources towards this end. However, since the policy status quo is associated with a progressively deteriorating fiscal situation – as interest costs of the mounting debt stock place ever-greater pressure on the budget – the calculus of resistance might dynamically change for different groups as time goes by. Stabilization that seemed impossible at an earlier stage could become

possible as certain groups now find it in their interest to acquiesce in bearing sacrifices and to use their political clout to endorse consolidation. When this point in time arrives depends on the socio-economic characteristics of different groups, which determine their respective fiscal and economic interests and the tradeoffs between these interests. Therefore, understanding how long debt is allowed to grow and when consolidation will take place in a given polity requires mapping out the socio-economic landscape of the country as well as investigating the distribution of political influence and the possibilities for political coalition formation across different sections of society.

The logic of this framework is identical to the logic of the veto actor models discussed above, but instead of looking at institutional veto points in the narrowly understood governmental sphere, this theoretical approach studies directly the clusters of interests present in a given polity and investigates how the conflicts between them shape policy outcomes. It places less emphasis on institutional structures. Instead, it takes a fundamentally society-centred, structuralist approach towards explaining policy outcomes – based on Peter Gourevitch's theoretical framework developed in 'Politics of Hard Times' (1986) – and combines this approach with insights of Alesina and Drazen's (1991) war of attrition model about dynamically changing costs and benefits of different strategies in the fiscal stabilization game.

By developing such a theory to explain a puzzling fiscal policy phenomenon, the thesis also taps into a broader debate in comparative political economy about the relative importance of structural, institutional and ideational factors in determining policy outcomes in different countries. While it readily acknowledges the role of institutional and ideational aspects of politics and policy making in influencing fiscal performance, it argues that these aspects are secondary – and to a great extent derive from – the constellation and evolution of interests within the polity and hence from the socio-economic position of different groups within society. It analyses in detail the politics of risky debt accumulation through time (from the mid-1970s to the present) in Italy and Belgium through the lens of a society-centred theory, and attempts to depict the interplay of socio-economic factors with different institutional – electoral, party-political, corporatist and governance – arrangements and with ideational issues (such as policy traditions, paradigm shifts and ideological transformations) in shaping the experiences of these two countries with excessively high public debt.

The next chapter explains the theoretical approach of the thesis in detail and sets it against possible alternative institutionalist and ideationalist explanations of the observed puzzling policy phenomenon. It also contemplates the methodological considerations involved in empirically evaluating the validity of such a society-centred and dynamic theory and explains the reasons for choosing Belgium and Italy as concrete cases to study. Chapters three through six analyse the Italian and Belgian experiences with excessive debt accumulation in the past three decades employing the theoretical framework and methodological approach developed in chapter two. Each country study is divided into two parts. The first part explores the emergence of the problem of alarming debt growth in the 1980s and explains why the appropriate policy response was initially delayed by analysing the socio-political context of fiscal policy making. The second half of each country study describes how each country addressed the debt problem in the later periods with special emphasis of the impacts of the euro-accession on the evolution of fiscal policies, both in terms of the fiscal preconditions for joining the euro and in terms of the economic and financial effects of the common currency. The last chapter gives an overview of the findings of the case studies. First, it considers how they managed to combine the two relatively distant approaches of Gourevitch and the war of attrition model. Second, it evaluates how the empirical material enriched the theoretical framework proposed here. Finally, it assesses the explanatory power of the mechanism posited here relative to other theories and spells out the contributions of the thesis to theoretical, methodological and policy debates.

## **Chapter 2.**

### **The theoretical approach: Coalitions of societal interests and delayed fiscal stabilization**

The basic debate in comparative political economy centres on the relative importance of interests, institutions and ideas in governing economic and political developments in different countries (Hall 1997, Immergut and Anderson 2008). Structuralist (or society-centred or group-) theories argue for the primacy of raw societal conflict, determined by the constellation of economic interests as well as the distribution of resources and power (Gourevitch 1986, Rogowski 1990, Frieden 1991a and 1991b, Frieden and Rogowski 1996). Institutionalist and ideational approaches, on the other hand, call attention to the way in which institutional arrangements as well as cognitive models influence both the definition of interests by different social actors and the power imbalances between them (Thelen and Steinmo 1992, Pontusson 1995, Hall and Taylor 1996, Jacobsen 1995, Blyth 1997, 2002 and 2003). Ultimately, all three approaches try to make sense of how collective decisions are made concerning policies and institutions and how conflicts of interests are sorted out in the political sphere to give rise to different outcomes, but they disagree on which factors matter most in explaining the variation in these outcomes across polities and times.

In trying to account for the puzzling phenomenon of excessive debt accumulation in certain countries, this thesis takes a structuralist approach. This decision is motivated partly by the conclusions drawn from the review of existing literature on fiscal policy, but also and more importantly by Peter Gourevitch's (1986) argument about the manifest importance of structural factors – socio-economic interest and political power – in determining systemic policy choices in times of crisis.

In prosperous times it is easy to forget the importance of power in the making of policy. Social systems appear stable, and the economy works with sufficient regularity that its rules can be modelled as if they functioned without social referent. In difficult economic times this comfortable illusion disintegrates. Patterns unravel, economic models come into conflict, and policy prescriptions diverge. Prosperity blurs a truth that hard times make clearer: the choice made among conflicting policy proposals emerges out of politics. The

victorious interpretation will be the one whose adherents have the power to translate their opinion into the force of law<sup>14</sup>.

In other words, in the day-to-day business of fiscal policy making – where numerous questions of varying significance need to be decided upon – it is easy to forget about the broader societal conflicts of interests that bear upon the broad characteristics of policies that govern the economy and redistribution in a given polity. It is tempting – and reasonable – to assume that policy-making is the internal matter of the policy-making machinery of the state and that policy choices are determined by the preferences of the political actors that form part of this machinery, which, in turn are influenced by institutional and ideational constraints. However, at times of major economic adversity – or in Gourevitch's words in 'hard times' – when difficult and momentous zero-sum decisions need to be made, the wider societal embeddedness of policy making manifests itself more clearly, as large socio-economic groups mobilize in defence of their vital interests.

'Hard times' are times of economic dislocation that trigger major political controversy and ultimately lead to large adaptations in economic policy (Gourevitch 1986 p19). They represent systemic crises in the sense that accepted ways of managing economic and political life break down under the effect of a large external shock, such as a global slowing of growth, realignment of global production patterns, the emergence of new production procedures or the disruption of global trade and financial flows. The key feature of such a situation is that change seems inevitable, but its direction is highly contentious. In 'hard times', the stakes are unusually high, because of the long-term consequences of economic and political adjustments made in response to the profound changes in exogenous circumstances. Economic and political institutions as well as ideologies come under pressure as different groups within society marshal up their resources and rethink their political coalitions in an effort to influence the emergent systemic policy choices in their own favour<sup>15</sup>.

Times of large fiscal imbalances and dangerous debt accumulation are also 'hard times', because they expose the unsustainability of the redistributive status quo in the given country. Existing spending and revenue arrangements – even if they kept the budget in balance at some point in the past – now require constant and substantial borrowing that leads to accelerating debt growth. Just as in economic crises, exogenous shocks are

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<sup>14</sup> "Politics in Hard Times" (1986, p17)

<sup>15</sup> On the issue of the resilience and adjustment of institutions in the face of societal conflict, see also Shepsle (2008).

likely to play a role in generating the original problem. A sudden increase in world real interest rates might generate extra interest costs on outstanding public debt, a permanent slackening of economic activity might cause tax revenues to decrease or a surge in unemployment might generate extra social outlays etc. Fiscal 'hard times' often accompany economic 'hard times' in the sense that economic downturns trigger fiscal problems, but this is not necessarily always the case. The shocks generating fiscal issues could be independent of the economic cycles. Furthermore, earlier policy mistakes can also engender problems for the present via creating a public debt stock that gives rise to high interest expenses.

A distinguishing feature of 'fiscal hard times' is that in the absence of effective adaptation to the problem, the situation gets progressively worse as the growing interest costs of the accumulating debt burden continuously compound the effect of the original shock. Therefore, such crises have a pronounced dynamic element due to the endogenous escalation of the issue to be solved and the passage of time itself becomes an important element in influencing the parameters of the situation.

Apart from this diachronic, continuous aspect, however, times of fiscal troubles are conceptually very similar to Gourevitch's hard times in that they require a major adjustment in policies – large cuts in spending and/or increases in taxes – that affect the long-term pecuniary interests of large sections of the society and therefore are likely to give rise to political controversy. Furthermore, the order of magnitude of losses to be faced are likely to be sizeable, since stabilizing public finances require major sacrifices from society once the debt stock has grown large and the interest pressure on the budget is significant<sup>16</sup>.

Therefore, the constellation of conflicts and commonalities of interests between different sections of society and the *de facto* power relations between them can be expected to play a major role in how and when public finances are consolidated. The purpose of the theoretical model to be developed in this chapter is to understand how

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<sup>16</sup> Empirical examples help to appreciate the size of the challenge. In 2006, the year before a consolidation programme was started in Hungary, the cyclically adjusted deficit of the budget was over 11 percent of the GDP. In the same year, the total non-interest spending of the government was 48 percent and total revenues amounted to 42 percent. Reversing debt growth required cutting non-interest spending by more than a fifth or increasing taxation by almost a fourth. Similarly, in 2010 when the Conservative Party won the British elections on the promise of averting a debt spiral, the cyclically adjusted deficit of the budget was 9 percent of the GDP, almost a fifth of total non-interest expenditure or a fourth of revenues. Consolidating Greek public finances in the five years of boom and historically low interest rates before the global economic downturn would have taken cutting expenditure or increasing taxes by a sixth.



and why societal conflicts about fiscal stabilization can lead to a policy deadlock and thereby to an endogenous reeling out of control of debt accumulation in a country.

The next section sets down the criteria for identifying social groups within a polity that are relevant for fiscal policy making and for determining the sources of influence they can exercise on policy outcomes. It follows Gourevitch's own model for explaining policy responses to economic dislocation, but it adapts its guiding principles specifically to the problem of fiscal consolidation. The third section incorporates into this society-centred analysis a dynamic aspect, using the insights of the war of attrition model of delayed stabilization of Alesina and Drazen (1991). Gourevitch's original approach is targeted at comparative statics: it focuses on explaining why a certain economic shock changes policies and institutions in a certain way in a certain polity. Given that fiscal problems endogenously escalate once an exogenous shock sets them into motion, the behaviour of the relevant actors should be traced in a continuous, diachronic framework when it comes to explaining fiscal consolidation. The war of attrition model helps to explain how the interests and strategies of relevant actors evolve as the fiscal situation deteriorates if a commensurate policy response to fiscal imbalances is delayed.

The fourth section attempts to put the model developed here into perspective by setting it against a range of alternative explanations. It briefly discusses how institutions of interest representation and of the state might influence the way societal conflicts about fiscal policy play out in different countries, how ideational factors might modulate the effect of structurally given interests and political coalitions on fiscal choices and how the international system might shape the way fiscal problems are handled in the domestic political sphere. The fifth section discusses methodological considerations involved in applying the society-centred framework to empirical cases and explains the reasons for choosing Belgium's and Italy's experiences with public debt as concrete cases to study.

### **Applying the Gourevitchian society-centred framework to fiscal policy**

Society-centred approaches to explaining economic policy choices and outcomes have been applied to a variety of policy areas, but so far not to fiscal policy. Among others, Kindleberger (1951), Rogowski (1990) and Frieden and Rogowski (1996) concentrated on producer groups in accounting for variation in trade policy across countries. Frieden

(1991) also explains trade and industrial policy in different Latin-American countries by examining the conflicts and commonalities of interests among different classes and sectors in each country. Monetary and exchange rate policies have similarly been analysed through the lens of conflicting societal interests by, for example, Henning (1994) and Frieden (1991 and 2001). In 'Politics of Hard Times', Gourevitch (1986) uses this approach to make sense of the choices between complex policy packages – incorporating various areas of economic policy – which different countries took at different turning points in economic history. This section investigates the ways in which this society-centred approach can be applied to the analysis of fiscal policy, using Gourevitch's model as a template.

For Gourevitch (1986, Chapter1), the starting point is that governments need societal support in order to carry out decisions in highly contentious situations. In other words, governmental discretion is limited by the fact that influential groups within society can mobilize against decisions that encroach on their interests. This is also likely to be the case when public finances are out of balance, existing redistributive arrangements have to be renegotiated and large sections of society need to be convinced or forced to acquiesce in losing part of their income via higher taxes or cuts in public spending. Although elections authorize governments to make policy choices, they are unlikely to possess the *de facto* authority to decide as they please in redesigning the redistributive features of policies.

For such momentous policy decisions to succeed, the government's executive and legislative authority needs to be complemented with the political support and the cooperation of economically and politically influential societal groups. Beyond delegating their representatives into the parliament, these groups can defend their interests through several extra-parliamentary ways. Workers can go on strike; investors can move their capital out of the country; producers can withdraw into the underground economy; various groups can stage demonstrations or lobby the government etc. For the government's policies to pass and to have their desired effect, a large enough proportion of the groups needs to support them or at least acquiesce in them. Every stabilization package creates losers, who will have to pay more into or take less out of the public purse, and winners, who are spared of the sacrifices required for the sake of stabilizing public finances. The prospective losers of a consolidation initiative are likely to mobilize their policy influence in order to defend their interests.

The success of stabilization thus depends on whether the prospective winners are strong enough to ensure the success of the given package.

Therefore, understanding whether stabilization is possible and debt accumulation can be reversed – or, conversely, whether a country keeps borrowing even in the face of mounting risks – requires finding out whether there exists a viable stabilization package in the given polity, one that can garner the necessary societal support. This, in turn, requires mapping the structure of societal interests within the polity, identifying the sources of policy influence that can be used to defend these interests and analysing how the different societal groups unite their forces in support of or in resistance to certain stabilization initiatives. Using Gourevitch's terminology, the task is to identify the relevant *societal actors*, determine the *sources of their influence* on policy choices and observe how they form *societal coalitions of interests* in the struggle over policy choices.

#### *Relevant societal actors*

In identifying relevant groups within society, authors in the society-centred tradition mostly base their investigation on *a priori*, theoretical assumptions about the distributional effects of different economic policies across different groups. For example, in investigating the politics of trade policies Frieden and Rogowski (1996) systematically review the implications of the Ricardo-Viner, Stolper-Samuelson, Heckscher-Ohlin etc. theories for identifying socio-economic characteristics of groups that are likely to be differentially affected by trade policy choices. In explaining economic policies in Latin-America, Frieden (1991) delineates relevant social units according to class and asset specificity. In accounting for preferences concerning exchange rate and monetary policies, Frieden (1991 and 2001) concentrates on exposed and sheltered sectors.

Gourevitch (1986, Chapter 2), on the other hand, adopts a different strategy. Instead of categorically defining the groups whose interests are expected to play a defining role in economic policy choices, he lists a number of general socio-economic characteristics that could play a role in delineating the relevant groups. He argues that within broad categories, such as class, a number of important variations need to be taken into consideration in order to better understand the conflicts and commonalities of interests that arise between groups across classes. He points out, for example, that

business groups might have differing policy preferences depending on their competitiveness, the nature of demand for their products, the character of their labour needs and the structure of the capital markets they face. The interests of workers might differ based on their skill levels, the scale and character of the enterprise they are working for or the sector they are employed in, whereas landholders might be divided according to the scale of production and the nature of their products. On the basis of these general criteria, he maps what he calls the 'production profile' of the given country at the given point in history and identifies relevant producer and labour groups on a case-by-case basis. This flexible strategy is necessitated by the fact that he is looking at choices between complex policy packages, rather than at binary alternatives within the same policy field, and therefore dissecting society along a single dimension is unworkable. At the same time, this approach has the added benefit of being highly sensitive to the specific socio-economic context of the countries under consideration.

This pragmatic, context-dependent approach is useful in identifying relevant clusters of fiscal preferences, too. From the perspective of fiscal policy, relevant societal actors are groups within society characterized by largely similar fiscal preferences. These, however, are impossible to categorize based on a handful of theoretically motivated criteria, because variability in tax regimes and spending patterns is practically limitless. In principle, fiscal policies can be tailored to advantage or disadvantage a wide variety of groups, based on class, income or wealth, age, enterprise size, geographical position and so on. Therefore, it is not possible to delineate groups within society according to their *a priori* fiscal interests.

When it comes to preferences towards different ways of fiscal stabilization, however, the policy status quo provides a useful starting point for finding the relevant societal groups. Since fiscal stabilization involves large negative changes to the status quo, the preferences of societal groups are likely to be determined in the first instance by their vested interests in existing policies. Some groups are attached to extant spending programmes, others to specific tax arrangements etc. While socio-economic position is likely to play a large role in determining these vested interests, clearly identifying the relevant groups *a priori*, on theoretical grounds is not possible, because of the country-specificity of the structure of government spending and revenues. For example, public employment has very different order of magnitude in different countries. Therefore, in some countries, public employees might constitute a powerful societal group, whereas

in other countries they might not play such a significant role. Another example for national variations in fiscal policies is the profound differences in welfare programmes, such as pensions or unemployment benefits. Since eligibility criteria vary widely across countries, the weight of groups with vested interests in these expenditure items will differ nationally. Consequently, the constellation of preferences towards policy adjustment will be country-specific. Identifying relevant actors thus requires exploring the fiscal policy status quo in the given country and delineating the groups of beneficiaries of existing spending programmes as well as major categories of taxpayers.

At the same time, it is important to note that the effect of fiscal policies on different groups within society is not one-dimensional. Beyond the direct effect of taxes and revenues on income, the budget balance itself can have indirect effects on the welfare of certain groups via its influence on the general economic environment. Large persistent deficits can give rise to considerable macroeconomic problems, which can cause significant losses to societal groups depending on their position within the economy. High inflation is a typical side effect, if part of the deficit is monetized. Another is high interest rates that crowd out private investment. For groups that suffer from the corollary macroeconomic costs of the fiscal problem, the calculus of supporting or opposing a given stabilization package has to go beyond evaluating the package's impact on the vested interests of the group in certain spending and tax measures. These corollary costs therefore modulate the distribution of preferences towards fiscal stabilization.

In sum, the constellation of conflicts and communalities of interests towards fiscal stabilization in a given polity are jointly determined by the fiscal status quo – i.e. the existing spending and tax arrangements – and by the economic structure of production, which influences the sensitivity of different groups within the country towards side effects of fiscal problems. The policy status quo delineates major categories of taxpayers and beneficiaries of public spending, whereas the economic structure defines groups that are under similar levels of pressure from unresolved fiscal problems. These dimensions might demarcate overlapping groups but crosscutting divisions are also possible. Specific economic structures and fiscal histories are likely to give rise to country-specific patterns of relevant societal groups.

### *Policy influence*

The sources of policy influence that the different societal groups can employ in defence of their interests are also likely to be context-specific for the given country. Gourevitch (1986 p58-60) emphasizes the link between actors' position in the economy and the sources of pressure they can exercise to thwart policies they oppose. The primary source of influence of capital owners, workers, professionals, investors, buyers etc. over the success of policies is their economic decisions that they make in response to a given policy. In other words, Gourevitch underlines that the distribution of policy influence across groups is rooted in the economic structure of the given country. At the same time, he explicitly foregoes identifying the exact organizational channels through which this power is wielded and the institutional structures through which they are incorporated into policy makers' decision-making. Thereby, he separates economic structure – as a variable he is most interested in – from institutional arrangements that are epiphenomenal to his explanatory framework.

In the context of the politics of fiscal stabilization, it is important to take into consideration not only the actual use of such positional power, but also the threat of it. For example, workers can go on strike in response to announced stabilization packages – spending cuts and tax increases – or governments can limit themselves in light of the credible threat of a disruptive strike. Large employers can relocate from a country in response to tax increases or governments can forego such tax measures in order not to scare productive capital away. Clearly such threats can be made explicitly by the organizations representing the relevant groups, but they could be implied in observed past behaviour. Furthermore, beyond using their economic clout, different groups can exercise leverage over policies via harnessing other resources they can mobilize to put pressure on decision makers – such as violence and destruction or disruptive demonstrations. The distribution of these sources of influence among different socio-economic groups is likely to vary across countries. For example, the ability of workers to blackmail policy makers via the threat of strikes is likely to be much stronger in a tight labour market than in one where workers have reason to fear for their jobs. Similarly, demonstrations and riots can cause more disruption in some settings than in others. Therefore, identifying the ways in which different groups can prop up their interests requires clarifying the relevant conditions in the given country.

### *Societal coalitions*

Crucially, the balance of power between different groups and the extent to which their policy influence is translated into their preferred policy outcomes depends on the coalitions that groups build with other groups. Such coalitions might even give politically less powerful sections of society a disproportionate leverage in influencing eventual policy choices. For Gourevitch (1986 p55), observed policy choices are bargains that arise from political coalitions between distinct groups. Therefore, understanding policy decisions is equivalent to being able to account for the successful formation of specific societal coalitions around a set of shared interests.

Since potential for coalition building is a function of commonalities and conflicts of interests<sup>17</sup>, it can be traced back to the constellation of interests of different groups. In the context of fiscal stabilization – as explained above – these are jointly dependent on vested interests in specific features of the fiscal status quo and on the sensitivity of different groups to the negative macroeconomic side effects of fiscal imbalances. Hence, the formula for the way different socio-economic groups unite their forces against others to promote their joint (or at least mutually compatible) preferences is specific to each country according to its fiscal history and socio-economic structure.

### *The limits of comparative statics in the fiscal stabilization context*

Exploring these three components of the societal background of policy-making – the relevant actors, the sources and strength of their influence and, finally, the commonalities and conflicts of their respective interest – allows for explaining why and how a specific fiscal consolidation programme succeeds or fails in a certain national economic and social context and why it may be impossible to find a feasible stabilization package under a given balance of power between different coalitions of societal interests. At the same time, such an analysis of the societal context of given stabilization attempts can only capture snapshots of different moments along the trajectory of risky debt accumulation. This template for society-centred policy analysis has been developed and used to explain discreet policy choices at given points in time, under the prevailing economic and societal circumstances. Therefore, it can only

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<sup>17</sup> This context dependence of coalition-formation and the significance of the international economy in this context is underlined by the so-called internationalization-literature. This line of scholarship is dedicated to analysing the shifts in societal coalitions under the effect of shifts in the international economy (e.g. Milner and Keohane 1996, Rogowski 1989, Thatcher 2007).

explain why a certain policy – in this context a certain stabilization programme – is proposed and gains or fails to gain the necessary societal support in a given moment.

However, the puzzle of risky debt accumulation is a dynamic problem that can only be fully understood in a diachronic context. As debt gradually piles up, the country's vulnerability to exogenous changes in the economic and financial environment progressively increases, the government's room for manoeuvre shrinks and the negative effects on the economic environment grow. Understanding why a country continues borrowing under such circumstances goes beyond accounting for the lack or failure of specific stabilization initiatives. It also has to entail an explanation for how the societal context of fiscal policy making might or might not change under pressure from the alarming escalation of the debt problem, in order to better understand the conditions under which windows of opportunity open up for stabilization or persistently elude policy makers. In other words, a full explanation of the puzzle needs to include a clarification of the conditions under which the escalation of the problem generates or fails to generate the necessary societal support for a specific stabilization package. The next section describes a game theoretical model that helps to understand this evolution.

### **The war of attrition model: strategic choices of societal actors in a dynamic context**

In order to understand how the societal context of fiscal policy-making changes under the effect of the increasing debt problem, it is necessary to study how the fiscal preferences of the relevant societal actors towards fiscal stabilization evolve. As the balance of costs and benefits of intransigently defending one's vested interests in the fiscal status quo changes under pressure from the deterioration of the economic environment, the attitude of different groups towards different stabilization packages is likely to change. For groups that originally formed political coalitions with other groups in defence of certain policy arrangements, such a strategy might become increasingly costly if they suffer economic harm from the side effects of the deficits. This would put pressure on existing coalitions and potentially enhance the formation of new ones that promise to promote the resolution of the fiscal stalemate. Therefore, tracking the evolution of the preferences of different groups allows for explaining how coalitions of societal interests might break up and reconfigure and how these shifts in



the support for and opposition to a given stabilization package might eventually open the way for a successful consolidation.

### *Evolving strategies in the fiscal stabilization game*

The evolution of the preferences of the socio-economic groups towards specific stabilization packages in the presence of growing debt was modelled by Alesina and Drazen (1991). Their war of attrition model of delayed stabilization explores a situation in which some exogenous shock creates a structural gap in the public finances of a country. Unless new taxes are levied, the country keeps borrowing and the original structural gap widens due to the growing interest burden associated with the accumulating debt. Socio-economic groups within the country have the power to resist tax increases that affect them and thereby to delay the resolution of the issue. However, in the absence of stabilization, the situation becomes progressively more difficult to solve, because higher and higher tax increases are needed to fill the growing gap. The model investigates under what conditions it is rational for a socio-economic group to acquiesce in bearing all or most of the new tax burden or to intransigently resist making sacrifices for the sake of restoring the balance of public finances. In doing so, the model identifies a number of parameters that determine whether and how long fiscal stabilization will be delayed in a given country<sup>18</sup>. The insights of the model provide invaluable help in understanding how the societal context of fiscal stabilization evolves<sup>19</sup>.

Alesina and Drazen set out from the assumption that the attitude of important societal actors towards given stabilization packages might change with time, if these actors suffer growing harm from macroeconomic problems connected to the escalation of the debt issue, such as inflation, high interest rates or slowing growth. The sensitivity of each group to such negative side effects of debt accumulation depends on each group's position within the domestic and international economy. For groups that suffer from the corollary macroeconomic costs of the fiscal problem, the calculus of supporting or opposing a given stabilization package has to go beyond evaluating the package's

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<sup>18</sup> For a detailed discussion of the logic and the results of the model, see Appendix 1.

<sup>19</sup> While the war of attrition model has been widely cited in scholarly literature on persistent fiscal imbalances, its empirical applications have been sporadic (Grilli et al. 1991, Padovano and Venturi 2001, Alesina et al. 2006). Furthermore, since the few existing empirical studies test the implications of the model in a quantitative, large-n setting, they are unable to capture the crucial diachronic element of the logic of the model. In attempting to document the working of the diachronic logic of the model, this thesis contributes to our understanding of the empirical relevance of the theory posited by Alesina and Drazen.

impact on the vested interests of the group in certain spending and tax measures. It also needs to take into consideration that if a given package fails, the group will have to put up with the negative side effects of debt longer.

As debt keeps accumulating and the deficit widens under pressure from a growing interest burden in the absence of stabilization, the macroeconomic harm becomes larger, too. In this dynamically deteriorating context, societal groups are faced with a dilemma between supporting stabilization packages that harm their vested interests in extant policies or putting up with the ever-growing macroeconomic problems longer in the hope that other groups have a greater urge for consolidation and thus a more favourable stabilization package can be adopted in the near future.

Consequently, for a group that is sensitive to the side effects of the fiscal problems it is rational to acquiesce in paying (some or all of) the price of fiscal consolidation – i.e. to not resist an unfavourable package – as soon as it becomes clear that adopting a more favourable package is impossible in the foreseeable future. Therefore, a group that initially prefers to oppose a given package because of the sacrifices it imparts on its vested interests might come to support the same (or even a harsher) package when it realizes that this is the only way it can get rid of the growing losses caused by the macroeconomic side effects of the debt.

Importantly, the shift between opposition and support is motivated by a cognitive factor: a change in the group's assessment of the likelihood that other groups would consent to bearing the costs of consolidation soon enough to make it worthwhile to put up with the macroeconomic problems a little longer. This assessment depends on assumptions about how urgent it is for other groups to deal with the fiscal problem and how strongly the other groups are wedded to their vested interests.

Unless one group is obviously worse affected by the macroeconomic harm than any other, all groups will initially resist making sacrifices and will first try to gauge the likelihood that others will pick up the bill for consolidation. As time passes, all groups get a better sense of their chances of being able to “wait out” other groups in the polity and to free ride on others sacrifices. As soon as a group realizes that its chances to prevail in this game of waiting are low, it is rational for it to throw in the towel right away in order to avoid further macroeconomic harm and also to stem the self-generating escalation of the problem. Therefore, the passage of time – and the

deterioration of the situation – is as an important informational element that actors in this game take into consideration when forming their strategies. Consequently, initially resisting unfavourable stabilization packages could be rational even as a means of sending signals to other groups to induce them to reconsider their strategies and soften up their stance.

Based on this logic, the delay in consolidation will depend on two factors. On the one hand, the resistance of groups to stabilization packages will depend on the long-term harm they suffer from it. Therefore, the more polarized the fiscal interests of different groups – and thus the more one-sided their preferred stabilization packages – are the longer they are likely to resist and wait for a favourable package. On the other hand, the stalemate will persist longer and fiscal stabilization will be delayed longer, the longer the different socio-economic groups can afford to wait for others to pick up the bill for dealing with the problem. Therefore, the delay in dealing with the accumulation of the debt depends on the size of the macroeconomic harm that the fiscal problem generates, the sensitivity of socio-economic groups to these macroeconomic side effects<sup>20</sup> and the speed at which the fiscal problem endogenously escalates (which is determined by the interest rates the state has to pay on newly incurred public debt). These factors influence the magnitude of the costs of waiting for the resolution of the problem and, consequently, the incentives of each group to make sacrifices for the sake of swift consolidation. Importantly, if the debt has no macroeconomic side effects or all groups are insulated from the side effects, such incentives are missing and the problem is expected to escalate as long as the country manages to secure financing for its deficits.

#### *Evolving strategies, evolving coalitions*

It is important to note that Alesina and Drazen's framework is based on modelling the strategies of groups that are assumed to be unitary actors with their specific strategic calculus and a given ability to fend for themselves in the political struggle. These groups have a binary choice between paying for the stabilization themselves (i.e. accepting an unfavourable stabilization package) and enduring the macroeconomic costs of having to wait for other groups to pay. Bargaining with other groups about the parameters of the stabilization package is not included in the model and neither is the possibility that some groups would gain extra power to prevail over others by forming

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<sup>20</sup> Strictly speaking, it is the sensitivity of the most vulnerable group that matters for the timing of stabilization, because the group that suffers most from the macroeconomic side effects is expected to throw in the towel first. For more detail, see Appendix 1.

a coalition<sup>21</sup>. In this sense, the war of attrition model does not have an immediate connection to the Gourevitchian framework, which is based on bargains between different societal groups and on political coalitions between them, cobbled together in order to muster the necessary influence to defend their interests. However, the insights of the model can be usefully injected into Gourevitch's approach to track how the calculus of maintaining, leaving or reforming coalitions changes for each group as the debt problem escalates. In this context, the choice is not necessarily between accepting or rejecting a given stabilization alternative, but between maintaining a coalition that can secure the defence of a group's vested interests in the fiscal status quo and forming a new coalition that might involve fiscal compromises but is likely to be able to enforce a stabilization package that stems debt accumulation for the longer term.

In the context of the Gourevitchian framework, the insights of the war of attrition model help to explain stability and change in coalitions of support and resistance to given policy choices. The constellation of the different societal preferences towards fiscal policy is jointly determined by the distribution of vested interests in existing policies and by the differential urge for stabilization across the population. As the pressure from the macroeconomic side effects of the fiscal problems increases with the passage of time, the latter dimension becomes increasingly important. Therefore, the commonalities and conflicts of interests between different groups evolve with time. Societal coalitions that were based on the joint defence of vested interests in a specific policy might split up if part of the coalition becomes willing to compromise on that policy for the sake of consolidation and a new, consolidation-minded coalition might form. As this happens, a window of opportunity opens up for stabilization.

Notably, these results are based on the assumption that all groups are motivated by their private interests only. The growing vulnerability of the country to exogenous changes in economic and financial conditions remains a purely public problem that no groups are keen on voluntarily sacrificing their vested interests for. Therefore, if no group suffers from the macroeconomic consequences of debt accumulation or if such consequences are completely absent, there is no basis for cobbling together a societal coalition in support of stabilization. In this situation a prisoner's dilemma arises between the different groups. All of them resist stabilization attempts that would harm their vested interests, in an effort to free ride on others' sacrifices. Stabilization

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<sup>21</sup> In fact, the model assumes a two-group society, although the conclusions work for a larger number of separate groups, too.

remains elusive despite the potentially deleterious effects of debt growth for the country as a whole and likely for each of the groups, too.

In sum, in the theoretical framework proposed here, continued borrowing in the presence of alarming debt accumulation reflects the inability of influential socio-economic groups to allocate the costs of stabilization amongst themselves. The country flirts with fiscal disaster because stabilization is not determined by the increasing risks for the country as a whole but by the private harm that influential groups suffer from it. If this harm is significant enough to force at least some of the groups to make concessions on the issue, the danger can be averted, but if not, consolidation might be delayed all the way until a sovereign debt crisis turns the public problem into private economic loss.

### **The missing pieces of the puzzle: institutional, ideational and international aspects of delayed fiscal stabilization**

By studying the constellation of interests and the distribution of policy influence, and by modelling the evolution of the rational behaviour of actors in a progressively deteriorating fiscal situation, the theory presented above provides a logic that accounts both for delay in fiscal stabilization and for a possible later consolidation. It allows for explaining both why certain countries flirt with fiscal disaster and pile up dangerous amounts of debt even in times of peace and relative prosperity and why and how they eventually might make much harsher sacrifices than initially needed, in order to put their public finances in order. At the same time, this theory sidesteps many important questions about how the posited mechanisms – the definition of groups' interests, coalition-formation, -breakup and -realignment as well as bargaining and compromises – play out in an actual political setting. It keeps quiet about how interests are articulated and how they are represented in the policy making sphere, how policy alternatives are formulated and decisions are made within governments and bureaucracies, or how the manoeuvring space for policy making might be constrained by a country's position in the international political and economic system.

Institutional aspects – such as partisan and corporatist constellations that affect interest representation, the electoral regime determining preference aggregation, the rules and conventions guiding the working of the state etc. – are given a secondary, subordinate place in this structuralist, society-centred approach based on the

argument that the intensity of conflict that surrounds decisions to be made in 'hard times' puts existing institutional frameworks under great pressure and make them prey to the struggle between societal actors. Similarly, ideational factors – such as the role of ideological traditions and policy paradigms in forming conceptions about possible policy alternatives – are assumed to play an epiphenomenal role to conflicts of interest in this approach. In other words, ideas and institutions are subject to how the struggle evolves, rather than the other way around. Obviously, this puts this theory at odds with ideational and institutionalist approaches that argue that institutional and ideational factors crucially determine how interests are identified and preferences are defined, how societal actors are delineated and political coalitions are formed and how bargains are struck and compromises are made.

Furthermore, the proposed theoretical framework focuses strictly on the domestic political arena without explicitly referring to possible constraints on policy making that derive from the country's position in the international political and economic system. Countries are typically members of international organizations and are tied up in networks of international agreements about economic policy. These commitments limit their room for manoeuvre in shaping their responses to economic and fiscal challenges, unless they are ready to give up their existing status within the system. International factors can be fitted into the logic of the society-centred approach from two angles. On the one hand, insofar as the international economic and political system affects the constellations of interests and the distribution of resources in the given country, international factors are exogenous variables in the model, which affect the parameters of the domestic struggles about policy choices. On the other hand, the country's decision to honour or to attempt to change its international commitments is in itself likely to be the outcome of the domestic policy conflict<sup>22</sup>. The question of international commitments is especially important in the context of European countries that have delegated ever more of their policy making powers to the European Union and subjected themselves to rules in the field of fiscal policy.

This section contemplates the possible roles that institutions, ideas and international constraints can play in influencing the likelihood of excessive debt accumulation in a country. On the one hand, this serves the purpose of setting up alternative explanations against which the explanatory power of the theory presented here can be measured. On

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<sup>22</sup> On the two-way effect of the international economic and political system on domestic politics, see Gourevitch (1978).

the other hand, however, reflecting on the institutional, ideational and international aspects of policy-making also helps to place the abstract theory into the context of concrete political settings. It provides a more explicit treatment of the implications of the theory for questions like how socio-economic groups with convergent interests and societal coalitions can be identified behind interest representing organizations (such as parties, trade unions and employer organizations and their alliances); how the policy influence of these actors is rooted in electoral and corporatist arrangements; how these groups interact with representatives of the state; how they put ideologies into the service of their interests and how they use or defy international constraints in order to further their cause.

### *Institutions*

Institutionalist approaches are usually classified into three branches – historical, rational choice and sociological institutionalism – according to their genesis and their specific theoretical assumptions (Hall and Taylor 1996, Steinmo 2008). However, for the purposes of reviewing competing and complementary theories of the structuralist framework offered here, Pontusson (1995) offers a more useful categorization by differentiating between intermediate organization-centred, polity-centred and state-centred theories. These three groups of institutionalist theories allow for contemplating how interests are mediated by interest-representing organizations, how preferences are allowed representation in the policy making arena via specific rules of the political game (such as electoral systems) and how decision making takes place within the state.

In modern democratic societies, intermediate organizations – such as parties, trade unions, employer organizations, artisan associations etc. – normally serve the function of representing the clusters of interests and exerting the different forms of political and economic pressure that the above-described structuralist theory focuses on. Institutionalist theories see these intermediate organizations as having their independent genesis and their independent effect on policy outcomes. For example, an important branch of the literature (for a review, see Grofman 2008) contend that the crucial structural characteristics of party systems – the number of parties, their programmatic and ideological orientation, their predisposition towards coalitions etc. – are defined mostly by the electoral system of the given country. Others stress the role of historical contingency in the emergence of current partisan landscapes (Lipset and

Rokkan 1967, Sartori 1969, Boix 2009). Similarly, the literature on trade unions often concentrates on the effect of historical development in defining the strategies and strength of these interest-representing institutions (e.g. Rothstein 1992, Crouch 1993). In this approach, differences in observed policy outcomes can be explained by variation in party and union strategies – subject to different electoral and party systems as well as the historical evolution of social partnership – without a need to explicitly spell out the differences in the current underlying societal interests in the given policy<sup>23</sup>.

The theory offered here, on the other hand, implicitly assumes that interests determine the landscape of intermediate organizations. It is expected that there is normally congruence between such organizations – their supporter base and strategic outlook – and significant clusters of interests. Whenever new clusters of interests arise, a niche opens up in the organizational space that political entrepreneurs can occupy. Whenever interests change – under the effect of exogenous shocks or under the impact of an endogenously evolving economic situation – the organizations have to adapt their strategies and possibly face a transformation of their constituencies. In short, intermediate organizations are assumed to be vehicles for underlying interests. Alliances and cooperation between the different intermediate organizations are expected to be the main avenue for forming coalitions among different clusters of interests. In some cases, individual organizations can serve as umbrellas for social coalitions, but as soon as coalitions break up and new ones reform, the umbrella organization has to adapt accordingly. In the context of the model outlined above, one would expect to observe the stability or evolution of the policy preferences of different societal groups under pressure from the escalating fiscal problem to be directly reflected in a parallel stability or evolution of the strategic position of parties, trade unions etc.

Inextricably intertwined with the issue of interest mediation through parties and other associations is the question of how interests are aggregated and channelled into the policy making sphere through electoral rules, the organization of the legislature and the executive as well as through corporatist practices. Institutional theories emphasize the independent role of such arrangements on the distribution of formal policy influence amongst different groups within society as well as their representative

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<sup>23</sup> Indeed, Steinmo's (1989) paper about variations in tax systems as well as the theories reviewed in the introduction about the effect of electoral structures and government formation patterns on spending and deficits (e.g. Roubini and Sachs 1989, Grilli et al 1991, Spolaore 1999, Balassone and Giordano 2001, Hallerberg et al. 2009) follow exactly such a logic when investigating fiscal outcomes.



organizations (e.g. Cox and McCubbins 2001, Taagepeera 2009, Lijphart 1999, Schmitter 1974, 1977, 1999).

The framework outlined here, on the other hand, posits the primacy of those sources of policy influence that are linked to different groups' position in the domestic economy and to their control over crucial resources, such as capital, labour, professional expertise, the ability to cause disruption etc. Thereby, it assigns the formal, institutionalized ways of channelling the preferences of different actors a secondary role. For example, a group that has been sidelined in the electoral and government formation process and lacks corporatist access to the policy making sphere, might still exert pressure on the government and influence policy choices through control over its resources. Similarly, the formal electoral predominance or institutional veto rights of a group can be useless in the face of a credible threat from other groups to use their economic position to frustrate policies not to their liking. Whether such positional sources of influence and weakness are eventually formalized – through changes in electoral, corporatist or other coordinative arrangements – is a different issue, but the theory offered here assumes – in contrast to the institutionalist approaches – that the formal provisions have little added impact on the extent to which the given group has a say in policies. In the context of the model outlined above, it is expected that shifts in coalitions of interest – and consequently changes in the combination of resources that can be mobilized behind a given policy option – can either happen under unchanging institutional parameters or themselves be the cause behind changes in those parameters.

The third important question that institutional theories focus on is the nature of decision making within the state. Most importantly, these theories are interested in the extent to which the state itself can be considered an autonomous entity with its own set of objectives and preferences when it comes to policy formation. They investigate whether the institutional aspects of decision making lend state actors a degree of freedom to influence policy outcomes or they make the policy making process permeable to conflicting societal interests. In other words, they are looking for institutional structures that make the state “strong” or “weak” in the face of the multitude of societal pressures (Krasner 1978, Skocpol 1985, Fukuyama 2004).

These considerations about the independent role of the state do not arise in context of the society-centred theory presented here. Policy choices are by definition assumed to

be the outcome of societal conflict, whereas the state itself is seen as an entity that has no weight of its own. Its policy authority is expected to arise from the societal support it can muster behind a given policy option, but that support needs to be rooted in the interests of the supporting group, rather than in some abstract power of the state.

### *Ideas*

Ideational approaches seek to capture the independent effect of cognitive factors in the process of policy adjustment. They argue that when a country radically alters its policy course, the constellation of interests and institutional parameters might explain why change was necessary, but not why a specific new course was chosen. Instead, they contend that the range of possible policy choices and, therefore, the scope of and direction of policy change is determined by two cognitive factors: what crucial actors believe are possible responses to existing policy issues, and how actors conceive their own interests in the given situation (Hall 1993, Jacobsen 1995, Blyth 1997, 2002, 2003).

The first of these factors is usually investigated from a statist angle: i.e. authors look at how conversion to a new policy 'paradigm' takes place or fails to take place within the policy making structures of the state, especially among technocratic apparatuses (Weir and Skocpol 1985, Hall 1993). This issue has little relevance for a society-centred approach that underplays the role of the state as an independent actor. Instead, it constitutes a competing theory to explain policy change.

The question of how societal actors' interests are defined, on the other hand, poses an intriguing challenge for a society-centred theory that assumes interests to be materially given. Blyth (2002), in particular, underlines the power of ideas in making coalitions between different actors possible, by providing a cognitive basis for identifying commonalities and conflicts of interests within society. This raises the question whether policy entrepreneurship – and therefore the agency of individual politicians or party elites – plays an independent role in influencing coalition formation between different clusters of societal interests and the choice between different policy options. The logic of the society-centred approach assumes that interests are objectively given, providing an opportunity for entrepreneurs on the political market place to seize upon and nurture coalitions that enhance their political fortunes. In the context of the model developed above, it is expected that as the policy preferences of different actors evolve

under pressure from fiscal deterioration, a political actor (old or new) should decide to assume the role of the leading promoter of fiscal stabilization and thereby gain the support of those, who are now more interested in swift consolidation than in the defence of their vested interests in the political status quo.

### *International constraints*

The question how the international economic and political environment affects domestic policy choices has occupied scholars in all three traditions of comparative political economy alike (Thatcher 2007). Structuralists have focused on how changes in the international economy change the constellation of interests among domestic groups and how it thereby transforms domestic politics (e.g. Gourevitch 1978, Frieden and Rogowski 1996). Institutionalist scholars are interested in how domestic institutions mediate and modulate international changes in the domestic political sphere, on the one hand, and how they are shaped by international pressures and adapted to better fit new conditions, on the other (e.g. Garrett and Lange 1996, Streeck and Thelen 2005). Ideational approaches look at how the international dissemination and acceptance of given policy paradigms influence policy convergence and international cooperation (e.g. McNamara 1998).

For the politics of fiscal policy making, international effects can become relevant through two channels. First of all, since the constellation of interests and the resources of domestic actors are posited to be the fundamental driving factors behind the accumulation of debt as well as an eventual consolidation, the effect of the international developments on the interests and policy leverage of different groups are crucial. For example, changes in competitive conditions on the international markets – due to the integration of new, low-cost producer countries, a change in technologies or a more complete liberalization of trade – can influence the sensitivity of different producer groups to the negative side effects of fiscal problems such as high inflation or high interest rates. Such a change is expected to alter the trade-off between defending their vested interests and promoting consolidation, and thereby to influence the societal coalitions they form. Similarly, the opening up of lucrative investment or employment opportunities abroad can influence the ability of capital owners or workers to blackmail each other in the political process.

Secondly, international economic and political coordination might limit the range of available policy options within a country. For example, exchange rate arrangements under Bretton Woods or the European Monetary System (EMS) put a constraint on monetary policies in participating countries. This had indirect consequences for fiscal policy as well, insofar as the monetization of debt clashed with the commitment to fixed exchange rates. In the Economic and Monetary Union, monetary autonomy is completely ceded. An instance of a more direct limit on fiscal policy options of countries is the system of fiscal surveillance and excessive deficit procedures that were launched in Europe in the run-up to the euro, placing ceilings on admissible deficits. The crucial question in this respect is to what extent a country's willingness to enter into and to comply with commitments within such international and European frameworks of cooperation should be considered to be an exogenously given parameter of domestic politics or seen itself as an outcome of domestic struggles over economic policy. This question can only be answered on a case-by-case basis by empirically investigating the relative influence of international political and economic pressures and the domestic political impetuses in the two-level game<sup>24</sup> of international cooperation.

*Conclusion: observing societal struggle over fiscal stabilization*

By spelling out in detail the divergences between the model offered here and alternative theoretical approaches to policy making, this section also provided a series of observable implications for the hypothesized explanation for excessive debt accumulation. This is important because the model operates with largely abstract variables and actors, whose concrete manifestations in political life and their relationship to observable political phenomena – such as parties, interest groups, electoral rules and corporatist arrangements, state structures, ideologies and international arrangements – need to be clarified. This section summarizes these implications in a list of points.

1. Intermediate organizations are assumed to be the vehicles for representing clusters of interests within society. In other words, their organizational parameters and strategic choices are expected to derive from the underlying constellation of interests within the polity. Organizations – parties, trade unions, employer associations etc. – either stand for a well delineable cluster of interests or for a

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<sup>24</sup> See Putnam (1988).

coalition of interests. In the latter case, the separate clusters are likely to represent factions or cliques within the same organization. Accordingly, coalitions of interests can be formed under the umbrella of a single organization or through cooperation among organizations for a common policy goal. As the conflicts and commonalities of interests evolve, intermediate organizations have to adopt their strategies and suffer/enjoy a transformation of their constituencies, membership or supporter base. Adaptation to the evolution of the constellation of interests can also happen through the rise of new and the fall of old interest representing organizations. Consequently, as fiscal problems become progressively more severe in a country suffering from excessive debt accumulation – and the preferences of societal actors towards fiscal stabilization evolve – this is expected to be reflected in the strategies and fortunes of parties and other interest representing organizations.

2. Policy choices are not expected to closely correspond to the formal distribution of power among intermediate organizations. Electoral strength or the presence/absence of corporatist consultation procedures and veto rights might not always explain why a policy choice was taken or a policy initiative failed. Such discrepancies should be possible to account for based on the leverage of different societal groups arising from their position within the economy and in the societal coalition they form part of. Accordingly, very similar stabilization packages might fail and then eventually succeed in a largely unchanged electoral setting or amongst similar corporatist arrangements if the balance of power shifts between groups and/or coalitions reconfigure. At the same time, a shift in the balance of power and within coalitions might themselves trigger changes in electoral rules and corporatist arrangements.
3. State actors are not assumed to have autonomous power to influence policy choices. The presence of strong advocates of a given policy option within the echelons of the state – especially amongst the technocratic elite – only matter insofar as their views are backed by a strong enough political coalition. Similarly, institutional arrangements that are aimed at guiding policies in a predetermined direction – such as rules, procedures or the centralization of decisions in the hands of a single decision maker in order to limit public spending – are only expected to work, if that pre-defined direction has the necessary societal support. In other words, insulating the state from the pressure of societal groups through institutional engineering is not expected to be possible. Consequently, technocratic

initiatives to alter the fiscal policy course and stem borrowing are expected to succeed only in conjunction with underlying a rearrangement of societal coalitions in favour of a stabilization initiative.

4. Ideologies are a powerful tool in the hands of political entrepreneurs in cobbling together new coalitions of societal interests. However, the successful realignment of coalitions is assumed to be predicated upon the transformation of underlying material interests of the groups involved. Since, the attitude of different societal groups towards stabilization involving potential sacrifices is assumed to be affected by the negative side effects of fiscal problems, new coalitions are only possible amongst groups that suffer similar levels of harm from such side effects. Political entrepreneurs might seize upon the growing but yet politically unharnessed discontent with the policy status quo amongst the affected groups, but they are not expected to have much manoeuvring space with respect to the coalition they can assemble.
5. International constraints are assumed to act upon domestic policies through the behaviour of societal actors. In the context of fiscal stabilization, conditions on international markets are expected to influence the sensitivity of certain groups to the side effects of excessive debt accumulation. International commitments, on the other hand, are expected to be both exogenous and endogenous to the problem of fiscal stabilization in the sense that assuming such commitments is expected to be just as much the outcome of policy struggles as an important constraining factor on them.

These institutional, ideational and international considerations make the theory based on Gourevitch's societal coalitions approach and the war of attrition model more complete. The next section investigates the methodological considerations involved in empirically applying this theory to better understand excessive debt accumulation in certain countries and in gauging its exploratory power relative to other explanations via analysing the experiences of Belgium and Italy with dangerous debt.

### **Methodology: Studying the societal background of fiscal policy making**

This thesis attempts to explain a puzzling policy outcome – potentially disastrous debt accumulation in prosperous developed countries – by marrying two very different

theoretical approaches. Gourevitch's societal coalitions approach provides a conceptual framework for mapping the socio-political context of policy making, whereas the war of attrition model helps to track and explain the evolution of the central variable of that context – the interests of societal groups – through time. The thesis uses this combined theoretical framework to explore the politics of fiscal policy-making in Belgium and Italy – two countries that had profound difficulties in controlling the growth of their public debt in the past decades – and to explain the policy trajectory that led to this risky outcome.

Through this investigation, the thesis aims to achieve three goals. First, it probes into the plausibility of the causal mechanism posited here by looking at the extent to which it helps to explain the observed policy course and political developments in these two countries (Eckstein 1992 pp147-152). In conjunction with this, it explores the relationship between the theoretical framework proposed here and alternative theories about the determinants of fiscal outcomes. It seeks to establish their relative explanatory power for the two concrete cases and explore complementarities and contradictions between them. Second, the thesis attempts to further develop the theoretical framework by observing the empirical manifestations of the core concepts the theory is based on. This is likely to yield interesting insights that could be used in further research, because of the theoretical choice taken here not to identify *a priori* key societal actors, sources of societal influence, mechanisms of coalition-formation etc. Third, the case studies seek to build a coherent template for marrying the very different methodological approaches that the two component parts of the theoretical framework require. The Gourevitchian approach calls for historically informed, “thick” socio-political description whereas the game theoretical model uses formal analytical methods to provide a handful of testable predictions about the behaviour of different actors through time. The case studies develop a consistent procedure for weaving together these two different methodological requirements. This section describes the empirical strategy that the thesis follows in order to realise these goals. First, it explains the motivation for choosing Belgium and Italy as historical examples to study. Then it expounds on the method for using the findings to evaluate the explanatory power of the theory relative to alternative propositions and specifies the way the relevant empirical detail is teased out of the concrete cases.

### *Case selection*

Italy and Belgium are highly relevant examples of the puzzle that this thesis tries to explain. The question to be answered here is why certain countries “flirt with fiscal disaster”. Why do they fail to eliminate imbalances in their public finances that threaten with debt crisis and default and what does it depend on when they manage to reverse their risky policy course? Italy and Belgium were struggling with such imbalances in the 1980s. Both countries borrowed heavily and persistently throughout the 1980s, and by the early 1990s both had debt-to-GDP ratios well in excess of a hundred per cent of the GDP. At the time of the adoption of the Maastricht criteria, it was widely assumed that Belgium and Italy were the targets of these criteria, because both were deemed fiscally too vulnerable to be included in the monetary union.

The two countries’ fiscal problems were quite substantial in international comparison, too. Figure 2.1 shows an overview of the development of the debt to GDP ratio of selected OECD countries<sup>25</sup> from 1975 to 2005<sup>26</sup>. It shows that Belgium was the most indebted developed country in the world throughout the 1980s, until Italy overtook it in the early 1990s, to be then overtaken by Japan by the end of the decade<sup>27</sup>. Of all OECD-countries, Belgium, Italy, Ireland, Canada, Greece and Japan have dealt with gross debt stocks close to or in excess of a hundred per cent of the GDP in the past three decades<sup>28</sup>. A similar ranking is observable by looking at the net financial liabilities of the governments<sup>29</sup> in the same period in Figure 2.2<sup>30</sup>.

All of these countries would be fascinating cases to study, but Belgium and Italy perhaps best exemplify the puzzle in the focus of this thesis. Both have consistently ranked among the most prosperous developed countries of the world as shown on

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<sup>25</sup> For reasons of presentation, the graph only shows those OECD countries for which debt-to-GDP figures are available from the mid-1970s until the mid-2000s. Debt-to-GDP figures for all OECD countries are shown in the graph in Appendix 2 (for years depending on data availability).

<sup>26</sup> Debt figures are shown here only until 2005 in order to disregard the confounding effects of the present financial and economic crisis on fiscal figures. Debts incurred in the past four years will be an important problem for countries in the years to come and it will therefore be interesting to study how different governments adapt public spending and revenues to deal with the challenge. At this point, however, in the absence of a clear picture of the eventual policy responses, the shocks are more of a confounding factor than useful information.

<sup>27</sup> Countries are sorted according to their debt-to-GDP ratio in 1990.

<sup>28</sup> Of all the countries that were excluded from Graph 2.1 due to lack of continuous data, only Israel has had a similar debt problem to the six countries listed above, with a debt-to-GDP ratio that peaked at 102 per cent of the GDP in 1995.

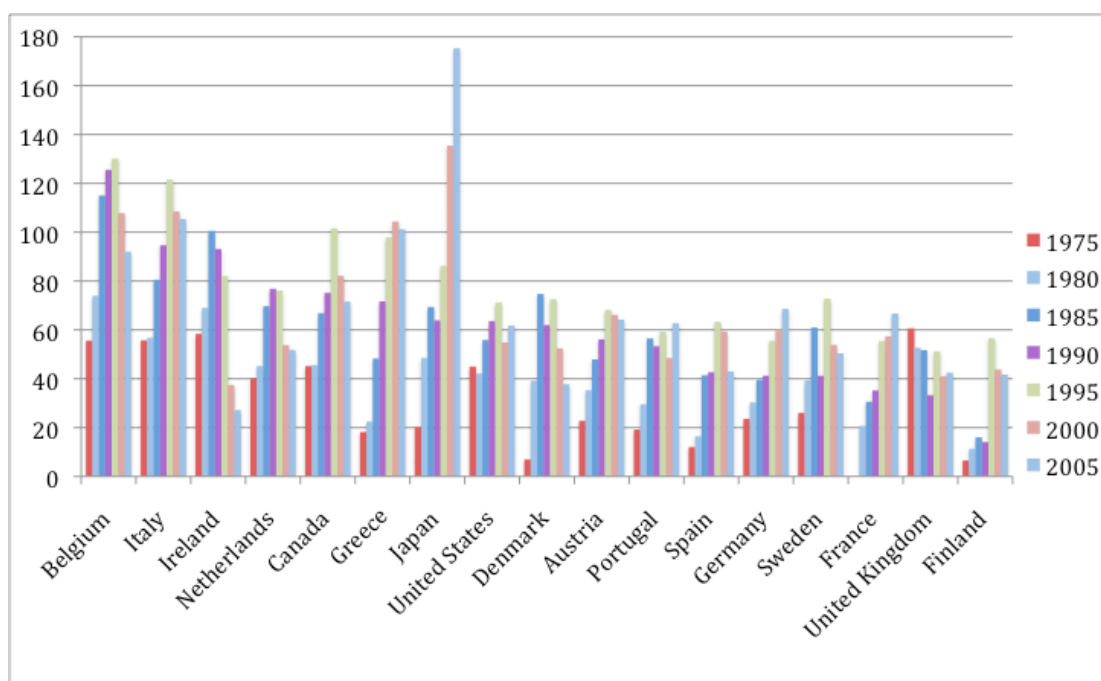
<sup>29</sup> N.B. the lack of figures for Ireland before 2000 hide the problems of that country in the 1980s and early 1990s

<sup>30</sup> Countries are sorted according to their net liabilities in 2000, the first year for which figures are available for all countries.



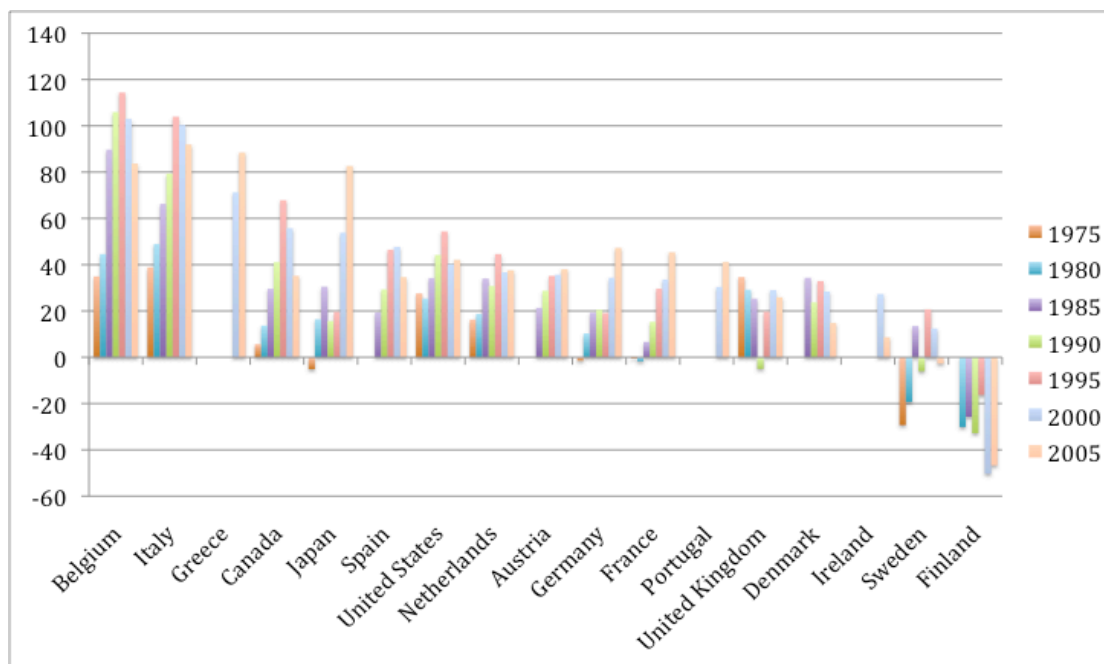
Figure 2.3. In this respect, Ireland and Greece are less ideal candidates, as they were two of the poorest OECD countries in the 1980s and early 1990s when they registered the greatest increases in their debt stock. Furthermore, Belgium and Italy displayed a sustained inability to deal with the accumulation of debt throughout the 1970s, 1980s and the early 1990s. In this respect, Japan is a less suitable case with a much shorter experience with alarming net debt growth, which only seriously started in the 2000s. Canada's experience with debt growth and then consolidation is somewhat unique due to the dependence of that country on resource revenues. Canadian fiscal problems seem largely correlated with a slump in resource rents from the early 1980s to the mid-1990s, whereas the recovery benefited greatly from a sizeable increase in oil and gas royalties from the early 1990s, which provided a windfall support for governments in balancing the budget<sup>31</sup>. In sum, Belgium and Italy seem to be the most suitable examples of prosperous countries that steadily amassed excessive amounts of debt in times of peace and prosperity.

**Figure2. 1 - Gross consolidated debt general government in selected OECD countries per cent of GDP**  
Source: Ameco

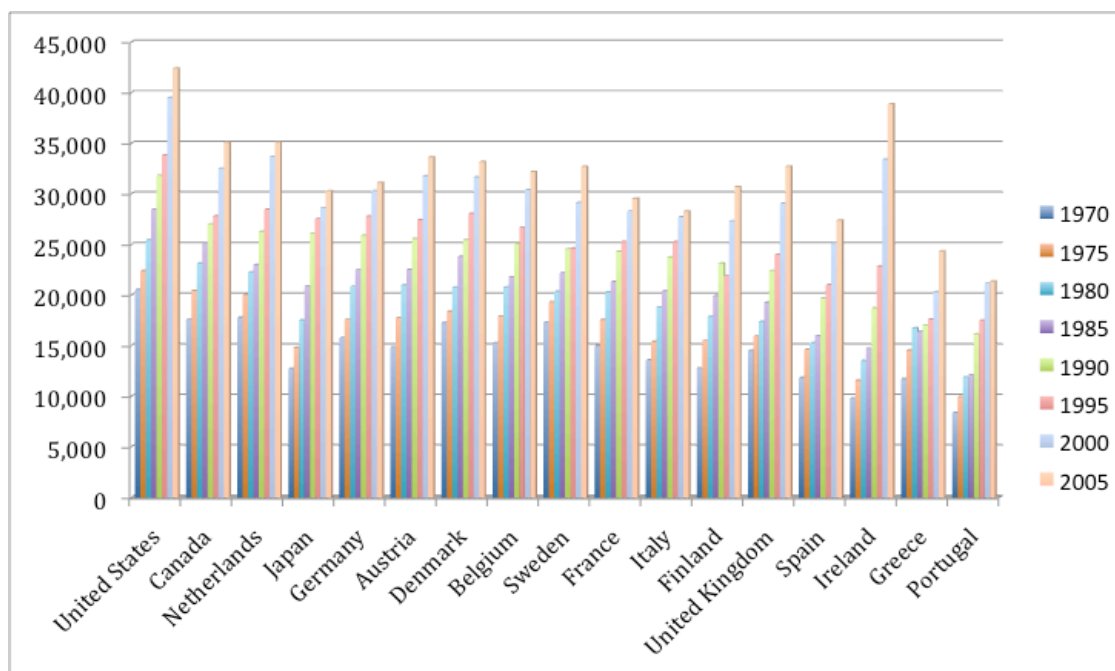


<sup>31</sup> For figures on the evolution of resource rents in Canada, from the mid-1960s to the present day, see the World Development Indicators Database of the World Bank: [data.worldbank.org/data-catalog/world-development-indicators](http://data.worldbank.org/data-catalog/world-development-indicators).

**Figure2. 2 – Net financial liabilities of general government in selected OECD countries  
per cent of GDP  
Source: OECD.Stat**



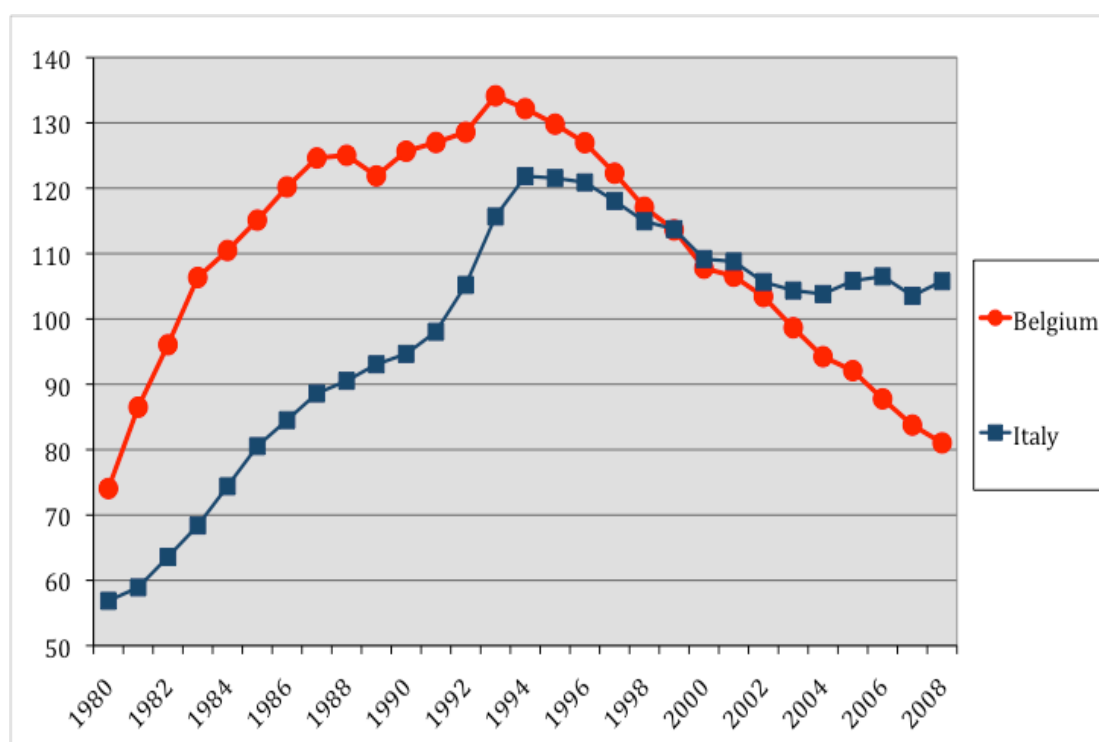
**Figure2. 3– GDP per capita at constant prices in selected OECD countries  
USD, constant PPPs  
Source: OECD.stat**



Beyond being obvious examples of the phenomenon under consideration, the two countries also display interesting variation in the ways they were able to deal with their fiscal problems in subsequent periods. Italy had a promising bout of fiscal tightening in the mid-1990s, but it relapsed into sizable deficits after 2000, and failed to harness the beneficial effects of its temporary efforts and its EMU-accession on its

interest burden to further eliminate its excessive debt. By the mid-2000s, its debt-to-GDP ratio was on the rise again and on the eve of the crisis, it was back to where it had been in the early 1990s. Belgium, on the other hand, regained control over its borrowing and significantly reduced its indebtedness in the past two decades. By the time the crisis started, most of the damage of the 1980s had been undone and the country's debt-to-GDP ratio was in a more moderate range (see Figure 2.4). In other words, after having encountered the same problem in the 1980s and shown similar difficulties in dealing with it initially, the two countries showed very different performance in later periods. Therefore, this choice of countries entails considerable variation on the dependent variable both within countries across time and across countries in the same period. This facilitates both probing the plausibility of the theoretical framework proposed here and its further development by observing significant similarities and differences in each case.

**Figure2. 4 – The evolution of gross government debt in Belgium and Italy  
per cent of GDP**  
Source: Ameco and Belgostat



An additional appeal of the two country cases is that they display considerable variation on aspects that a large stream of alternative theories of fiscal performance focuses on. The significant institutional changes that took place in the two countries in the period under consideration allow the case studies to speak to the literature that

emphasizes the institutional determinants of fiscal discipline. Political institutions changed considerably in both countries. Italy adopted an important electoral reform in 1993, whereas Belgium underwent waves of federalizing reforms, which progressively devolved fiscal decisions to the regional level. In Italy, the party system was completely transformed at the beginning of the 1990s. Furthermore, both countries gave up their monetary policy autonomy by joining the European Monetary Union and both adopted various domestic budgetary institutions in order to improve their fiscal management and subjected themselves to external fiscal oversight under the effect of the Maastricht criteria and the fiscal rules of the Stability and Growth Pact. This variation on the institutional aspects of fiscal governance in the two cases allow not only for evaluating the relative explanatory power of the society-centred theoretical framework compared to the institutional theories but also for detecting complementarities and contradictions as well as relations of subsidiarity and superiority between them.

Studying these two countries' experiences with alarming debt growth does not allow for rigorously testing the theoretical framework advanced in this thesis. However, the nature of the argument made here does not make a controlled comparison of cases possible. The theoretical framework described in the previous section identified in abstract terms the relevant units of analysis and laid out a general mechanism through which these units are expected to drive the observed outcomes of interests. At the same time, it explicitly forewent defining in more concrete terms the observable implications of the posited mechanism in an effort to avoid prematurely limiting the application of the theory by hypothesizing what content the abstract concepts will assume in the empirical cases. For example, it did not specify the type of economic arrangements that would create constellations of interests that make a country more or less prone to difficulties in stabilizing its public finances. It did not identify the types of economic or societal cleavages that determine the probability of dangerous fiscal trajectories. Instead, it clarified a logic along which the politics of fiscal stabilization is expected to work. This lack of a more concrete definition of the independent variables makes the application of Mill's methods unfeasible. It is one of the objectives of the case studies to gain a better understanding of the possible concrete content that the key units of analysis and explanatory variables can assume and thereby further develop the theoretical framework.

### *The empirical strategy*

At the same time, the case studies do seek to provide a plausibility probe for the theory. On the one hand, this is facilitated by the choice of cases, which display considerable variation on the variable of interests. The case studies use the society-centred theoretical framework developed above to explain the observed changes in policy outcomes through time and the differences across countries. They compare the fit of these explanations with alternative ones based on government centred-theories. On the other hand, the case studies also gauge the fit of the theory with the observed facts through carefully tracing the empirical observations the mechanism that the theory outlines, leading from the interests of societal groups to the observed levels of borrowing. They register developments on four different levels. Besides tracing the variable of interest (borrowing), they also investigate and explain choices made about different expenditure and revenue items, follow and account for political developments – such as changes in party and union behaviour or shifts in electoral and membership support – and point out changes in the economic situation of societal groups. The analysis shifts between these four levels of the policy process in an effort to provide a continuous link from the interests and policy preferences of societal groups to their political choices to the decisions of political actors and, finally, to policy outcomes. At the same time, this tracing of the political process does not amount to “process-tracing” in the methodological sense, because it does not involve contrasting the explanation for developments along each step of the procedure with alternative theories about fiscal outcomes (George and Bennett Ch10). Since theories about fiscal discipline concentrate strictly on what happens within the narrowly understood governmental sphere, they do not provide predictions about the phases of the process that lie outside of this sphere.

The close tracing of the policy making process and the shifting of the focus of analysis between policy, politics and society is also useful in dealing with the methodological difficulties entailed in combining Gourevitch’s emphasis on historical accuracy with the formal analysis of the game of attrition model. Gourevitch’s societal coalitions framework provides the bridge from policies through politics to societal actors, whereas the war of attrition model provides a heuristic device to analytically identify the factors that bear upon the choices of the societal actors. Therefore, each case study first uses “thick” historical description to identify societal coalitions behind a given political constellation observed in the given country. Then it uses the categories and

mechanisms provided by the war of attrition model to make sense of the observed changes and stability in the constellation of societal coalitions<sup>32</sup>. For the thick historical detail, the case studies rely on secondary sources. They use existing historical, political and sociological analyses of the given countries to understand the socio-economic structure underlying policy making in each polity. They use these existing studies as the basis for inferences about the configuration of societal interests towards fiscal policies and about the distribution of political influence. It is these inferred interests that are then used to explain the observed fiscal policy patterns, which are extracted from government finance statistics.

The next four chapters apply this empirical strategy in attempting to better understand the experiences of Italy and Belgium with excessive debt accumulation in the past three decades. Each country study is divided into two parts. The first part explores the emergence of the problem of alarming debt growth in the 1980s and explains why the appropriate policy response was initially delayed by analysing the socio-political context of fiscal policy making. The second half of each country study describes how each country addressed the debt problem in later periods. The last chapter gives an overview of the findings of the case studies with a special emphasis on the theoretical insights to be gleaned from each.

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<sup>32</sup> It is perhaps useful to point out that although the combination of historical description and game theory closely resembles the method known as analytic narrative (Bates et al. 1998), the methodological approach used here is fundamentally different from analytic narratives. Analytic narratives are inductive. They build models to explain specific historical cases and then attempt to draw generalizable conclusions from the formal representation of the observed facts. In the approach applied here, a general model's empirical plausibility is gauged using concrete cases.

## **Appendix 1. to Chapter 2.**

### **The war of attrition game**

This appendix discusses some game theoretical aspects of the war of attrition model of delayed fiscal stabilization developed by Alesina and Drazen (1991). It shows that the model is an extension of the basic public goods game in which actors decide whether to make private contributions to the provision of a non-excludable public benefit. It explains the central role of time and cognitive factors in yielding a solution to the fiscal game. Then it presents the observable predictions of the mathematical modelling.

#### *Fiscal stabilization as a public good*

The modelling of the political economy of fiscal stabilization sets off from the insight that a welfare-improving policy adjustment in a policy area with distributive consequences is analogous to the problem of how a public good can be provided to members of a community (Roubini and Sachs 1989, Alesina and Drazen 1991, Drazen 2000). Fiscal stabilization is assumed to improve welfare because it contributes to a generally more stable economic environment. Lower and more stable inflation and interest rates, lower share of tax revenues spent on debt service burden, more efficient working of automatic stabilizers and Keynesian demand management etc. benefit society as a whole, although the utility accruing to different sections might be different (Artis and Buti 2005). For example, low inflation is less important for those with indexed incomes etc. The costs of stabilization are either private, when taxes are increase and entitlements are cut; or public when public consumption and investment are cut. Admittedly there is a whole range of different public spending items that cover intermediate ranges of the private-public continuum. For example, expenditure on education and health care are more directly related to private consumption – especially for certain sections of the society – while defence spending or investment in infrastructure is closest to pure public spending.

The fact that in the case of fiscal consolidation, players can opt for trading in public goods (through cuts in public consumption and investment) for the public benefits associated with stabilization does not cause too much of a discrepancy with the analogy of public good provision. As long as it is assumed that the items on which spending are cut have a positive net benefit for the public, such a conversion of one public benefit for

another essentially amounts just to an extension of the way in which players trade off publicly shared benefits for private savings. In other words, the benefit of stabilization is not bought at private cost but in return for foregoing a publicly shared benefit.

#### *Uncertainty in the public goods game*

The problem at the heart of the provision of public goods is free riding. A public good requires private contributions, but no one can be excluded from sharing its benefits. Whether such a good is provided, depends on the individual decision of the members of the community. Each member has the option to agree to contribute to the provision of the public good or to try to free-ride on others' contributions. If at least one member of the community agrees to pay, the good will be provided. If there are more members willing to pay, they share the costs. If all members wait for others to do it (i.e. they choose to free-ride), the public good will not be provided.

The pay-off matrix in Figure A.1. demonstrates the choices and possible outcomes that individuals face in a simple, static, two-player example of the public good provision game. The public as a whole (player A and B together) is better off, when the good is provided if the benefit enjoyed by all minus the full cost is greater than zero. It is even possible that the individuals are better off paying for the public good alone (and letting the other free-ride) than not having the benefits of the public good at all, whenever the individual benefit minus the full cost of the public good is greater than zero. At the same time, even if all of the former are true, it is still possible that the final outcome is the socially inferior one where the public good is not provided, if all players tried to maximize their net benefit by deciding to opt for the free-riding strategy.

It is important to point out that there is no pure strategy Nash equilibrium in this game. If one player decides to pay for the public good, the other will prefer to free ride, but if one was known to free ride for sure, the other will prefer to provide the public good. Therefore, we know that all of the outcomes – including the one where both players attempt to free ride on the other's contributions – will have positive probability.



**Figure A. 1 - stylized game of public good provision**

Player A	Player B		
		pay	free ride
	pay	$B_A - \lambda C$ $B_B - (1 - \lambda)C$	$B_A - \rho C$ $B_B - (1 - \rho)C$
	free ride	$B_A - \tau C$ $B_B - (1 - \tau)C$	0 0

Where  $B_A$  and  $B_B$  is the benefit A and B gain from having the public good,  $C$  is the total cost of the public good,  $\lambda$ ,  $\tau$  and  $\rho$  is the share of the total costs that A pays under a symmetric solution, under free-riding at B's expense and under free-riding at A's expense respectively.

$$B_A + B_B > C$$

$$B_A - \tau C > B_A - \lambda C > 0$$

$$B_B - (1 - \rho)C > B_B - (1 - \lambda)C > 0$$

$$B_A - \rho C > 0 \text{ and/or } B_B - (1 - \tau)C > 0$$

Each player tries to maximise his expected net benefit. Assuming he knows his payoffs corresponding to the different possible outcomes, he has to make assumptions about the likelihood of each outcome. In other words, he has to make assumptions about how likely his opponent is to free-ride.

Each player can best make assumptions about the opponent's likely strategy by trying to think with the opponent's head. However, since each player only knows his own payoffs, he needs to guess how much net benefit the other gains from the good. In the above stylized example, the payoff matrix was symmetrical in the sense that both players had the same net benefit in each of the roles (sole payer, co-payer, free-rider etc). This is not necessarily so in all the cases: a public good can entail different benefits to different players. Whoever is benefiting more from the provision of the public good can draw smaller benefit from free-riding relative to the loss suffered if the good is not provided and will therefore be more likely to opt for the strategy of agreeing to contribute to the public good. Therefore, if it was unambiguous that one player has a greater benefit from the public good and therefore suffers a greater loss in every moment of not having it and if he also knew that the other is clear about this, he would have to opt for providing the public good and – knowing this – the other player would opt for free-riding. Thus, in the presence of reliable information on the relative benefits of the public good to the different players, a Pareto-optimal equilibrium would automatically and instantaneously form: the player to whom the public good is dearer would pay for it and the other would free-ride on his contribution. In most cases, there is no such unambiguous information about who stands to lose most from a “free-ride : free-ride” outcome. Therefore, in a one-off game actors would have to make their choices between paying or free-riding randomly, or more accurately: based on an

assumed probability distribution<sup>33</sup> of the other actor's responses. Therefore, the outcome would also be predictable in the form of a probability distribution only<sup>34</sup>.

However, if a public good is welfare enhancing, there are likely to be repeated attempts to secure it. Attempts will go on until at least one actor agrees to foot the bill. Throughout the repetitions, the randomness arising from the lack of information will give way to more informed strategy if the passage of time and the decision of each player in each moment gives clues to the other about his payoff matrix. As time goes by and in each moment the players have to make yet another decision whether to pay for the public good or wait for the other to provide it, the assumptions about other players' optimal strategy can be continuously updated as each moment that passes without the other's concession to foot the bill gives a further indication of how much the other suffers from the absence of the public good. In this sense, the players' decision in each moment can be interpreted not only as a way to optimize their welfare, but also as a signal sent to the other player. If the public good has a positive net utility for either player (its benefits are higher than the full cost of providing it), it will be provided in finite time if rounds of the game are continuously repeated, because after a sufficient number of repeated rounds, at least one player for whom the good has positive net utility becomes convinced that the other is credibly determined to refuse to pay and he will provide the good. Therefore, the question is only *when* it happens and who will pay for it.

This analysis shows the ways in and the conditions under which economic actors are willing to trade off publicly shared benefits for savings on private costs. In a number of repeated rounds, players are prepared to forego positive net benefits from having a public good in the hope of larger net benefits in later rounds. In a sense, they opt for playing a costly lottery (Fearon 1995) in which only one of them can win. The larger the difference between the net benefit accruing to the winner and the loser and the higher the chances of winning, the more attractive the lottery is. The two players together would be better off sharing the jackpot (i.e. the total net public benefit from the provision of the public good) through bargaining and saving the costs of the lottery (i.e. the welfare loss from the delay in the provision of the public good). But if each

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<sup>33</sup> As said above, this assumption will be based on what he thinks about the benefit that the other draws from the public good, relative to his own benefit. If he has no information, he would attribute 50-50% chance the other paying or free-riding. If he thinks the opponent benefits more, he gives a higher chance to pay and vice versa.

<sup>34</sup> I.e. one could say that "pay : pay" happens with a probability X, "pay : free-ride" with a probability Y etc. But one will never be able to predict the outcome of a specific round of the game.

firmly believes that he has a good chance of winning (which necessarily means that one side overestimates the odds in his favour due to imperfect information), then the lottery will be their preferred option<sup>35</sup>.

### *Delayed stabilization*

The war of attrition model of delayed fiscal stabilization complements the above described mechanism with one crucial element: added emphasis on time. In the public good game, the loss from the delay of providing the good was implicitly assumed to be a linear function of time. (In each period, the absence of the good caused a certain loss.) Alesina and Drazen's model incorporates the insight that the fiscal problem gets ever more pressing over time and thus the loss from delay grows exponentially. The longer the deficit persists and as public debt mounts, the more painful the negative consequences are – in terms of high debt service burden, high interest rates and high inflation – and thus the benefit of stabilization becomes ever bigger. At the same time, the cost of stabilization also gets larger as taxes will have to increase or publicly financed consumption needs to be cut by more to cover the original deficit plus the ever growing debt service burden. These characteristics – a continuous game, with uncertainty about the other actor's characteristics, where the decision variable is when to end the game and payoffs are a decreasing function of the timing of the end - make the problem analogous to a particular example of a standard game of timing: the war of attrition game.

The name of the model is a metaphor: in a war of attrition, warring parties cannot directly defeat each other in battle and therefore try to tire each other out to win the war. However, holding out until the enemy surrenders is costly and costs are increasing as ammunition gets scarce. Moreover, the country is getting devastated by the war, so the prize for which the war is fought loses some of its value as the war drags on. So each party would like to end the war as early as possible, but still later than the enemy (since winning is defined as holding out longer). Crucial to this game is that the warring parties should have limited information about the relative strength of the other. Otherwise, the army that realises that it is unambiguously weaker and cannot escape surrender would give up right away to avoid all the costs of trying to hold out, if it is anyway in vain. As time passes and the enemy still persists, each camp has to re-

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<sup>35</sup> For a formal treatment on why conflict is chosen over cooperation in the absence of perfect information, see Fearon (1995) and Powell (2004 and 2007)

evaluate its estimates of its chances of winning and when one camp feels that its chance of winning are lower than what could compensate for the pain of having to wait longer, it surrenders and the war is over.

Alesina and Drazen's model describes a case, in which a country needs to eliminate a long term deficit in its public finances – that was created by some unexplained exogenous shock – through levying a new tax, but groups within the polity are unable to agree upon the distribution of the tax burden and each insists on a sharing ratio that puts most of the burden on the other group. Until the deficit is eliminated, the government has to cover part of it by issuing debt and part of it by printing money. The latter causes accelerating inflation, which makes all groups worse off for the time of the delay, but not (or not necessarily) to the same degree. The cost of inflation for the actors has two components: on the one hand, it functions as a tax because it erodes the real value of actors' income (and creates income for the government), and on the other hand, it causes distortions in the working of the economy. Alesina and Drazen assume the inflation tax to affect all interest groups equally (all "pay" the same amount), but the distortionary effect could have different consequences for different groups. In the meantime, debt is also growing, which means that once the new taxes are imposed, they will have to cover the interest payments on the accumulated debt, too, so every minute of delay decreases future consumption. So, in this model, the public good to be provided is an inflation-free environment and a stable debt level. The cost is a permanently higher level of (non-distortionary) taxation – with differential incidence for the winning and the losing group.

For each group, the optimal strategy is to wait and refuse to accept the additional tax burden as long as the cost of waiting an additional moment seems smaller than the expected benefit from prolonging resistance an additional moment. The costs of waiting include having to pay the inflationary tax, bear the effects of the distortions from inflation and seeing future consumption shrink for another moment longer. The expected benefit depends on the difference in the share of the stabilization costs for the winner and the loser and expected size of the debt at the time of stabilization as well as each actor's assumptions about the likelihood of prevailing – by being able to persist in a high inflation environment longer than the others. This in turn depends on his assumptions about who is suffering more from inflation.

Alesina and Drazen show<sup>36</sup> that stabilization will happen in finite time as long as – at least for one group – the burden of the costs of waiting incurred indefinitely are higher than the cost associated with being the loser of the game and paying higher taxes forever (i.e. stabilization has a positive net benefit even if the group has to bear the higher part of the burden). Each actor's cut-off time and therefore the delay in stabilization is longer

- the greater the difference between the share of the burden borne by winner and loser,
- the lower the level of welfare loss suffered by the worst-hit actor from the same level of inflation<sup>37</sup>,
- the lower the interest rate at which the debt is compounded and
- the lower the part of the deficit that is being financed by money printing (i.e. the lower the share of the deficit dealt with in the present and the higher the share of it pushed into the future in the form of debt)<sup>38</sup>.

This latter result has to be qualified in light of how long the game could possibly go on. If a positive share of the deficit is financed by debt, then it can become infeasible to assign the bulk of the adjustment costs to one player if the resolution of the conflict is delayed beyond a certain time. In other words, the debt grows so large that no group could possibly afford to pay a disproportionate share of the tax burden needed to close the original gap and the interest burden on debt. The infeasibility of the situation would become obvious for example if debt reached a level where the government finds it difficult to raise new funds to cover the deficits. In other words, if the markets send a signal that they do not see repayment secured from the future tax revenues. The authors assume, that in such a case, the government would have to (and also would be able to due to the pressing situation) enact an emergency measure to close the gap. They also assume that such an extraordinary measure would entail a very large loss of utility for all players. If there exists the possibility of such a drastic and exogenous end to the game, a player whose optimal cut-off time would be beyond this end point may become motivated to give up just before the emergency measures are enacted, if being the loser is still less costly for him than to bear half of the utility loss caused by the havoc. On the other hand, this might induce some groups, who would otherwise have

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<sup>36</sup> For the mathematical derivation see Alesina and Drazen (1991).

<sup>37</sup> Some countries, for example, have institutions that make inflation more bearable for economic actors – like automatic indexation of incomes or a flexible exchange rate etc. In these countries, the delay is expected to last longer as the costs of waiting arising from inflation will be lower.

<sup>38</sup> This latter result only holds if we assume that any increase in inflation causes a proportional increase in the welfare loss suffered from the associated distortion. For the assumption that the welfare loss is an exponential function of the level of inflation, the opposite might hold.

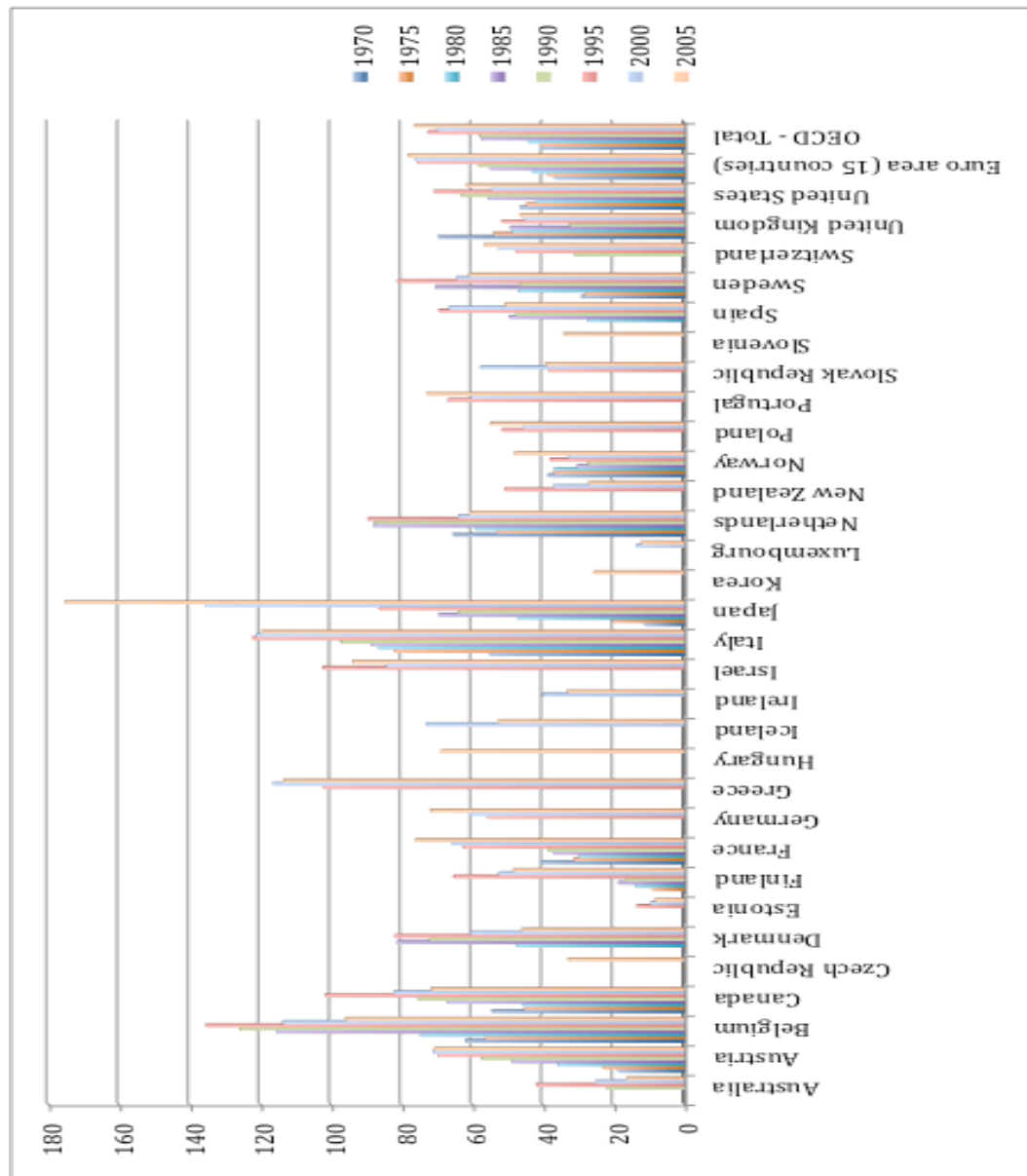
surrendered before the exogenous end point, to postpone their surrender until the emergency intervention becomes imminent, in the hope that the other groups have an incentive to surrender early and take on the loser's share of the taxes. If all groups wait until just before the emergency measures and concede at the same time, each has an equal chance of becoming the winner or the loser. In light of this, if a higher proportion of the deficit is financed by debt issuance (and less by inflation), that brings the possibility of such an emergency closer. This potentially induces certain groups to concede earlier than suggested by their strategy but also makes other groups concede later.

In sum, the mathematical modelling by Alesina and Drazen led to the prediction that the length of the delay depends on two things: (i.) on how we try to deal with the deficit on a temporary basis, before a permanent solution is found, (ii.) on how bad the consequences of the mix of temporary measures are compared to the permanent solution. In this model, until stabilization, the deficit is partly financed by inflation, partly pushed into the future in the form of debt accumulation. If a higher share of the deficit is dealt with in the present, part of the costs of waiting are higher, because the level of distortion from inflation is higher and therefore delay should be shorter. At the same time, for a higher share of inflation financing, a lower share is pushed into the future, and therefore the decrease in future consumption will be smaller as debt increases more slowly, so actors will not be in such a hurry to end the game to stem debt growth. So this other component of the waiting cost is lower and that makes the delay longer. Furthermore, if less debt is accumulated, the emergency scenario is less likely, which either brings forward or delays the expected time of stabilization. Which one of these three effects of a higher share of inflation-financing dominates, is determined by the level of interest rates and the degree to which actors suffer from the distortions caused by inflation. Higher interest rates, i.e. the rate at which debt grows until the deficit is eliminated, would make the latter two effects more dominant: higher inflation financing would delay stabilization. Higher utility loss from the same amount of inflation would strengthen the first effect, that is higher inflation financing precipitates stabilization.

## Appendix 2. to Chapter 2.

Overview of debt per GDP ratios in OECD countries

**Figure A. 2 Gross debt general government – in OECD countries 1970-1980**  
percent of GDP  
Source: OECD



## **Chapter 3.**

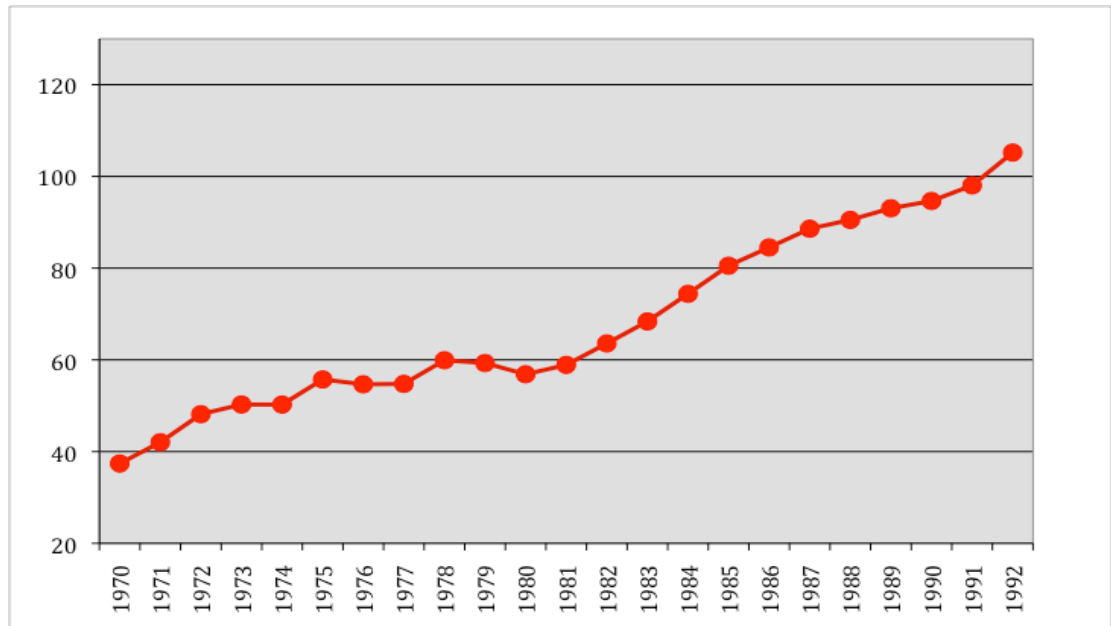
### **Biding their time: Policy passivity and debt accumulation in Italy in the 1980s**

In the midst of the European sovereign debt crisis, default hung over Italy like Damocles' sword last summer. Since then, policy makers have adopted a series of harsh austerity measures to convince markets that the country will be able to service its enormous debt, and they secured support from Europe. The danger seems to have subsided for the time being, but the immense precariousness of Italy's fiscal position has been amply revealed. This chapter goes back to the 1980s in order to explain how the country got into such a perilous situation.

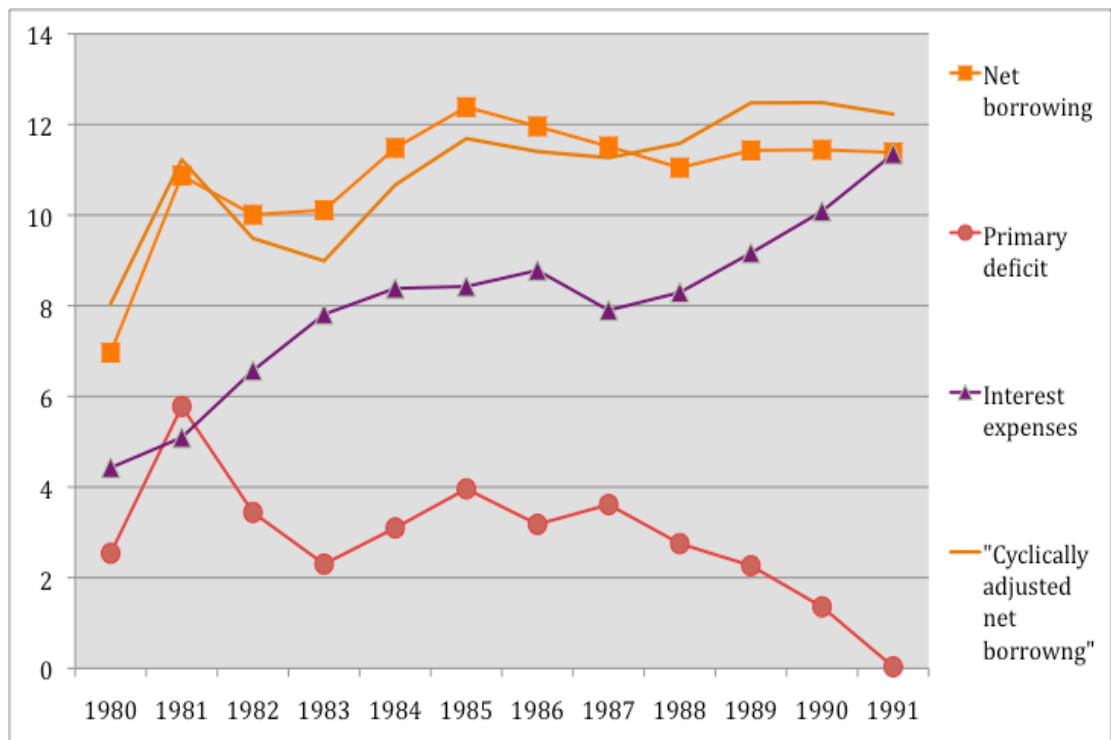
Although Italy's public finances were already out of balance throughout the late 1960s and the 1970s, it was after 1980 that the problem of debt accumulation started to reach truly alarming proportions. In the 1980s, the slowing of economic growth and a jump in the real interest rates charged on outstanding debt greatly magnified the underlying imbalances between revenues and expenditure and speeded up the growth of debt. Between the late 1970s and the early 1990s, the debt-to-GDP ratio doubled. By 1994, it exceeded 120 per cent (see Figure 3.1). Despite gradual corrections in the primary balance, net borrowing stayed uniformly high throughout the 1980s, as the costs of servicing the outstanding debt spiralled out of control. By the early 1990s, the interest bill was 10 per cent of the GDP (see Figure 3.2). It was only in the mid-1990s that debt accumulation was finally halted. This chapter is aimed at explaining how and why fiscal problems could reach such perilous proportions and why decisive action to avert further escalation was delayed for such a long time. It seeks to answer the question why successive governments failed to react more forcefully to the dramatic deterioration of public finances from the early 1980s and how the way to consolidation was eventually opened in the early 1990s.



**Figure3. 1 - Gross consolidated debt general government (1970-1991)**  
**per cent of GDP**  
**Source: Ameco**



**Figure3. 2 - Net borrowing, cyclically adjusted net borrowing, primary deficit and interest expenses (1980-1991)**  
**per cent of GDP**



Source: Ameco

Analysts of Italy's troubled fiscal history have mostly concentrated on the role of political institutions, emphasizing the extraordinary extent to which particularistic interests were able to permeate parliamentary policy making and diverted policy

outcomes from a collective optimum throughout the 1980s. Cox and McCubbins (2001) quote Italy as a typical example of a polity that would be given to pork-barrel politics. On the one hand, the system of preference votes in national elections encouraged competition amongst candidates within the same party and gave incentives to legislators to distinguish themselves in the eyes of their voters through measures targeted at their electorate. On the other hand, these impulses for overspending were given free rein in the parliamentary sphere, where decision making was dominated by committees, diminishing the control of the government over the budget. Padovano and Venturi (2001) focus on fragmentation and ideological polarization arising within the parliamentary sphere as a result of Italy's proportionate electoral system and link these factors to observed levels of public borrowing in the post-war period.

Hallerberg (2004 Chapter 7) also emphasizes the role of fragmentation within parliamentary and governmental decision making, especially the dispersion of authority among committees and ministries, which gave a say in fiscal matters to all the parties within government, and at times even in the opposition. At the same time, he points out that it bears explaining why parties in successive coalitions forewent applying coordination devices to reassert discipline over the budgeting process. Coalition governments often successfully maintain fiscal balance despite the conflicting spending preferences of their constituent parties via signing fiscal contracts in which they commit to spending targets. However, such contracts were absent in this period in Italy and fiscal policy was governed by what Hallerberg calls the "fiefdom" approach. Fiscal contracts were unfeasible but also unnecessary from the point of view of coalition partners – Hallerberg argues – because of the lack of real competition for government. Throughout the 1980s, there was no viable alternative to the so-called *pentapartito* coalition. Therefore, it was not possible to enforce contracts by threatening to bring down the government, because there was no possibility to exclude renegade spenders from the coalition after a new election. At the same time, the lack of a viable alternative also prevented the electorate from meaningfully punishing the five stable coalition partners for the appalling fiscal results, which greatly reduced the sensitivity of policy makers to the downside of fiscal problems.

These approaches provide a compelling account for the role of political institutions in shaping policy makers' incentives to care more about their electorates' particularistic preferences than about fiscal discipline. However, governments arguably have other possible, not immediately electoral motivations to overcome their internal

coordination problems for the sake of restoring the equilibrium of public finances. The costs of fiscal imbalances – and therefore the costs of the government’s failure at coordinating party positions and controlling ministers – are steeply increasing for policy makers as the debt-to-GDP ratio reaches proportions that jeopardize the economic and financial stability of the country due to the immense political and policy consequences of a default or a major fiscal crisis. This consideration was especially important in the case of Italy in the 1980s, where – due to the country’s peculiar political system – the same parties and, in fact, the same people were likely to stay in government for extended periods of time. Therefore, the very policy makers who were procrastinating effective fiscal stabilization in the 1980s could realistically expect to still be in charge when a potential crisis would unfold or when desperate measures would need to be put into place to avert a fiscal meltdown<sup>39</sup>. Policy makers of such long time horizons would have a very large incentive to sort out their internal coordination problems in the face of large risks<sup>40</sup>.

Therefore, this chapter looks beyond the governmental and parliamentary scene in search of the forces that motivated policy making actors to defend particularistic interests even in the face of escalating fiscal problems and held governments back from effective consolidation. It shows that throughout the 1980s fiscal policy was hostage to unresolved redistributive conflicts between socio-economic groups, who blocked policy change through their representatives both from inside and from outside the government. This argument draws on Della Sala’s insight (1997). Della Sala contends that the dangerous debt accumulation of the 1980s was the result of the weakness of successive Italian governments in the face of different societal demand pressures, which made them unable to decisively adjust the policy course<sup>41</sup>. In other words, the

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<sup>39</sup> Evidence that the leading personalities of the two largest parties of the government coalition that held power throughout the 1980s expected to be in policy-making position in the decades to follow is provided by Ginsborg (2001 p249). He quotes the joint interview of the leaders of the Christian Democratic and Socialist parties – the two dominant parties of the so-called *pentapartito* coalitions of the 1980s – laying out their plans for joint government for the next decade in 1991.

<sup>40</sup> It is of course an open question what makes policy makers sufficiently sensitive to the risks entailed in a progressively escalating fiscal problem. Hallerberg, Strauch and von Hagen (2009 pp126-129) seek to integrate into their framework the role of past fiscal crises as a factor that determines this sensitivity (although they focus on the electorate rather than the policy makers themselves). In Italy, experiences with having to turn to the IMF and to Germany for loans in the 1970s could have possibly served as warning signs about the dangers of continued heavy borrowing, but Hallerberg, Strauch and Hagen do not count these among crisis events. At the same time, the next section of this chapter argues that policy makers were increasingly concerned about fiscal developments as the 1980s progressed.

<sup>41</sup> Della Sala’s point about the role of conflicting societal interests in generating fiscal problems is reinforced by Regini and Regalia (1997) and Ferrera and Gualmini (2004), who emphasize how tensions between social partners spilled over into fiscal problems, as governments aimed to secure agreements vital to the satisfactory working of the economy by offering large compensations for both sides in the form of increased transfers and tax adjustments.

fiscal problems were the consequence of a socio-political situation that rendered the executive weak and lacking the authority to achieve its policy objectives.

However, Della Sala does not spell out the specific sources of and political channels for the pressures that kept governments' authority over the budget in check. Therefore, the chapter identifies the socio-economic groups from whom these pressures emanated. It clarifies the nature of the demands of these groups and the sources of their influence on policy makers. It uses this information to explain why the specific constellation of societal interests prevented meaningful adjustments to the budget. Finally, it explores how the policy demands of these groups evolved with the escalation of the fiscal problem to explain how and why the weakness of the executives gave way to decisive action in the 1990s.

The chapter contends that the delay in effective fiscal adjustment was the consequence of the inability of successive governments of the 1980s to assert control over conflicting demands on public finances of four large societal groups: large business, small entrepreneurs, organized labour and the dependents of the state in the South. This impotence arose from the political predicament of the party that dominated every government from the war to the early 1990s, Christian Democracy (DC). The DC was dependent on the support of the entrepreneurial class and on the votes of its clientele of public employees and welfare beneficiaries in the South and it had strong ties with large business. At the same time, the party was unable to sideline the policy demands of organized labour after these demands had been forcefully asserted in the labour unrest of the late 1960s and early 1970s. Unwilling to harm groups within the DC's core supporter base but unable to inflict fiscal pain on the main societal group outside of it, successive DC-led governments responded to growing fiscal problems by adjusting spending and revenue items that none of the four societal groups had strong vested interests in and by making very cautious corrections in those areas where vested interests were present. These responses were inadequate and lagged behind the fast rate of growth of interest expenses. This led to the escalation of the fiscal situation. Effective stabilization was impossible as long as trade unions continued to resist cuts to welfare entitlements or higher taxes on wage income and the DC continued to hang on to power through a strategy of protecting the specific interests of three disparate societal groups.

Ultimately, the deadlock was resolved when the DC lost the ability to further pursue this strategy. Simultaneously, unions adopted a more conciliatory tone. Although the DC's passing from the scene happened under rather dramatic circumstances that involved a wave of corruption scandals, this chapter argues that by the time of the party's final demise, its strategy was already defunct as the support of the societal groups it had relied on had been considerably eroded by the negative economic side effects of the fiscal imbalances. Similarly, even though labour's change of heart ensued in the midst of considerable political and economic upheaval, it had been fostered by the cumulative adverse consequences on employment of the persistent fiscal problems. The progressive deterioration of the general economic environment – manifested in high inflation, high interest rates and the attendant appreciation of the real exchange rate of the lira – caused significant difficulties to those sections of the society that depended on the competitiveness of Italian industry in the international economy. These groups gradually withdrew their support from their representatives in the policy making sphere – from the DC, on the one hand, and from trade union, on the other – and from the strategy of the intransigent defence of their vested interests that had caused the fiscal stalemate of the 1980s. This opened the way for a resolution of the fiscal problem in the context of a radically new political situation.

Conceptually, this narrative rests on two pillars. The first one is the notion of societal coalitions. These unite specific clusters of interests, wield specific forms of political leverage and motivate the choices of interest representing organizations in the policy making sphere. In the Italian case, the relevant clusters of interests were ordered into two opposing coalitions at the time of the greatest accumulation of debt. On the one side, the DC served as a political umbrella for an awkward coalition of three clusters of interests: large businesses, small enterprises and a clientele network in the South. On the other side, trade unions represented labour. These four groups can be identified by their vested interests in four quite clearly delineable areas of the policy status quo of the 1980s: tax exemptions, the toleration of tax evasion, clientelistic systems of public employment and investment, and welfare spending.

The balance of power between the two coalitions remained relatively even throughout the decade and therefore all four major societal groups were able to effectively protect their vested interests in these areas. Consequently, stabilization was delayed. Importantly, the chapter shows that societal coalitions with no institutional access to

policy making fora – such as workers in the Italian case – can have effective influence on policies via non-institutional sources of leverage.

The second conceptual pillar is the notion that the interests of the key socio-economic groups are not fixed, but evolve with the evolution of the economic environment, opening up the way for new coalitions of societal interests and the resolution of the policy deadlock. The development of each group's interests can be explained by the predictions of the war of attrition model, which shows that the escalation of fiscal problems can generate corollary costs for each group, which might induce the groups to give up their vested interests in given policies for the sake of fiscal stabilization. In the Italian case, the economic side effects of budgetary imbalances arose in the form of declining international competitiveness, which forced business groups and labour in the exposed sectors to reconsider their attachment to welfare policies and tax exemptions, respectively, and led to a decline of support for both the unions and the DC, whose *raison d'être* was by this time little more than the defence of these policies. This ultimately led to the break-up of the DC-led distributive coalition and a formation of a new alliance between large business and labour.

The chapter lays out the argument in three parts. The next section gives a brief overview of the fiscal developments of the 1980s to underline the contradiction between the seeming urge of policy makers to regain control over fiscal problems and the feebleness of their attempts at effective fiscal retrenchment or revenue generation. The third section explains the socio-political origins of the weakness of successive governments in the face of the escalating problems. It provides a historical account of the evolution of the defining coalitions of societal interests and of the origins of the political gridlock between the actors representing their conflicting preferences. The fourth section uses the war of attrition model to explain the changing stances of the different socio-economic groups within the two coalitions as a result of the deterioration of the economic environment. The last section concludes.

### **Fiscal policy in the 1980s: perilous passivity<sup>42</sup>**

At the end of the 1970s, Italy looked back on a tumultuous decade of major economic shocks and soaring fiscal deficits that left a difficult legacy. Debt had doubled, reaching

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<sup>42</sup> Unless otherwise noted, all data referred to in this section are taken from the Annual Macroeconomic Database of the European Commission's Directorate General for Economic and Financial Affairs (Ameco).

almost 60 per cent of the GDP, interest expenditure had quadrupled, eating up 5 per cent of the GDP in 1981, while the government's revenues still fell short of its non-interest spending commitments. At the same time, monetizing the deficit – a channel that had been extensively used in the 1970s to dissipate some of the pressure created by the fiscal imbalances – became increasingly unattractive after the country committed to maintaining a fixed exchange rate with its main trade partners in the framework in the new European Monetary System (EMS) in 1978. Inflation needed to be brought down from the double digits, if parity was to be kept with low-inflation Germany. This foreshadowed increasing interest rates, putting further pressure on the budget. It was clearly time to get the country's fiscal house in order.

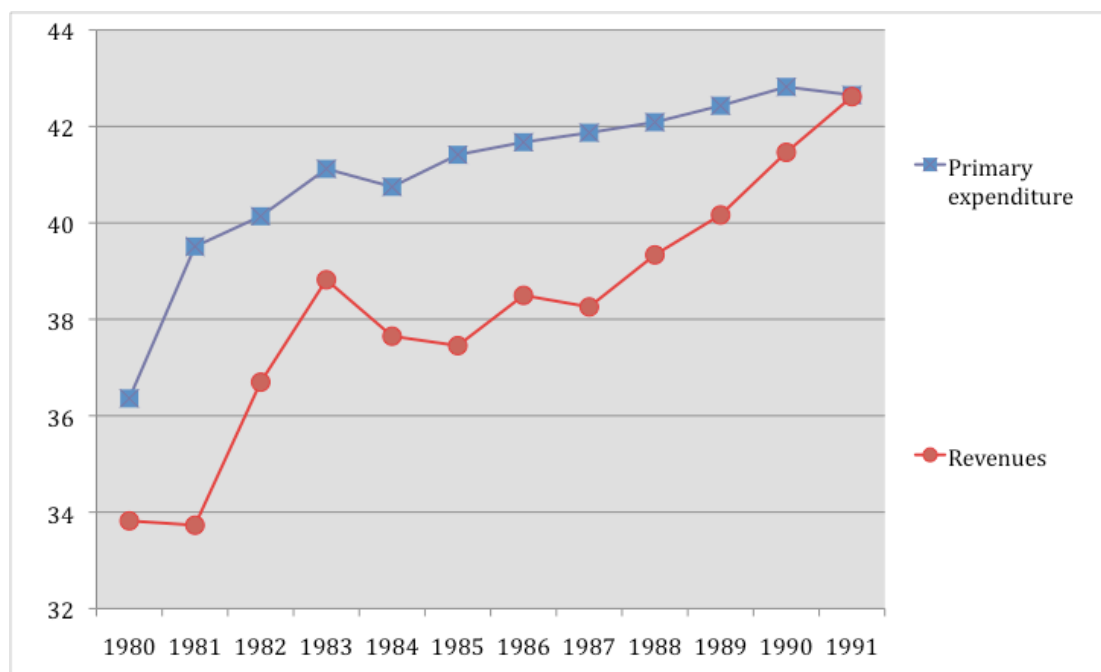
It seemed like policy makers were acutely aware of this. In the decade that followed, the discourse of fiscal policymaking was dominated by the objective of "*risanamento*" (Radaelli 2000) as ministers and central bank officials repeatedly called for austerity measures to stabilize public finances (Walsh 1999). Throughout the decade, ever more institutional and procedural reforms were introduced to ensure better control over the budget<sup>43</sup>. The tax system went through a series of adjustments and attempts were made to control spending (Guerra 1993, Bosi et al 2003). By the second half of the decade, one major adjustment package was announced after another, promising to comprehensively deal with the fiscal problem<sup>44</sup>. Yet, net borrowing stayed firmly above ten per cent of the GDP. The primary deficit narrowed only gradually and with cyclical setbacks. The pace of its correction fell behind the rate of increase of the interest burden. Spending was approximately stabilized, but not cut, revenues increased only hesitantly. For all the talk of "*risanamento*", the trends and figures gave little indication that real fiscal sacrifices were forthcoming for the sake of balancing the budget (see Figure 3.3). This section analyses the different spending areas and revenue sources in order to gain a better understanding of what was and was not done and why consolidation eluded policy makers in this period despite their apparent urge to bring the budget back into balance.

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<sup>43</sup> Some of these reforms were aimed at ensuring better planning, such as the introduction of a standardized format for presenting the budget as a single law (Legge Finanziaria) in 1978, or the launching of comprehensive economic-financial planning in 1988. Other procedural adjustments were aimed at enforcing discipline on the members of parliament. From 1983 and 1985, the budget would be debated in separate, designated sessions in the Chamber and the Senate (Ferrera and Gualmini 2004 p64). In 1986 secret voting on budgetary issues was abolished to stop „snipers“(franchi tiratori) from undermining the government's fiscal plans (Padovano and Venturi 2001).

<sup>44</sup> The Gorla plan of 1986 attempted to cut expenditure by 9 percentage points over the following four-year period but failed (Bosi et al 2003). From 1988 on, several adjustment programmes were launched, but none of them managed to meet its deficit targets (European Economy 1993).

**Figure 3.3 - Primary expenditure and revenues (1980-1991)**  
per cent of GDP  
Source: Ameco

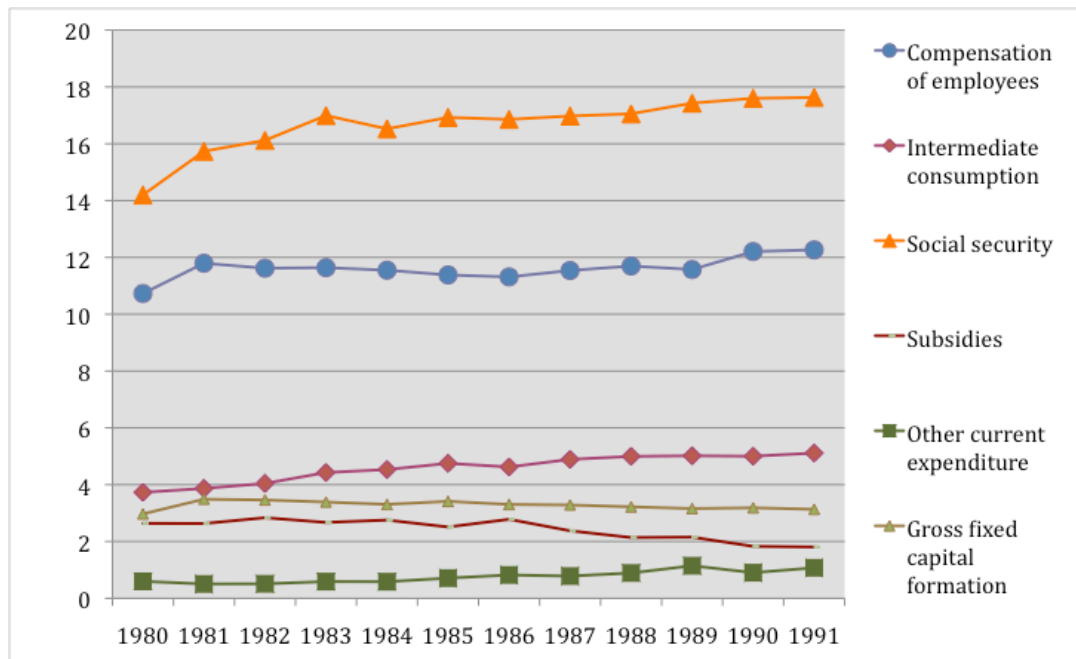


Bringing non-interest expenditures under control was a huge challenge in the 1980s. In the preceding decade and a half, public spending had skyrocketed, growing from just under 30 to close to 40 per cent of the GDP (Morcaldo 1993). The results achieved in the 1980s in taming this expansion were modest. Initially the growth was even compounded by a further boost to social security spending from a wave of redundancies in the wake of a large campaign of industrial restructuring in the first years of the 1980s<sup>45</sup>. In the rest of the decade, expenditure growth was slowed considerably, but not reversed. Practically all categories of public spending continued to slowly drift up (see Figure 3.4).

<sup>45</sup> Workers laid off in the restructuring process were entitled for up to three years to generous income-replacement benefits – from the so-called *Cassa Integrazione Guadagni* (CIG) and *Cassa Integrazione Guadagni Straordinaria* (CIGS)– that had been created in the previous decades. Furthermore, early retirement was introduced for redundant workers in 1981, in an effort to dissipate the growing tension over the large number of redundancies. Therefore, the wave of reorganizations had repercussions for the budget. In later years, even though unemployment kept increasing, the budget remained unaffected, because this mostly involved workers not covered by the CIG and CIGS, and regular unemployment benefits were trivially small and short in duration (Bertola and Garibaldi, 2004).



**Figure3. 4 - Non-interest spending by type (1980-1991)**  
per cent of GDP  
Source: Ameco



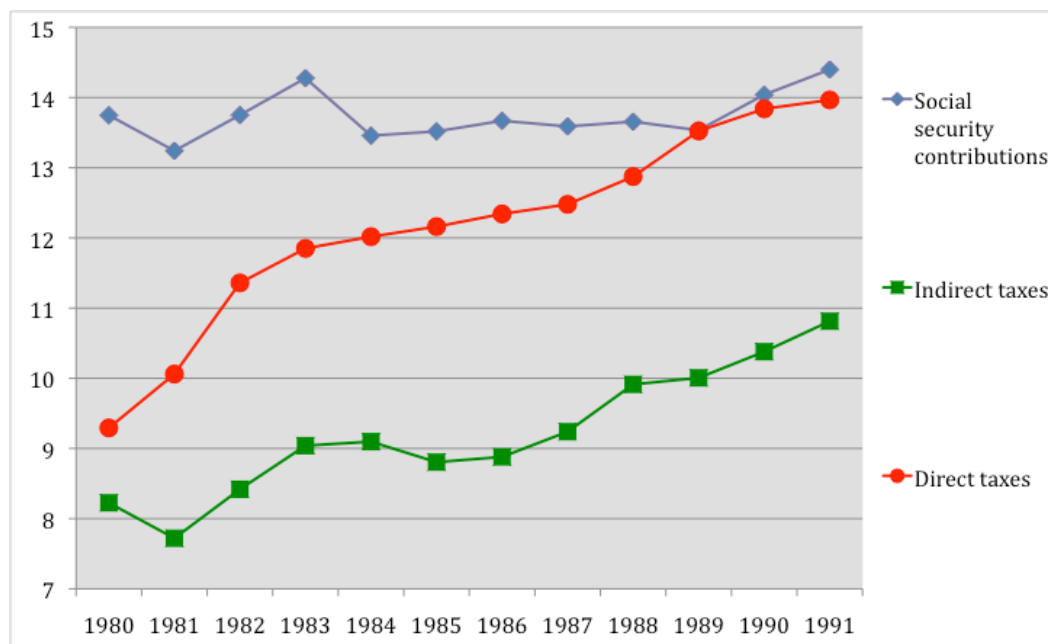
Successive governments tried to achieve savings on social security, the largest item in the budget, but they accomplished little. They performed some marginal adjustments on the pension system<sup>46</sup>, but never managed to put to the Parliament a comprehensive proposal for pension reform despite discussing several of these in the cabinet (Ferrera and Jessoula 2007 p422). They introduced stricter rules on invalidity pensions, which could have potentially produced more notable savings, given the widespread abuse of these entitlements, but they did not ensure the strict enforcement of these, and the savings never materialized (Ferrera and Gualmini 2004 p94). Instead of declining, social security spending increased by half a percentage point by the end of the decade, as pension expenditure slowly edged up with the growing number of people in pension-age. The other major expenditure item, the compensation of public employees also marginally increased. Although the large waves of hiring in the public sector seen in the 1970s had stopped, employee numbers kept marginally drifting up and salaries increased in line with rest of the economy (Morcaldo 1993, Bosi et al 2003). Only two fields stand out where the government could achieve savings: health care, where co-payments were introduced (Ferrera and Gualmini 2003 p95), and production subsidies, because state aid was gradually phased out after 1986 in compliance with

<sup>46</sup> For example, they introduced limits on the collection of multiple benefits and defined income ceilings for the entitlement to social pensions (Ferrera and Gualmini 2004 p94).

rules of the Single Market. In all other areas of spending, inertial forces were stronger than savings efforts.

On the revenue front, the improvement was larger. Between 1980 and 1991, revenues grew by almost 8 percentage points of the GDP. However, more than half of this growth was achieved not by government intervention, but as a result of the combination of the extreme progressivity of the personal income tax system and high inflation, which automatically and swiftly increased fiscal pressure on employment income, boosting direct tax revenues (Giavazzi and Spaventa 1989). After the governments readjusted the brackets in 1983 under pressure from trade unions, the momentum of revenue growth considerably slowed. Even though fiscal drag kept gradually pushing up personal income taxes (triggering new adjustments to the brackets in 1986 and 1989), this had a much weaker effect than before 1983. Other revenue items stagnated until the last third of the decade, when a major improvement – of around 4 per cent of the GDP – was finally achieved (see Figure 3.5).

**Figure 3.5- Revenues by type (1980-1991)**  
per cent of GDP  
Source: Ameco



Although the corporate income tax rate was raised from 25 to 36 per cent as early as 1983 and the rate of local taxes on productive entities grew from 15 to 16.2 per cent, this had little effect on revenues due to the frequent use of tax rebates to help industry, and also due to widespread tax evasion (Guerra 1993). A reform on income reporting

and tax collection was put forward in 1984 to deal with the latter problem, but it was adjusted in the face of fierce opposition from self-employed groups (Ginsborg 2003, p154). Evasion continued to be a major drain on public revenues. Social security contributions on the income of the self-employed were raised several times, but revenue from contributions remained flat until the end of the decade. Revenue growth only gained new momentum after 1986, when the government abolished tax exemptions on interest income from government bonds and considerably increased the withholding tax on other forms of capital income. In the same year, the treasury managed to capture the windfall gain from a reverse oil price shock, via increased excise taxes on fuel (Guerra, 1993). At the same time, privatization – a possibly considerable source of extra revenue – was not on the agenda in this decade. The sale of public enterprises remained sporadic and was usually motivated by the companies' financial problems rather than by the urge to raise revenues (Goldstein 2003).

In sum, despite a seeming sense of emergency, fiscal policy was lacking bold measures and decisive action throughout the 1980s. Even when apparently drastic action was taken – such as the increasing of the corporate income tax rate by almost a half – results failed to come forth due to countervailing decisions to soften the blow and due to a permissive attitude towards enforcement. At times, governments were even putting into place measures that set fiscal consolidation back for the medium term, by agreeing – for example – to the introduction of early retirement in 1981 in order to deal with industrial conflict stirred by mass redundancies. Another example of expansive measures was the adjustment of income tax brackets in 1983 and 1986 that stopped the increasing of tax pressure on wages. It was only in the second half of the decade that some real progress started to be seen – on the revenue side – but this came fairly late and was insufficient. Interest expenses had already increased to almost 9 per cent of the GDP, at which point a gradual narrowing of the primary deficit was not going to do much for the stopping of the debt spiral.

Why were the consolidation measures so hesitant despite the accelerating escalation of the problem? Why did governments shy away from taking effective measures in fields that could have yielded substantial savings, such as welfare spending and public employment, or major revenue increases, such as corporate or personal income taxation? Why did they only achieve successes in such relatively minor fields as healthcare or the taxation of interest income? In 1990, health care expenditure amounted to 6 per cent of the GDP. In comparison, welfare spending accounted for

three times as much, the compensation of employees twice as much (Ameco and Banca d'Italia). Tax revenues from interest income added up to as little as 3.6 per cent of the GDP in 1991 (Japelli and Pagano 1994). Clearly, in order to achieve the required savings and/or revenue increases a larger spending ticket or a greater tax pool would have needed to be targeted. The next section disentangles this puzzle by investigating the political and socio-economic background of the policy paralysis.

### **Coalitions of societal interests in the making: the origins of the policy stalemate of the 1980s**

The political legacy of the 1960s and 1970s was at least as onerous as the fiscal one. In the 1980s, policy makers were faced with a practically impossible task in attempting to consolidate public finances in the face of strong political resistance from different societal groups with vested interests in different policy areas. It was virtually inconceivable to find substantial savings or extra revenues in a political context where each major fiscal area was protected from bearing the brunt of consolidation by some influential societal group that had a vested interest in it. Workers' welfare entitlements were ring-fenced by potent unions. Large corporations continued to obtain exemptions from taxes and contributions by lobbying the government. A weak attempt to rein in tax evasion by small enterprises and the self-employed brought the government to the brink of crisis<sup>47</sup>. Finally, public employment and public investment was a major way to channel funds to crucial voters in extensive clientele networks of the dominant party of the government. Explaining how these vested interests were created and how fiscal policy became hostage to so many disparate socio-economic groups requires looking back at the events of the 1960s and 1970s. Therefore, this section analyses how the distributive conflicts of post-war Italy created a specific constellation of coalitions of societal interests by the 1980s.

A useful starting point for mapping coalitions of interests and the balance of power between them is studying the evolution of the strategic position of a pivotal party in the political system, Christian Democracy, as well as its relationship to its main opponents, the workers' movement, because this opposition captures the structure of socio-political conflicts that so strongly determined the context of policy making in the 1980s. The DC occupied a peculiar, ambivalent position at the centre of the Italian political system. On the one hand, it was "bound" to dominate every government from the end of

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<sup>47</sup> For a description of the Visentini-attempt to control the reporting of incomes, see Ginsborg (2003 p154)

the war, because the only other party of comparable size – the Communist party (PCI) – was isolated due to what was seen at the time as an anti-system ideology (Bull 2004)<sup>48</sup>. On the other hand, however, the DC was not immune to electoral pressures, because the number of votes it received crucially determined its bargaining position in negotiations over the distribution of ministerial seats and other influential posts in the state bureaucracy and public enterprises at the time of each coalition formation (Pasquino 1994). Therefore, the party's economic policy choices were strongly guided by the preferences of its constituencies and these choices, in turn, determined the policy decisions of every government due to the DC's central position.

In the 1950s and first half of the 1960s, the DC-led governments pursued neoliberal, business-friendly policies, characterized by low inflation, low taxation, low spending and balanced budgets (Posner 1977, Ginsborg 1990 p112-113, Sassoon 1986 p18). These policies favoured the DC's core supporter base amongst the populous stratum of self-employed and small entrepreneurs, but also bigger corporations, which had originally supported the DC's coalition partners, but which then created ever-stronger ties with the DC itself<sup>49</sup>. This policy mix required the suppression of policy demands from labour. Spending on public education, health and housing stayed very low, despite repeated calls for the improvement of these public services and the social insurance system remained rudimentary<sup>50</sup> (Ginsborg 1990 pp188-190, Ferrera and Gualmini 2004 p33). In the underdeveloped South, little was done directly to ease the massive un- and underemployment of the large reservoirs of unskilled labour, which continued to fuel mass emigration from the region to areas of the industrial North and also abroad (Ginsborg 1990 p212). Businesses in the region received subsidies and interest-free loans in order to encourage investment and public companies built large heavy industrial plants in the South but these efforts were not tailored to helping the unskilled labour force<sup>51</sup>.

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<sup>48</sup> Throughout the 1980s, the DC governed in a (practically) fixed coalition with the same four parties: the Socialists (PSI), the Republicans (PRI), the Liberals (PLI) and the Democratic Socialist Party (PSDI) The coalition is usually referred to as the *pentapartito*.

<sup>49</sup> Traditionally, the Liberals used to be the party of big business. Later this role was increasingly taken over by the Republicans, whose ministers and party notables channelled business views and demands to the government. At the same time, the main employer organization, Confindustria had privileged ties with the DC, too. (Ruzza and Fella 2007, p12, Pasquino 2004)

<sup>50</sup> Calls for reform in these areas were put forward as early as 1950 in the Communist trade union's *Piano del lavoro* and by the National Committee for Labour's (CNEL) comprehensive proposal for welfare reform in 1963 (Ginsborg 1990 188-190, Ferrera and Gualmini 2004, p33).

<sup>51</sup> State enterprises brought crucial basic industries – such as petrochemicals and steel – to the South but these were capital- rather than labour-intensive production processes and in any case could not employ unskilled labour (Rodgers 1970, Sassoon 1997, p32).

Sidelining labour's policy preferences was unproblematic in the first decades after the war. First, the political quarantining of the Left "neutralized" most of the working class vote in the electoral competition, since the vote of most industrial workers went automatically to parties that could not stake a claim for a governmental position<sup>52</sup>. Second, the oversupply of labour – especially due to the constant influx of Southern workers into the Northern industrial districts – practically eliminated the possibility of effective industrial action (Sassoon 1991). Third, in the absence of any meaningful resources, the proletariat of the South lacked any political clout. Some of the severe socio-economic tensions in the area were dissipated by outmigration, while the remaining population remained largely politically unorganized and it continued to vote along religious lines, increasing the electoral strength of the DC without gaining substantial policy advantages in return.

However, the situation rapidly changed in later decades. In the context of a swiftly changing society and a fast-growing economy, the balance of power between labour and business shifted. As labour markets in the Northern industrial districts tightened with the drying up of internal migration from the South, industrial action became a more powerful weapon (Sassoon 1991). The conflicts of interests that had been previously suppressed finally erupted in the form of intense worker unrest in the late 1960s and throughout the first half of the 1970s. The large industrial areas of the North were shaken by a wave of unusually intense and intransigent strikes and demonstrations from 1968 to 1973. At the same time, there were sporadic, but intense outbursts of discontent in many areas of the South, too, involving riots and violence<sup>53</sup>.

The massive mobilization of labour put an end to the DC's ability to tailor policies to the interests of business. In the short term, this meant that the hitherto suppressed policy demands had to be accepted. Between 1968 and 1975, a series of welfare reforms were put into place for workers with regular employment<sup>54</sup>. These affected mostly organized labour in the North. Furthermore, large resources were allocated to creating jobs in the

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<sup>52</sup> Until 1963, the political quarantine extended to both the Communist and the Socialist party. The latter was reintegrated into the political system, when it joined the government coalition in 1963.

<sup>53</sup> Demonstrations took place Avola (Sicily) and Battipaglia (Campania) against the dire employment situation. In Reggio Calabria the population fought a year-long battle against the police in order to force the government to make their city the capital of the newly formed region of Calabria, so that the new administrative jobs that come with the function can help alleviate the city's soaring unemployment. (Ginsborg 1990 p337, Partridge 1998 p50)

<sup>54</sup> These reforms involved the upgrading of unemployment benefits in 1968; a pension reform in 1969 setting up social pensions, linking regular pensions to previous earnings and introducing indexation to the costs of living; a reform of invalidity benefits in 1974; and the putting into place of a generous system of income replacement for the temporarily unemployed in 1975, the *Cassa Integrazione Guadagni* (CIG) and *Cassa Integrazione Guadagni Straordinaria* (CIGS) (Ferrera and Gualmini 2003 p37)

underdeveloped South<sup>55</sup>. As a result, public spending grew from a little over thirty per cent of the GDP in 1964 to almost forty by the end of the 1970s (Morcaldo 1993). In the longer term, the experience with mass mobilization provided effective influence for the representatives of labour within the policy-making sphere, abolishing the monopoly of advocates of business on policy formation.

The representation of labour interests was taken up and the political potential of labour mobilization was harnessed by two fairly different sets of intermediate interest representing organizations. On the one hand, trade unions were the natural beneficiaries of the sudden outbursts of political energy of industrial workers in large enterprises. The unions had been weak and divided in the 1950s and the 1960s, but when the first major strikes and demonstrations started – mostly spontaneously organized on the shop floor without the involvement of unions<sup>56</sup> – they were best placed to assume leadership, to coordinate action and to negotiate with the representatives of employers and with the government. The years of worker protest enormously boosted their standing: it doubled their membership<sup>57</sup>, forced the three confederations – the Communist CGIL, the Catholic CISL and the Socialist UIL – to suppress, at least temporarily, their party-political divisions and allowed them to comment on and negotiate over policies from a position of power. They also gained important institutionalized roles in managing the welfare architecture built at the time of the turmoil and they were often consulted on and signed bilateral agreements with the government about economic policy decisions (Regini and Regalia 1997, Natali and Rhodes 2004). At the same time “riding the tiger” (Ginsborg 1990 p317) of worker discontent required that the unions adopt an intransigent position in their dealings with employers and the government. This was especially so for the CGIL, whose Communist credentials and dominance amongst the three confederations predestined it to a militant position. In other words, in the years following the workers’ unrest, the unions’ power was linked to a strategy of uncompromisingly defending the achievements of the late 1960s and early 1970s.

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<sup>55</sup> Employment was boosted in the South via investment from public enterprises in the area (for example the port of Gioia Tauro was built specifically with the purpose to increase employment opportunities in Calabria), via the overtaking and strengthening of existing but weak companies by the public sector (a specific fund was set up in 1971 for this purpose), and by the progressive overstaffing of the public administration. (Partridge 1998 p50, Ginsborg 1990 and 2003 p338-340 and p345, Alesina et al 1999)

<sup>56</sup> Ginsborg (1990 p317) claims that unions and even the Communist Party were taken by surprise by the turn of events. Sassoon (1997, p136) goes even further in claiming that “[t]he unrest of 1968 would not have occurred with that level of intensity if the Italian unions had been stronger. A strong and well-entrenched union movement would have exercised a measure of restraint and control, partly in order to protect vested interests, partly in order not to jeopardize existing power relations.”

<sup>57</sup> The membership of CGIL grew from 2.5 to 4.5 million, that of the CISL from 1 to 2.5 million between 1968 and 1975 (Ferrera and Gualmini 2004).

On the other hand, union representation did not extend to large sections of labour in the South, because of the chronic lack of permanent employment opportunities in the region, making much of the Southern proletariat “unorganizable”. Their case was instead taken up by local politicians of the DC itself. The demonstrations and riots – and especially the involvement of the post-fascist *Movimento Socialista Italiano* (MSI) in perpetuating the violence in Reggio Calabria – revealed the depth of the dissatisfaction of the local DC voter base with the way their plight was handled by the government and their susceptibility to mobilization by alternative, anti-system forces, adding to the threat to the existing balance of political power from the working classes – albeit from a right-wing extremist direction and underlining the need for the DC to pay more attention to these disadvantaged sections of the society in the South. The party had traditionally relied on clientele networks in the region and used state resources to reward voters and supporters (Tarrow 1977). In the wake of the turmoil of the 1960s and 1970s, these networks were extended to new strata of society and augmented with resources of various kinds. Apart from the stepping up of investment of public enterprises in the region, the decentralization of public administration in 1970 and the expansion of public education was also used as a vehicle to create extra jobs via overstaffing<sup>58</sup>, and the practice of fraudulently awarding welfare benefits – primarily disability benefits – became established to provide income for many of those who could not be given public jobs (Ferrera and Gualmini 2004 p45). The increased significance of the Southern proletariat also increased the weight of those politicians within the DC that operated the clientele networks in the region. Since the new uses of public funds benefited local DC politicians, as well as their clients, they were crucially interested in ensuring the continuous supply of those funds in the longer term.

As a result, the upheaval of the 1960s and the 1970s not only created large spending commitments for the state but also established two important power nodes within the policy making sphere that were crucially interested in and capable of safeguarding those spending commitments. The unions mostly stood in opposition to the

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<sup>58</sup> In 1999, Alesina et al. calculated that public institutions in the South in different types of public services were overstaffed ten-fold compared to the North and concluded that more than half of the public employment bill in the South were *de facto* income transfers in the sense that they only served the purpose of keeping up incomes, rather than providing services to the public. They also point out that almost a quarter of the people who had jobs in the South were working in the public sector. Alesina and his colleagues’ calculations relate to the middle of the 1990s and similar calculations are not available for the seventies and 1980s, but given that public employment decreased in the nineties compared to the 1980s, it seems likely that their conclusions about overstaffing and income transfers would hold – possibly even more strongly – in the 1980s.



government, and exerted power through the implicit or explicit threat of mass mobilization. The patrons of the Southern proletariat gained influence within the dominant party of government through the revealed risks to the DC voter base in the South. These new wielders of power, however, did not replace the old ones. The DC continued to rely heavily on the self-employed and to cultivate good ties with big business, even after it co-opted the Southern poor and was faced by strong opposition from the unions.

Therefore, Christian Democratic policy makers were faced with a difficult dilemma. The irreversible jump in spending required a corresponding increase in revenues, but they were reluctant to force their business constituencies to pick up the bill. At the same time, unions would surely not acquiesce in a tax system that assigns all the costs of the new spending programmes to dependent workers. Initially, this dilemma gave rise to procrastination and tax reform was delayed until 1974 despite the growing gap in the budget from the mid-1960s<sup>59</sup>. While the reform that was ultimately put into effect formally conformed to labour's preferences, with its extreme progressivity<sup>60</sup> in personal taxation and relatively high rate of corporate tax, the *de facto* fiscal pressure on business was eased both by explicit countervailing measures – tax-rebates, temporary and sector-specific exemptions from payroll taxes, as well as a so-called negative VAT on investment – and by the tacit toleration of increased tax evasion (Guerra 1993, Della Sala 1997, p27)<sup>61</sup>. The explicit measures were more accessible to large firms, which were likelier to achieve specific relief to their problems via lobbying, whereas evasion was more available for small firms and the self-employed due to their lower visibility. The share of corporate taxes remained low (less than a tenth in 1990) in total tax revenues (Jappelli and Pagano 1994), and evasion increased in response to higher rates, partly through the adjustment of behaviour of individual firms and

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<sup>59</sup> The tax reform was already legislated in 1972, but its actual introduction was postponed by two years on request from independent entrepreneurs, who claimed they needed more time to prepare. (Ginsborg 1990 p330)

<sup>60</sup> The personal income tax system had 32 brackets and the top rate was 72 per cent. (Jappelli and Pagano 1994)

<sup>61</sup> Naturally, it is difficult to ascertain why the government remained passive in the face of growing tax evasion. A few facts, however, feed the suspicion that evasion might have been part of a tacit agreement between small business and the DC to allow the former to avoid the consequences of formally ever-higher fiscal pressure. First, as Ginsborg (1990, p330) points out, the tax reform of 1972 failed to introduce a proper method of tax collection. Second, the years to follow brought a number of tax amnesties: a general one in 1982 and one especially for the self-employed in 1983 (Torgler and Schaltegger 2007). Third, property taxes – the type of tax most difficult to evade – were conspicuously absent from the range of taxes applied in Italy (Guerra 1993). Fourth, the uproar and government crisis following the Visentini attempt to reform tax collection shows how difficult government parties found it to touch the tax collection issue (Ginsborg 1990 p419 and 2003, La Palombara 1987 p49).

through a general shift towards organising production into smaller scale units, making income and employment easier to conceal<sup>62</sup>.

In sum, the events of the late 1960s and 1970s completely reordered the policy landscape relative to the post-war years. First, the tightening up of labour markets in the North and the attendant increase in the potential for industrial action caused a shift in the balance of power in favour of worker groups, placing the policy hegemony of business under pressure. In the political sphere, this shift manifested itself via the increased influence and assertiveness of the political left – the newly strengthened union movement – as well as threat to the DC's positions from the political right. The response of the DC – the chief interlocutor of business interests – to these developments was threefold. First, it could no longer avoid making significant policy concessions to organized workers. Second, it politically co-opted the Southern proletariat through extended clientele networks, in order to avoid having to fight a two-front battle. Third, it did all it could to shield its business constituencies from the costs of the new spending commitments.

The new sets of measures – the ones on the spending side and the negative, exemptive policies on the taxation side – created four very distinct fiscal clusters of interests based on strong vested interests in specific policy areas. They split labour as well as business into two by reinforcing existing distinctions within the classes. Among labour – which was originally uniformly interested in all-encompassing welfare and employment-creating policies – they created a divide according to labour market position, which largely corresponded to geographic location as well. The welfare architecture built between 1968 and 1975 was closely targeted to employees with regular employment histories. Therefore, its benefits and entitlements – regular pensions, income replacements etc. – remained inaccessible for workers in areas of chronic unemployment, like in many provinces of the South, where jobs, if available at all, were mostly seasonal, unpredictable or in the shadow economy. Notably, long-term unemployment benefits and basic pensions remained notional (Bertola and Garibaldi 2002). Conversely, the funds channelled to the Southern proletariat through public employment and welfare fraud were inseparable from the clientele networks that provided them and therefore not available outside of those networks. Business, which

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<sup>62</sup> Alworth and Castelucci (1993) point out that in the decade between 1977 and 1988, only a little over one-third of all companies reported a positive income in any one year – i.e. approximately two-thirds reported no taxable gains. Schneider (1997) estimates that the size of the underground economy grew from around one tenth of the GDP in 1970, to around one eighth in 1980 and to almost one fourth by 1990. See also Chiesi (1999).

had previously had a general interest in maintaining low taxes, was now split according to size, due to the differential ability of large and small firms to achieve exemptions from high taxes or avail themselves of evasion.

As a result, by the time fiscal problems turned severe at the end of the 1970s and beginning of the 1980s, four relatively well-delineable clusters of vested fiscal interests structured the politics of fiscal policy. As explained before, these four groups were ordered into two opposing political camps, with organized labour on one side, facing an awkward redistributive coalition of large and small business and clientele networks involving the Southern proletariat under the umbrella of the DC. The power of these two camps were approximately balanced in the sense that neither could force the other to make significant fiscal sacrifices. The coalition of large and small business and clientele networks involving the Southern proletariat had direct access to policy making through the DC's permanent central role in government, whereas labour wielded power through unions and the threat of mass mobilization.

The legacy of these developments was a completely paralysed policy space. The room for adjustment was marginal. Taking on the welfare system in the face of a militant workforce would have been a risky undertaking. In fact, strikes and demonstrations could even extract a new welfare measure – the introduction of early retirement in 1981 – when workers faced new challenges due to the wave of redundancies. Furthermore, unions achieved the adjustment of tax brackets when fiscal drag was increasing the tax pressure on wages. The Southern clientele would have been electorally costly to pick on. While the DC's vote share was declining in every other region, the party was getting growing support in the South throughout the 1970s (Cattaneo). Indeed, the compensation of employees remained stable as a percentage of GDP and even the attempt to crack down on benefit fraud remained unenforced. The government seemed ambivalent towards the idea of increasing the fiscal pressure on business. On the one hand, it did try to elicit higher contributions – through, for example, the drastic increase of the corporate tax rate – but, on the other hand, it also seemed to be ready to counter this increase by exemptions and rebates. The Visentini affair in 1984 with the shopkeepers' tax reporting also showed that willingness to clamp down on evasion was less than firm. In light of this, it is less surprising that successive governments resorted to trying to make savings on health care, increased taxes on interest income and waited for opportunities like capturing a windfall in oil

prices via excise taxes to generate extra revenue, even though these measures were obviously too small relative to the problem at hand.

Throughout the 1980s, it was difficult to see when and how concessions needed to stabilize public finances could be elicited at last from any of the four main interest groups, even though the primary budget gap created by the unfunded rise of welfare and employment spending was still open, the debt amassed in the previous decade was generating ever-higher interest costs and the growth of the debt-to-GDP ratio was set on a much steeper path. The next section shows that in the end, it was pressures from the international economy that broke the political and policy deadlock, by making it ever more costly for some of the four socio-economic groups to insist on defending their vested interests in the policy status quo.

### **Fiscal problems as catalysts for political change: The fall of the First Republic**

However irresolvable the deadlock might have seemed in the 1980s, it was suddenly gone in the early 1990s. A drastic consolidation package was enacted in 1992 and in the following years, affecting virtually all large, previously untouchable areas: corporate taxation, tax evasion, public employment, benefit fraud and to some extent even pensions. The explanation for how the mighty political obstacles to thoroughgoing retrenchment were removed – how and why the representatives of the four defining socio-economic groups lost the ability or the willingness to intransigently defend the vested interests of their supporters – rests on the insights of the war of attrition model.

The model underlines that the same socio-economic groups can have dynamically changing attitudes towards making concessions for the sake of fiscal stabilization, if the lack of stability causes progressively increasing losses to them through secondary effects such as, for example, inflation. Therefore, understanding the changing political context of stabilization requires analysing the changing balance between the constant benefits accruing to each group from defending their vested interests in certain policies and the increasing loss they suffer from the deterioration of the general economic environment due to the persistent fiscal imbalances. Through such an analysis, this section shows that while politics seemed frozen and policies appeared to be caught in a permanent deadlock throughout the 1980s, the stances of some of the four important socio-economic groups towards making concessions were gradually shifting and their loyalties to their representatives and to the political strategies they were pursuing was

progressively eroded. This led to the loss of support of both the DC and the unions, leading to the fall of the former and a dramatic re-evaluation of the strategies of the latter, allowing for a fundamentally different political basis for fiscal consolidation.

The key to understanding how fiscal imbalances exercised their secondary, negative effects on different socio-economic groups is Italy's membership in the European Monetary System. Italy committed to participating in this system of quasi-fixed exchange rates when the regime was launched in late 1978. This decision became a crucial exogenous international factor in determining the ability of different groups within the Italian polity to live with the consequences of the escalating fiscal problems, because of the ever-increasing tension between the exchange rate commitment and the need to slow the accumulation of debt through monetization. Given the country's double-digit inflation at the time the decision was taken – and the double-digit inflation differential with Germany – the decision was generally seen as a dangerous one for the international competitiveness of Italian industry and all political forces were opposed to such a turn.<sup>63</sup>

However, Italy was under considerable external pressure to join (Ludlow 1982 pp114-115, Frieden 2001, Quaglia 2004). Both Germany and France exerted pressure on Italy, even though Andreotti, Prime Minister at the time had originally announced that Italy would for the time being stay out of the EMS. Italy's final acquiescence was probably motivated by the willingness to reconfirm its European credentials, but perhaps also by the precedent of having received considerable help with its balance-of-payment differences from Germany at the beginning of the decade (Posner 1977, Spaventa 1980, Ludlow 1982, Frieden 2001, Quaglia 2004). In the end, the country managed to secure preferential treatment within the system in the form of a broader, more permissive fluctuation band, but this was not quite enough to resolve the tension between its exchange rate commitment and the severe inflation issues the country was riddled with.

The main source of high inflation was that the Italian central bank automatically acted as a buyer of last resort of government bonds between 1975 and 1981 and, therefore, the growth of the money supply was subjected to budgetary outcomes. After fixing the exchange rate, any further monetization of debt and the further fuelling of inflation

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<sup>63</sup> For an overview of the commentary at the time by the president of Confindustria and former governor of the central bank as well as by the minister for industry and the minister for agriculture see Ludlow (1982 pp209-211). Among parties, none supported the move (Frieden 2002 p31)

would automatically translate into real exchange rate appreciation and consequently into a loss of competitiveness for Italian industry. In order to avoid the perpetuation of such a chain of policy problems, the central bank was given a degree of independence in 1981 and its automatic obligation to buy up all unsold government bonds was terminated. However, it continued to provide financing for the deficit – albeit at a much smaller scale – throughout the 1980s<sup>64</sup>, in an effort to avoid having to pay even higher interest rates on debt and to prevent the debt-to-GDP from growing along an even steeper trajectory (Fратиanni and Spinelli 1997). This practice contributed to the persistence of a sizeable inflation differential with Germany and to real appreciation. Thereby, it created a direct link between fiscal problems and the (loss of) welfare of all those in the exposed sectors of the economy.

Policy makers tried to escape the Scylla and Charybdis of faster debt growth and real appreciation by combining the continued partial monetization of deficit with repeated adjustments of the exchange rate<sup>65</sup>, but the nominal depreciations they achieved in negotiations with their EMS-partners did not make up for the cumulative inflation differential in this period. The lira appreciated by 42 per cent in real terms between 1978 and 1991 (Fратиanni and Spinelli 1997 p236-237). The effect of the real appreciation was different across different industries: some suffered large setbacks whereas others held up well in world markets despite the exchange rate disadvantage<sup>66</sup>. Generally, large-scale manufacturing – such as the production of cars and white goods – was worst affected, but some of the traditional products of small enterprises of the industrial districts – such as textile and apparel or leather goods – also lost market share in this period (Guerrieri and Milana 1990 pp147-163). The setbacks suffered by manufacturing were also reflected in a loss of employment. Between 1980 and 1990, 10 per cent of the jobs were lost in the sector. In the same period, unemployment grew from around 7 to almost 10 per cent.

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<sup>64</sup> Frатиanni and Spinelli (1997, p 242) point out that the 1981 “divorce” of the Banca d’Italia from the treasury – i.e. the lifting of the obligation of the central bank to automatically buy unsold treasury bonds – was far from a complete break with the practice of domination of the bank by the treasury. In fact, the bank continued to finance a sizeable share of the deficit via overdraft and buying a predetermined share of the bonds at auctions. See also Bruni et al. (1989), Epstein and Schor (1989) and Bartilossi (2003).

<sup>65</sup> The lira was realigned eleven times between 1979 and 1990: twice in 1979, twice in 1981, twice in 1982, once in 1983, once in 1985, twice in 1986 and once in 1987 (Fратиanni and Spinelli 1997, p236-237).

<sup>66</sup> The automotive industry, electric appliances, telecommunications, computers and office machines, petrochemicals, chemicals and pharmaceuticals as well as textiles and apparel lost a part of their market share in world exports in the 1980s. Other industries, such as wood and furniture, ceramics and glass, metal products or trains and airplanes recovered after a short fall or held up well throughout the period despite the exchange rate disadvantage. Some, such as agricultural machines or thermo-mechanical equipment even increased their market share (Guerrieri and Milana 1990 pp147-163).

Real appreciation and the loss of international competitiveness introduced a new aspect into the redistributive conflict between the four main socio-economic groups whose vested interests paralysed fiscal policy throughout the 1980s. For those workers and large and small businesses that felt the full weight of declining international competitiveness, the fiscal stalemate became ever more costly and the benefits arising from intransigently defending their interests were progressively dwarfed in comparison. For those entrepreneurs, workers and dependents of the state, whose livelihood was sheltered from international competition, the calculus of resistance to fiscal pain did not change. Two of the fiscally important socio-economic groups – the dependents of the state in the South and large business – clearly stood on two opposite sides of the exposed-sheltered divide. Small business and labour, however, were cut in the middle. Politically, the exposed-sheltered divide fuelled internal conflicts of interests both within the DC's constituency and within the labour movement, between those who would have been better off with a fiscal compromise resolving the stalemate and those who had little to win from making sacrifices for the sake of stabilization. Thus, both the DC and the unions were confronted with an ever more pressing internal dilemma between sticking to their policy of intransigence and accepting fiscal pain for their supporter bases.

Out of the four groups, the Southern clientele of the DC was in the least ambiguous position. Since it depended on the flow of public funds – via public employment and benefit fraud – rather than on market forces, it remained unaffected by the deterioration of international competitiveness. If anything, the employment opportunities provided by the clientele network became ever more valuable as the private labour market in the region further deteriorated and unemployment more than doubled between the mid-1970s and the late 1980s<sup>67</sup> (Bertola and Garibaldi 2004). Therefore, the Southern clientele had more to fear from fiscal retrenchment than ever.

The situation of large business was similarly clear-cut. Due to its export-orientation and its concentration in those industries that were losing market share most rapidly, this group endured uniformly large losses from real appreciation. These were compounded by high capital costs due to the upward pressure on interest rates from sustained borrowing by the state. At the same time, this group anyway had little hope to preserve the public benefits it had previously enjoyed – namely the elaborate system

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<sup>67</sup> In 1990, unemployment stood around 15 per cent among men and around 38 per cent among women (Bertola and Garibaldi 2004)

of tax rebates, exemptions and subsidies – since such measures were to be phased out under the Single Market. Therefore, by the end of the decade, fiscal consolidation had become the overriding concern for large businesses and Confindustria, the peak industry association was calling ever more insistently for immediate stabilization (Walsh 1999).

Small businesses and organized labour were more divided. Small firms and self-employed active in sheltered services and commerce were mostly spared from the negative consequences of macroeconomic imbalances. They continued to enjoy the benefits of a lax tax collection system without suffering from real appreciation. They were also likely to benefit rather than suffer from the high interest rates generated by large public debt, because they were likely to be savers and their capital needs were moderate. Accordingly, they had more reason to be resentful about the introduction of withholding taxes on interest income from government bonds than about deficits. On the other hand, small entrepreneurs engaged in tourism or involved in export production in one of the many industrial districts in the North and Centre of the country were under increasing pressure and became increasingly vehement in their protests about the macroeconomic problems (Walsh 1999).

Organized labour was also differentially hit, although their divisions were complicated by labour market institutions. Workers in heavily regulated large and medium-sized companies tended to be largely cushioned from the effects of declining competitiveness by stringent redundancy laws<sup>68</sup>, a generous income replacement scheme<sup>69</sup> and early retirement, and enjoyed a guarantee on the real value of their wages through the system of automatic indexation. In contrast, workers in more permissively-regulated small firms and in the ever-expanding informal economy felt the full weight of the declining economic dynamism and growing unemployment, along with new entrants to the job market, who had not earned entitlements to job protection and welfare benefits<sup>70</sup>.

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<sup>68</sup> The Workers Statute legislated in 1970 placed very strict constraints on dismissal in firms with more than 15 employees. (Sassoon 1986, Hine 1993, Partridge 1998)

<sup>69</sup> Workers in large industrial enterprises are entitled to wage-replacement benefits up to eighty per cent and up to three years from the CIGS (OECD 2009).

<sup>70</sup> Unemployment grew disproportionately fast in younger cohorts throughout the 1980s. The generation that was already employed at the middle of the seventies was practically unaffected. (Bertola and Garibaldi 2002)



As the pressure grew on firms and workers that were most directly exposed to the consequences of deteriorating competitiveness, so weakened their attachment to their party or unions, which were still caught up in a dilemma between the conflicting interests of their constituencies and did little to bring about a decisive resolution of the problem. The disenchantment with the DC was most visible in the industrial districts of the North, where a new political movement of regionalist parties – the so-called *lega-s* – appeared in protest to deteriorating economic conditions and started to seriously threaten the traditional voter base of the DC among small entrepreneurs in the region. They achieved remarkable advances<sup>71</sup> within a very short period of time, based on an electoral message that urged a retrenchment of the state and privatisation in the South to allow for both the consolidation of public finances *and* low tax rates, appealing both to entrepreneurs and workers in the region by identifying public spending in the South as the main target for the consolidation efforts (Bull and Newell 1993). The unions were experiencing similar losses of support. By the second half of the 1980s, they were heavily losing membership among active workers<sup>72</sup> and undergoing a general deterioration of relations with their remaining active rank-and-file<sup>73</sup> (Regini and Regalia 1997).

Paradoxically, the clearer the signs of the disaffection of supporters in the exposed sectors became, the less the DC and the unions could do to help them. Given the decline of its Northern vote, the DC could not possibly risk the alienation of its Southern electorate – who by 1987 gave more than a third of its vote – or of the ranks of shopkeepers and other self-employed in sheltered sectors that kept supporting it (Cattaneo). Therefore, neither the cutting of public employment, nor a crackdown on benefit fraud and tax evasion was a serious option. Instead, the DC sponsored the upgrading of the pension entitlements of the self-employed at the end of the 1980s, in a feeble attempt to buy back the sympathy of its traditional supporters (Ferrera 1997, Jessoula and Alti 2006). This made the fiscal problem even worse but it achieved little in terms of reversing the electoral losses of the party in the North-Eastern industrial districts (Cattaneo). Furthermore, the decline of the DC made its largest coalition partner, the Socialists more influential in the government. Since the PSI's electoral

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<sup>71</sup> In Lombardy, one of the DC's former strongholds, the *Lega Lombarda* demonstrated spectacular progress, growing from just under three per cent in the 1987 regional election to six and a half per cent in the European election of 1989, to over sixteen percent in the regional election of 1990 and to over twenty percent in the 1992 election for the senate.

<sup>72</sup> Between 1980 and 1990, the unionization rate of workers fell from fifty to under forty per cent.

<sup>73</sup> This manifested itself in the growth of independent unions and in expressions of discontent such as the so-called, 'self-convened' councils. (Regini and Regalia 1997)

growth in the 1980s capitalized on the support among public employees, white collar workers and managers – often organized into similar clientele networks as those of the DC in the South – the growing weight of the PSI in the government strengthened those groups that were institutionally and sectorally insulated from the consequences of declining international competitiveness but depended on public spending (Ginsborg 2003 pp150-153). As far as trade unions were concerned, their weakness in organizing younger cohorts and workers with less regular employment patterns made their membership shift ever more towards older and retired workers, making the offering concessions on pensions for the sake of cutting the deficit a suicidal choice for unions.

In this political climate – which was characterized by the policy-primacy of groups sheltered from the consequences of declining competitiveness – the fiscal status quo momentarily seemed as immutable as ever and demands for fiscal consolidation and disinflation appeared to have little chance of prevailing in the policy-making arena towards the end of the 1980s. However, the tension among those who were suffering most economically from the paralysis of the political system did not cease to grow. It manifested itself in various forms of political protest. Support for protest parties like the *Lega Nord* grew. The share of empty and spoiled ballots in various elections increased<sup>74</sup>. Most importantly, a referendum movement was launched that called for a reform of the political system as a whole<sup>75</sup> (Bull and Newell 1993, Ginsborg 2001 p276).

Around the elections of April 1992, the shifts in underlying commonalities and conflicts of interests and the loss of political support of key interest representing organizations came to fruition. The procession of events accelerated and the political system suddenly radically changed. The elections brought about another notable drop in the DC's share of the vote – leaving the DC with considerably less than a third of the national vote – accompanied by the comet-like rise of the *Lega*. Politicians and political scientists called the results an electoral “earthquake” (Bull and Newell 1993). It was in this atmosphere of general tension that the so-called *Mani Pulite* corruption scandal began. The waves of scandal exposed vast networks of corruption and clientelistic practices, discredited the DC and ended the political careers of large ranks of Christian Democratic (and other *pentapartito*) politicians (Ginsborg 2003 pp267-269). It

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<sup>74</sup> Voter turnout decreased and the number of spoiled ballots doubled in the 1980s compared to earlier decades. (Bardi 1996)

<sup>75</sup> Incidentally, the referendum for electoral change was also initiated by a disillusioned Christian Democrat, Mario Segni. Sixty-two per cent of the citizens voted, ninety-six per cent supported electoral reform (Partridge 1998 p76, Welhofer 2001).

practically swept away the largest political force in the country, which had defined the policy choices of the previous half-century. The DC's coalition partners suffered similar fates.

With the demise of the DC, the vested interests of large business, small entrepreneurs and the dependents of the state in the South ceased to be politically linked and the three groups were freed as well as forced to find new representatives for their interests and new allies in the political space. Furthermore, the fall of the old party system also ended the automatic electoral sidelining of much of the labour vote, opening up the possibility of alternative representation of labour interests outside of the unions, in the governmental sphere.

In the intermediate aftermath of the political meltdown of 1992, however, the party political space was empty. The old political class was trying to deal with its fall from grace and with the series of criminal investigations directed at it. At the same time, new parties were still to stake a serious claim for power in the post-DC political scene. In this political void, only two of the four defining socio-economic groups retained effective representation of their interests: large industry, through the influential employers' organization, and labour through the trade unions. These social partners were given an unprecedented opportunity to work together with technocratic governments<sup>76</sup> – unshackled by the types of electoral considerations that had so tightly circumscribed the room for manoeuvre of DC-led governments – in order to shape policy choices to their preferences.

The social partners' interests converged on the need to restore economic competitiveness. *Confindustria* – freed from its political ties with earlier governments – was able to assume an independent political role, and was calling ever more insistently for macroeconomic stabilization (Ginsborg 2003, p266). The urgency of these demands – although already fairly clear by the end of the 1980s – were definitively driven home to the unions by the exchange-rate crisis in September 1992, which exposed Italy's hopelessly precarious position on the international stage and by a new boost to

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<sup>76</sup> Although the government formed after the 1992 elections under Socialist Prime Minister Amato still incorporated four of the five permanent coalition partners of the *pentapartito*, it was unusually "low-key" politically, enlisting technocrats rather than powerful party-political figures, who came under increasing pressure from the scandal. When this government resigned after less than a year – in response to public outrage over an attempt to decriminalize corruption and to a referendum signalling of citizens' urge to change the political system – a caretaker government took over under former central bank governor Ciampi, composed of unaffiliated experts and technocrats from the former Communists (Partridge 1998 p77, Ginsborg 2001 p276)

unemployment, especially in the industrial North. These new negative developments forced unions – and most importantly, the CGIL – to face up to their internal tensions and to the plight of younger workers. They finally *de facto* acknowledged the rift within their membership between older workers with established work histories cushioned by the welfare system and workers outside of the most protected core of the labour market. They adopted a two-pronged strategy that allowed them to make major concessions on welfare policies on behalf of and for the sake of the more vulnerable members, while defending the rights and entitlements of the older, safer members<sup>77</sup> (Regini and Regalia 1997).

The tripartite negotiations between the government and social partners achieved very significant results in consolidating public finances. All four big problems of the previous two decades were attacked: public employment, tax evasion, corporate tax revenues and to some extent, even the welfare system (Bosi et al 2003, Ginsborg 2003, Ferrera and Gualmini 2004)<sup>78</sup>. The social partners achieved important compromises amongst themselves and supported technocratic governments in inflicting considerable fiscal pain on the other two groups that were temporarily left without representation in the policy sphere. The measures that were enacted by the technocratic governments in 1992 and 1993 set the primary balance on an increasing path, stopped the growth of debt as a percentage of the GDP and contributed to the descent of the debt-to-GDP ratio after 1994.

The contrast between these years and the 1980s could not have been starker. Fiscal stalemate gave way to radical reform, the opposition between organized labour and the awkward coalition of large business, small enterprises and the Southern proletariat gave way to cooperation between organized labour and large business, sidelining the two other groups. By the time new elections were called under the new electoral rules to inaugurate the so-called Second Republic, the political slate had been cleared and the first steps towards fiscal consolidation showed that a window of opportunity had been opened by the new configuration of redistributive coalitions. Italy's decade-long fiscal problems now seemed solvable.

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<sup>77</sup> This redefinition of the strategy of unions was greatly helped by the democratization process launched in response to the legitimacy crisis within unions in the early nineties. This allowed for a greater voice for emerging policy demands among members. Unions reorganized themselves, introducing a system of referenda and other channels for voice within the organization, greatly increasing legitimacy (Regini and Regalia 1997).

<sup>78</sup> These measures will be described and analyzed in detail in the next chapter.

## Conclusion

This chapter outlined the socio-political background of fiscal policy making in Italy in the 1980s in an effort to gain a better understanding of the forces that were driving the alarming accumulation of public debt in this period. It explored the factors beyond the realm of Parliamentary politics – which most existing accounts of Italian fiscal policy concentrate on – that help to explain the approach of successive governments to the escalating fiscal problems. It found that policy makers' hands were completely tied by unresolved redistributive conflicts between four major socio-economic groups within the Italian polity. It also showed that the stalemate was partially generated by the presence of conflicting interests within a single party, Christian Democracy, and partially by the implicit veto of a non-Parliamentary actor, the labour movement. It argued that these conflicts were impossible to resolve in the political context of the First Republic, because the system of interest representation was centred on the defence of the vested interests of the four groups in existing (formal and informal) policy schemes. The representatives of each group insisted on defending their constituencies' stake in the *status quo* despite the fact that this *status quo* became ever-more costly for certain sections of those constituencies.

The chapter argued that the tension between main political actors' strategies and part of their constituencies' interests undermined the support for those important actors and contributed to the political earthquake of the early 1990s as well as to the rapprochement between unions and employers, which created the basis for the fiscal consolidation that started in the 1990s. At the beginning of the Second Republic, the political slate was clean and the political space was open for new strategies and alliances between the four main interest groups.

The next chapter shows that the political reordering described in this chapter played a crucial role in creating a window of opportunity for meaningful retrenchment that not only allowed Italy to stop the accumulation of debt but also to enter the euro zone with the first group of countries. At the same time, it also shows that the new alliance was a wasting asset that lost its *raison d'être* as soon as its main goals were reached. As the alliance disintegrated, legacies of the First Republic came into the foreground again. In the longer term, the four defining socio-economic groups continue to structure politics. Vested interests in the policies created in the 1960s and 1970s still delineate the

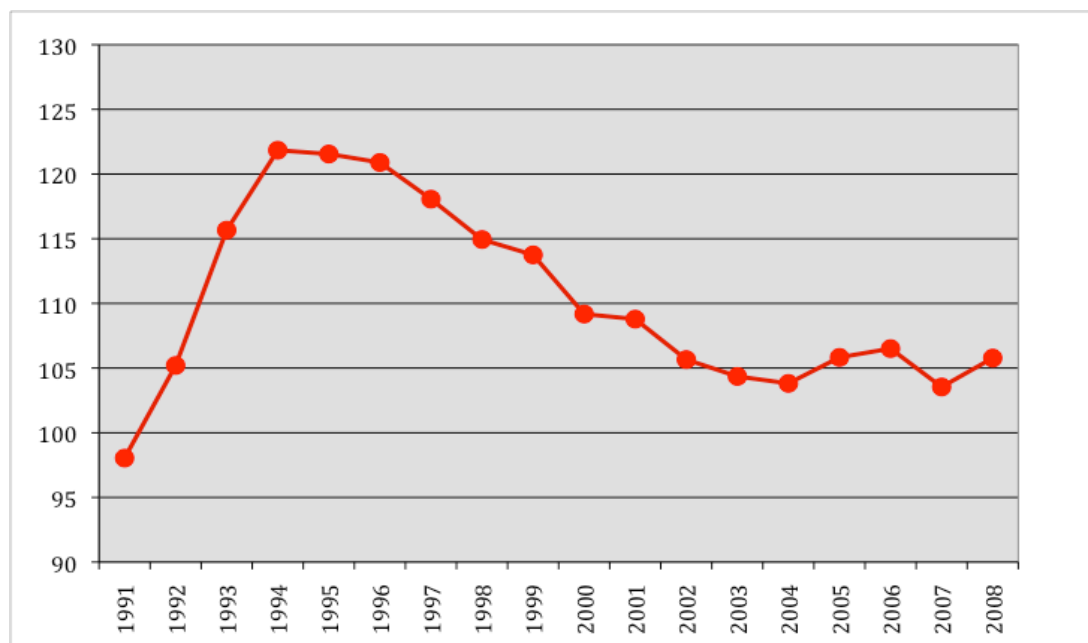
constituencies for the new actors on the political scene and the conflicts between the four groups continue to define and limit fiscal policy choices up to the present day.

## Chapter 4.

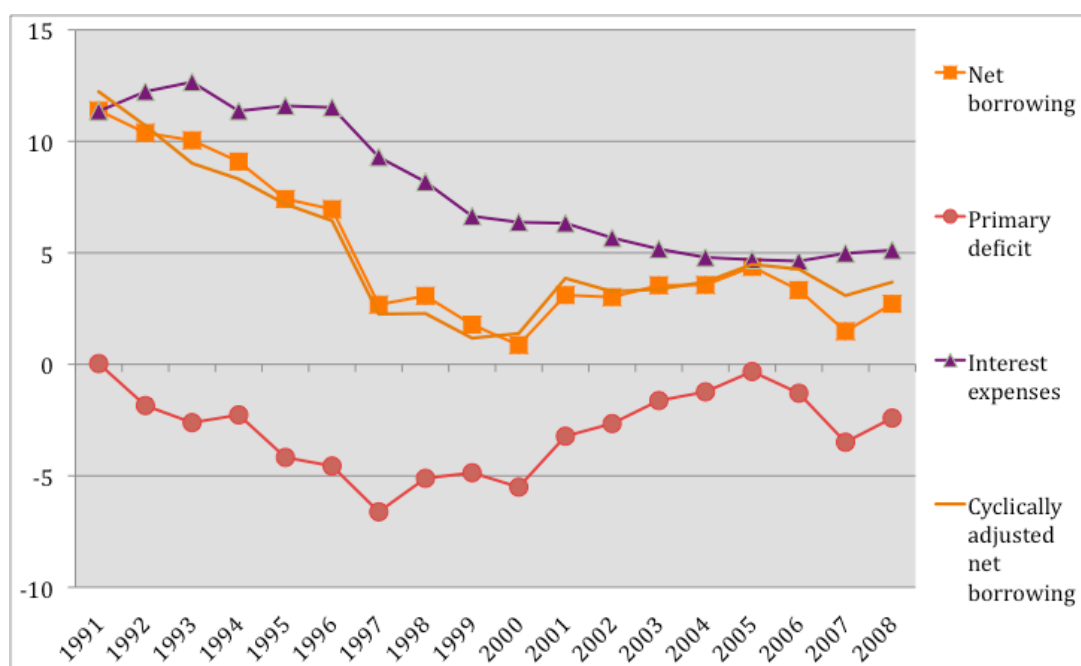
### Fiscal roller-coaster: Consolidation and relapse in Italy after Maastricht

In the past two decades, Italy had a mixed record of dealing with its excessive indebtedness and fiscal imbalances. In the 1990s, it achieved a remarkable fiscal turnaround. Three decades of uninterrupted and accelerating debt accumulation gave way to a steady decline of the debt-to-GDP ratio by 1994. Deficits that still amounted to more than a tenth of the GDP in 1990 were almost eliminated by the end of the decade. Revenues were considerably increased and spending was cut. The discipline did not last, however. In the 2000s, net borrowing progressively increased and by 2005 the debt-to-GDP ratio was rising again. Then, a renewed round of fiscal tightening in 2006 and 2007 put the ratio on a descent once more, before the global economic downturn evaporated all hopes for fiscal improvements in the near future (see Figures 4.1 and 4.2). This chapter is aimed at explaining this series of dramatic policy reversals and the puzzling combination of remarkable efforts to cut the deficit and the subsequent failure to exploit these efforts to bring debt permanently down to safer and more manageable levels.

**Figure4. 1 – Gross consolidated debt general government (1991-2008)**  
per cent of GDP  
Source: Ameco



**Figure4. 2 - Net borrowing, cyclically adjusted net borrowing, primary deficit and interest expenses (1991-2007)**  
**per cent of GDP**  
**Source: Ameco**



Most scholarly accounts of fiscal policy in the Second Republic were written around the turn of the millennium and were aimed at explaining the astonishing fiscal consolidation of the 1990s. Almost invariably, they emphasize the role of the EMU accession process in making the previously elusive stabilization possible, but they focus on different aspects of policy making that were transformed in response to the euro-objective. Hallerberg (2004 Chapter 7) argues that the race for the euro played a role in conjunction with the parallel changes in the electoral and party system. He underlines that the shift towards a more majoritarian set of electoral rules and the consequent consolidation of the party system into two relatively stable electoral blocks made possible the centralization of the budget process under a strong finance minister who restrained the impulses towards overspending. At the same time, he emphasizes that the threat of being left out of the euro zone greatly enhanced the successful adoption of this “delegation” form of fiscal governance by assigning inadmissibly high political costs to deficits and thereby providing the newly empowered finance ministers an important stick with which to enforce fiscal discipline amongst members of the government.

Della Sala (1997), on the other hand, attributes the remarkable fiscal improvement to the increased capacity of policy makers to ignore policy demands from diverse socio-



economic groups and to override their resistance to fiscal pain in the name of the national imperative of fulfilling the Maastricht criteria in time for the first round of euro-accession. He underlines that by shifting the authority over fiscal target setting to the supranational level, a previously impotent executive obtained the necessary clout in the domestic sphere to carry out the measures needed for reaching those targets. In other words, he argues that the race for the euro enhanced the capacity of a weak state to act autonomously of societal actors.

By logical extension, these theories successfully explain the deterioration of fiscal performance in the 2000s, since it coincided with the progressive discrediting of the post-accession fiscal rules of the EMU. In Hallerberg's framework, the commitment devices provided by the targets and procedures specified in the Stability and Growth Pact are not aiding discipline within the delegation form of fiscal governance. Since the Pact lacked clear enforcement mechanisms that would strengthen the hands of a finance minister in the face of spending ministers but it limited his discretion in adjusting the fiscal course, the constraints it imposed on policy making were not helpful for allowing a strong finance minister to control spending and keeping the economy and public finances on an even keel<sup>79</sup>. In Della Sala's approach, the lack of painful punishment mechanisms in the Stability and Growth Pact diminished the natural imperative for fiscal discipline after the desired goal of euro accession was achieved and thereby removed the restraint on interest groups to forcefully make their claims on the government again. Therefore, fiscal deterioration after 2000 is an unsurprising development for both approaches. At the same time, the success of the fiscal effort exerted in 2006 and 2007 pose more of a challenge for this EMU-centred view.

This chapter questions both the crucial importance of changes in political institutions and the fiscal governance regime and the centrality of the EMU accession in turning the tide of Italian fiscal policy. It agrees with Hallerberg that the centralization of the control of public finances was an important aspect of achieving the desired fiscal figures. However, it contends that the truly crucial unity of purpose in achieving the balance of public finances is not the one that was achieved within governments – via the changes in the underlying electoral system and the adoption of the delegation form of fiscal governance – but the one that was created among the societal groups that

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<sup>79</sup> On the different fiscal adjustment strategies in delegation and commitment (or contract) forms of government and the efficiency of fiscal targets for delegation states, see also Hallerberg, Strauch and von Hagen (2009, pp 80-84)

supported the governments of the 1990s. These groups were willing to make sacrifices for the sake of fiscal stability and lend support to the government in enforcing such sacrifices on other groups. The worsening of fiscal results after 2000, in turn, reflect the disintegration of the societal coalition that had been so united behind the restoration of fiscal stability, rather than a loss of centralized control within the governments.

The chapter also agrees with Della Sala that policy makers' newfound ability to resist policy demands from social groups disadvantaged by the austerity measures was key to the restoration of fiscal health. However, it claims that this imperviousness to pressure, this empowerment of the executive to inflict fiscal pain on large sections of society did not arise from an unquestioned external constraint or a society-wide agreement with the national imperative of early euro accession. Instead, it was strongly connected to the ability of a certain coalition of societal interests to fully capture the policy making sphere and to exclude other socio-economic groups from decision making. Conversely, the deterioration of public finances in the 2000s reflects the ascendancy to fiscal power of those groups whose interests were sidelined in the consolidation process.

This argument draws on Walsh's (1999) insight. Walsh ascribes the dramatic fiscal improvements of the 1990s to a new political constellation that arose after the collapse of the First Republic, which allowed a new coalition of interests – formed across class-lines, uniting labour and business groups exposed to international competition – to shape macroeconomic policies (p79). The chapter argues that *both* the decision to embrace Maastricht *and* the successes in fiscal consolidation – in the 1990s and then again in 2006 and 2007 – can be connected to the ascendancy of this coalition of socio-economic groups exposed to the consequences of international competition. Conversely, the relapses in fiscal performance can be linked to the coming into government of a different coalition of interests.

Thus, the study presented here couches the explanation of fiscal developments in an analysis of the socio-economic context of policymaking. It traces the observed deficit cycles to the polarization of interests between two societal coalitions that coincide with the core constituencies of the two large and broadly stable political blocs – the centre-left and centre-right – that have governed in the first two decades of the Second Republic. The profound conflicts of interests between these constituencies concerning spending and taxation induce each political bloc to fundamentally redesign fiscal policy as soon as it comes to power, in order to reverse crucial policy decisions of the other

side and thereby redress the grievances of its core supporters. The centre-right has been less successful in reconciling the need to assert the interests of its constituencies with fiscal rectitude due to its inability to impose the costs of its preferred policies on the constituencies of the centre-left in the face of opposition from trade unions. Therefore, its spells in government – a short intermezzo in 1994 and a full term between 2001 and 2006<sup>80</sup> – were marked by deteriorating balances. The centre-left's policy choices have been more impervious to resistance from the opposing side, leading to pronouncedly better fiscal results under its governments: the formally technocratic cabinet of 1995 and the elected governments between 1996 and 2001 and between 2006 and 2008. However, the relative electoral weakness of this bloc and its disregard for the policy preferences of groups outside of its core constituencies prevent it from cementing its achievements for the longer term.

The defining coalitions of interests supporting the two blocs were formed in the crucial first years of the Second Republic. In 1992 and 1993 – in an atmosphere of economic and financial emergency and in the political vacuum created by the collapse of the party system of the First Republic – organized labour joined ranks with big business to support technocratic governments in carrying out painful adjustments. The cooperation of organized labour and large enterprises was induced by their shared interests in improving the conditions for Italian industry to compete in world markets via resolving their persistent old conflicts. At the same time, it also crucially affected the path of fiscal retrenchment taken in these years, because it allowed social partners to influence fiscal decisions and to offload the costs of consolidation on socio-economic groups temporarily excluded from the policy-making arena, small entrepreneurs and the dependents of the state in the South. The decisions of this coalition of interests were supported in parliament and government by parties and personalities that were later to constitute the centre-left bloc. The centre-right bloc formed largely as a defensive reaction to these developments, when parties representing groups most disadvantaged by the fiscal tightening of the early 1990s joined forces in the 1994 election to counter the assault on the vested interests of their electorate. These coalitions of societal interests and political blocs were locked into place for most of the past two decades.

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<sup>80</sup> The centre-right has been in power again since 2008, but that period will not be analysed here due to the confounding effects of the global economic downturn.

In the broader context of Italy's long-term fiscal problems, the policy developments of the past two decades underline the paramount importance of the persisting conflicts between the vested interests of four major socio-economic groups – large businesses, small enterprises, organized labour and the dependents of the state in the South – and, crucially, the ability of each of these groups to ensure the effective defence of their interests in the policy making sphere. In the early years of the Second Republic the strength of the alliance of sectors exposed to foreign competition – uniting large sections of business and labour – helped to overcome the conflicts that had prevented governments from stabilizing public finances in the 1980s. However, the conflicts resurfaced in the 2000s as this alliance disintegrated. Up to the most recent times, when the spectre of sovereign default opened the way for radical action, these conflicts of interests frustrated efforts to bring the excessive public debt into more moderate ranges.

The war of attrition model helps to explain this change in political conditions by shedding light on the changing costs of different political strategies for different socio-economic groups. Before the euro, the negative economic consequences of fiscal problems – high inflation, the crowding out of private investment and loss of competitiveness through high real exchange rates – greatly outweighed the pain from fiscal sacrifices for all those groups whose livelihood depended on international competition. These corollary costs of fiscal imbalance therefore provided incentives for these groups to seek compromise with others. After the euro-accession, however, these incentives vanished. The Maastricht convergence process and the actual joining of the single currency greatly diminished the macroeconomic costs of fiscal problems for each group by insulating monetary variables from the effects of fiscal policy. Thereby the motivation for socio-economic groups to acquiesce in fiscal sacrifices for the sake of a better economic environment disappeared.

The chapter lays out the argument in three parts. The next section analyses the political and economic situation of the early years of the Second Republic. It shows how the social partners used the window of opportunity created by the suspension of party politics under the technocratic governments of Amato and Ciampi to strike bargains between them about ways to address the most pressing macroeconomic problems, with far-reaching negative consequences for socio-economic groups not included in decision making. The third section investigates the way party politics was reconfigured after the turmoil of 1992. It examines the voter base and programmatic outlook of the

two major party-formations and shows that the new political alliances formed in this period arose in relation to the experiences of the technocratic period. It points out the strong pattern of policy reversals between the two sides and uses it to explain the observed sinusoid pattern of budget balances. The fourth section turns to the analysis of distributive coalitions in a war-of-attrition framework and argues that, although in a much better shape fiscally throughout the 2000s, Italy was caught in the same distributive gridlock that had generated its fiscal problems in the 1980s between the four most important socio-economic groups. The last section concludes.

### **The not-so-exceptional politics of the formative years of the Second Republic**

It is tempting to depict the years between 1992 and 1993 as a period of “exceptional politics” in Italy. On the one hand, the country faced a perilous economic situation. In 1991, real growth slowed considerably and exports had shrunk in real terms for the first time in ten years. The country went through a major currency crisis in 1992 and had to leave the European Monetary System. The government had difficulty in raising funding for its expiring debt and saw confidence in the currency and the banking system wane<sup>81</sup>. To make matters worse, the process of European integration was to move to a higher level and Italy seemed destined to be left behind due to its macroeconomic problems. On the other hand, political control over policy making was practically suspended. Non-aligned experts, such as professors and central bank executives, occupied most of the key decision-making posts. Politicians themselves feared the end of their political careers as criminal investigations discovered ever-newer corruption cases. They had little concern for fighting for the interests of constituencies they might not ever receive votes from again. Prime ministers Amato and Ciampi received blanket authorizations from the Parliament to reform such broad and crucial policy areas as pensions, health care, public administration and local government finances (Ferrera and Gualmini 2004 p70) and had a free hand in increasing taxes. The economic situation clearly seemed to demand immediate and resolute action, the transcending of political differences and conflicts of interests for the sake of national welfare, and the political situation seemed to provide exactly the right setting for this kind of technocratic action. This section argues, however, that the scope of technocratic policy making was circumscribed very early on by the demands of the social partners, who left a strong imprint on the policies of consolidation in these

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<sup>81</sup> Ginsborg (2003, p271) notes that the Treasury had difficulty finding buyers at its monthly bond sales and the Bank of Italy had to step in as a buyer of last resort to maintain confidence while there were signs of a possible bank-run.

years and that the responses to the economic emergency were emphatically political, rather than purely technocratic.

The limits to technocratic decision making were shown as soon as the government's attention turned to pensions. The Amato government – having gotten a free hand from Parliament to reform social security – presented a pension reform that was to significantly tighten eligibility criteria (raise the retirement age and lengthen the required contributory period) and decrease the benefit levels (by expanding the reference period on the basis of which pensions were to be calculated and by changing the indexation mechanism from a wage based one to an inflation-based one). Such a move was to be expected, since old-age pensions accounted for more than an eighth of the GDP and more than a fourth of total expenditure (Brugiavini and Fornero 2001), the deficit of the pension funds accounted for half of the total deficit and the policy discourse had revolved around the need to reform pensions for over a decade (Jessoula and Ferrara 2006). Nevertheless, the proposed measures sparked wide-scale protests and demonstrations and the trade unions strongly denounced the package. In response, the government entered into extensive tripartite negotiations. The reform that was finally enacted included most of the elements originally proposed, but it mandated very long phase-in periods<sup>82</sup> and exempted older cohorts already in retirement or likely to retire within the next decade<sup>83</sup>, which meant that the financial impact of the new measures would only start to appear in the long run. Unions even managed to block plans for freezing the indexation of pensions for 1993. In other words, while it was an important breakthrough for longer-term sustainability, the reform practically did not contribute to the immediate stabilization effort, and the largest single item in the budget was left virtually untouched for the time being (Ferrera and Gualmini 2004 p144, Jessoula and Alti 2006). Amato's experience showed that unions were bent on protecting the current pension payments to their members and would not consent to sacrificing these for the sake of the consolidation process<sup>84</sup>.

Other avenues, however, remained open for attacking the deficit. The Amato government issued a decree decreasing the employment protection of public

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<sup>82</sup> The reform is expected to be fully in effect by 2032 (Brugiavini and Galasso 2004).

<sup>83</sup> Workers with at least 15 years contribution were exempted from all new rules, for employees with shorter contribution period, the new rules will be applied on a *pro rata* basis (Ferrera and Gualimini 2004 p114).

<sup>84</sup> This lesson seems to be reflected in Ciampi's pension reform proposal of 1993, which concentrated on encouraging the development of a second pillar and placed penalties on early retirement but left regular pensions fully intact.

employees in preparation for a wave of redundancies, making savings on compensation of employees an important pillar of retrenchment throughout the rest of the decade. This expenditure item decreased by more than a percentage point of the GDP by 1995, accounting for half of the savings in this period (Ameco). Subsidies to companies in the South stopped with the closing of the *Cassa per il Mezzogiorno* in 1993, leading to savings of another per cent of the GDP by 1994 and further ones throughout the decade (Bull and Baudner 2004). Considerable cutbacks were made on health expenditure and on the tightening of the eligibility conditions for disability benefits (Ferrera and Gualmini 2004 p23). Significant steps were made towards privatization by converting the large public corporations into shareholding companies and placing them on the market (Ginsborg 2003, p273). Privatization became a major source of revenue in the years to come<sup>85</sup>. Amato also introduced new taxes on real estate and a corporate tax on net worth, and increased social security contributions by a tenth (Brugiavini and Galasso 2004, Battilossi et al 2005). The Ciampi government followed suit by dramatically increasing tax pressure on corporations via the ending the tax deductibility of a major local tax (ILOR) from the general corporate tax (IRPEG) (Bernasconi et al 2005). Personal income taxes and VAT were, on the other hand, left untouched. Revenues increased by 4 percentage points of the GDP between 1991 and 1993.

These measures had very different effects across different groups and across different regions. The South was especially hard-hit. The state had been a provider of livelihood for much of the population in formal and informal ways: via state-owned enterprises, state-subsidized private investment, overstaffing in public administration or, as a last resort, the fraudulent allocation of disability benefits<sup>86</sup>. All of these channels were threatened with drying up completely. Unemployment in the region rose to unprecedented heights in the five years to follow (Bertola and Garibaldi 2003, Bull and Baudner 2004). Despite the dramatic effect of these measures, they were politically unproblematic. The benefits that were thus taken away from the South had been obtained and channelled to the South – often via clientelistic networks – by politicians of the Christian Democratic Party (DC). The party now lay in ruins and many of the politicians were under investigation for corruption. The South was left politically abandoned. Furthermore, the transfers to the South were the object of substantial

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<sup>85</sup> The average yearly revenue from privatization amounted to 1 per cent of GDP, with a peak between 1996 and 1998. (Goldstein 2003, Vasallo 2007).

<sup>86</sup> Public employment accounted for a quarter of the total employment possibilities in the South and the compensation of public employees was a fifth of the local GDP, even in 1998, after the retrenchment of the public sector (Bibbee and Goglio 2002).

hostility in the rest of the country by the 1990s and the closing of the “Cassa” as well as the abolition of the Ministry for State Holdings and Agriculture – responsible for managing public enterprises – were popular demands reaffirmed by referenda (Bull and Baudner 2004). This made it easy for the technocratic governments to place a significant share of the burden of consolidation on the dependents of the state in the South.

Another group of big losers of the retrenchment measures were those small enterprises and self-employed<sup>87</sup> that had benefited from the tacit toleration of tax evasion during the 1980s (Della Sala 1997). The taxes on net worth and real estate introduced by the Amato government were clear attempts to bring into the fold of taxpayers those entities that persistently hid their income<sup>88</sup>. This signal of a tougher stance on tax evasion, the increasing of tax rates and the abolition of exemptions and reductions foreshadowed a huge increase in the *de facto* fiscal pressure on these tax subjects. In light of these developments, the future looked rather bleak especially to those small enterprises that were worst hit by the shrinking of domestic demand in the harsh economic downturn that was affecting Italy at the time. Shopkeepers and the self-employed organised protests against the tax on net worth (Ginsborg 2003 p443). However, unlike in the 1980s, when the government watered down an attempt to strengthen tax collection in the face of opposition from the shopkeepers’ association<sup>89</sup>, this time no one in the policy making sphere felt particularly compelled to take up the cause of the self-employed against a tax whose largest apparent defect was that it was difficult to evade. Larger enterprises also had to take a share of the consolidation bill via higher corporate taxation and higher payroll taxes. At the same time, the increase in tax rates was less of a shock for them, because they had less opportunity to evade taxes and the *de facto* increase in fiscal pressure was therefore smaller.

Private sector employees stand out as the group who made the smallest direct and immediate contributions to the stabilization efforts in these years. Pensions, income replacement benefits<sup>90</sup> and other employment related schemes<sup>91</sup> were left unchanged

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<sup>87</sup> In Italy, self-employment is unusually prevalent. It accounted for around a third of all employment at the mid-nineties (Ameco).

<sup>88</sup> Such taxes had been absent in the 1980s due to strong political opposition (Guerra 1993).

<sup>89</sup> For details of the protest against the 1984 Visentini reform of tax collection, see the previous chapter.

<sup>90</sup> Classical unemployment benefits – the so-called *Indennità di disoccupazione ordinaria* – are famously low and short duration in Italy. However, for workers with regular employment history, generous income replacement schemes – under the *Cassa Integrazione Guadagni* and *Cassa Integrazione Guadagni Straordinaria* – are available for up to three years (Bertola and Garibaldi 2004). CIG is based on private contributions but also involve complementary contributions from the state (OECD 2009). No proposals have been put forward to cut back on any of these.



in the medium term and taxes directly affecting dependent employees also stayed the same. It seems somewhat surprising that such a large socio-economic group was shielded from most of the immediate costs of consolidation. Why did the government back down in the face of union opposition to cutting pension expenses already in the short term despite the large imbalances in that sector? Why did the employers acquiesce in the government's retreat during the tripartite negotiations on pensions, despite their own contributions to deficit cutting? Answering these questions requires looking at the deals made in this period between employers, employees and the government in the field of industrial relations.

In 1992, shortly before the start of the currency crisis and the appearance of the governments' first difficulties in refinancing its debt, the unions consented to the abolition of the wage-indexation mechanism, the *scala mobile*. This mechanism had been a major bone of contention between labour and business throughout the 1980s, due to the constant upward pressure it put on labour costs and the attendant difficulties it created for maintaining international competitiveness. This breakthrough marked a crucial change in the attitude of the largest and most potent of the three main union confederations, the Communist CGIL, which had put great emphasis on defending the mechanism throughout the 1980s. The new approach seemed to reflect the realization that maintaining an intransigent line in the face of high and ever-growing unemployment was untenable. Employment in manufacturing – the core constituency of the CGIL – had decreased dramatically by the early 1990s (Ameco). The CGIL was under contradicting pressures. On the one hand, it had to safeguard the interests of the older cohorts of its membership<sup>91</sup> by defending the entitlements and job protection legislation achieved in the 1960s and 1970s. On the other hand, it was pressed to assist in dismantling the greatest obstacles to restoring competitiveness, in order to aid the creation of new jobs for younger cohorts of workers, amongst whom unemployment was twice as high as among older cohorts (Bertola and Garibaldi 2003). The acquiescence in the abolition of the *scala mobile* was the first sign that the CGIL was not oblivious to the problems of the younger generations. This move was followed by a

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<sup>91</sup> Companies have to set aside part of their employees' gross wage in a fund for the severance payments, payable when an employee leaves the company because he or she is fired, retires or otherwise leaves voluntarily. This payment, called the *Trattamento di fine rapporto (Tfr)*, *de facto* serves as income replacement in the case of redundancy or as additional pension income (if the worker does not have to use it in his or her active life). Successive governments have tried to redirect the Tfr funds into the pension system, by mandating their transformation into a second pillar, but these attempts have so far been unsuccessful, due to the resistance of the social partners (Brugiavini and Galasso 2004).

<sup>92</sup> Notably, more than half of the CGIL membership consisted of pensioners by the early 1990s (Chiarini 1999). Their interests and those of generations nearing retirement were therefore impossible to sideline.

series of important compromises with employers. All of these were characterized by a seemingly schizophrenic urge of the unions to defend the welfare system and labour regulations intact for true labour market insiders – primarily the older generations – while at the same time helping to dismantle it for the younger cohorts<sup>93</sup>.

The abolition of the wage indexation mechanism – and the freezing of wages for 1992, which was also part of the agreement signed – provided very visible immediate as well as long-term gains to employers. Labour costs fell and the profit share and the net return on the capital stock increased (Ameco, Torrini 2005). The effect of wage restraint was coupled with a boost to competitiveness via real depreciation once the lira was ejected from the EMS and allowed to float in the medium term. An export-boom followed, helping export-oriented firms to weather the shrinking of domestic demand in 1993 and boosted profits in the subsequent years. Under these conditions, employers – especially the large export-oriented firms, which came to dominate the employers' organization, Confindustria, in the 1990s – were in a better position to reciprocate the change in unions' attitude with a willingness to cooperate (Thompson and Price 2009b). They were ready to compromise on issues crucial to the unions, in the hope of further progress on labour market liberalization, industrial peace and a consensus-driven wage bargaining regime (Ginsborg 2001 p266). Such progress was indeed achieved fairly soon. A tripartite pact was signed in July 1993 that formalized a new incomes policy and ensured cooperation in industrial relations for the rest of the decade (Bertola and Garibaldi 2003).

The rapprochement of the unions and the employers' organization created an effective tripartite sphere for policy making, which conferred benefits on all three participants. The Amato government needed the social partners' support, because it was unlikely to be able to override any serious opposition to its policies in view of its dubious political standing in the midst of constant scandals and new revelations about ministers and the members of Parliament. Large companies were rewarded by crucial concessions on wages and by the promise of more breakthroughs in labour market reform as well as macroeconomic consolidation, counterbalancing increased fiscal pressure. Unions

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<sup>93</sup> The Amato pension reform is a case in point. Furthermore, all subsequent pension reforms passed with the agreement of unions shielded the older generations from cuts. In the field of labour market liberalization, the reform achieved with union support in 1996 – the so-called Treu-package – made hiring and training young workers easier but it did not relax restrictions on firing, because that would have harmed older workers. When a subsequent package of liberalizing measures – the Biagi-reform – attempted to loosen the conditions for redundancy, the CGIL became intransigent. It could not block the passing of the reform, but prevented its implementation (Thompson and Price 2009b).

practically obtained a waiver for labour from contributing to fiscal stabilization in the short run in exchange for inevitable compromises on wages and sacrificing distant future – and in any case rather uncertain – benefits<sup>94</sup>. The tripartite alliance lived on under the Ciampi government. It allowed large enterprises and private employees to emerge from the first round of fiscal tightening with a relatively favourable result, especially in view of the gravity of the fiscal and economic situation. At the same time, the alliance's success in reconciling internal conflicts of interests were based to a great extent on offloading of much of the costs – practically all the spending cuts and a large share of the revenue increases – on groups temporarily lacking representatives in the policy making sphere: the dependents of the state in the South and the self-employed and small enterprises. This greatly improved the terms of the bargain for both sides of the social partnership. The next section shows that the divide created in these two years of not-so-technocratic governance had a profound effect on the mobilization of each of these groups by political parties and on the formation of coalitions between parties that would shape the next two decades and policy choices.

### **The two fiscal poles in Italian politics**

An interesting feature of the political life of the Second Republic is the remarkable stability of the cores of the two political blocks that were formed for the first elections in 1994 despite the incessant formation, reformation and renaming of parties and reformulation of programmes<sup>95</sup>. The centre-right has consisted of Forza Italia (FI), the National Alliance<sup>96</sup> (AN) and the Northern League (LN) ever since 1994, although the League ran alone in the 1996 elections<sup>97</sup>. The centre-left is made up of the two successor parties of the former Communists – the Democratic Party of the Left (PDS – later renamed Democrats of the Left) and the Communist Refoundation (RC) – and various formations comprising progressive groups and personalities from the former

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<sup>94</sup> Formally, the Amato-reform involved huge concessions in terms of younger cohorts' pension wealth (Thompson and Price 2009b). However, given the risks surrounding the younger cohorts' ability to fulfill the eligibility criteria under the prevailing labour market conditions and the uncertainties about the future viability of pension funds, the *de facto* losses of these cohorts are considerably smaller.

<sup>95</sup> This section – in line with most analyses of Italian political life – only concentrates on the most important parties in each political block and ignores, for the sake of clarity, the innumerable small parties, unions, movements and other political formations that are included in each electoral alliance. While these entities occupy almost a fifth of the electoral space together, none of them are large enough or have a distinct enough policy agenda to decisively divert the development of policies. Therefore, their omission from the discussion should not distort reality too much.

<sup>96</sup> The National Alliance was called Italian Social Movement until 1995.

<sup>97</sup> FI and AN merged in 2007 – along with numerous small parties and groups – creating the People of Freedom party. This party has since split, with the erstwhile leader of the AN, Gianfranco Fini, creating a new party, Future and Freedom, but continuing to support the centre-right government.

Christian Democratic, Liberal and Radical parties, coalescing into a unified party under the name Daisy only in 2001<sup>98</sup>.

The constancy of the blocks has corresponded to an unmistakable stability of fiscal preferences on each side, evidenced by a consistent contrast between the policies of the governments given by each block. This section argues that the persistent contrast of fiscal preferences boils down to the rejection or acceptance of the distribution of the costs of consolidation created under the Amato and Ciampi governments. This contrast in preferences, in turn, is rooted in the conflicts of interests of the societal coalitions that the two political poles represent. The centre-left has stood for the competitiveness coalition between large business and labour that was cobbled together in the early 1990s, whereas the centre-right has been bent on furthering the interests of those groups – small entrepreneurs and the dependents of the state in the South – that have suffered most from the consolidation efforts of the technocratic governments. These divisions have strongly influenced political alliance-formation up to the present day.

#### *The “impossible coalition” of the centre-right*

The first centre-right coalition was practically built on the unifying theme of protest against the way things were evolving in the years before 1994. It consisted of protest parties: the National Alliance, which had been “untouchable” in the First Republic, the Lega, whose rise contributed to the disintegration of the previous political system and Forza Italia, the brand-new, politically untainted party of a businessman, who explicitly claimed to enter the fray to fix things that politicians got wrong (Ginsborg 2003 p292). The self-identification of this force was strongly framed in negative terms, emphasizing anti-Communism – a rejection of leftist parties and trade unions – and demanding a break with the past (Diamanti 2007, Hopkin and Ignazi 2008). The parties’ stances on redistribution – although in contradiction with each other – were reconciled through the unanimous rejection of the policy developments of the years of technocratic government in 1992 and 1993, the tax increases hitting small businesses and the abandonment of the dependents of the state.

The Lega’s core message had been centred on an anti-tax rhetoric right from its inception. This rhetoric appealed greatly to the dynamic small enterprises and the self-

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<sup>98</sup> The centre-left also made an attempt to unite its various constituent parties under a single name, creating the Democratic Party in 2007.

employed in the industrial districts of the North, which were the party's electoral heartland (Ruzza and Fella 2009 p64). When the Amato government introduced new taxes, the Lega went as far as attempting to incite a tax revolt (Ginsborg 2003 p287). It was unsuccessful in actually organizing civic resistance to the government's measures, but this attempt clearly underlined the Lega's claim to become the defender of the "overtaxed" (*tartassati*). The National Alliance, given its historical roots and voter base in the South emphasized the responsibility of the state to provide employment and to aid underdeveloped regions. This message naturally resonated with the fears and worries of a large section of the Southern electorate, whose sources of livelihood had recently come under a major attack. The AN received more than twice the vote in 1994 than its predecessor did in 1992 and continued to do so ever since (Ruzza and Fella 2009 p149). Finally, Forza Italia engineered its electoral appeal on the basis of a thorough research of the electoral market. Its political marketing strategy combined elements of both of the other two parties' messages. On the one hand, it put forward a pronouncedly neoliberal programme, focusing above all on the reduction of the tax pressure. On the other hand, it implicitly assumed responsibility for employment by promising to create new jobs (Thompson and Price 2009b). These messages earned the FI sizeable vote shares both in the North and the South among various social groups, such as entrepreneurs, the self-employed and dependent employees (Shin and Agnew 2007). In later years, the FI "recycled" many pre-existing clientele networks of the erstwhile Christian Democrats and re-established the old practices of rewarding voters by targeted spending (Hopkin and Ignazi 2008).

The "impossible coalition" (Diamanti 2007 p736) of the Lega and the AN – of a party that most adamantly calls for the cutting of taxes and another that demands more state intervention and transfers – survived up to the present date under Forza Italia's leadership. It also continues to win a relatively stable and quite sizable share of the vote, which is consistently higher than the share of the core parties of the centre-left. The electoral performance of the individual parties within the alliance displays greater volatility than that of the alliance as a whole, as voters shift between the Lega and Forza Italia or between the National Alliance and Forza Italia (Cattaneo). This phenomenon was especially visible in 2001 when the FI colonized a sizeable share of the Lega's and the AN's electorate (Hopkin and Ignazi 2008). It suggests that the electoral space delineated by the specific redistributive messages of each party – which have a crucial importance in defining the parties' identity – is fairly fixed and the parties of the coalition can only expand at each other's expense.

When in government – briefly in 1994 and then for a full term between 2001 and 2006 – the centre-right fully lived up to its anti-tax commitments and to its professed image as the protector of the interests of small businesses. During its first brief stint in power in 1994, it managed to pass a three-year tax credit programme that practically eliminated taxes on reinvested profits and set back the revenue raising efforts of the previous governments for the next three years (Bernasconi et al 2005, Ameco). At the same time, it announced an amnesty on previous tax irregularities. Within one year of its next electoral victory in 2001, it repealed the tax reform of the centre-left cabinet that was very unpopular amongst small enterprises and replaced it with a system far more favourable to them, decreased the corporate income tax rate by a percentage point and launched a new investment tax credit programme (Maurizi and Monacelli 2003). The next year, it reformed the system of personal income taxes – again, cancelling out the changes made by the previous government – conferring benefits primarily on middle and high earners (OECD 2005a). In 2004, it decreased corporate rates by further three percentage points and proposed to lower tax rates on financial income (OECD 2005a). As a corollary to these measures, it issued further amnesties on evasion (OECD 2005a). Under this government, the size of the direct tax revenues shrunk by almost two per cent of the GDP (Ameco).

The devotion of the centre-right to helping those dependent on public employment and investment for their income is less easy to gauge. The spending directed towards clientele networks is also difficult to assess. Ginsborg (2003, p298) claims that the first centre-right cabinet slowed down privatization under pressure from the AN, which insisted on keeping up the state's involvement in the South. However, given the coalition's short stay in government, it remains an open question whether there would have been a lasting willingness to stop or considerably delay privatization, especially in the face of the League's defiance of its coalition partner's preferences<sup>99</sup>. By the time of the next centre-right government, privatization had been mostly completed, but the coalition promised to launch major infrastructural projects in the South. Although only a quarter of all envisioned projects were funded and initiated by the end of the government's lifetime, the total capital expenditure still increased by more than a per cent of the GDP (Ruzza and Fella 2009 p209, Ameco). Furthermore, spending on the

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<sup>99</sup> Bull and Baudner (2004) point out that the Lega delegated the minister who negotiated the phasing out of the tax deductibility of social security contributions for firms in the South, which were deemed incompatible with the Single Market, and he secured a much faster end of these subsidies than the Commission insisted on, exploiting European pressures to cut one more channel of funding going to the South.

compensation of public employees started to grow again, after almost a decade of continuous decrease. Both public employment and wages increased at all levels of government, raising total spending by another half per cent of the GDP (OECD 2005b, Ameco). Spending on the purchase of goods and services also increased considerably (Ameco).

Given their determination to keep taxes low and their inclination to let spending rise, centre-right governments were bound to take on the social security system, in order to find a budgetary counterbalance to their preferences. Shortly after the election victory of 1994, the new centre-right cabinet unveiled a plan that proposed the revision of pension formulae, the introduction of a new, less favourable system of indexation, the cutting of benefits for early retirees and a freeze on seniority pensions. The plan was to inflict large losses on dependent workers and – since it was targeted at generating immediate fiscal savings – it was not to cushion retirees and older cohorts of workers like the Amato reform had done. Incidentally, the schemes and rules covering the self-employed were left virtually intact. The unions instantaneously rejected the plan and organized massive demonstrations. The proposal was revoked and the government fell soon afterwards (Regini and Regalia 1997, Natali and Rhodes 2004, Molina and Rhodes 2007, Thompson and Price 2009b). The next centre-right government was more cautious in putting forward its new pension reform. The Tremonti-Maroni reform of 2004 introduced an increase in the retirement age and disincentives for early retirement, and mandated the channelling of the “severance payment funds” (*trattamento fine rapporto, tfr*) into a formal second pension pillar. The reform was to come into effect only in 2008. The unions responded by general strikes and protests in major cities, but the government stood by the reform, only compromising on making the transfer of the tfr funds into a second pillar elective (Jessoula and Alti 2006, Molina and Rhodes 2007). However, the success of the centre-right in passing this legislation was short-lived, because the centre-left government that came into power in 2006 postponed and watered down the measures of the reform (EIU Country Report, August 2007), making pension reform a continued challenge for the centre-right.

Failing to compensate tax cuts and growing spending on public employment and investment by major immediate savings on pensions, the centre-right’s stints in government in 1994 and between 2001 and 2006 saw the budget balance deteriorate. In 1994, the previous rapid improvement of the primary balance was halted and marginally set back, and in the period between 2001 and 2006, the primary surplus

that was still at 5.5 per cent of the GDP in 2000 was practically completely eroded (Ameco). The centre-right's urge to reverse the policies of 1992 and 1993 was not matched by its ability to overcome the power of the unions' resistance to cuts in social security. This had tangible negative consequences for the efforts to deal with excessive indebtedness.

### *The targeted austerity of the centre-left*

The centre-left's evolution was equally strongly determined by the policy developments of 1992 and 1993 as that of the centre-right. However, while the centre-right organized itself in protest of those developments, the centre-left coalesced in defence of the achievements and distributive consequences of the policies of Amato and Ciampi, once the threat from the centre-right had revealed itself. The two large streams of what later became the centre-left bloc jointly supported the Ciampi government and the tripartite deals sealed during its time, but in the subsequent elections in 1994 they decided to run separately<sup>100</sup> (Hopkin and Ignazi 2008). The successors of the reformist, left-leaning segment of the erstwhile Christian Democrats – who were later to become a unified party, the Daisy – coalesced under the “Pact for Italy” banner, while the former Communists organized an alliance under the “Progressives” electoral list (Diamanti 2007). However, the defeat of these lists at the hand of the unified centre-right bloc and the policy developments under the new government made the parties of the centre-left put their differences aside. As soon as the first centre-right government fell, they joined their forces in propping up the formally technocratic cabinet of Prime Minister Dini<sup>101</sup> and decided to contest the upcoming elections of 1996 under a unified list, the “Olive Tree”.

The centre-left had an important stake in defending and perpetuating the cooperation of labour with large business, primarily because of its strong ties with trade unions and its voter base among manufacturing workers, but to a smaller extent also because of its good connections to large business. The ex-Communist PDS and RC had a long-standing

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<sup>100</sup> Diamanti (2007, p6) explains this choice to run on separate list with the parties' distinct historical origins, which resulted in “very deep political, cultural, organisational – and even personal – divisions” amongst the parties of the centre-left.

<sup>101</sup> Dini had been Minister of the Treasury in the first centre-right government, but he then agreed to become caretaker Prime Minister despite the insistence of Forza Italia that new elections should be called after the fall of their government (Ginsborg 2003, p299). The Dini government was propped up primarily by the centre-left, its policies reflected the centre-left's preferences and in the elections of the following year, Dini joined the centre-left electoral alliance. Therefore, the Dini cabinet can hardly be called independent.



close relationship with the largest and most important union, the CGIL, and they inherited the labour electorate of their predecessor (Hopkin and Ignazi 2008, Shin and Agnew 2007). They were, therefore, crucially interested in policies that helped to deal with labour's – and the trade unions' – internal conflicts of interests: with the need to reconcile the defence of the entitlements of older cohorts with the improvement of conditions for the employment of younger generations. The two successor parties' put different emphasis on the competing labour goals: the PDS adopted a considerably more market-friendly, "Third Way" type of programme, whereas the RC stuck more adamantly to old Communist values (Hopkin and Ignazi 2008). The Daisy's electoral base was slightly harder to define in economic terms – as its most defining characteristic is its Catholic leaning – but the party had tangible ties with labour, as many important personalities in it had been officers within the Catholic union, the CISL. At the same time, the association of the centre-left bloc with erstwhile central bankers, like Ciampi and Dini, and top corporate executives, like Prodi also created a link and shared understanding with large business.

Accordingly, when in government – in 1995, between 1996 and 2001 and between 2006 and 2008 – the centre-left followed the path set by the Amato and Ciampi cabinets and tried to balance the (disparate) interests of labour with those of large business under the shared objective of increased competitiveness. This involved fostering the dialogue between the social partners and negotiating with them a reform of the labour market<sup>102</sup> as well as pressing forward with fiscal consolidation, while at the same time respecting labour's sensitivities. Pensions remained largely untouched. Cuts and revenue increases were made at the expense of the centre-right's constituency as much as possible. Although fiscal pressure increased on big business, too, measures aimed at reducing the costs of labour were put into place in order to partially compensate large firms for higher taxes.

Privatization efforts were redoubled. Revenues from this source reached record heights in 1997 and 1998 at over 2 per cent of the GDP (Vasallo 2007). Spending on public employment was further reduced<sup>103</sup>. In 1995 corporate tax rates were increased by 1 percentage point and social security contributions by more than 5 percentage points (Bernasconi et al 2005, Brugavini and Galasso 2004). In 1997, a comprehensive

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<sup>102</sup> The Treu package of 1996 took an appreciable step towards freeing companies from the rigidities of the rules on hiring and created better circumstances for the employment of the young, albeit the employers considered its measures insufficient (Thompson and Price 2009b).

<sup>103</sup> Compensation of employees decreased by more than 1 per cent of the GDP between 1994 and 2001 (Ameco).

tax reform was launched. Health contributions (and several other taxes) were abolished and replaced by a new regional tax (IRAP) on added value. Besides decreasing the costs of labour, the new tax was designed to be a major attack on tax evasion. It not only made the fulfilment of tax obligations much more transparent but also reduced the opportunities for manipulation of the reported tax base and thus brought into the fold of taxpayers companies that consistently reported non-positive profits<sup>104</sup>. In order to further prop up revenues, VAT rates were increased. The personal tax system was also reformed and simplified, but this was largely a revenue-neutral operation (OECD 2005a). The issue of pensions was carefully handled. Two reforms were passed<sup>105</sup> in close cooperation with the unions, but only the second had immediate – albeit limited – fiscal effect (Ferrera and Gualmini 2004, Thompson and Price 2009b, Radaelli 2002).

In the period between 1996 and 1998, the fiscal efforts of the centre-left governments were reinforced by the imminence of the launching of the euro. Efforts to speed up the consolidation already underway induced several temporary measures, such as the oft-mentioned one-off euro-tax levied in order to make sure that the deficit is under the required threshold in the crucial year and the acceleration of privatization (Goldstein 2003). However, most initiatives taken by the centre-left cabinet in these years – for example the tax reform of 1997-1998 – indicated the intention to lay the foundations of long-term fiscal consolidation and to reduce the debt. It also showed the centre-left's urge to lock in its preferred terms of redistribution. In 1997, the year of qualification for EMU-entry, the primary balance stood at almost seven per cent of the GDP, more than four per cent higher than in 1994. Even after the effect of the one-off measures petered out and the government has returned some of the taxes in the form of a rebate, the surplus stayed at a healthy five and a half per cent in 2000 (OECD 2005b). Net borrowing was almost zero for the first time in decades. Due to the dramatic fall of interest rates charged on Italy's debt, interest expenditure was down to a little over six per cent of the GDP and falling further. During the lifetime of the government, the debt-to-GDP ratio fell by a tenth. In 2001, however, the centre-left lost the elections, and when it returned to government after a five-year break, it found the primary surplus

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<sup>104</sup> Since the base of the new tax was turnover minus the cost of goods sold minus depreciation (in other words, labour and interest costs were not deductible), overstating costs to conceal profits would not help companies evade this tax.

<sup>105</sup> The Dini-reform of 1995 mandated the phasing in of new, contribution-based formulae for the calculation of pensions and created disincentives for early retirement. The Prodi-reform of 1997 tightened the availability of seniority pensions in the public sector, but left the rules covering private sector employees intact, ignoring the much more radical recommendations of a commission that the government had previously invited to work out a blueprint for comprehensive reform (Radaelli 2002)

practically eliminated and the debt-to-GDP ratio on the rise. Once in power again, it tried to apply its old proven formula: it increased direct taxes and cracked down on evasion, froze expenditure on public employment and generated a primary surplus of more than 3 per cent of the GDP within two years (EIU Country Report, October 2006). However, its successes in engineering fiscal consolidation were not matched by its ability to hold on to power and by 2008, the centre-right took over the government again.

### *The policy reversals of the opposing poles*

The polarization of the two political blocs' policy preferences becomes even more tangible when their policy decisions are presented in chronological order, due to the contrast between measures of successive governments. Policies were regularly reversed, giving rise to large swings of revenues and expenses. At times, the undoing of the previous government's policy choices already formed part of election programmes, like the centre-right's pledge in 2001 to abolish the new value-added tax IRAP introduced in 1997 by the centre-left. At other times, the reversals were less advertised, but could nevertheless be expected, like the regular tax amnesties of the centre-right after each spell of stringency on evaders by the centre-left, or the decision of the centre-left in 2006 to practically annul the immediate effects of the pension reforms pushed through by the centre-right in 2004.

Incidentally, the scope of such policy reversals was not limited to the field of fiscal policy only, but involved any measures that affected important interests of each bloc's core electoral base, further reinforcing the impression that the blocs were completely beholden to the vested interests of their constituencies and were unwilling to compromise on them. For instance, in 2006 the centre-left decided to water down the most contentious elements of an important labour market reform achieved by the centre right in defiance of union protests in 2004 (EUI Country Report, November 2007). The centre-right in turn failed to follow up on the programme of liberalization of protected services, which was hurting many self-employed groups (EIU Country Report, July 2011). Figure 4.3 summarizes in chronological order the most important policy decisions of successive governments presented in the previous two sections, in order to provide a better picture of the full scale and depth of the policy reversals.

**Figure4. 3 - Chronology of the main fiscal policy measures of successive governments & labour market developments 1992-2008**

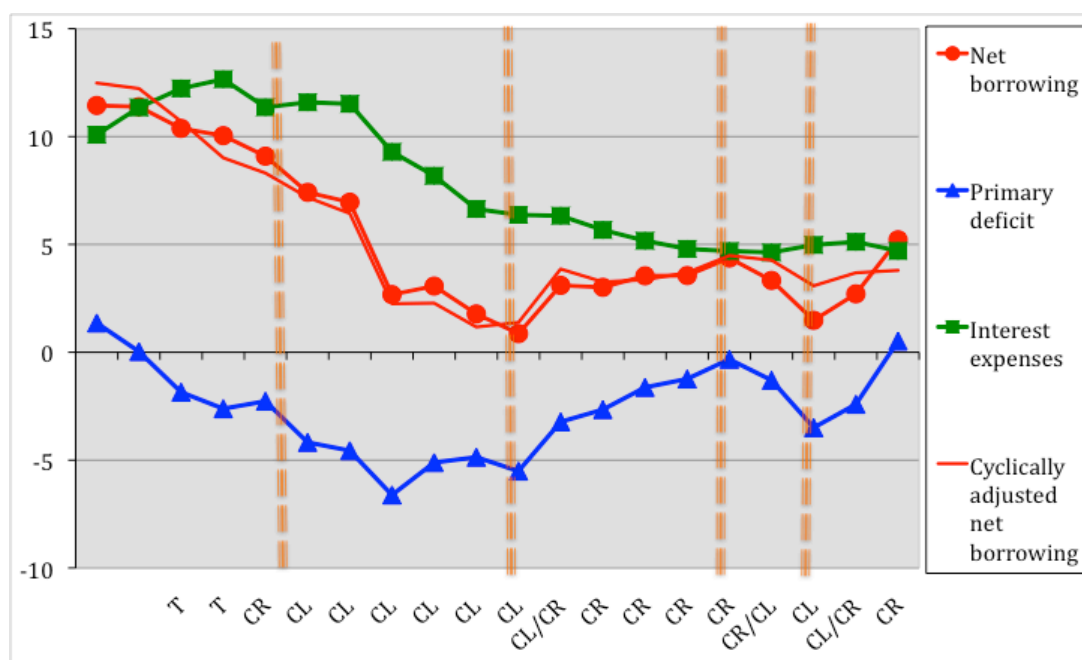
	1992-1994	1994	1995-1996	1996-2001	2001-2006	2006-2008
	technocracy	centre-right	<i>de facto</i> centre-left	centre-left	centre-right	centre-left
<b>compensation of public employees<sup>1</sup></b>	hiring-freeze salary-growth under inflation	hiring-freeze salary- growth under inflation	hiring-freeze salary- growth under inflation	salary- growth slightly above inflation	salary- growth double of inflation	hiring-freeze salary-growth under inflation
<b>taxation</b>						
corporate <sup>2</sup>	CIT pressure up + tax on net worth	investment tax credit	increase of CIT rate	IRAP on added value (revenue neutral)	IRAP watered down + CIT decreased + investment tax credit	no change
personal <sup>3</sup>	tax on real estate	no change	no change	compression of brackets, tax-shields on low incomes	cuts in rates, upper-middle and high incomes favoured	reform in favour of lower & middle incomes + reintroduction of inheritance tax
payroll costs <sup>4</sup>	increase in social security contribution rates	no change	increase in social security contribution rates	health contributions replaced by IRAP	no change	no change
indirect taxes <sup>5</sup>	no change	no change	no change	VAT increased	no change	no change
tax evasion <sup>6</sup>	new non- evadable taxes (on real estate and net worth)	amnesty on evaded taxes	no change	transparency -increasing and difficult- to-evade new tax (IRAP)	modifications in IRAP + amnesty on evaded taxes, repatriated capital, breach of regulations	crackdown on evasion
<b>pension reform<sup>7</sup></b>	Amato and Ciampi reforms: consensual, only long-term savings	Berlusconi reform: unilateral, immediate savings ⇔ fails!	Dini reform: consensual, only long- term savings	Prodi reform: consensual, a few immediate savings	Maroni- Tremonti reform: unilateral, short and long-term savings	Maroni- Tremonti watered down and postponed
<b>labour market reform<sup>8</sup></b>	consensual abolition of scala mobile + long-term pact on tripartite cooperation	no change	no change	Treu package: consensual, hiring more flexible, implemented	Biagi package: unilateral, strong CGIL opposition, passed but not implemented	most contentious elements of Biagi package repealed
<b>Sources</b> 1. EUKlems, OECD (2001), OECD (2005b) 2. Bernasconi et al (2005, p748), OECD (1999), OECD (2005a) 3. OECD (1999), OECD (2005a), EUI Country Reports (various issues) 4. Brugiavini and Galasso (2004), OECD (1999) 5. OECD (1999) 6. OECD (1999), OECD (2005a), 7. Ferrera and Gualmini (2004), Brugiavini and Galasso (2004), Jessoula and Alti (2006), EUI Country Reports (various issues) 8. Thompson and Price (2009b)						

The entrenched practice of policy reversals also helps to explain the observed sinusoid pattern of the budget balance. Since the centre-right has been unable to take on pensions, its preferred tax cuts and spending increases are not counterbalanced by significant savings in other areas and therefore they are bound to worsen the balance, whereas the centre-left is relatively free to cut many expenditure items – it has been especially efficient in keeping the compensation of public employees in check – and does not shy away from tax increases and campaigns against tax evasion. Therefore, its

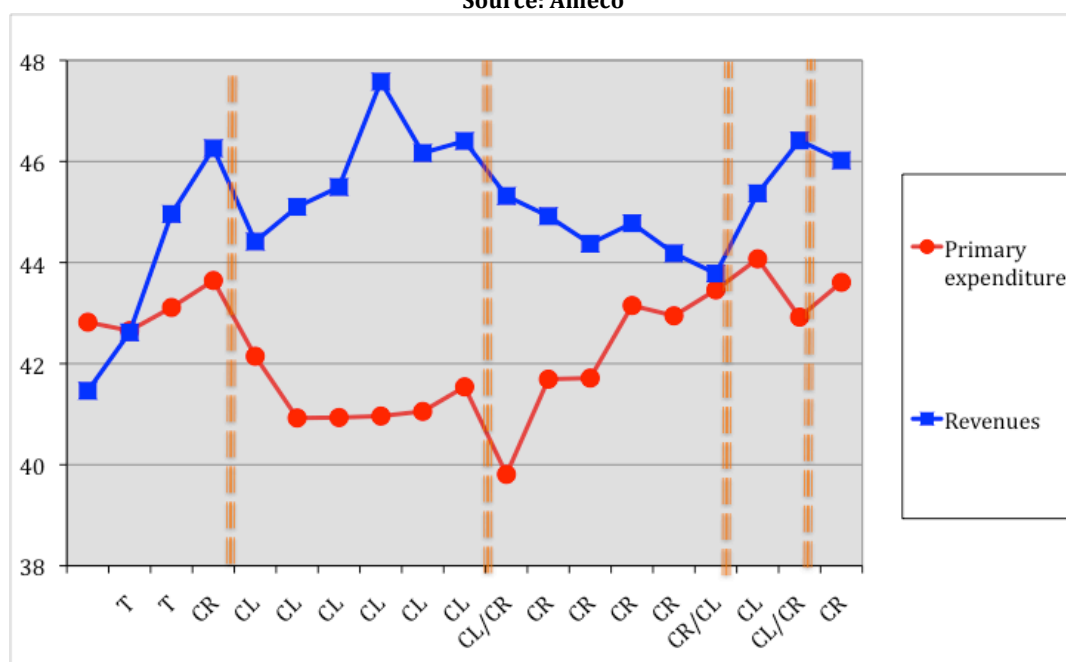
governments produce improving balances. At the same time, these measures predictably generate resentment and are sure to be reversed once the centre-left loses power.

Figure 4.4 and 4.5 demonstrate the temporal evolution of net borrowing, the primary balance, revenues and expenditure over the government terms of the two sides. They show that although the continued decrease of interest rates charged on outstanding debt dampened the effect of the negative effects of the deterioration of balances under the centre-right, the period between 2001 and 2006 caused a considerable setback to the effort to deal with excessive indebtedness. It almost completely eroded the primary surplus generated in the previous decade. Although it could be argued that part of this worsening is a consequence of the considerable slowing of growth in this period, the cyclically adjusted deficit figures show that the effects of the cycle were negligible on fiscal balances during this period and the above table gives evidence that the discretionary measures of the government – tax cuts and expenditure increases – gave a strong impetus to decreasing balances.

**Figure4. 4 - Net borrowing, cyclically adjusted net borrowing, primary deficit and interest expenses (1990-2008)**  
per cent of GDP  
Source: Ameco



**Figure4. 5 - Revenues and non-interest expenses (1990-2008)**  
per cent of GDP  
Source: Ameco



Notes: the dashed vertical lines represent changes in government, T=technocracy, CL=centre-left, CR=centre-right

The entrenched pattern of policy reversals is problematic not only because of the lack of policy stability and the volatility of the economic environment, but also because it undermines the possibility of lasting achievements in reducing the excessive debt level, which continues to be a major source of economic and fiscal risk. Even though governments are ready to undertake bold reforms and to make difficult decisions with dire consequences for different social groups, their initiatives add up to policy stasis over the longer term, as the measures do not have time to exercise lasting effect. The next section examines the socio-economic bases of this political and policy gridlock, and investigates the role of EMU within in.

### **Making sense of dynamic stasis: coalitions of societal interests, the euro and the war of attrition**

Although the Second Republic is very different from the regime that collapsed in 1992 – its bi-polar party structure and the regular alternation of the two sides in government stand in marked contrast with the blocked political system of the First Republic – the fundamental underlying social conflicts that drive electoral competition and policy making in the new regime changed little since the 1980s. This section shows that the

redistributive conflicts that arose in the later decades of the First Republic between four major socioeconomic groups – organized labour, the dependents of the state in the South, small and large business – continue to structure the policy space even after the complete transformation of the party system. There was one crucial difference in the socio-economic forces shaping policy making in the 1990s. A coalition of societal interests emerged that depended on the restoration of the macroeconomic preconditions of international competitiveness and was therefore strongly interested in fiscal consolidation. This coalition managed to suppress the paralysing conflict between the four defining groups of vested interests and achieved considerable results in fiscal consolidation. This section argues that the definitive decision to join the single currency – only taken relatively late in the run-up to the launch of the euro – also reflected the incentives of this coalition. At the same time, membership in the EMU – which insulates international competitiveness from the effects of fiscal problems – has since undermined the drive of the groups in this coalition for further fiscal improvements. The weakening of this coalition allowed the old redistributive conflicts to define the policy space and block further fiscal consolidation. Policy makers' attempts to achieve lasting fiscal stabilization are now frustrated by the same societal deadlock that had caused the debt accumulation of the 1980s.

Below the surface of remarkable political transformation, the break between the First and the Second Republic left largely untouched the foundations of political interest representation. One important source of continuity was the trade unions, most importantly the CGIL, which were strengthened, rather than shaken by the political turmoil and continued to be the main representative of labour interest in politics. In order to hold its membership together, the CGIL had to adopt a two-faced strategy. On the one hand, it was urged to intransigently defend the acquired rights of the older labour market insiders. On the other hand, it was ready to make circumscribed concessions for the sake of increasing employment among groups in more precarious position. This schizophrenic strategy allowed unions to continue to act as the main representatives of labour, even though the linking of the fate of labour market insiders and outsiders had disadvantages for the latter group, and even though labour now gained proper representation in the parliamentary and governmental scene by parties that defined labour interest in their own way (Molina and Rhodes 2007, Hopkin and Ignazi 2008)<sup>106</sup>. Moreover, via their mobilizing capacities unions held onto their *de*

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<sup>106</sup> An important example of how unions dominated labour issues and why this was often disadvantageous to labour market outsiders is the debate over the strengthening of the safety net for workers with irregular

*facto* veto on policy measures contrary to their mission to protect workers' acquired rights. Therefore, the group with vested interests in maintaining the generous – albeit exclusive – welfare system remained a very strong factor in politics.

Another source of continuity with the old system of interest representation was the entrenched political infrastructures left behind by the old parties, which the newly born or refashioned parties could easily take over and use to build up their own electoral strength. The best example of this is the “colonization” of the clientele networks used to distribute state resources under Christian Democracy and the Socialist Party by Forza Italia (Hopkin and Ignazi 2008). This ensured renewed representation in the policy making sphere of the interests tied into these networks and created political incentives for the FI to subscribe to continued spending on public employment and large-scale public investments. This, in turn, provided a basis for allying with the National Alliance, which built on its predecessor's capacity to organize the discontented urban proletariat in the South and captured the growth of the unemployed vote in the region that is crucially dependent on public funds for its livelihood. The alliance of these two parties created strong representation for vested interests in continued high public employment and public investments.

A third source of continuity was Forza Italia's decision to engineer its own electoral base on the basis of political market research, which led the party to the “orphans” of the DC and the PSI (Diamanti 2007, Hopkin and Ignazi 2008). As a result, the FI embraced the anti-tax sentiment of small businesses and the self-employed, who had been core supporters of the DC. This created a link – albeit also an aspect of competition – between FI and the LN, whose electorate was also mostly based on the erstwhile voter base of the DC in the North. Together, the two parties formed a powerful anti-tax alliance within Italian politics.

Thus, the new party system that emerged in the first years of the Second Republic, continued to provide strong representation for all the vested interests that were created in the last decades of the First Republic and to structure political life along the

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employment histories. When the centre-left government wanted to address this oft-lamented weak point of the Italian welfare system as part of the Treu-package of reforms of the labour market, its efforts were received with suspicion in the labour movement because they were seen as a prequel to trimming the generous income replacement schemes of welfare-insiders under the CIGS and to a more radical liberalization of the labour market (Jessoula and Alti 2006, OECD 2009). In the event, the universal unemployment scheme remained marginal. The failure of this attempt suggests that the CGIL's position largely determined the manoeuvring space of the parties that relied on labour vote, despite signs that the PDS wanted to loosen its ties with the CGIL (Hopkin and Ignazi 2008).



fault lines between anti-tax, state dependency and welfare-system constituencies. Even though the erstwhile core constituencies of the DC were now represented by three different parties, these were allied in one political block, thanks to the success of Forza Italia in recycling many of the political assets of the DC and the PSI, which allowed it to find commonalities of interests with parties as far apart as the LN and the AN and hold together the anti-tax and the state-dependency constituencies once their vested interests came under attack. Similarly, the DC's erstwhile main adversary, the labour movement also stayed largely intact and continued to define labour interests – even though labour gained important electoral representation after decades of being blocked from government in the First Republic – by retaining a veto on short- and medium-term welfare retrenchment against governments of any colour. Strong political representation for these polarized interests augured ill for the restoration of fiscal health.

At the same time, there were three significant novelties in the new political system that made the first decade of the Second Republic considerably different from the First. First of all, a major party, the Lega Nord drew its support from a cross-class electoral base that belonged partially to the anti-tax, partially to the welfare-system constituency and was unified by its uniformly strong interest in policies to secure the macroeconomic bases of international competitiveness. In fact, the party had risen to prominence in the second half of the 1980s on the wave of profound discontent of owners and workers of small enterprises in the industrial districts of the North with the policies of DC-led governments, which were a continuous threat to the foreign competitiveness of those districts (Diamanti 2007, Hopkin and Ignazi 2008). This introduced an aspect into electoral competition that was not exclusively focused on the conflicts between the constituencies of vested interests, but was also directed towards sound macroeconomic policies. Second, unlike in the First Republic, large business chose to remain politically unaligned and – under pressure from failing international competitiveness – was particularly open for cooperation with labour (Regini and Regalia 1997, Molina and Rhodes 2007). Third, labour itself accommodated within its strategy the need to achieve some compromises for the sake of increased employment.

These novelties created room for the competitiveness-alliance of large business and labour by the early 1990s under the political umbrella of the centre-left coalition, which managed to defeat the centre-right and to turn the fiscal situation around at the expense of the anti-tax and state-dependency constituencies as explained in the

previous sections. The Lega never became part of this alliance and its voters observed the tax policies of the centre-left with great aversion. At the same time, the party was not ready to cooperate too closely with the AN and FI either, in these years. It was opposed to the centre-right's readiness to perpetuate the erstwhile DC's policies, which had fuelled discontent among its constituency in the 1980s. In these early years, the anti-tax motive was in itself not strong enough to ensure the cohesion of the centre-right bloc. The Lega brought down the first centre-right government in 1994 in the wake of the attempted pension reform that was to affect its blue-collar voters too harshly. It then supported the "traitor" Dini's technocratic government along with parties of the left in pursuing further fiscal consolidation. Finally, it refused to join the centre-right electoral alliance in the 1996, keeping over ten per cent of the national vote out of the centre-right camp (Ginsborg 2003 p298-300). These decisions greatly contributed to the electoral and governmental viability of the centre-left coalition that fostered the competitiveness-alliance and achieved profound fiscal improvements, because they allowed for the exclusion of the anti-tax and state-dependency constituencies from policy making.

The ascendancy of the competitiveness-alliance and the centre-left in the 1990s was crucially important not just in achieving the fiscal turnaround but also in the decision to join the euro with the first group of countries. The decision to make a bid for early accession was not an easy one for a political force for whom international competitiveness was a first priority and the centre-left government dithered quite long before it definitively decided to aim for accession in 1999 (Quaglia 2004). Irrevocably fixing the exchange rate between Italy and its largest trade partners in the presence of the country's persistent macroeconomic imbalances entailed the danger of undermining the competitiveness of Italian industry in the long term<sup>107</sup>. However, in the broader context of Italian realities, shaped by the country's daunting fiscal problems, by the economics and politics of European integration and by domestic political uncertainties, joining early was a safer option for those exposed to the effects of foreign competition – business and workers alike – than to postpone the decision into the distant future.

First of all, given its precarious fiscal position – with debt above 120 per cent of the GDP – Italy could not afford to forego the opportunity to bolster the credibility of its

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<sup>107</sup> For detailed studies on the debate over Italy's decision to join in the first round, especially on business's, Banca d'Italia's and even centre-left Prime Minister Prodi's doubts about this choice, see Radaelli (2002) and Quaglia (2004).

macroeconomic policies by committing to the accession target and to thereby decrease the risk premium on its outstanding debt stock. Faced with interest expenses in excess of 11 per cent of the GDP, Italy's only realistic chance to get out of the debt spiral and to create stable macroeconomic conditions for economic vitality was to convince the markets to charge lower rates on Italian public debt (Ferrera and Gualmini 2004). The decrease of interest rates on public debt could also confer direct benefits on industry through lowering the general rates of interest and thereby reducing the costs of investment.

Second, missing out on the next round of economic integration with the country's largest trade partners and competitors might have conferred a real competitive disadvantage on Italian industry. On the one hand, foregoing the potential decrease in transaction costs or the benefits of exchange rate stability would have generated an economic handicap vis-à-vis firms within the Eurozone. On the other hand, and perhaps more importantly, Italy's ability to influence important economic decisions in the Single Market could have been reduced, if it had failed to stay in the innermost circle of integration<sup>108</sup>. Furthermore, the lack of irrevocable fixing would not necessarily have meant free adjustment of exchange rates as Italy's European trade partners – especially as a unified bloc – could always put pressure on Italy not to use its exchange rate policy as a means of boosting competitiveness.

Third, the surprising success of the centre-right in the 1994 elections and its policy choices during its brief stay in power highlighted the risks to international competitiveness from an electorally strong alternative policy platform. This increased the appeal of locking in certain policy choices. The first centre-right government not only set back the stabilization efforts with its tax cuts – at a time when Italy had barely emerged from the crisis of 1992 and the clock for euro-accession was ticking – but also attacked the independence of the central bank, raising fears about its anti-inflation commitment (Ginsborg 2003 p298). Given Italy's experiences with persistent fiscal problems and with the negative effects of the monetization of deficits on competitiveness, these choices were alarming from the perspective of actors exposed to international competition. Therefore, opting into a system that delegates monetary policy to a supranational entity and thereby severs the link between debt and inflation in the future was an attractive choice. This option would need to be taken while the

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<sup>108</sup> These factors are what Amato's oft-quoted statement referred to by saying that – if left out of the euro zone – Italy will become Europe's "Disneyland" (Della Sala 1997).

competitiveness-minded centre-left government was in power. The other side might indefinitely put off joining the euro in the absence of a binding deadline, given the lack of interest of its voter base and the professed scepticism of some of its key politicians about the euro-project (Radaelli 2002).

The euro accession benefitted the competitiveness-alliance in many ways. It delivered the expected confidence premium of much lower interest rates on outstanding debt. The inflation-adjusted yield on 10-year government bonds dropped 270 basis points between the decision to join the EMU in the first round in September 1996 and the January 1999 (Global Financial Data). This drop permanently eased the pressure on the budget by seven per cent of the GDP over the following decade. Thereby, it had a greater impact on fiscal stabilization than the cuts in non-interest spending and revenue increases taken together. Furthermore, the euro insulated international competitiveness from the effects of fiscal problems. Once monetary policy was delegated to the ECB, deficits would not generate inflationary pressures and in the integrated European financial markets the crowding-out effect of public debt on private investment would be dispersed. At the same time, exactly because it largely insured foreign competitiveness from future fiscal policy mistakes and because it reduced the gravity of existing problems via the dramatic fall on outstanding debt, the EMU-accession diminished the motivation to maintain a strong competitiveness-alliance to safeguard fiscal policy choices and allowed old conflicts of interests to resurface and eclipse the objective of further reducing the debt.

By shielding international competitiveness from the negative side effects of fiscal outcomes, membership in the monetary union undermined the demand for fiscal discipline among the groups that had been the main supporters of consolidation in the 1990s. Even though fiscal rules under the Stability and Growth Pact and the Excessive Deficit Procedure required Italy to limit its deficits to under three per cent and work towards medium term objectives close to balance or in surplus, these constraints had little effect on the politics of fiscal policy after the 2000s. In the absence of a credible punishment mechanism that would have interfered with the material interests of the important interest groups, violation of the rules could not generate the impetus for compromises needed to maintain a strong societal coalition behind continued consolidation.

In the 2000s, all of those aspects of the socio-economic context of fiscal policy making that made the 1990s different from the 1980s disappeared. In the 2001 elections, the Lega joined the centre-right bloc again and cooperated faithfully with its government partners throughout the electoral term, delivering tax amnesties and tax cuts to its constituency. Its concerns for international competitiveness of producers in the industrial districts were now expressed by empty gestures such as criticising the decision to join the euro and advocating the imposition of tariffs on Chinese imports (Ruzza and Fella 2009 p79). The employers' organization, *Confindustria* became increasingly critical of concertation and under the new centre-right government became more confrontational and pushed more aggressively for faster and more extensive reforms (Molina and Rhodes 2007, Thompson and Price 2009b). The three union confederations drifted apart, with the CGIL adopting intransigent positions on all contentious issues, in defiance of the two other two confederations' readiness to compromise with employers and the government.

The situation under the centre-right government could not have resembled the 1980s more: the awkward coalition of anti-tax and state-dependency constituencies of the FI, AN and LN was facing a militant CGIL, while the government was borrowing extensively to satisfy the demands of its own constituencies, since it was unable to place the costs of its preferred policies on its opponents. Even though the new centre-left government that came to power in 2006 made an aggressive attempt to restore the fiscal achievements of the 1990s and to undo the harm to labour interests, it was not strong enough electorally to hold onto power for long. Once more, the long-term health of Italian public finances was undermined by the conflicts between the vested interests of different socio-economic groups: centre-right governments were weak in the face of labour's veto, whereas centre-left governments were weak electorally.

In the framework of the war of attrition model, the fiscal history of Italy of the past two decades underlines the importance of the corollary costs of fiscal problems in driving the solution to persistent fiscal imbalances. The model predicts that the willingness of major socio-economic groups to bear a share of the burden of fiscal stabilization depends on the secondary harm that they suffer from persistent deficits. The previous chapter showed that in the case of Italy, the partial monetization of persistent deficits throughout the 1980s eroded the competitiveness of Italian industry in the *quasi*-fixed exchange rate regime of the European Monetary System. This helped to gradually undermine the system of interest representation, because it forced groups exposed to

international competition – within large and small businesses as well as labour – to withdraw their support from parties and unions that intransigently defended the redistributive *status quo*. This opened the way for a different political constellation and for compromises for the sake of fiscal consolidation.

This chapter showed that even though the system of interest representation changed much less than could be expected from the profound political transformation of the early 1990s, the groups exposed to international competition managed to reach important compromises amongst themselves and sacrificed some of their vested interests for the sake of better macroeconomic conditions. However, as soon as the EMU insulated them from the costs of fiscal problems, they rediscovered the importance of their vested interests and realigned with groups with the same vested interests as themselves in the sheltered sectors. As a consequence, further progress on fiscal consolidation became politically inconceivable until the start of the current fiscal emergency triggered by a loss of investor confidence and a hike in interest rates.

## **Conclusion**

This chapter explained the puzzling volatility of fiscal outcomes in Italy's Second Republic by analysing the evolution of the political context of fiscal policy making as the party system underwent profound restructuring in the early 1990s and the country made a bid to join the euro along with the first group of member states. The chapter argued that political realignment was of primary importance in the astonishing improvement of fiscal outcomes of the 1990s, whereas euro-accession played a secondary role. In the early 1990s a coalition of societal groups emerged under the centre-left political umbrella with a very strong shared interest in the restoration of international competitiveness and therefore in fiscal stabilization. Socio-economic groups in this coalition were willing to make sacrifices for the sake of consolidation and had the necessary political clout to impose a large share of the costs of stabilization on other groups. This opened the way both for spending cuts and tax increases. The political ascendancy of these groups and their crucial stake in competitiveness explains both the success of fiscal austerity and the decision to join the euro early.

However, the accomplishments of this coalition of interests were also its undoing. After the alarming debt growth had been reversed, the interest burden was brought considerably down and monetary stability had been guaranteed for the long term by

the euro-accession, the coalition that had required considerable sacrifices and compromises from its constituent groups throughout the 1990s disintegrated. This allowed the groups hitherto excluded from policy making to capture the government under the centre-right political bloc and redress their grievances. Many of the cost-cutting and tax measures of the 1990s were undone in the 2000s and the favourable fiscal trends were reversed, albeit interest costs remained low until the most recent waves of the European sovereign debt crisis.

This evolution of societal coalitions of interest explains the astonishing consolidation of the 1990s as well as the relapse of the 2000s and even the short intermezzo of austerity between 2006 and 2008. Furthermore, it accounts for the curious pattern of policy reversals between the 1990s and 2000s: for the U-turns in tax laws, pension measures, expenditure cuts and so on as governments representing one coalition of societal groups replaced governments standing for the others. Moreover, the societal analysis helps to better understand the momentous political realignment that took place after the collapse of the party system of the First Republic and the creation and composition of the two solid political blocks of the Second Republic.

In the wake of several interest rate hikes in the past months, the country's fiscal fortunes look alarming again. Balancing on the verge of default, the current centre-right government has passed three austerity packages within one and a half months, undoing many of the measures the centre-right itself had introduced in the 2000s to compensate its supporters for the sacrifices of the 1990s. Despite all the fiscal pain dealt out to different parts of the society in the 1990s, Italy was not able to leave its fiscal problems behind. Its enormous debt stock places the country – and potentially the whole euro-zone – into an infinitely dangerous situation in the midst of the present turmoil in the world economy and the international financial markets.

Italy's present calamities confirm the worst fears of the architects of the euro. They felt it necessary to set strong fiscal criteria for accession to the common currency and to perpetuate those criteria in the form of fiscal rules for members. When the present crisis hit, the first reactions were once again calls for better rules and better monitoring. This chapter and previous one argued, however, that in Italy's case, the fiscal issues were rooted in deep-seated societal conflicts about redistribution. When discipline worked, it was imposed by a strong domestic coalition of interests. This

suggests that rules and targets would also only work if a societal coalition of interests was willing and able to enforce them.

The next two chapters look at a case, where the Maastricht criteria and the fiscal rules within the Stability and Growth Pact did seem to make an important difference to fiscal performance. In Belgium, the fiscal consolidation associated with joining the euro had a lasting effect. Debt – which had reached record-setting proportions in 1993 – had relentlessly decreased until the onset of the global economic downturn in 2008. The next chapter investigates the nature of Belgium's fiscal problems in the 1980s. The chapter after it explores the way Maastricht and the euro-accession shaped policy making in the 1980s and 1990s, in order to gain a better understanding of the effects of the adoption of fiscal rules on that country's fiscal performance.



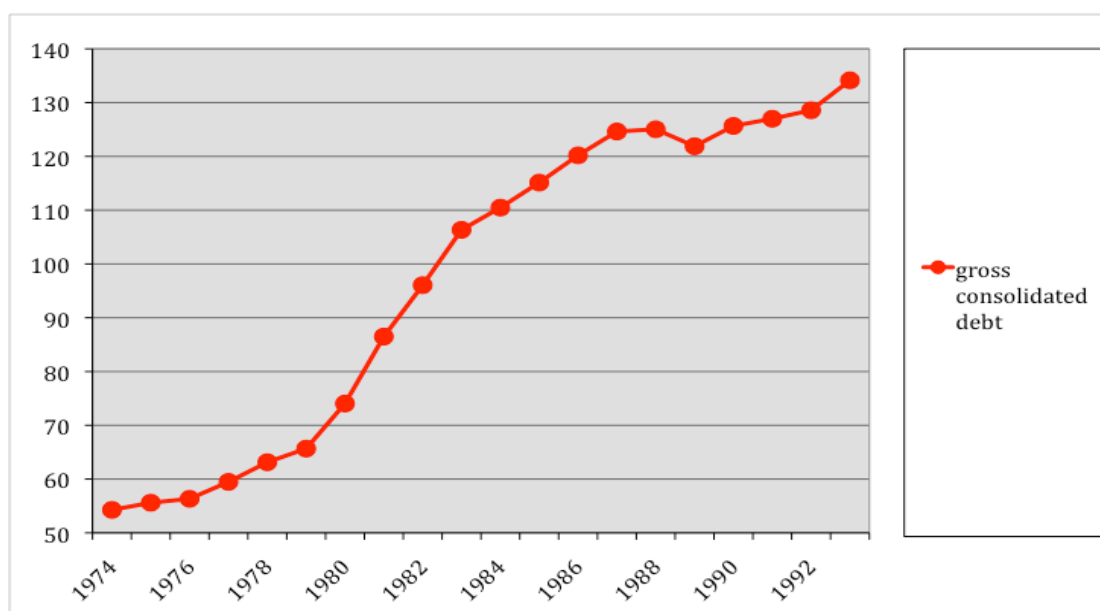
## **Chapter 5.**

### **Lopsided austerity: Belgium's experience with unstoppable debt growth in the 1980s**

Between the mid-1970s and the early 1990s, Belgium had the most severe fiscal problems in the entire developed world. Its debt was higher and surging more dramatically than that of any other developed country. The debt-to-GDP ratio started to increase after the first oil shock and took a frightening new boost after the second one. Between 1979 and 1983, the ratio grew by ten percentage points each year. This rate was slightly moderated afterwards, but by the turn of the next decade, the ratio reached 126 per cent and showed no sign of ceasing to grow, apart from a moment of respite around the boom years at the very end of the 1980s (see Figure 5.1). Successive governments laboured hard to turn the tide and the primary balance improved by almost 13 per cent of the GDP over the decade. Yet, these efforts were countervailed by the relentless growth of the interest burden (see Figure 5.2). Eventually, the debt-to-GDP ratio peaked at 134 per cent in 1993 and started to decline gradually thanks to the combined effect of one last stepping-up of the retrenchment effort and the steep drop of interest rates charged on Belgian debt. Yet, at that point, Belgium was on the verge of a fiscal abyss. This chapter provides an explanation why Belgium was unable to stop the snowballing of its debt throughout the 1980s and why governments failed to turn public finances around sufficiently to stabilize the debt-to-GDP ratio despite their demonstrated readiness to take painful fiscal adjustment measures.

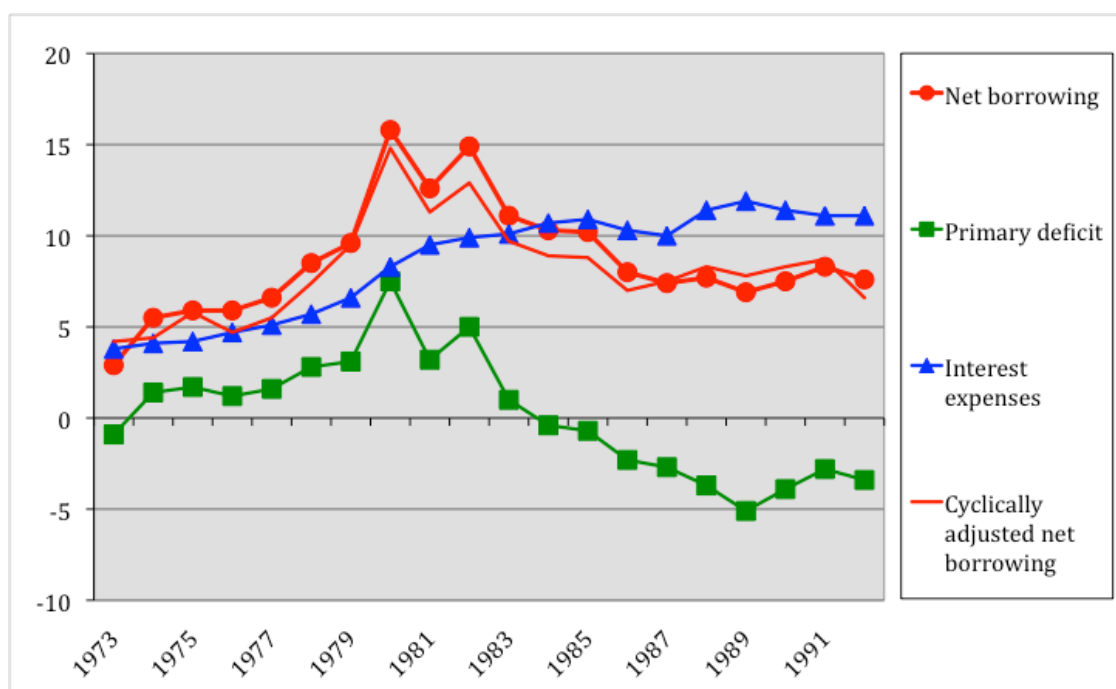
**Figure5. 1 - Gross consolidated debt general government (1974-1993)  
per cent of GDP**

Source: Belgian Statistics Office



**Figure5. 2 - Net borrowing, cyclically adjusted net borrowing, primary deficit and interest expenses  
(1974-1993)  
per cent of GDP**

Source: Belgian Statistics Office and Ameco



The issue of excessive debt accumulation in Belgium in the 1980s has already been addressed by Hallerberg (2000, 2004). He argued that the inability of successive Belgian governments to overcome fiscal imbalances arose from the lack of a suitable institutional mechanism to keep under control the divergent interests of a large

number of political actors who were involved in fiscal policy making. He points out that in the highly fragmented Belgian political scene – where government coalitions comprise numerous parties representing disparate social and territorial constituencies – fiscal rigour was liable to fall prey to the temptation of the coalition partners and individual ministers to give preference to their own spending priorities over the collective objective of stemming debt growth. He emphasizes that although there were repeated attempts to set fiscal targets to keep spending under control, parties in successive coalitions lacked the necessary incentives and coalition-building flexibility to adopt a mechanism to punish individual spending ministers who defected from the agreed targets. On the one hand, the entrenched position of Christian Democrats in successive governments ostensibly reduced the party's electoral sensitivity to fiscal outcomes. On the other hand, it was difficult to threaten to break up a coalition and form a new one over the missing of fiscal targets in a system where the rules requiring parity of ministers between the Flemish and Walloon linguistic communities greatly constrained the options to reshuffle coalitions. This made territorially targeted spending especially difficult to restrain (Hallerberg 2004 p31).

Hallerberg's analysis sheds light on important tensions and conflicts of interests over fiscal policy within successive governments in the period under investigation. His basic approach, however is at odds with the sustained and significant improvement of the primary balance observed from 1983 onwards. While Hallerberg sees the Belgian debt accumulation problem as one rooted in a chronic spending control issue, the fact that the drastic improvement in the primary balance was achieved mainly by spending cuts belies this assumption. Therefore, this chapter revisits the Belgian puzzle. Instead of focusing on the internal dynamics of policy making in coalition cabinets, it concentrates on the constraints that successive governments faced when trying to reshape fiscal policy. It analyses the societal pressures on policy makers of the time as well as the way these pressures constrained available policy options and produced the puzzling outcome of painful but insufficient fiscal stabilization. It makes a two-step argument.

The first part of the argument is that Belgium's persistent fiscal woes throughout the 1980s arose primarily from the failure to consolidate the social security sector that had been destabilized by the surge in unemployment and early retirement in the wake of the economic shocks of the 1970s. The lack of stabilization of this part of the public budget stands in marked contrast with the huge progress achieved in restraining spending on collective consumption and public investment. The enormous gap in the

social security sector soaked up much of the funds successfully freed by retrenchment in other areas of public spending, and set back the fight against the snowballing of debt. The evolution of fiscal figures throughout the decade – i.e. the changes in the composition of revenues and expenditure – clearly demonstrate the lopsided nature of the stabilization effort. Collective consumption and public investment as a percentage of GDP decreased dramatically, whereas revenues and expenditures of the social security system were only marginally adjusted. In other words, spending control was very effective in the discretionary areas of the budget, whereas the welfare system continued to generate enormous problems for public finances.

The second part of the argument is that the consolidation of the welfare system was prevented by the unresolved conflict between labour and business over the question whether it should be done via increasing taxes and contributions or via cutting entitlements. In a period of large economic upheaval characterized by waves of bankruptcies, business was squarely opposed to any changes in taxes or contributions that further endangered profit margins, whereas labour was unwilling to give up on welfare entitlements and the safety net they provided in the face of dramatically rising unemployment and shrinking employment opportunities. Both interest groups had significant leverage over policy making and their failure to compromise created policy paralysis in this field, which entrenched the deleterious fiscal effects of the oil crises for the longer term and undermined efforts to restore the balance of public finances in the face of a swiftly growing interest burden.

This explanation relies on Jones's (2008) analysis of the political background of the economic adjustment that took place in Belgium in the 1980s. Jones underlines how important the simultaneous influence of organized labour and of business was for the political choices of parties and, consequently, also for the policy choices made by different government coalitions<sup>109</sup>, suggesting that governments' room for manoeuvre was limited to measures that had the support – or at least the tacit acquiescence – of both organized labour and business. Although Jones does not specifically analyse fiscal or welfare choices, scholarly accounts of the attempts to reform the welfare state<sup>110</sup> clearly show that social security was an area where neither labour nor business was willing to make significant compromises. In light of this, Jones's emphasis on labour's

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<sup>109</sup> He points out that although economic policies took a pronounced neoliberal turn in response to the protracted crisis in the wake of the oil shocks – reflecting the strong influence of business on policy making – this shift was possible only because the largest trade union secretly gave its consent (Jones 2008 pp187-188).

<sup>110</sup> See for example Kuipers (2006), Anderson et al. (2007) or Marier (2008)

and capital's policy clout provides an important clue to the enduring policy stalemate in the social security sector despite the destructive fiscal effects of policy passivity.

At the same time, identifying two important societal groups within the Belgian polity with diametrically opposed preferences towards welfare consolidation and the necessary political influence to shape policy choices in defence of their divergent interests is only the starting point for explaining the observed policy trajectory and, in particular, the deadlock in the social security sector. The aversion of powerful business groups to further concessions towards financing the social security system and the attachment of a strong labour movement to existing entitlements explains why conflict between them could get in the way of the fiscal consolidation of the sector. However, it leaves the question open how these groups could afford to maintain their resistance to fiscal pain in the face of dangerously mounting debt. This question is especially relevant in an open economy, like the Belgian, where international competitiveness is a key priority both for business and for labour.

The chapter shows that concern over competitiveness was initially very high, as a currency crisis exposed the link between fiscal problems and external stability in the early 1980s. The ensuing threat to employment bent those sections of labour in the exposed sectors towards compromise and thereby created conflicts with workers unaffected by international competition. This resulted in the successful launch of the sustained austerity campaign that led to the dramatic decrease in public consumption and investment spending. After the experience with the currency crisis, however, the government made international competitiveness a first priority under joint pressure from labour and business and maintained monetary stability. From then on, problems of public finances did not threaten with spilling over into problems for the private sector and neither business nor labour had an incentive to reconsider its strategy of intransigence over social security, because neither suffered direct harm from the accumulation of debt. The fissures that had opened within the ranks of labour disappeared and both interest groups formed united fronts in their conflict over social security.

While the private sector was thus spared of the consequences of fiscal problems and therefore had no incentives to alter its behaviour, political changes nevertheless ensued that slowly but surely changed the context of the fiscal stabilization by the end of the 1980s. The drastic cuts in public consumption and investment that made it

possible to keep the private sector shielded from the effects of the problems in directly redistributive areas amplified political tensions between regional political actors. Due to the radical reduction of public funds, the pre-existing linguistic-regional cleavage within society gradually assumed an ever-stronger economic dimension as linguistic-regional groups were competing for shrinking funds. The new economic relevance of the old cleavage was seized upon by the Flemish Christian Democratic Party – the country's largest party and the pivot of every government in the period – to drive a wedge within the ranks of labour and create new, regional coalitions across classes. By the end of the decade, it had successfully redefined the fiscal conflict and, importantly, the specific redistributive conflict within social security as a conflict between regions rather than classes.

The chapter presents these arguments in four parts. The next section analyses fiscal trends and demonstrates that Belgium's excessive debt accumulation in the 1980s was rooted in the persistent deficits of the social security system, which had been destabilized by economic shocks. The third section identifies the key socio-economic groups that determined the evolution of fiscal policies and it explains the policy passivity in the field of welfare finances as the result of a political stalemate between labour and business. The fourth section uses the war of attrition model to explain both groups' intransigence in the social security issue. It also investigates the strategic response of the pivotal party of the political system to the persistence of the fiscal problem, which led to the redefinition of the issue along regional, rather than class lines. The last section concludes by pointing out that even though the 1980s ended with no visible sign of an end to the fiscal problem, considerable headway had been made towards resolving the underlying political problem through the rechanneling of the issue into a new, potentially more manageable dimension.

### **Fiscal policies in the 1980s: fiscal pain in vain<sup>111</sup>**

Belgium's serious fiscal troubles began with the oil crises. The country had previously been on a favourable fiscal path. Although it inherited a large debt from the time of the war, the debt-to-GDP ratio dwindled swiftly in the post-war decades due to robust economic growth and moderate deficits (Reinhart 2010 p23). In the second half of the 1970s, however, the budget was thrown out of balance by the effects of the major

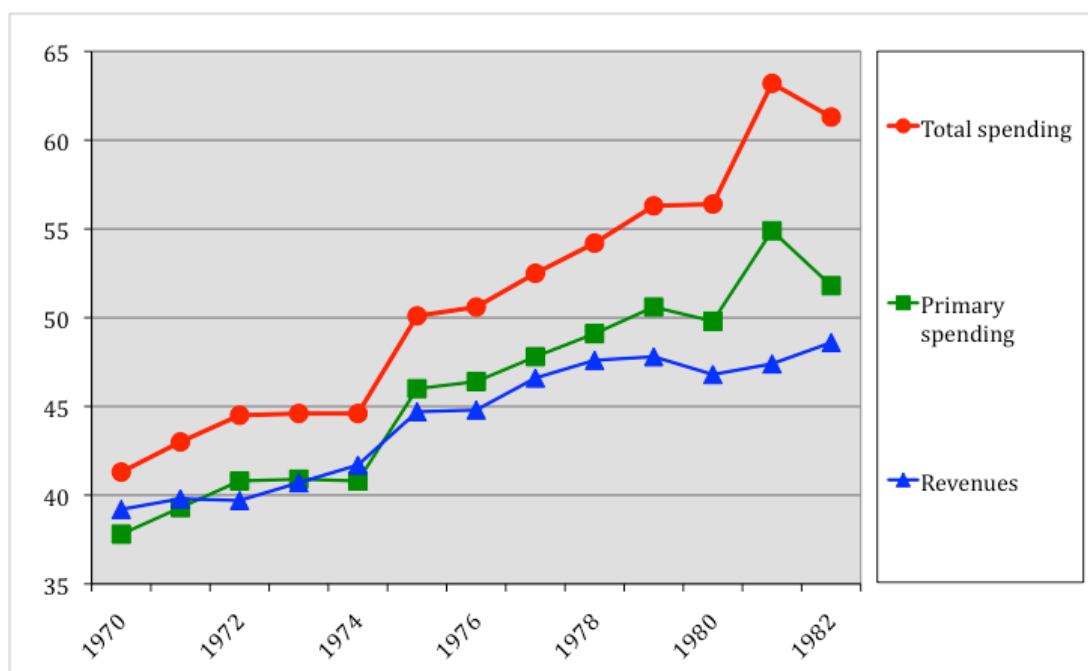
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<sup>111</sup> Unless otherwise indicated, fiscal data cited in this section can be found in the database of the National Bank of Belgium ([www.nbb.be/belgostat](http://www.nbb.be/belgostat)).

economic downturn triggered by the two oil crises and by a jump in the costs of outstanding debt (see Figure 5.3). Expenditure was set on an explosive trajectory, growing by a half from 45 to 64 per cent of the GDP within ten years after the first oil shock. Social expenditure grew by 8 percentage points of the GDP as the welfare system was flooded with unemployed and early retirees in the wake of the economic downturn. Non-social security expenditure also increased by 5 percentage points as successive governments tried to remove excess workforce from the job market by boosting public employment. The increase in primary expenditure was compounded by a jump in the interest burden around the turn of the decade – from 4 to 10 per cent of the GDP – due partly to increased borrowing but, more importantly, also to a two-thirds increase in the interest rates charged on Belgian sovereign debt.

Initially, the expenditure explosion was partially counterbalanced by a surge of revenues, because double-digit inflation generated extra tax income via fiscal drag (Blöndal 1986 p117). However, when Belgium joined the fixed exchange rate regime of the European Monetary System in 1979, it became crucial to rein in inflation to maintain parity with low-inflation Germany. As inflation was brought down, revenues levelled and the full scale of the fiscal damage of the economic and financial shocks became visible. By the beginning of the 1980s, it was also clear that the damage would last beyond the immediate crisis years.

**Figure5. 3 - Total spending, primary spending and revenues in the wake of the oil crises (1970-1982)**  
per cent of GDP  
Source: Belgian Statistics Office



This section describes the Belgian policy response given to this massive problem. Analysing spending and revenue trends throughout the 1980s reveals a curiously lopsided adjustment effort. This effort left virtually unaddressed the enormous imbalances in the social security sector created by the fivefold increase in the rate of unemployment and it shied back from tax increases. Public investment and collective consumption expenditures, on the other hand, were drastically cut back, bringing them far below their pre-crisis levels. In these years, Belgium moved from spending on public consumption and investment on par with countries of similar levels of development to spending the least on public consumption and by far the least on public investment, whereas social security spending remained significantly higher than in comparable countries (IMF 1998 p17, IMF 2004 p6). The sizable deficit of the sector continued to create a huge drain on public resources and – in the absence of revenue increases – considerably undermined efforts to rebalance the general budget. Therefore, the second half of this section looks more in detail at the policy approach taken to social security and taxation throughout the decade.

The year 1982 marks a significant turning point in Belgian fiscal history and the start of a period of drastic austerity. In that year, the debt-to-GDP ratio had grown close to 100 per cent and borrowing was above 10 per cent of the GDP. Fiscal imbalances had started to cause problems with maintaining a fixed exchange rate within the EMS, due

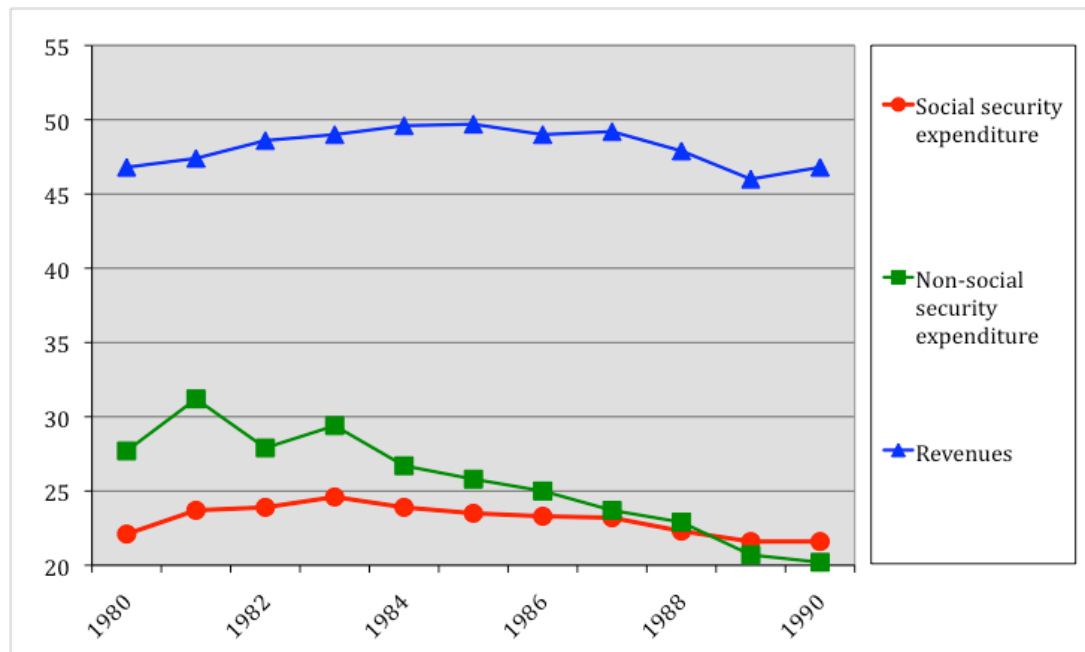


to high inflation and balance of payments issues. Belgium was forced to devalue the franc in the wake of several currency crises, but other member states only consented to such realignment on the condition that austerity measures were taken (Hemerijck and Unger 2000 p236, McNamara 1998 p142). Although a year earlier the government fell over its inability to agree on the details of a “Disaster Plan”, the time for political dithering seemed to have run out and decisive action was unavoidable (Anderson et al 2007 p321). In view of the direness of the situation, the Parliament granted “special powers” to the government to enable it to embark on a radical consolidation path.

By the end of the decade, austerity had yielded savings worth 13 per cent of the GDP. Non-social security expenses were cut back by 11 percentage points to 20 per cent of the GDP, a fifth lower than their pre-crisis level in the early 1970s. Two norms were introduced to achieve considerable savings. One was a general rule that expenditure cannot grow in real terms, the other was that additional cuts would be made whenever this was necessary to ensure that the nominal value of the deficit does not increase (European Economy 1993). This gradually eroded the share of collective consumption and public investment in the GDP and in total spending. Investments were cut by two-thirds; subsidies to firms were halved, the compensation of employees decreased by a fifth (Ameco). All functional spending categories suffered, but transport and communication and defence were especially hard hit, with education expenses being a distant third (Frank 1993 p18).

Social security outlays also decreased slightly during the decade, but only by 2 percentage points, which was a rather small improvement in light of their preceding surge. Importantly, the reduction happened mostly endogenously: family allowances dwindled in the wake of a decrease in the number of births, while unemployment transfers decreased thanks to the relative improvement of the labour market situation in the second half of the 1980s (Festjens 1993 p236). Some adjustments were made to the system of social entitlements in 1982, but these made relatively little impact on overall social spending levels. The revenue side was not involved in the consolidation effort. On the contrary: after a prolonged period of growth, revenues declined from the mid-1980s onwards due to two personal income tax reforms (European Economy 1993). At the same time, an increase in social contributions enacted in 1982 partially offset the decrease in direct taxes (see Figure 5.4, Anderson et al 2007 p322).

**Figure5. 4 - Social security expenditure, non-social security expenditure and revenues (1980-1990)**  
per cent of GDP  
Source: Belgian Statistics Office

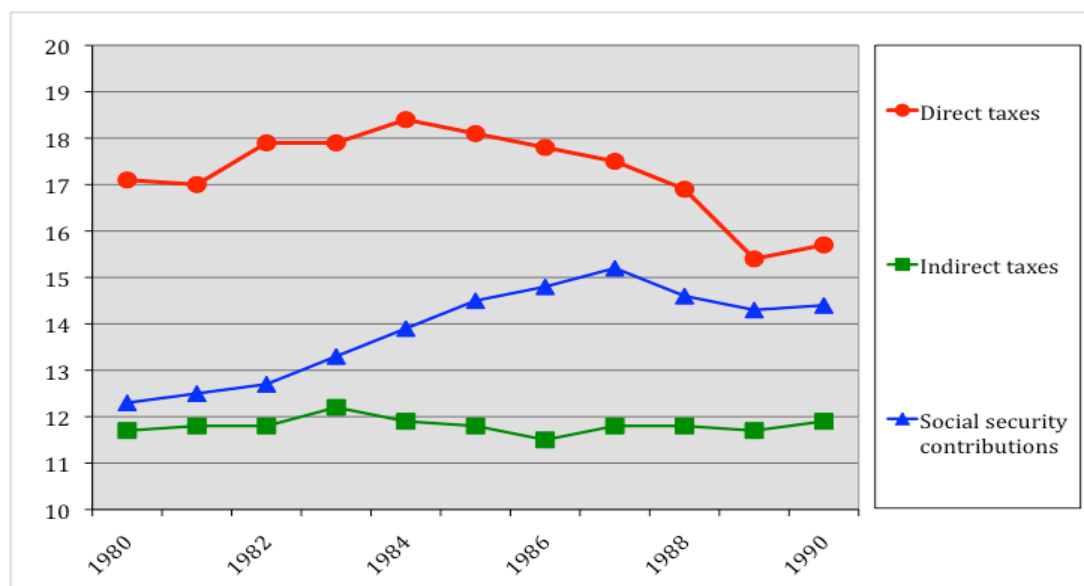


As a result of the sustained campaign of austerity, the primary balance climbed to a surplus of 5 per cent in 1990, 13 percentage points higher than at the beginning of the decade. Nevertheless, net borrowing still amounted to 7 per cent of the GDP, because the interest burden had kept steadily growing throughout the decade, to 12 per cent of the GDP by 1990. The country still seemed to be losing the race against the debt spiral. The steady growth of the debt-to-GDP ratio was only paused for a single year, on the peak of an economic boom in 1989, but it was rising to new heights again in 1990. The efforts made in the preceding decade – however drastic – were clearly insufficient to stop the country’s drift towards fiscal disaster. In the absence of revenue increases or a cut in transfer payments out of the public purse, turning the fiscal situation around in the face of soaring interest costs was not possible.

Increasing taxes and contributions to shore up the ailing public finances seems to have been an unpalatable option to successive governments of the period, who were worried about the vulnerable competitiveness of Belgian industry (Jones 2008 pp141-143). The so-called “Maribel operation” – introduced in 1981 – granted employers of manual workers exemption from contribution to social security. This demonstrates that limiting fiscal pressure was given priority over rebalancing public finances (Festjens 1993, p238). The Grootjans tax-reform of 1985 and the Maystadt tax-reform of 1988 – which led to a significant decline in direct tax revenues – provide other important

examples (European Economy, 1993). Indirect taxes were left untouched throughout the decade to avoid detrimental impacts on inflation and competitiveness. The only instance when revenues were raised was the decision to increase pension contributions and to create new levies as part of the emergency measures enacted under the Special Powers Act of 1982 (see Figure 5.5, Anderson et al 2007 p322).

**Figure 5.5 - Direct and indirect taxes and social contributions (1980-1990)**  
per cent of GDP  
Source: Belgian Statistics Office

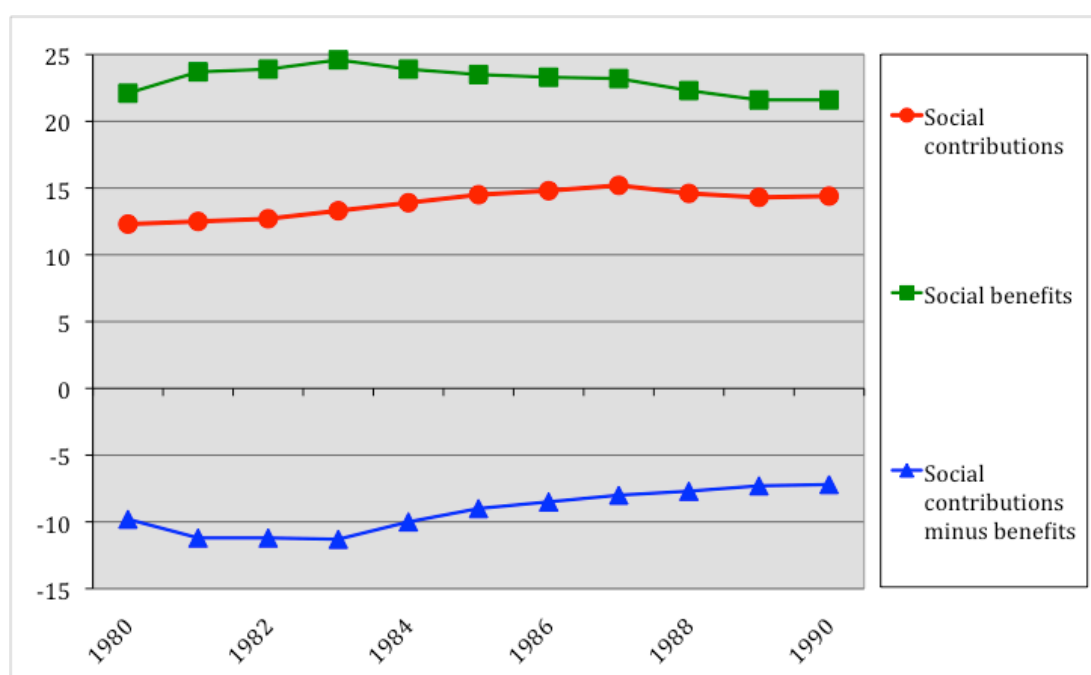


With respect to adjusting transfer payments, successive governments demonstrated greater readiness. The 1980s saw four attempts to retrench the social security sector. However, only one of these achieved visible results, while the other three initiatives were never put into practice. The 1981 Disaster Plan, which attempted to freeze pension expenses and tighten conditions on several social security benefits failed, because coalition partners disagreed over how radical the retrenchment should be and the government fell over the issue. A proposal to reform the pensions of civil servants put forward in 1983 was withdrawn in the face of strikes. The St. Anna Plan of 1986 – which included heavy cuts in the unemployment insurance and limited future pension entitlements – also stirred up fervent labour demonstrations and was left unexecuted after the government that proposed it had to resign. It was only under the Special Powers Act in 1982, that cuts in social security were actually enacted, although they proved ultimately insufficient (Anderson et al 2007 p321-323, Marier 2008 p88).

In sum, Belgian fiscal policy in this period was extremely austere and astonishingly reckless at the same time. While public consumption and investment was painfully cut

back, directly redistributive items were spared. The parameters of social security were only slightly changed despite the greatly increased pressure on the existing system. Taxes were even reduced to compensate for the earlier growth of fiscal pressure under the effect of fiscal drag in the late 1970s. This, however, was a dangerous luxury. In the beginning of the 1980s, the deficit of the social security sector exceeded 11 per cent of GDP. By the end of the decade it shrank somewhat, but still stood above 7 per cent and the gap started to widen again<sup>112</sup> (see Figure 5.6.).

**Figure 5.6 - Social benefits, contributions and the balance of the sector (1980-1990)**  
per cent of GDP  
Source: Belgian Statistics Office



In the absence of an increase in taxes or contributions to subsidize this deficit, much of the resources gradually freed by the enormous effort exerted on the non-social security front were swallowed in this black hole and could not be used to fight the self-fuelling growth of debt. Given a debt-stock of 125 per cent of the GDP and interest expenses equivalent to 12 per cent, this did not augur well for the future. The next section investigates the political background of policy making in order to explain why successive governments failed to confront the imbalances of the system of

<sup>112</sup> These financing gap figures are not the official consolidated deficit figures for the different social security funds, because the central government covers the financing gap of the social security sector through yearly subsidies. Therefore the official budget for the social security always balances. Instead, these figures reflect the balance of social security contributions and social benefits paid (source: [www.nbb.be/belgostat](http://www.nbb.be/belgostat))

redistribution – and raise revenues or forcefully push through cuts in entitlements – in the face of the constant escalation of indebtedness.

### **Labour, business, Flanders and Wallonia: The politics of welfare-consolidation Belgian-style**

It goes without saying that consolidating the social security sector is a challenging political task, since it involves asking large sections of the society to give up income: to lose transfers or pay more in taxes and contributions. In the Belgian case, the order of magnitude of the problem itself was also daunting as the deficit of the sector amounted to more than a tenth of the national income in the early 1980s. Social security was a particularly sensitive issue in Belgium due to its historical role in achieving cooperation between labour and business throughout the post-war period. The expansion of the welfare safety net had been important in compensating workers for wage restraint exercised for the sake of international competitiveness, especially under the tight labour market conditions of the 1960s (Jones 1998, p48). Revoking these entitlements exactly when unemployment skyrocketed was a major menace to industrial peace. At the same time, businesses were struggling to survive in a wave of bankruptcies and were likely to resist both higher payroll taxes that increase the cost of labour and taxes on capital income. The conflicts about consolidating the social security sector were, therefore, formidable. However, in 1982 – at the peak of unemployment and in the midst of the wave of bankruptcies – both cuts and revenue increasing measures were successfully enacted under the Special Powers Act. When sacrifices hurt most, they were made. Later in the decade, when growth and profitability picked up and unemployment somewhat subsided – and the opposing sides could have better afforded to thrash out a compromise – the stalemate became entrenched despite the escalation of the fiscal problem.

This section explains this apparent contradiction. It shows that even though the conflict over social security pitted business and labour against each other throughout the decade, neither of the two camps was a monolithic interest group due to internal variations of the sensitivity of different subgroups to the economic side effects of debt. Evolving commonalities and conflicts of interests between groups within and across the two camps is crucial for understanding both the early compromise and the later stalemate. Divisions within the ranks of labour are of special relevance. Economic divergence between the North and the South of the country induced a modulation of

interests among workers in the two regions. For workers in the economically more dynamic and open Flanders, safeguarding international competitiveness was a priority they shared with business, and therefore they were amenable to compromise when competitiveness was at stake. For labour in the depressed Wallonia, on the other hand, compromising the social safety net entailed no gains, only losses, as it would do little against the structural unemployment problems in their region but would endanger the livelihood of the long-term unemployed. This situation accorded pivotal importance to Flemish workers in the conflict over social security. Whenever they sided with business in defence of international competitiveness – as was the case in 1982 – compromise was possible. When the risks to the economic viability of industry in their region subsided, they rediscovered worker solidarity and joined in the defence of welfare benefits.

In order to understand how different labour and business interests permeated policy making and shaped the politics of social security consolidation in the 1980s, it is necessary to analyse the political scene in some detail. Clusters of labour and business interests were represented by an intricate web of interest representing organizations, which allowed the commonalities and conflicts of interests between the different clusters play out in a complicated pattern within the political scene. The societal cleavage between capital and labour had historically played an important role in structuring Belgian political life, creating a significant left-right opposition within the party system as well as nurturing a strong trade union movement and a corresponding employers' organization. At the same time, the labour-capital opposition was modulated by religious-laical conflicts and linguistic divisions between Flemish-speakers and Francophones, which fragmented both the party-political scene and the system of social partnership.

The party system came to be dominated by three pairs of parties: Christian-Democratic, Socialist and Liberal, with a separate Flemish and Francophone party in each family<sup>113</sup>. Parties of different linguistic affiliation competed in largely isolated electoral spheres since the constitutional reform of 1980 designated Flanders and Wallonia as exclusive electoral territories for Flemish and Francophone parties, respectively, leaving the Brussels-capital region as the only shared electoral turf. This caused the “sister parties” on each side of the linguistic divide to drift slightly apart as they adjusted to electoral

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<sup>113</sup> Since all of the parties described here changed their names several times in the past decades, I refer to them by their linguistic and ideological affiliation rather than the different names they took at different times.

pressures in their own competitive arenas. Despite their linguistic, electoral and organizational separation, the “sister parties” entered the government together because of the need to ensure the linguistic parity among ministers of the national government that the constitution prescribes (Fitzmaurice 1996). Electoral competition between the three pairs of parties was relatively balanced in the 1980s. For most of the 1980s, the Christian Democrats maintained their primacy. This was primarily due to the overwhelming electoral strength of the Flemish Christian Democrats. The Francophone counterpart was a relatively minor party (Claeys 1996). Socialists were not far behind – in fact they pulled ahead of the Christian Democrats in the 1987 elections – mostly due to their solid performance in Wallonia, but also due to their reasonable showing in Flanders. Liberals were firmly in third place throughout the decade, with no clear linguistic domination between the two parties, as the Flemish and Francophone parties attracted votes in approximately the same order of magnitude (Delwit 1996, Deschouwer 2009).

The trade union movement was also divided along ideological lines, but all three unions – Christian, Socialist and Liberal – retained their national unity, despite different linguistic proportions within their memberships. Unionization was traditionally and persistently high, due to the role of unions in administering social benefits (Anderson et al 2007). The Christian Democratic union was the largest of the three, the Socialist a close second, while the Liberal unions were rather insignificant (Marier 2008). The membership of the Christian Democratic union was biased towards the Flemish, while that of the Socialist trade union is balanced between the two linguistic communities (Claeys 1996, Marier 2008). On the employers’ side, a single national organization participated in the system of social partnership, representing enterprises on both sides of the linguistic divide. At the same time, this organization has been in competition with an alternative Flemish organization for the support of Flemish business. The social partners wielded policy-making power in their institutionalized roles, for example in the National Labour Council or in the Central Economic Council. More importantly, however, they achieved policy clout through cultivating strong ties with the political parties, achieving synergies from the mobilization capacity and the electoral power of their membership.

Despite the fragmentation of the political scene into a large number of influential actors, the social security issue was still quite clearly dominated by the three ideological poles – Liberal, Socialist, Christian Democratic – in the 1980s. The Liberal

camp stood for business interests. It demanded a significant shrinking of the system of entitlements and lower taxes and contributions. This strategy ensured a steady electoral support for both the Flemish and the Francophone party amongst relatively younger, better educated white-collar employees, managers and self-employed – in general the middle- and upper-middle classes – from the economically most dynamic areas of each region and the Brussels area (Fitzmaurice 1996).

The Socialist camp uncompromisingly fought for keeping up the social security system. Socialist parties and the Socialist trade union traditionally relied on a largely homogenous labour base, somewhat biased towards older workers in declining industries. The *Parti Socialiste* was the strongest party in the Francophone electoral sphere throughout the 1980s, relying on a strong electoral base in the large heavy industrial towns (especially in Hainaut and Liège). These areas suffered from an enormous structural unemployment problem since the mid-1970s and half of the jobless were long-term unemployed (Fitzmaurice 1996). At the same time, Wallonia had a large share of pensioners with above-average pensions due to higher-than-average wages among industrial workers in the past and due to a high proportion of civil servants (Marier 2008). Consequently, few issues could be more important for the Walloon Socialist constituency than unemployment benefits and the generosity of pensions (Delwit 1996). The Flemish Socialists were similarly relying on a worker base in the industrial areas of Antwerp and Ghent (Delwit 1996). Both parties cultivated strong ties with the Socialist trade union, the membership of which largely overlapped with their voter base. The Socialist union has been a militant defender of the *acquis sociaux* and frequently mobilized its membership against attempts to retrench social security entitlements.

The Christian Democratic camp was torn over the social security issue. The Flemish Christian Democratic Party represented very different socio-economic groups within Flanders: a large section of labour, business interests and the self-employed. Naturally, these groups (usually referred to as *standen*) exerted influence on the party's policy choices via electoral channels. More importantly, however, the interest organizations representing the *standen* – the Christian workers movement, the union of the middle classes and the agricultural association – also had their own representatives within the party, because they had the right to select candidates on the party's electoral lists (De



Winter 1996, Claeys 1996)<sup>114</sup>. Consequently, the party had to reconcile within its own ranks profound conflicts of interests as regards the consolidation of social security.

To complicate things further, the Christian trade union was itself ambivalent between the defence of social entitlements and cooperation with employers for the sake of better employment opportunities. Its Flemish majority could potentially benefit from the latter, whereas its Walloon minority would only gain from the former. Similarly, the business constituencies of the Christian Democratic parties were also hesitant in their policy preferences, because they were reluctant to push for harsh retrenchment that might trigger large-scale labour unrest at a time when businesses were barely coping (Jones 2008, p170).

Its internal contradictions and conflicts notwithstanding, the Christian Democratic camp was bound to play a defining role in the social security issue. On the one hand, the Christian Democratic parties occupied a pivotal governmental position due to their electoral strength – in particular, the electoral strength of the Flemish Christian Democrats, the largest party in the country by far – and because the preferences of the other two camps were so strongly opposed that they could not have formed a coalition with each other in these years. In effect, the Flemish Christian Democrats were to decide over government strategy towards social security consolidation by choosing between potential coalition partners to their left or right.

On the other hand, the Christian trade union played a key role in determining the level of labour militancy and thereby the viability of specific policy choices. Christian workers constituted more than half of organized labour and, therefore, the participation of Christian unions was crucial to make strikes effective. For all its militancy, the Socialist union was unlikely to be able to place meaningful pressure on the government on its own. In this political situation, the social security issue was practically subject to the interests of Flemish workers and businesses: successful consolidation hinged upon a compromise between these two groups. Whenever Flemish workers in the Christian union were ready to make concessions on their welfare entitlements and Flemish employers consented to some increases in the fiscal pressure, they made deals that affected workers and businesses in the entire country. However, when they had more to gain from resisting policy measures that would have

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<sup>114</sup> Up to the 1990s, 90 per cent of the candidates were nominated by the *standen*. The remaining 10 per cent was usually filled by the narrow leadership of the party and former/present ministers (De Winter, 1996, Claeys, 1996).

restored the balance of the social security sector at their cost, consolidation was blocked and it was impossible to forge a coalition of interests that could overcome the resistance of either of these two groups, especially since both could always count on the support of groups even less amenable to compromise than themselves.

This helps to shed light on the political and policy developments of the 1980s. Different government coalitions, different levels of labour militancy and differential success of governments in consolidating the social security sector can be explained via the incentives of Flemish labour and business within the Christian Democratic camp under changing economic conditions. The successful adjustments to social security under the Special Powers Act of 1982 were achieved in an atmosphere of economic emergency, when unemployment soared due to a wave of bankruptcies and fiscal troubles were threatening the Belgian currency's stability and its place within the European Monetary System (Sneessens and Dreze 1986 pS97, McNamara 1998 p142, Hemerijck and Unger 2000 p236). The Christian worker movement could not take the responsibility for undermining the recovery in the otherwise strong and dynamic Flanders. It secretly consented to opening to the Liberals and to some welfare sacrifices<sup>115</sup>, laid down in an economic recovery plan developed by the workers' movement (Jones 2008 p170-171). Under these conditions, the business constituencies of the Christian Democrats were more confidently pushing the party to break up its decade-old coalition with the Socialists, which the party did after it failed to achieve consensus on a "Disaster Plan" in 1981 because of Socialist resistance to pension cuts. In 1982, a new coalition with the Liberals was formed (Anderson et al 2007 p321). This new coalition passed the Special Powers Act, cut pensions, increased social contributions and launched a general austerity programme that decreased non-social security expenditure dramatically throughout the rest of the decade. Socialist unions organized large-scale protests, but Christian unions kept themselves to the secret promise made by their leaders and did not join the strikes (Anderson et al 2007 p322). The austerity measures were thus successfully executed.

However, this breakthrough was not repeated again, as Christian unions had much less incentives to consent to further sacrifices on behalf of their members after the threat to international competitiveness had been successfully averted, growth gradually picked up and unemployment started to decline in Flanders (Jones 1998 p52). The renewed

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<sup>115</sup> This secret consent given by trade union leaders only became known to the wider public in 1991 (Jones 2008, p188).

Christian Democratic and Liberal coalition tried to push for further consolidation when it became clear that the measures of the Special Powers Act were insufficient to significantly improve the balance of social security. They adopted the so-called St. Anna Plan in 1986, which included heavy cuts in the unemployment insurance, limited the accumulation of benefits and decreased the level of future pensions. However, the Christian unions would have none of these sacrifices and this time they did join the Socialist unions in the mobilisation for strikes. The government had to resign not long afterwards due to pressure from the Christian workers movement on the leadership of the Christian Democratic Party to break with the Liberals (Marier 2008 p88). The St. Anna Plan remained unexecuted (Anderson et al 2007 p325). After the new elections in 1987, the Socialists joined the Christian Democrats in government again. Cuts to the social security system were off the agenda for the rest of the decade. In fact, the Socialists even achieved some corrections in entitlements that had not been indexed under the previous governments. Business managed to use its influence on the Christian Democrats to make sure that fiscal pressure did not increase, but it could no longer generate the political will to take on social entitlements.

In sum, the politics of the consolidation of the social security sector in Belgium was driven by a curious dynamic in the 1980s. Class conflict dominated the issue, but economic divergence between different regions of the country weakened the cohesion of the coalitions of interests within classes. Although the shocks of the 1970s hit both Flanders and Wallonia hard, the 1980s made it increasingly clear that Flanders had the capacity to rebound on the basis of its export industries whereas Wallonia faced lasting problems and became increasingly dependent on public funds, at least in the short term. Under such circumstances, international competitiveness created a pole of common interest between business and labour in Flanders and a source of conflict with Wallonia. However, this new dimension of conflicts and commonalities of interests only played a role in the politics of consolidation in the emergency years at the very beginning of the 1980s. Then Flemish business and labour managed to seal a deal about a drastic austerity programme that even managed to cut some entitlements and raise the revenues of the social security sector despite the protests of groups not involved in this deal. For the rest of the 1980s, however, the front lines followed class divisions again and further adjustments to the social security sector remained elusive. Along the class dimension, the social security issue was intractable, because both labour and business had the political power to defend its redistributive position and both refused to pay more into or take less out of the welfare system.

Neither labour, nor business showed a willingness to make further sacrifices, even though the debt situation turned progressively more menacing. By the mid-1980s it became clear that the initial compromises made under the Special Powers Act were insufficient to meaningfully stabilize the sector, since unemployment persisted at very high levels in Wallonia and stayed higher than its pre-crisis levels in Flanders. Since interest costs were still rapidly increasing, the persistent deficits of the social security sector looked ever-less affordable, even when heavy cuts were made in other areas of spending to stop the snowballing of debt. However, the socio-economic groups that showed such concern when the stability of the currency was at risk from the fiscal problems now seemed much less bothered by the alarming debt issue in and of itself. The next section argues that the competitiveness-alliance between Flemish business and labour lost its *raison d'être* once policies were put into place to cushion international competitiveness from the negative effects of fiscal troubles. As both groups lost interest in further compromises, a radically new political solution was needed if the structural imbalances in Belgian public finances were to be sorted out.

### **Fiscal trouble as a catalyst for political change: The emergence of the Flemish-Walloon redistributive conflict**

By the second half of the 1980s, fiscal prospects looked worse than ever. The debt-to-GDP ratio had grown above 120 per cent and showed no sign of levelling off. Eliminating the social security deficit would have been crucial, but the demise of the St. Anna Plan and the end of the Christian Democratic-Liberal coalition signalled a breakdown in cooperation between powerful labour and business groups over this issue. Surprisingly, despite the daunting situation, the focus of politics seemed to have shifted from fiscal issues to other matters. Parties were bickering about further state reform: government formation took a record five months in 1988<sup>116</sup> as coalition talks were dragging on about interregional and intercommunity matters<sup>117</sup> (Covell 1993). Welfare consolidation seemed to receive low priority.

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<sup>116</sup> The 1988 record has since been eclipsed by the present stalemate – over another round of state reforms – that has kept Belgium governmentless for fourteen months.

<sup>117</sup> Since the 1980 state reform, Belgium has a curious, two-layer federalized structure that divides the country into 3 linguistic communities (Flemish, francophone and German) and 3 regions, Flanders, Wallonia and Brussels. Communities are administrative units with authority over so-called 'personalizable' matters such as education, health etc. Regions are administrative units with authority over territorial matters such as local economic policy, infrastructure etc. To make things more complicated, the Flemish Community and Flanders (the region) have been merged. Since for the arguments made here, these

However, the seemingly unrelated new state reform was in fact strongly connected to the fiscal stalemate that beset the country. On the one hand, it reflected the scramble of regional political actors for dwindling funds for public consumption and investment in the midst of “permanent austerity”<sup>118</sup>. On the other hand, it represented the Flemish Christian Democrats’ quest for an alternative solution to the social security deficit once interclass cooperation in Flanders broke down: one that would shift the costs of stabilization fully out of Flanders, into Wallonia. Using the insights of the war of attrition model, this section argues that the redefinition of the social security problem as one of interregional rather than interclass redistribution was likely the only avenue through which the country’s fiscal problem could be tackled.

The logic of the political and policy events in the late 1980s can best be understood through analysing the pressures weighing on and the options available to the Flemish Christian Democratic Party at the time. As explained above, the party housed within its ranks the forces that had defining importance for Belgian politics and policy-making in the 1980s – Flemish business and labour – and used its permanent dominance within the government to put into practice the policy choices arising from the interaction of these forces. Therefore, the party’s incentives and constraints accurately reflect the evolution of the conflict between the two pivotal societal groups as well as the consequences of this conflict for national policy making.

After being pressured by its labour flank to break with the Liberals – and thereby with a programme of welfare retrenchment – the party was in an immensely difficult situation. On the one hand, it was fairly clear that eliciting voluntary sacrifices from its two constituencies for the sake of further fiscal stabilization was not possible in the foreseeable future. Extorting concessions from either side by force was out of the question. On the other hand, the party could not be oblivious of the mounting debt, not only because it was the dominant partner in every government and would need to deal with debt crises in the future, but also because a fiscal crisis was likely to have grave consequences for its own supporters. Unable to convince and unwilling to force its own powerful constituencies to pay for consolidation, the party had to find a way to target groups outside of its own electoral sphere, i.e. in Wallonia. This required the separation

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administrative specifications make little difference, I will refer to regions and communities interchangeably.

<sup>118</sup> The term was coined by Pierson (2001) to describe the pressures on public consumption arising from imbalances in social security.

of fiscal matters between the two regions. Therefore, a state reform was the only way forward.

At first sight, it might seem puzzling why the Flemish Christian Democrats gave up on attempting to resolve the fiscal issue by trying to bridge the class divide within their own constituencies. After all, this strategy had worked in the early 1980s, so they could have tried to elicit new compromises from each side. Why did they choose instead to enter a cumbersome, potentially lengthy and open-ended conflict over regional financing and the regionalization of social security? The war of attrition model provides a clue why the latter option was more promising. The model proposes that societal groups will only acquiesce readily in sacrifices for the sake of fiscal stabilization if they suffer considerable harm from the side effects of fiscal imbalances. Unless they suffer private pain from the public debt problem, influential groups will put up fierce resistance to tax increases and/or cuts in transfers that negatively affect them. Therefore, if policies are put into place to minimize side effects of fiscal problems, the different groups will be able to afford resisting sacrifices despite the ballooning of debt and wait for other groups to make the necessary concessions to prevent national bankruptcy. In the early 1980s, the first priority of both Flemish business and labour – and, thus, of Christian Democrat-led governments – was to put into place exactly such policies. Once this was done, both interest groups were able to adopt intransigent stances on taxes and entitlements. Unless the government got rid of the policies that cushioned these groups – which was inconceivable while the Christian Democrats retained their pre-eminence – it would have been exceedingly difficult to sell further sacrifices to either group.

The insulation of the two interest groups had been achieved by the Special Powers Act of 1982 and by the consistent austerity efforts in public consumption and investment that followed in its wake. In the years before the Act, fiscal problems and relatively high inflation had undermined the exchange rate stability of the franc. By 1982, the currency's position within the EMS was untenable after several currency crises (McNamara 1998 p 142, Hemerijck and Unger 2000 p236). The government faced a choice between falling out of the system and a one-off large devaluation combined with disinflation to stabilize the currency's position within the system. The latter choice entailed a likely worsening of the fiscal situation, because it would lead to higher real interest rates paid on the outstanding debt stock. Nevertheless, the stability of the currency was so crucial to industry – especially to dynamic Flemish industry, which,

unlike its Walloon counterpart, was structurally fit for international competition – that the government did not hesitate to choose devaluation, monetary tightening and higher interest rates on debt (Pochet 2004). From that point on, inflation was kept tightly under control and exchange rate stability was safeguarded. Flemish industry regained its competitiveness, allowing businesses to recover their margins and employment to rebound, freeing labour and capital from the side effects of the fiscal problem.

It is notable that even though the constituencies of the Flemish Christian Democrats had a high stake in the Special Powers Act and were therefore willing to make some sacrifices, the actual fiscal pain that the policy package had in store for them were relatively minor compared to the adjustments affecting other societal interests. It was public investment, the compensation of public employees and subsidies that were drastically cut, whereas adjustment to pensions and payroll taxes were relatively minor. In later years, when it became clear that the fiscal measures of the Special Powers Act were insufficient to stop the snowballing of debt, successive governments kept tightening the screw on public consumption and investment. This made it possible to keep debt growth more or less under control without having to resort to monetary financing that would undermine exchange rate stability. Economic policy was quite clearly tailored to the interests of the constituencies of the Flemish Christian Democrats. This was exactly what made it possible for them to intransigently defend their redistributive interests. In the absence of much pain from fiscal imbalances, neither group was pressed to contribute to the consolidation of the social security sector and to agree to entitlement cuts or tax increases. Both could afford to wait for other groups to make sacrifices.

The insulation of the two pivotal societal groups from the effects of the fiscal problems created an irresolvable stalemate. Not only were both resolute in resisting concessions to the other side, but also both had reasons to avoid a dramatic showdown over the social security issue. Business constituencies were wary of protracted industrial unrest over welfare cuts and labour had a lot to lose if rising costs of financing social security induced businesses to relocate abroad. Both constituencies thus continued to support the party, which kept its vote share approximately stable throughout the decade (Deschouwer 2009 p128). These factors locked the Christian Democrats' policy choices into place: monetary and exchange rate discipline continued to enjoy absolute priority, the question of the social security deficit was put on ice, austerity in public

consumption and investment intensified in line with the increasing interest burden and – most importantly – the debt continued to grow incessantly.

Although this situation seemed to create no immediate political threat for the Christian Democrats' electoral standing, they could not afford to be complacent. On the one hand, the fiscal situation was very serious, which the dominant party of present and future governments and the representative of influential societal groups could not ignore. On the other hand, the unrelenting rigour in collective consumption and public investment was likely to sooner or later take its toll. Even though austerity in these fields did not directly affect the private welfare of the party's constituencies, the persistent squeezing of public services and especially of public infrastructure was threatening to undermine the party's electoral position in the long run. The only way out of this tight corner was to find a solution that would not require sacrifices from the two pivotal Flemish interest groups, that is, to engineer a way to make Walloon groups pay for fiscal consolidation.

Tension between the two linguistic communities had been an increasingly important factor in Belgian political life in the post-war period. This is best reflected in the state reforms of 1970s and 1980s, which introduced official divisions into the administrative and political structures of the country (Deschouwer 2009 pp48-53). However, the divisions had not gained economic-redistributive relevance before the 1980s, when fiscal difficulties highlighted the unequal fiscal capacities of dynamic Flanders and stagnating Wallonia (Beland and Lecours 2008 p153). The Flemish Christian Democrats started to put ever more emphasis on the redistribution between the two parts of the country and the conflicts of interests between Flanders and Wallonia. They launched a two-pronged campaign for devolution, which concentrated on the social security sector and on the different tax capacities of the two regions.

Attempts to redefine the social security problem as one of interregional redistribution started with the commissioning of a large number of studies in the second half of the 1980s by Flemish organizations. These were conducted by Flemish academics and clearly showed that that Flanders was paying the bills of high unemployment and disproportionately high health costs in Wallonia<sup>119</sup> (Kuipers 2006, Marier 2008, Beland

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<sup>119</sup> The first Flemish study on interregional financial transfers appeared in 1984 and focused on the discrepancy between the social insurance revenues and expenditures ratio between Wallonia and Flanders. In 1989–90, the *Centrum voor Sociaal Beleid* published a study that put the difference in per capita social insurance expenditures between Flanders and Wallonia close to 30 per cent (Beland and



and Lecours 2008). This implied that it is unfair to ask Flemish workers and businesses to contribute more to the system or take less out of it, when the root of the problem was Wallonia. This idea gained ethnic overtones as structural unemployment plaguing Wallonia and the inability to control health care costs started to be traced back to factors like “bad life habits” or a “culture of dependency” (Beland and Lecours 2005).

At the same time, the redefinition of the problem did not immediately bring a solution closer. Although it was a tool to undermine class-solidarity across regions, it had few immediate implications. The social security system was national and it was administered by the social partners, who had retained their national unity (Vilrocx and van Lemput 1998). Therefore, making changes that would only affect workers and/or businesses on the Walloon side was inconceivable without far-reaching institutional and structural reform that separates Flemish and Walloon social security funds and insurance. However, such reforms would need the cooperation of the social partners and, more importantly, require the blessing of the Walloon partners in the government. At the end of the 1980s, it was inconceivable that any Walloon party would voluntarily agree to reforms that allow for making the social security deficit a purely Walloon problem. Therefore, the splitting of the social security was to be a longer-term project, for which the right political preconditions had to be created.

The more immediate objective was to redistribute the costs of fiscal austerity between the two regions. This was accomplished via the state reform embodied in the 1988 Special Law and the 1989 Finance Act. The reform devolved many important functions and the funds to finance them from the federal level to the regions and communities<sup>120</sup>. The functions that were now placed under the exclusive authority of sub-national entities included, most importantly, economic affairs (including transport and communication infrastructure) and education, items that were hardest hit by the expenditure cuts since 1982. Funds for education were allocated to the communities on the basis of the number of students and were, therefore, independent on tax generating capacity. Funds for economic affairs were, however, distributed among regions

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Lecours 2008). Other studies were less dramatic but still quite striking: the Club van Leuven report for example claims that Walloons on average have more disposable income after taxes and benefits than the Flemish despite lower wages and much higher unemployment in Wallonia. (Kuipers 2006). Such findings gave ample material for inciting nationalist indignation towards the issue social security in Flanders. Building on such publications, a Flemish newspaper carried the headline that each Flemish family is buying a new car for each Walloon family per year (Marier 2008).

<sup>120</sup> Forty per cent of the total value added tax and personal income tax was assigned to communities and regions to finance education and economic affairs respectively.

according to the amount of personal income tax paid in the given region<sup>121</sup>. In addition, regions were given the right to levy and collect certain minor taxes (OECD 2007, Hooghe 1991).

This new system had two important consequences. On the one hand, it exempted the devolved spending items from further cuts made in order to cross-subsidize the gap in the social security sector, since the federal government would be obliged to transfer the pre-defined funds to the sub-national entities. On the other hand, it meant that funds available for public consumption and investment in Flanders would be able to recover at the expense of funds channelled to Wallonia, because personal income tax revenues per capita are higher in Flanders and, therefore, Flanders was to receive higher funding than it did before the decentralization, while Wallonia was to receive less.

These changes had two important advantages for the Flemish Christian Democrats. On the one hand, the reform secured more funds to spend in Flanders. On the other hand, however, it also promised to give the Flemish side more leverage in future negotiations about social security. Once the new system was fully phased in, Wallonia would be starved of funds even more than it was after almost a decade of austerity in 1989, possibly making it more amenable to discussion about splitting up the social security. In this sense, this agreement was a very important breakthrough in the Flemish Christian Democratic project to resolve the social security stalemate and the imbalances of the public finances in general by forcing Wallonia to deal with it.

In light of this big step forward in redefining the fiscal issue as a conflict between Wallonia and Flanders, the Walloon side of the political struggles also gains special relevance. Understanding what the Flemish attempts to shift the fiscal problem into Walloon political territory would mean for fiscal consolidation in Belgium as a whole requires clarifying what kind of options this strategic turn on the Flemish side left open for Walloon political actors. Two questions need to be answered. One is why the Walloon counterpart to the negotiations agreed to the state reforms of the late 1980s. Constitutional changes like this require the support of at least half of the members of parliament from each linguistic community (Anderson et al. 2007). The Walloons could,

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<sup>121</sup> The starting amount of the total funds was based on the spending on these functions when the agreement was reached. With time, the amounts would be indexed – first to the consumer price index and after a transition period to the growth rate of GDP. The repartitioning keys for these funds were fixed and would only change subject to changes in the number of students in the communities and the regions' contribution to total tax revenue. This repartition of funds between the federal and subnational levels was to be phased in over ten years.

therefore, have vetoed the Flemish Christian Democrats' plans. The other important question is what this regional separation of funds really meant for the distribution of fiscal sacrifices and what kind of pressures would arise for Walloon policy makers from the regional separation of the social security sector. After all, in and of themselves, the reforms of 1988 and 1989 amounted to little more than book keeping adjustments. Given the soft budget constraints of sovereigns, limiting the funds to one region does not necessarily have to lead to a significant tightening of policies there. Wallonia could borrow and secure funding for its spending from external resources. Therefore, the consolidated debt of the general government could continue to grow and threaten the fiscal stability of the country, even if the problems showed up in the 'books' of a sub-national, rather than the federal entity.

The two questions are interconnected. The *Parti Socialiste* – the Walloon partner participating in the coalition talks of 1987-88 in the course of which the state reform was agreed upon – could afford to agree to the separation of funds exactly because it remained unclear how the reforms would be put into practice, how Wallonia could be prevented from spending beyond its means and how much flexibility there would be in the future to renegotiate the terms of the deal. After all, nothing was irreversible in the agreement. Taxes were still levied and collected by the federal level, so the renegotiation of the key for allocating funds would remain technically possible in the future. Therefore, the sacrifice entailed in the agreement with such changes was uncertain.

Moreover, the Walloon Socialists got two very important concessions in return for agreeing to the devolution. The first was the revalorization of all transfers and public servant pay-scales (Covell 1993, Callatay 2002). The postponement of indexation of social security benefits and public sector salaries throughout the 1980s eroded the incomes of large parts of the Socialist constituencies. Restoring the purchasing power of these incomes to their earlier levels was a very important achievement for the party. The second concession concerned the securing of stable funding for education, independently of Wallonia's tax generating capacity. The drastic fall in the availability of funds for education throughout the 1980s had been a major preoccupation of Walloon Socialists (Fitzmaurice 1996). In other words, the Flemish Christian Democrats made quite significant pecuniary concessions to their Walloon Socialist counterpart for the sake of putting into place the first steps towards the constitutional separation of fiscal and social security matters. They were even willing to compromise

on the efforts to rein in public debt, by consenting to higher transfers and public salaries.

At the same time, what the institutional changes would mean for Belgian public finances in the longer term hinged on the enforcement of fiscal constraints on the Walloon side. If the decreased funding turned out to be a binding constraint, it would assign a large share of the sacrifices needed for fiscal stabilization to Wallonia and might even create more readiness for welfare retrenchment on the Walloon side. In this case, the quest of the Flemish Christian Democratic Party to offload the costs of stabilization on the Walloon population might even be fiscally beneficial for Belgium as a whole, because it would lead to consolidation in a situation in which persistent cross-class conflicts had blocked other solutions.

The state reform did create a mechanism to make the fiscal constraints binding. It instituted an oversight committee, the so-called Public Sector Borrowing Requirement Section within the High Council of Finance to keep the deficit of each region, community and the federal level under control. Since this body had the right to initiate suspending any entities' right to borrow for two years, the constraints created by the new partitioning of funds could in principle be enforced on the Walloons (IMF 1998 and 2003). At the same time, this committee comprised of representatives of the federal, regional and community governments as well as the central bank. Therefore, it was essentially a political question – subject to the negotiations of these political actors – whether and how this right would be exercised to restrain spending and borrowing in each region.

In sum, the efforts of the Flemish Christian Democrats to redefine the fiscal problem as a conflict between Flanders and Wallonia rather than one between classes yielded some very important results by the end of the 1980s. In view of the political deadlock that had prevented progress in dealing with the snowballing of debt for most of the 1980s, the creation of an institutional framework that could be used to tackle the problem from a new dimension was a promising development. In the new framework, the resolution of the problem depended on the willingness of Flemish political forces – first and foremost the dominant Christian Democrats – to use their electoral preponderance and their position in the new oversight committee to force the Francophone community and the Walloon region to fit into the constraints defined by their decreased funding. The struggle over how to resolve Belgium's daunting debt

problem was now ready to start again, with fundamentally rearranged coalitions of societal interests on two sides of the front.

## **Conclusion**

Throughout the 1980s, Belgium was fighting a losing battle against debt accumulation. Despite astonishing expenditure cuts and increasing primary surpluses, the government could not stop borrowing, because savings were always a step behind the growth of the interest burden on outstanding debt. This chapter showed that the government's efforts were hamstrung by its inability to consolidate the social security system, which had been destabilized by the oil shocks of the 1970s. Since organized labour and business took intransigent positions on benefit cuts and payroll taxes, the government was unable to tackle the deficit of the system, even though it was an enormous drain on public finances. The prolonged conflict between labour and business over the social security issue contrasted sharply with the unified support of Flemish labour and business for austerity in public consumption. In view of the impossibility of resolving the stalemate between labour and business over the issue, the Flemish political elite attempted to open up a new front to tackle the issue. At the end of the decade, it made a great step forward in creating the institutional preconditions for separating the funds between the two halves of the country and redefining the fiscal issue as a conflict between the Flanders and Wallonia.

The enduring conflict between influential labour and business groups in Flanders over social security explains not only the inability of successive governments to halt debt accumulation throughout the 1980s, but also the lopsided pattern of adjustment that was put into place: the contrast between strict austerity in public consumption and investment and the widening gap in the social security budget. Observers often pointed out this asymmetrical pattern (IMF 1998, European Economy 1993, Reynders 1993), but hitherto no explanation had been offered. The irresolvability of the profound societal conflict over social security also helps to better understand the progressive intensification of the economic dimensions of the regional cleavage, which first became the main axis of the conflict over the issue of how to restore the balance of the system around the end of the 1980s.

The next chapter presents the fiscal trajectory of the 1990s and 2000s and evaluates the effect of the euro-accession and the Maastricht criteria on policies in Belgium. It

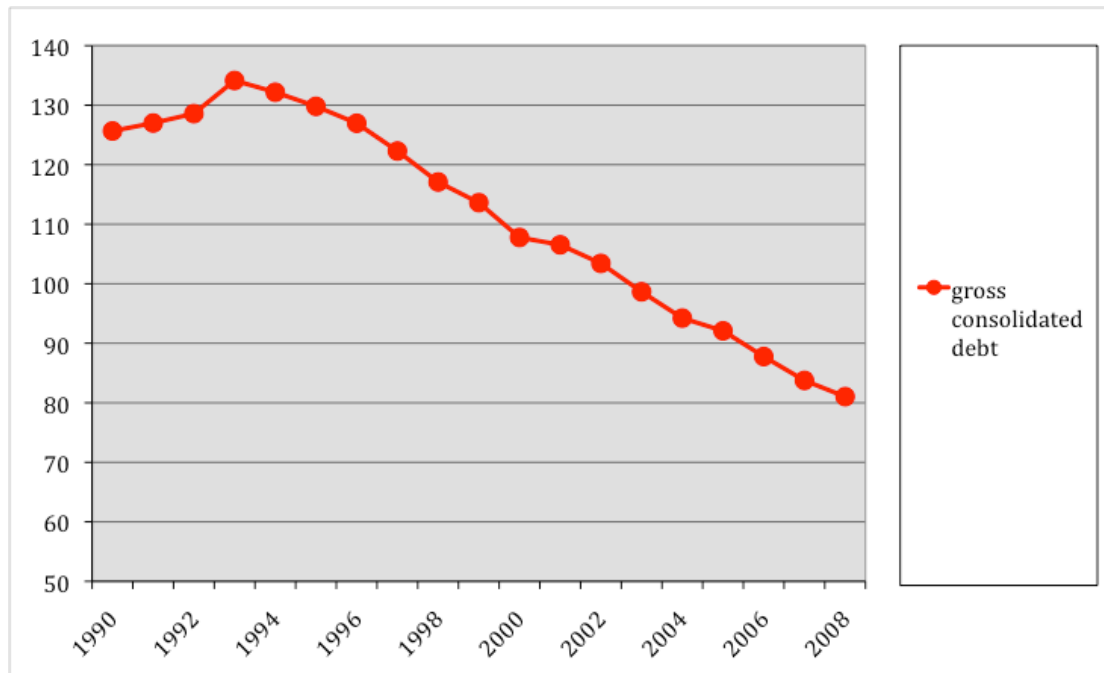
shows that the sustained austerity efforts of the 1980s finally bore fruit in the 1990s, when interest rates charged on Belgian government debt fell precipitously. Thanks to the sizeable primary surplus that sustained cuts in collective consumption and investments had generated, Belgium could take full advantage of the easing of pressure from interest costs and rapidly decreased its debt-to-GDP ratio. However, the chapter also underlines that this improvement was not connected to a policy change induced either by the euro accession or by the adoption of the Maastricht criteria. The strengths and weaknesses of Belgian fiscal policy remained essentially the same: remarkable determination at controlling and restraining discretionary spending still stood in sharp contrast with the lack of adjustment in the fundamentally unbalanced social security sector. The chapter contends, that Maastricht's effect on the politics of fiscal policy making in Belgium was in fact negative. The need to comply with the fiscal criteria in time for accession delayed the resolution of the social security question, because it set back Flemish efforts to reallocate the responsibility for fiscal austerity to Wallonia. Therefore, the issue that had such dire consequences for Belgian public finances in the 1980s lives on, albeit it has so far been much more affordable under the more clement market conditions.

## **Chapter 6.**

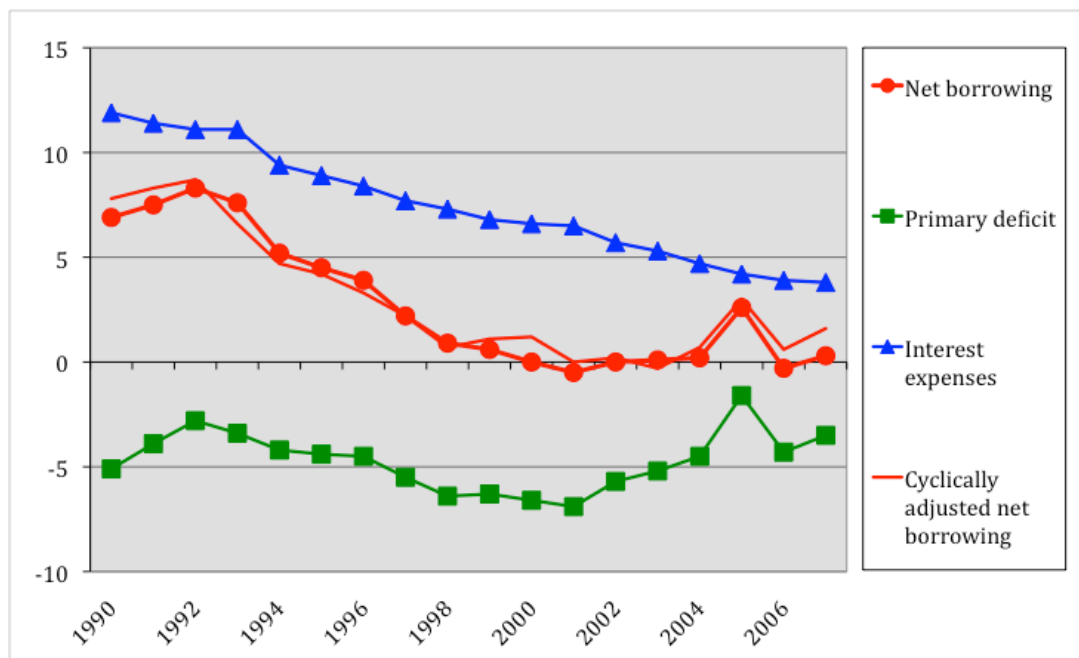
### **The undeserving poster child? Fiscal relief and persistent problems in Belgium after Maastricht**

If the 1980s were a fiscal nightmare for Belgium, the 1990s and the 2000s represented the awakening from the bad dream. The country's debt – which had relentlessly grown from the mid-seventies to the early nineties despite ever-stricter austerity – started to decrease steadily and rapidly. The debt-to-GDP ratio peaked at 134 per cent in 1993 and then descended to 84 per cent by 2007, before the banking crisis and the global economic downturn paused this favourable trend (see Figure 6.1). The interest-debt spiral that successive governments were unable to stop in the eighties reversed itself when interest rates on outstanding debt dropped. Two thirds of the interest burden evaporated from the early nineties to the late 2000s. Net borrowing steeply decreased, reached zero by 2000 and stayed firmly there until the crisis hit, except in 2005 when the state bailed out the national railway company (see Figure 6.2). Belgium seemed to have put its fiscal troubles definitively behind itself. It fulfilled the Maastricht deficit criterion comfortably in time for accession with the first group of countries and – in contrast to many other euro-members – consistently kept up its fiscal discipline even after it joined the Economic and Monetary Union. From the fiscally most troubled country of the entire developed world, it graduated to being the poster child of fiscal discipline in the eurozone. This chapter analyses the policy trajectory underlying this remarkable improvement and investigates whether, how and why the politics of fiscal policy making changed in this period.

**Figure6. 1 - Gross consolidated debt general government (1990-2008)**  
per cent of GDP  
Source: Belgian Statistics Office



**Figure6. 2 - Net borrowing, cyclically adjusted net borrowing, primary deficit and interest expenses (1990-2008)**  
per cent of GDP  
Source: Belgian Statistics Office



Scholarly accounts of policy making in Belgium in the 1990s depict the period as one of important breakthroughs. They argue that the euro-accession and the need to comply with the Maastricht deficit criterion helped to resolve long-standing problems. They underline that the common goal of joining the common currency with the first group of



countries forced different actors involved in policy making to set aside their conflicts, which had interfered with efficient policy making in the past. In explaining the improvement in fiscal results, Hallerberg (2004) contends that the urge to satisfy the Maastricht deficit criterion in time made possible the adoption and effective operation of a range of budgetary institutions that helped the representatives of different electoral constituencies to reach and enforce agreements about spending<sup>122</sup>. He argues that since the electoral relevance of fiscal balance became enormous in the run-up to the euro, policy makers both at the federal and at the regional level had a strong incentive to make and enforce binding commitments. Therefore, they put into place mechanisms – most importantly by strengthening the consultative and oversight functions of the High Council of Finance – that allowed for setting and monitoring targets for different federal and regional spending actors, thereby restoring spending discipline. Pochet (2004), on the other hand, concentrates on issues involving conflicts of interests between workers and employers. He invokes the *vincolo esterno* argument to contend that the euro-accession made it possible to carry out long-overdue policy reforms in certain areas, because the overriding interest in joining the single currency area forced unions and employers' organizations to resolve their differences. He argues that the accession process thus opened up new political opportunities to tackle previously intractable problems in various fields.

This chapter gives a much less optimistic interpretation of how the euro-accession and the Maastricht deficit criterion affected the political context of fiscal policy making in the 1990s. It agrees with the above authors that the need to satisfy the conditions for participating in monetary integration left no room for disagreement either between Flanders and Wallonia or between labour and business. Successful accession depended on the cooperation of political actors across the regional and class divides. However, it contends that the fundamental conflicts of interests that had undermined efforts to regain control over the country's indebtedness in the 1980s were not resolved in the run-up to the euro. Instead, they were put on ice, while policy makers concentrated on the euro-deadline. Keeping these conflicts dormant implied that crucial policy issues at the heart of these conflicts had to remain untouched. The previous chapter has shown that the imbalances in the social security system had been the main driver of debt growth as well as the most important source of contention between societal groups across both the class and regional divide in the 1980s. These imbalances were allowed

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<sup>122</sup> On budgetary institutional changes introduced in the run-up to the euro and their effect on compliance with the Maastricht deficit criterion, see also Bogaert et al. (2006), Stienlet (1999), Reynders (2002), IMF (1998 and 2003).

to worsen in the years after Maastricht. Changing the social security system would have been a too risky undertaking at a time when it was of paramount importance to secure all political actors' assistance in getting the headline deficit figures right for the euro-test. The issue was shelved until after the euro-accession. Thus, Maastricht retarded, rather than facilitated the resolution of this fundamental structural problem in public finances, by suppressing social conflicts and deferring their resolution. Under favourable financial conditions, this delay in resolving the social security issue has not stopped Belgium from reversing the explosive debt path of the 1980s, given its sustained success in controlling discretionary spending. However, significant problems in social security exist up to the present day and interregional conflict over this issue is currently causing massive problems in putting together a workable government. In this sense, the effect of the fiscal criteria of Maastricht were detrimental, rather than helpful.

In the regional conflict over social security, the race for the euro enforced a decade-long suspension. By the early 1990s, significant institutional reforms were in place that provided considerable means to politically and economically dominant Flanders to force Wallonia to bear the costs of consolidating the social security system. However, the balance of power changed with Maastricht, because Flanders became dependent on the cooperation of Wallonia in the quest for euro-compatible fiscal figures. Regional fiscal autonomy that was meant to shift the burdens of austerity to Wallonia became a liability to Flanders, because it dispersed control over the general government deficit figures across the different levels of government. Since dynamic and export-oriented Flanders had a much greater stake in participating in the common currency from the start than stagnant and state-dependent Wallonia, the deficit criterion gave an important political trump card to the latter. As a consequence, regional conflict over social security was put on ice and the Flemish even made fiscal concessions to the Walloons, in order to facilitate agreements on fiscal targets each year in the run-up to the euro. The social security issue was next taken up with more than a decade of delay, only after successful euro-accession and the *de facto* demise of fiscal rules in the EMU freed Flanders from having to show restraint towards Wallonia.

In the conflict between labour and business over the consolidation of social security, the need to comply with the deficit criterion had a less tangible negative effect, because the chances of a breakthrough had already been rather low before Maastricht. The 1980s had demonstrated that the headline deficit figures were possible to drastically

adjust even in the absence of significant cuts to welfare entitlements or significant increases in the fiscal pressure on business. Therefore, even though both labour and business had a crucial stake in international competitiveness and in early euro-accession, neither had a major incentive to make sacrifices in the social security question. When the Christian Democratic-Socialist coalition government of the early 1990s proposed changes to the system of unemployment and pensions, both unions and employers' organizations resisted the initiative. Given that government stability was crucial to producing the budgetary figures needed for the euro-test, neither coalition partner was interested in escalating the situation. The government remained unshaken by the fiasco and found alternative ways to cut expenses and raise revenues. Throughout the decade and the one to follow, no new reforms of the social security system were proposed.

In sum, the need for fiscal convergence delayed effective consolidation of the social security sector in both the interregional and the class context. In this sense, the structural problems of Belgian public finances remained the same. The large deficit of the social security system has even widened in the past two decades due to changes in demographic and economic conditions. At the same time, the structural strengths – primarily the strong political will to rein in discretionary spending – have also persisted and allowed Belgium to cross-finance the social-security deficit and erode its debt level at the same time, once the interest burden on the budget exogenously decreased.

It bears explaining how this chapter can draw conclusions about the political and policy effects of Maastricht that are in such pronounced contrast to the work of previous scholars. The root of the difference lies in the theoretical approach applied here. This chapter seeks to explain the observed policy trajectory by investigating the interests, incentives and constraints of different societal groups in the struggle over who should pay for the lasting consolidation of public finances. Therefore, it explores the effects of the euro-accession on policy choices in light of how they influenced the strategic opportunities of each group. This approach questions the implicit assumption of the theories that see Maastricht as an unambiguously positive influence on domestic policy making. These arguments consider early euro-accession a national imperative, which helps to silence the particularistic squabbles and provides strong incentives for sorting out long-standing policy problems. This chapter points out, however that early euro-accession was not equally important for every group in Belgium. Flanders had a much

greater stake in it than Wallonia. Therefore, the need to cooperate for the sake of producing the right headline figures constrained Flanders' room for manoeuvre while giving a breather to Wallonia. Furthermore, the resolution of long standing policy problems – such as the long-term structural consolidation of public finances – was not a precondition for entry to EMU<sup>123</sup>. Therefore, even though the stakes of early entry were equally high for business and for labour, they provided no incentives for painful compromises in the social security issue.

The rest of the chapter lays out this argument in three steps. The next section shows that – in line with the expectations of the *vincolo esterno* argument – the first political reaction to the Maastricht challenge was an attempt to cobble together a social pact to find a “global” solution to the country's structural problems, whereas the second was the restoration of consensus in fiscal relations between the Flemish and Walloon community via concessions to the Walloon side. However, the former failed, whereas the latter could only be achieved through the agreement of one actor – the federal government – to bear all the burdens of austerity. The third section shows that the failure of the 1993 “Global Pact” drove home how hopeless it was to find a solution to the social security issue via a compromise between labour and business and political actors gave up on pursuing such a solution. The interregional conflict, on the other hand, was opened up with renewed intensity after the country acceded to the euro. Conflict over this issue culminated in the years since 2007. The fourth section uses the insights of the war of attrition model to account for the way the interests and strategic position of different societal interest groups led to these outcomes. The last section concludes.

### **The Maastricht moment: opportunity or constraint?**

When the decision about the creation of a monetary union in Europe was made and the conditions for countries wishing to participate were adopted at the end of 1991, Belgium was in worse fiscal and monetary shape – and therefore farther away from meeting the relevant criteria – than almost any other country. The proportion of net borrowing and outstanding debt stock to GDP was more than double as high as the 3 per cent and 60 per cent limits stipulated in the Maastricht Treaty. Inflation had risen at the end of the 1980s and the country experienced problems with keeping parity in

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<sup>123</sup> For a critical assessment of the discrepancy between numerical criteria and the structural stability of public finances, see for example Easterly (1999).

the European Monetary System in the early 1990s (Pochet 2004 p207, Kuipers 2005). The large reductions in borrowing and inflation achieved in the mid-1980s were set back by 1990 as fiscal matters took a back seat behind interregional issues. In the course of government formation in 1988, the Flemish Christian Democratic party made large concessions to its Walloon Socialist coalition partner in exchange for important institutional reforms concerning the distribution of public funds across the different regions of the country. Social security transfers and wages in the public sector were corrected for the effect of cumulative inflation for many years back to please Socialist constituencies, eroding some of the results of previous years of austerity and monetary discipline (Callatay 2002).

At the same time, few countries could have afforded missing the first round of accession less than Belgium. Early accession was vital both because of the country's exceptional openness to trade and because of its exceptional indebtedness. Sharing in the benefits of permanent exchange rate stability and the elimination of transaction costs with the country's main trade partners was central to maintaining international competitiveness. It was a question of life and death for the Flemish economy, where the share of exports reached over three quarters of the gross regional product by the mid-1990s, imports were of the same order of magnitude and both were expanding faster than the regional economy<sup>124</sup>. For Wallonia the issue was less dramatic, since exports accounted for a third of the gross regional product and an even smaller share of the total income, given that the Walloon population was a net recipient of transfers from the federal funds (Reynders 2002). From the perspective of debt-management, the euro-deadline and the possibility of joining a 'stability community' safeguarded by fiscal rules was an unmissable chance to gain credibility for fiscal discipline in the eyes of the financial markets and convincing them to charge a lower risk premium on Belgian debt. With outstanding debt exceeding 120 per cent of the GDP and an interest bill above 11 per cent of the GDP, foregoing the opportunity to decrease the debt burden would have been a luxury.

While the task facing policy makers was truly daunting, the stakes involved seemed to create an unparalleled opportunity to deal with the alarming fiscal problem. In the decade preceding Maastricht, a series of governments had been fighting to stem the accumulation of debt, but their efforts were frustrated by the resistance of organized

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<sup>124</sup> For regional trade data in the 1990s, see the Belgostat website <http://www.nbb.be/belgostat/PublicatieSelectieLinker?prop=treeviewArch&LinkID=621000016|520000068&Lang=E>.

labour and business to the benefit cuts and tax increases that would have been needed to eliminate the huge deficit in the social security system. Simultaneously, the austerity in other areas of spending intensified conflicts over the geographic distribution of funds for collective consumption and investment between the two linguistic communities of the country. Euro-accession was an objective that had the potential to elicit compromises in both types of conflicts. Labour and business – especially of Flemish labour and business, which had played a pivotal role in the battle over social security in the 1980s – shared a crucial interest in the competitiveness aspect of the common currency, whereas Flanders and Wallonia were equally interested in getting rid of some of the interest burden, which at the time was eating up more than a tenth of the gross domestic product and more than a fifth of total expenditure. However, the need to compromise for the sake of the common goal did not eventually work in favour of the long-term resolution of their conflicts.

*The attempted breakthrough in the labour-business deadlock over social security*

The dominant party in the government, the Flemish Christian Democratic party was keen on seizing the opportunity to forge a voluntary compromise between labour and business in the social security question. The stalemate over this issue in the 1980s had been a major headache for the party not only because it created a huge policy problem for the governments it led but also because it was a constant source of tension between the two halves of its cross-class electoral base. By the early 1990s, its business constituencies were increasingly turning their backs on the party and flocking to the (Flemish) Liberals, but the Christian Democrats were unable to win them back without alienating their labour section (Fitzmaurice 1996). The Maastricht moment and the imperative of maintaining competitiveness at a critical juncture of European market integration seemed the perfect excuse both to ask labour for major sacrifices and to spare business from payroll tax hikes. In this exceptional moment, even the coalition with the Socialists seemed more an asset than a liability for retrenchment in the social security sector. It would have been very difficult for the Socialists to protest violently against a plan that was to ensure early euro accession. Their acquiescence, on the other hand, allowed for engineering a 'Nixon goes to China' scenario.

In the second half of 1993, the government announced a 'Global Pact on Employment, Competitiveness and Social Security'. It was presented as a historic compromise between labour and business at a time of great crisis and at an important turning point

in (economic) history<sup>125</sup>. It contained plans to reform the structure and administration of the social security system, to make it more selective, to limit expenditures and thus to restore the system's financial balance. It was especially in the field of unemployment benefits that substantial retrenchment of entitlements was to take place. Simultaneously, the plan proposed to decrease social security contributions on specific types of employment in order to decrease the costs of labour for business (Kuipers 2005 Ch5, Marier 2008 p89).

The plan turned out to be a miscalculation though. The crisis-discourse of the government did not soften labour enough for such an unbalanced 'compromise'. Unions rejected the Pact. Even though they had been involved in preliminary bargaining, their demands were left out of the final proposal presented to the public and the leadership was coming under increasing pressure from the rank and file for strikes (Kuipers 2005 p97). There was practically no hope that the Pact could be adopted. Christian unions had historically shown willingness to accept sacrifices whenever unemployment figures were truly menacing in Flanders, where most of their members were employed. However, the proposed plans were too unbalanced and the Flemish unemployment figures of the time were not dramatic enough to justify the sacrifices demanded<sup>126</sup>. Asking Catholic union members to show self-restraint under these conditions – especially when the Socialist unions were out on strike – was impossible. The radical Socialist unions would certainly not retreat. Given the large share of Walloon workers within their membership and the permanently high unemployment in Wallonia, defending social security was their main priority.

As the unions went on strike, the Maastricht deadline and the coalition with the Socialists suddenly turned into a major constraint for the Flemish Christian Democrats, who now had no other choice than to back down. They could not afford to risk the breakdown of the coalition over a struggle with the unions at a time when swift action was needed to bring the deficit down from over eight per cent (in 1992) to under three. Even if the Christian Democrats had been prepared for a drawn-out conflict, their Socialist coalition partners were already compromised in the eyes of their labour supporters by their acquiescence in the original proposal and they could not have

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<sup>125</sup> The word 'pact' had only been used once before, in 1944 when the foundations of the Belgian welfare state were laid down. By referring back to this earlier, highly important agreement, the government was symbolically emphasizing the gravity of the moment (Kuipers 2005 p96)

<sup>126</sup> For regional and federal unemployment figures see Dejemeppe-Saks (2002).

possibly stood by any effort to break union resistance to the plan. Therefore, the bold attempt to reform social security had to be abandoned.

The government adopted a 'Global Plan' that was reminiscent of the 'Global Pact' only in its name and introduced only marginal adjustments to social security benefits. At the same time, social security contributions were decreased on several different categories of employment in the exposed sector (IMF 2005). In the following year, plans were discussed to increase the financial viability of the pension system through an increase of the retirement age, higher taxes on the highest pensions and a decrease in civil servants' pensions, but when the unions expressed their disapproval the plan was dropped (Anderson et al 2007 p331, Marier 2008 pp90-24). In the years that remained until the euro accession, no other proposals were put forward. The hoped breakthrough in the social security issue failed to materialize.

In sum, far from helping to resolve it, Maastricht reconfirmed the intractability of the stalemate over social security between labour and business. This must have been a bitter disappointment to the Flemish Christian Democratic leaders. The unbalanced design of the Global Pact they offered to unions clearly suggests that they expected that the case was obvious for large sacrifices from organised labour for the sake of the country's economic future in the eurozone. In fact, they doubly miscalculated. They misjudged not only labour's readiness to make sacrifices, but even employers' interest in a settlement of the social security question. The national employers' organization rejected the Pact from the start – despite the absence of pecuniary sacrifices on business's side – because it deemed that it granted too much influence to the state in the future management of the social security funds (Kuipers 2005 p96). Employers achieved decreases in payroll taxes even without the Pact and it seemed that they were reluctant to make any concessions for the restoration of the fiscal balance of the system.

#### *Compromise in the interregional conflict over the distribution of funds*

The fiasco of the plan to consolidate the social security system and the attendant need to find the savings elsewhere was especially painful for the Flemish Christian Democrats due to concurrent developments in the Flemish-Walloon fiscal relations, which changed the distribution of fiscal pain across the linguistic groups to the disadvantage of the Flemish constituencies. Conflicts over the allocation of funds



available for collective consumption and public investments had grown by the end of the 1980s, as cross-financing the deficit of the social security system had progressively squeezed resources available for such uses. In 1988 and 1989, the Flemish Christian Democrats achieved federal reforms that made sure that the distribution of available funds would be progressively brought in line with the tax-generating capacity of each region. In other words, Flanders would receive progressively more, whereas Wallonia would have to do with less. This would also imply that a progressively larger share of the burdens of 'permanent austerity' arising from the social security problem would be borne by the Walloon population. In the Maastricht moment, the Flemish Christian Democrats had to surrender some of these benefits they had previously secured for their region.

The federal reforms of 1988-89 devolved decisions over more than forty percent of the funds to the subnational level (IMF 2003). In the context of Maastricht, this meant that the quest for the deficit target was doomed to failure unless all federated entities coordinated their plans, agreed on the contribution of each to the needed improvement and – most importantly – stuck to the pre-agreed targets. The reforms had created a forum for organizing such matters, but it had been left open how coordination would work in practice. The so-called Public Sector Borrowing Requirement section of the High Council of Finance – made up of the representatives of the federal government, the regions, the communities and the central bank – was a consultative forum for setting fiscal targets. In principle, it also had the power to penalize non-compliant subnational governments by suspending their right to borrow (IMF 1998 and 2003). However, passing such a resolution would inherently be very difficult politically, because it would imply all-out conflict between the two linguistic communities of the country. Short of a determination to succumb into such conflict, there was no way in which any federated entity – or the federal government itself – could be forced to submit itself to the targets set by the committee. The fiscal results of the year right after Maastricht highlighted the weakness of the system in terms of coordination and enforcement. In 1992 all entities exceeded their targeted deficit figures and the deficit of the general government was more than a percentage point higher than planned (Hallerberg 2004).

Due to the ineffectiveness of the institutional enforcement mechanism, the risk of defection was built into the system. It was especially unlikely that the Francophone community and the Walloon region could be readily convinced to cut back on its deficit.

The laws of 1988-89 that regulated the distribution of federal funds stipulated that these entities would be increasingly underfunded and therefore it would require increasing effort from them just to keep their deficits stable (IMF 1998 and 2003). The position of the Francophone community was made all the more difficult by the upgrading of the public sector pay scales at the end of the 1980s, since more than 80 per cent of the community's budget was wage costs (IMF 1998 and 2003). Cutting its deficit would inevitably involve firing public servants – a politically highly dangerous move in a region where unemployment was more than double the national average. The Flemish side was initially also underfunded. However, since the community and the region were merged – unlike on the Walloon-Francophone side – it had much greater flexibility in the allocation of the funds it was entitled to. Furthermore, it was to receive ever-larger sums as time went by (IMF 1998). Therefore, Wallonia and the Francophone community would need to make much greater sacrifices than Flanders, if each federated entity was asked to make 'equal' contributions to the reduction of the general government deficit for the sake of reaching the Maastricht target. This would have been politically completely unacceptable in Wallonia, especially as it had a much smaller stake in early euro-accession than Flanders.

Under different circumstances, the Flemish Christian Democrats – who represented both the federal and the Flemish government in the Public Sector Borrowing Requirement committee – might have taken an intransigent stance over the fiscal discipline of each federated entity. After all, the agreement of 1988-89 over the division of funds was meant to assign larger responsibility for fiscal adjustment to Wallonia and the Francophone community. However, given that the deficit had to be cut drastically in very limited time, the urge to achieve every decisive actor's cooperation won out. In 1993, the so-called St. Michel agreement increased the funding available to communities – at the expense of the federal level – allowing the Francophone community to postpone dramatic expenditure cuts into the indefinite future (IMF 2003). Furthermore, the Walloon region and the Francophone community were allowed to run deficits throughout the 1990s, which were offset by increased efforts at the federal level and after 1995 – when the funds available to Flanders had increased sufficiently – in Flanders (Savage 2002).

The concessions given to the Walloon side in the Maastricht moment largely freed Wallonia and the Francophone community from the extra constraints that the federalizing reforms were to place on their spending. Paradoxically, this also meant

that some of the expenditure items that had suffered great cuts in the 1980s – such as education or transport – were now exempted from further austerity, because they were under the control of regional or community authorities that were treated leniently when the contribution of each federated entity to stabilization was determined. Therefore, the burden of austerity on the federal level – where it affected both the Flemish and the Walloon population equally – was even higher than before. These developments represented a setback to Flanders in its redistributive conflict with Wallonia.

### *The fiscal consequences of Maastricht*

Since the social security system was not consolidated and the compromise deal between Flanders and Wallonia exempted many items from further spending cuts, the federal government resorted to what it had been most successful at in the 1980s: ensuring strict control over discretionary expenditure and complemented this with largely one-off measures to increase revenues. Fiscal efforts to achieve the necessary convergence to the Maastricht target were composed of a mixture of expenditure cuts, limited revenue increases and several one-off measures achieved at the federal level. The marginal changes the 'Global Plan' of 1993 introduced to social security spending included a reduction of the highest pensions and a one per cent solidarity tax on the highest early retirement benefits. The 'Global Plan' also increased VAT by a percentage point, raised the rates of excises on alcohol, tobacco and energy and introduced a new real estate tax. One-off measures included the sale of the central bank's gold reserves and privatization (IMF 2005, Kuipers 2005 Ch5, Marier 2008 pp89-90).

The consolidation achieved by these measures in the run-up to the euro was much smaller than the headway made in stabilization in the 1980s. While in the 1980s, the primary balance was improved by more than twelve percentage points of the GDP, the adjustment between 1992 and the launch of the euro in 1999 was less than four percentage points. However, in the 1990s the external financial environment was much more benign. While the constant growth of interest rates persistently frustrated the government's enormous efforts to restrain borrowing in the 1980s, their sharp drop drove consolidation despite the more modest adjustment in the primary surplus in the 1990s. The credibility-effect of the euro-deadline worked and the interest burden quickly melted away as the rates charged on the outstanding debt stock dropped. Between Maastricht and the date of the euro-accession, interest expenditure decreased

by five percentage points of the GDP, greatly helping Belgium to meet the deficit criterion in time.

The positive exogenous effect of changes in the financial market sentiments and renewed efforts in spending control counterbalanced the policy paralysis in the social security issue fuelled by Maastricht. By the time the euro was launched in 1999, the budget was practically out of the red and debt was down to a level last seen in the early 1980s. After more than twenty years of continuous fiscal emergency, Belgium was freed from the interest-debt spiral. However, its high level of debt and the large deficit of social security continue to make the country vulnerable to exogenous changes. Therefore, the next section investigates the progress made in resolving these issues in the decade since the euro-accession. It explores the political context of fiscal policy making in order to see how the legacies of the Maastricht-moment influenced the country's ability to deal with its redistributive conflicts and its structural fiscal problems.

### **The changing dimensions of the social security problem since the euro-accession**

Belgium's accession to the EMU not only signalled the end to the Belgian franc, it also stood for the end of a political era. In 1999, the Christian Democrats fell out of government for the first time in four decades, the Liberals headed the new government for the first time since the war, and fringe parties like the environmentalists and the extreme right Vlaams Blok/Belang captured respectable shares of the total vote. This section suggests that the simultaneity of the political sea change and the end of the race for the euro might be more than a coincidence. It argues that the conflicts and compromises of the Maastricht moment made explicit the changes that were latently underway in the constellation of coalitions of societal interests since the second half of the 1980s. The failure of the 'Global Pact' definitively drove home the futility of insisting on finding a solution to the labour-business conflict over the social security issue, whereas the forced compromises between the Walloon and Flemish regions and communities made clear the stakes involved in the interregional conflict over public finances. The end of the forced cooperation allowed these underlying societal changes come to the surface and lead to the dramatic political transformation.

The political changes emanated from Flanders, but they had far-reaching consequences for the politics of redistribution at the federal level and in the Flemish-Walloon context, too. The essence of the change was that class conflict lost much of its importance in structuring political competition in Flanders. Instead, the ability of parties to represent their constituency in the interregional conflict gained larger significance. The project that was started in the second half of the 1980s by the Flemish Christian Democratic party to redefine conflicts and commonalities of fiscal interests between its own constituencies and groups outside of Flanders now bore fruit. However, the party itself could not reap the benefits. Its role in the Maastricht intermezzo as the self-appointed broker of compromises – and the elicitor of painful sacrifices – in the labour-business conflict as well as its readiness to make concessions to the Walloon side undermined its image as the defender of Flemish (labour and business) interests. Even though it managed to secure early euro-accession, which was so crucial to its constituencies, the price it paid became more important than its accomplishment once the country was safely inside the EMU.

The Flemish Liberals were able to present themselves as better Flemings. They rebranded the party and created a strong nationalist and populist appeal for it (Jones 2005 p205). The rise of the Liberals and the backsliding of the Christian Democrats in Flanders was also facilitated by the electoral strengthening of the Flemish nationalist Volksunie and Vlaams Blok, who scored record votes amongst themselves, further underlining the increased importance of the regional divide over class conflict. The Christian Democrats responded to these challenges by further strengthening their Flemish identity and distancing themselves from their role as brokers in the labour-business conflict. They progressively weakened their political and organizational ties to the Catholic unions, adopted a new name, which – unlike the earlier one – explicitly had the word “Flemish” in it, and entered into electoral cooperation with one of the successor parties of the nationalist Volksunie, the New Flemish Alliance (Jones 2008 p218). The other half of Volksunie, Spirit joined the Socialist party. Now all the major parties in the Flemish electoral sphere showed strong regionalist traits.

Due to the diminishing significance of class conflict, the Liberals were able to form a coalition with the Socialists after they won the 1999 national elections. The previously contentious welfare issue ceased to stand in the way of a coalition agreement. The Liberals – who had pushed so ardently for welfare retrenchment in the early 1980s – seemed to have lost interest in downsizing reforms. They only passed one reform

explicitly dealing with the sustainability of the social security system, but it did not require sacrifices either from labour or from business. The Vandebroucke law of 2003 created the legal framework for a company funded secondary pension pillar, but the system is not mandatory and does not have any implications for the state's pension expenses (Marier 2008).

The Christian Democratic-Liberal-Socialist coalition that took over in 2007 also refrained from addressing the imbalances of the social security system. The issue seems definitively off the agenda despite warnings that the first budgetary effects of aging would kick in as early as 2011<sup>127</sup>. In order to address this question, the Liberal-Socialist coalition created the so-called Silver Fund in 2001 to pre-fund the expected increases in pension expenditure. Budgetary surpluses that were expected arise in the future with the continued fall in the interest rate expenses were to be set aside (Marier 2008). However, these surpluses never materialized and the filling up of the Silver Fund has been behind schedule ever since its creation, because the windfall gains have been used to finance tax cuts and the expansion of spending (IMF 2005).

In contrast to the revealed lack of interest in consolidating the national social security system, the issue of splitting it up and ending the flow of funds between the two halves of the country received increasing attention after the involuntary suspension of the conflict in this dimension during the 1990s. The issue had been dormant since 1993, when a constitutional amendment sealed the institutional reforms put into place in the late 1980s without tackling further separation of funds or the social security issue. In 1996, the Christian Democratic-led Flemish government released a document signalling its intention to launch a new round of state reforms, but this was not followed up by any concrete action (Beland and Lecours 2008 p176).

New developments came only after the entry into EMU. Initially, they concerned adjustments in the distribution of existing taxes and a gradual broadening of the fiscal autonomy of the federated entities. In 1999, the St. Eloi agreement corrected the allocation rates of VAT and personal income taxes so that Flanders would get more of the income taxes – reflecting its higher tax-generating capacities – in return for higher VAT receipts going to the Walloon side. The 2001 Lambermont agreement, on the other hand, increased the proportion of revenues over which the regions and communities have total autonomy and allowed the regions to set rates and grant exemptions for a

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<sup>127</sup> See for example Public Finances in EMU 2005.

range of taxes (IMF 2003). Obtaining the (limited) right to grant specific exemptions and to lower tax rates was an especially important achievement for Flanders, because it was a first step towards gaining the ability to reduce the fiscal pressure on the Flemish population independently of Walloon concessions.

At the same time, these compromises failed to tackle the real issue of redistribution, which takes place via the social security system. In 1999, the Flemish Parliament made a strong statement for more substantial institutional change calling for the federalization of health insurance and family allowances. It was supported by a strong majority of Flemish parliamentarians, with practically all the large parties voting yes (Beland and Lecours 2008 p177). However, putting into place such changes is technically difficult because of the strong parafiscal character of the Belgian social security system. Funds are financed by a range of specific contributions and they are managed by the social partners. Therefore, splitting up the system necessitates a whole series of institutional reforms: the abolishing of the authority of social partners over health care and family allowances and the shifting of financing from contributions to taxes. Such reforms require the cooperation of the social partners and the agreement of Walloon political actors.

Perhaps surprisingly, securing the cooperation of the social partners proves to be a manageable challenge. Even though all the social partners have a strong institutional interest in retaining their central role in the administration of funds, political motivations make the Catholic trade unions and – to a smaller extent – the employers' organization amenable to accepting the changes proposed by the Flemish Parliament, leaving the Socialist unions isolated in this question. The political realignment – away from class conflict towards regional conflict – has made its impact felt even in the world of social partnership. The Catholic unions support the devolution of health care and family allowances to the regional governments in order to please the Flemish majority of their membership. In the national employers' organization, the balance of power is more equitable between Flemish and Walloon businesses, but strong competition from an alternative Flemish business organization motivates the national organization to be more attentive to the interest of the former. Flemish members want a cheaper, leaner health insurance and family support system, and their interests overshadow the fears of the Walloon members about having to finance the Walloon system on their own. The Socialist unions consistently oppose the proposed reforms due to their strong Walloon membership and due to their political ties to the Walloon Socialist party. However, they

are not strong enough on their own to put up meaningful resistance (Kuipers 2005 Ch5, Beland and Lecours 2008 pp181-187).

On the other hand, the resistance coming from Walloon political actors is formidable. Due to constitutional rules that ensure that major decisions are based on a consensus between the two linguistic communities, the Walloon side has a veto on further devolution (Anderson et al. 2007). In the case of splitting the social security system, the veto is sure to be applied. The interregional transfers increase the per capita disposable income of an average Walloon household by more than eight per cent (Caruso 2002). No political actor in Wallonia can agree to reforms that potentially lead to giving up these funds on any time horizon. Consequently, Flemish intransigence on this issue threatens with major political crisis and – ultimately – even the breaking up of the Belgian federation altogether.

It was perhaps because of such risks, but the matter was not seriously brought up under the Liberal-Socialist governments between 1999 and 2007. The Flemish Christian Democrats, however, decided to make it a key issue for coalition talks, when they won the 2007 elections in cartel with the nationalist New Flemish Alliance. The question has been at the centre of political struggles<sup>128</sup> more or less continuously ever since and there is no end in sight. The coalition formation after the 2007 elections took a record nine months, as the parties involved were unable to compromise on the question of state reforms. Finally, they formed a government in the absence of an agreement and postponed the resolution of their differences. When this failed, the New Flemish Alliance withdrew its support from the government, which fell soon after – incidentally over a matter unrelated to state reform – and was replaced with a caretaker government. The 2010 elections brought an astonishing victory to the New Flemish Alliance – now running alone – suggesting that the issue of state reform has tangible electoral traction in Flanders. The emergence of the New Flemish Alliance as the largest party in the country triggered a new crisis and led to a coalition formation process that broke the record of 2007 by keeping the country without a government for much longer than a year. The question of state reform has practically paralyzed politics since 2007, while a succession of caretaker governments navigate the country through

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<sup>128</sup> Strictly speaking, the range of issues involved in the conflict is broader than just further devolution. A perennial bone of contention between the two communities since the 1980s is the so-called BHV-issue that concerns the – electoral, linguistic etc. status – of a small Francophone enclave in a Flemish-speaking area. This issue plays a role in the current conflict, too.



the dangers of the financial crisis, the economic downturn and the European sovereign debt crisis.

The experience of the past few years and especially the comet-like rise of the New Flemish Alliance clearly show how important the Flemish-Walloon redistributive conflict has become since the euro-accession. This section underlined that the flipside of this development is the complete loss of interest in finding a solution for the large and ever widening deficit of the national social security system in its present form. Political attention is centred on whose problem the imbalances of the redistributive system should be, not how they can be resolved. Arguably, however, as soon as the problem is institutionally assigned to Wallonia, its resolution is likely to come into sight. The region would not be able to persistently borrow from the market the funds that are currently transferred from Flanders. Therefore, Walloon socio-economic groups would be forced to come to an agreement about retrenchment and/or increased fiscal pressure amongst them. In this sense, due to the intransigence of the New Flemish Alliance, Belgium's persistent structural problems with social security might be closer to their resolution than at any time since the late 1970s. While this section has shown the party-political face of the conflict, the next one explains its evolving societal basis and its potential resolution, relying on the war of attrition model.

### **The changing faces of redistributive politics in Belgium: societal coalitions, the war of attrition and the euro**

In the twenty-first century, Belgium is a very different polity from the one it was in the last decades of the twentieth. More than two decades of struggles with intractable fiscal problems redefined commonalities and conflicts of interests between socio-economic groups within Belgian society to an extent that transformed the entire structure of politics. The deep labour-capital cleavage that had been one of the primary organizing forces of the party system and political competition in the post-war era has now completely ceded primacy to regionally focused politics. Redistributive battles are now fought between Flemings and Walloons, instead of workers and businesses. Whereas the institutional reforms of the late 1980s to reallocate authority over locally spent funds might have seemed like a squabble between politicians with little relevance to the electorate, the newest initiative for state reform and for the ending of the flow of funds between the two halves of the country is an issue that decided the latest elections. This section uses the insights of the war of attrition model to explore the

pressures that bore on the different socio-economic groups to reconsider their coalitions with other groups and at the same time evaluates the role of political engineering in the transformation. Finally, it looks at the role of Maastricht and the euro accession in this process.

In a certain sense, the fundamental transformation of Belgian politics was an elite-driven project. It was a result of the struggle of political parties to gain and maintain an edge in electoral competition and reflected the efforts of policy makers to find new ways to attack intractable policy problems. The previous chapter argued that the Flemish Christian Democrats embarked on the first steps of the federalization of public funds in 1988 in order to avoid having to generate further tension between the labour and business groups within their constituencies and in order to find an alternative way of dealing with unstoppable debt growth. Their manoeuvres endowed the issue of interregional redistribution with political salience. Without the campaign to make the electorate conscious of how massive the imbalances in the tax generating capacities of the two halves of the country were and how different the spending on certain big-ticket items in each was, the fiscal conflict between Flanders and Wallonia could hardly have emerged. Similarly, without the institutional separation of funds, it would have been difficult to define a target for adjustments in the redistributive relations between the regions. At the same time, the politicians at the head of this project responded to real pressures in the societal bases of their electorate. The war of attrition model helps to shed light on the ambivalent structure of commonalities and conflicts of interest within the population. In conjunction with the peculiarities of the Belgian political system and regional economic disparities, it helps to explain, the constraints and opportunities of political actors in engineering societal coalitions to garner political support.

The key insight of the war of attrition model is that the policy preferences of influential groups within society are subject to two countervailing forces. On the one hand, the attachment of members of the group to their vested interests makes them support the policy status quo. On the other hand, the perpetuation of fiscal imbalances harms their well-being and creates pressures for change. As explained in the previous chapter, in Belgium neither workers nor businesses supported change that would involve making sacrifices for the sake of restoring the equilibrium of the social security system, because neither group suffered significant private harm from its imbalances. At the same time, the social security problem was not entirely costless. Keeping the social security system intact and insulating labour and business from potential negative

economic side effects required enormous cuts in collective consumption and public investment. This had repercussions on the provision of public goods, generating discontent and pressures for change. Since most of the public goods are provided locally, the harm from austerity affected territorially delineated societal groups. Therefore, the harm arising from austerity created the basis for territorially based coalitions of interests, independent of class. It was this basis that the Flemish political elite built upon when redefining the fiscal problems as an interregional redistribution issue and trying to focus austerity on Wallonia.

This redefinition first gained practical relevance when agreement was reached over the repartitioning of some of the tax revenues and the devolution of authority over most collective consumption and public investment items to the regions and communities in 1988. Dividing up taxes – and channelling a higher share to Flanders – was an important step in promoting the interests of the Flemish societal coalition for two interconnected reasons. In the short run, it would ensure that the Flemish population bears a smaller share of the burdens of ‘permanent austerity’ that the deficit in the social security system necessitated. In the long run, however, it could play an important role in eliciting sacrifices from Wallonia in the social security question itself. Since the Francophone community was to be increasingly underfunded according to the original tax-sharing settlement, the toll on public consumption and investment would be progressively increasing. This would step up the pressure on the Walloon population and gradually create the political conditions for a new settlement in which concessions in the social security issue could be achieved in return for renegotiating the tax sharing agreements or possibly for bailing out a bankrupt Wallonia. This longer-term aspect is important, because of the constitutional veto power of each linguistic group, which makes compromise a precondition for important institutional changes. Unless the Walloon side is manoeuvred into a position in which it consents to major changes in the system of redistribution, forcing a change risks the breakup of the country.

The institutional changes of 1988 were just put into place when Maastricht temporarily changed the balance of power between the two halves of the country. Ironically, the institutional framework that was meant to give Flanders fiscal leverage over Wallonia became a major liability. Given that authority of almost half of the spending items had been devolved to the regional level, Wallonia’s cooperation in budget management was essential. Since Flanders had a much larger stake in early euro-accession than Wallonia, Flemish politicians made concessions in budgetary negotiations and expanded the

funds available to the Walloon and Francophone entities. Far from increasing the pressure on the Walloon side, devolution ended up giving Wallonia more fiscal ease in the run-up to the euro.

The Maastricht moment reinforced the Flemish societal coalition and polarized its conflicts of interest with the Walloon population. It underlined the common interest of different sections of the Flemish society in international competitiveness and therefore in early euro-accession. Simultaneously, it highlighted the contrast with the interests of economically stagnant Wallonia, dependent on the flow of funds from Flanders. At the same time, Maastricht also forced political actors to keep the intensifying conflict dormant for the sake of the quest to meet the deficit criterion in time for early accession and constrained the Flemish coalition from pursuing a settlement in its redistributive conflicts with the Walloon coalition. After euro-accession, the conflict erupted with new intensity and is currently threatening to break up the country.

## **Conclusion**

By the end of the 2000s, Belgium left its fiscal problems behind. It got rid of practically all of the debt that it had accumulated in the fiscally disastrous 1980s. At the same time, the structural problem that had made governments helpless in the face of alarming debt growth in the 1980s lives on into the 2010s. The deficit of the social security budget is large and widening. Only time will tell to what extent this structural problem will cause future governments further headaches in the face of deteriorating growth prospects and increasing interest rates in the wake of the global economic downturn and the European sovereign debt crisis. The debt ratio deteriorated in the past years, but it seems to have been stabilized before reaching the hundred per cent mark again.

While the country shows remarkable composure in its fiscal matters in the middle of the economic and financial turmoil, politically it has been in constant crisis for the past few years. This chapter has argued that the most recent developments reflect latent processes underway in the past decades, and that the country's past persistent fiscal problems as well as the euro accession contributed to the severity of the present political crisis. In this respect, the chapter shed interesting light on the unexpected side effects of the convergence process. By 'tying the hands' of the federal government, Maastricht gave a huge advantage to one of the parties involved in the struggle over the fiscal stabilization. Wallonia was able to strengthen its – otherwise weaker – position

and put up more effective resistance to Flemish initiatives to reduce the flow of funds to Wallonia and force the Walloon side to engage in retrenchment. By intervening in this domestic redistributive struggle, Maastricht indirectly retarded the resolution of the country's structural problems within the social security sector.

The case studies in the past four chapters presented a society-centred analysis of the politics of fiscal policy making in two countries with the most severe fiscal problems in Europe in the decades before the current age of turmoil and crises. The analysis highlighted the tight limits on governments' room for manoeuvre in resolving fiscal problems in both countries and underlined the importance for the success of stabilization of securing the support of strong societal coalitions. The case studies also evaluated the two countries' experience with adopting binding (external) fiscal rules in the run-up to the euro in the context of the societal struggles over fiscal policy. They concluded that Maastricht's impact on policy choices depended on how the race for the euro affected the different societal coalitions involved in the fiscal conflicts. In Italy, early euro-accession was the choice of a strong coalition that had captured policy making completely and had pushed through stabilizing policies even before the decision was made to join the common currency early. In Italy's case, therefore, Maastricht made little difference to fiscal results. In Belgium, the quest for early accession strengthened a societal coalition that had been likely to be forced to bear the burdens of consolidation and allowed it to resist such an outcome. Maastricht's effect was therefore to delay the resolution of the issue. The next, chapter evaluates these lessons from a theoretical perspective.

## **Chapter 7.**

### **Conclusion: Societal coalitions and the politics of fiscal pain**

Excessive public indebtedness is not simply a policy problem: it is a socio-political issue. Governments may borrow for all sorts of economic and political reasons in any given year, but failure to restore fiscal balance and stop borrowing once the level of indebtedness reaches proportions that expose a country to the risk of sovereign default is an altogether different matter. Such failure indicates stubborn redistributive conflicts among societal groups within the given polity, which render policy makers helpless even in the face of increasing fiscal vulnerability. Closing a persistent large gap in public finances involves forcing or convincing considerable sections of society to permanently pay more into or take less out of the public purse. Since societal groups have numerous ways of defending themselves against onslaughts on their interests in a democratic system, major budgetary adjustments require political support or at least tacit acquiescence from a large part of society. Until a specific stabilization package is found that can rely on the support of a strong enough societal coalition, imbalances persist, debt accumulates and risks mount. Therefore, understanding why a country would drift close to the edge of the fiscal abyss and when it would finally turn back requires studying the incentives of different societal groups to ally with other groups in resisting or supporting certain consolidation packages. Consequently, it requires exploring the costs and benefits of different stabilization programmes for each group. This thesis used this approach to account for the extraordinary fiscal troubles of two of the most indebted countries of the developed world, Italy and Belgium, and to explain their dissimilar experiences with correcting their fiscal performance in the context of the evolving European fiscal architecture.

This theoretical approach combines the society-centred tradition of studying policy choices – more specifically, the line of inquiry proposed by Gourevitch in *Politics in Hard Times* (1986) – with the analytical tools provided by the “war of attrition” model of delayed stabilization developed by Alesina and Drazen (1991). Gourevitch’s approach provides a conceptual template for mapping the constellation of coalitions of societal interests within a polity, for analysing the balance of power between them and for using this information to explain observed policy choices. The war of attrition model, on the other hand, helps to understand how coalitions realign as the interests of

individual groups evolve with time under pressure from a persistent fiscal problem. In other words, the model helps to investigate the formation, break-up and the reconfiguration of societal coalitions in a dynamic context and to explain the opening up – or potentially the closing down – of windows of political opportunity for fiscal stabilization.

This theoretical approach provided a plausible explanation for the evolution of the debt problem in Belgium and Italy by uncovering the link between observed policy changes and shifts in societal coalitions. This explanation outperformed alternative theories in its goodness of fit with the details of the observed fiscal developments. It was able to account not only for the development of the headline deficit and debt figures, but also for the specific composition of expenditures and revenues. Furthermore, investigating the empirical cases through the theoretical lens of this approach yielded interesting insights beyond the narrow field of fiscal policy and helped to better understand momentous changes in the political life and political institutions of the two countries during the three decades under consideration. It shed light on how realignments in societal coalitions of interests were reflected in realignments in the political sphere and how the societal and political shifts sometimes resulted in institutional reform.

The empirical case studies underlined three core elements of the theoretical approach employed here. The first is the lack of control of the government over fiscal stabilization. In both countries, several examples of botched fiscal reforms demonstrated that governmental determination on its own is not enough to carry out successful stabilization programmes and strong societal backing is needed in order to be able to inflict fiscal pain. Conversely, these episodes also bore witness to the central role of the choices of societal groups and highlighted several non-electoral sources and channels of policy influence they can avail of. These results called attention to the need to understand debt accumulation in the light of the interests of influential societal groups in supporting or opposing certain stabilization programmes. Second, the case studies highlighted the crucial role of the macroeconomic side effects of debt accumulation in inducing societal groups to acquiesce in stabilization programmes that require considerable sacrifices from them. They suggested that if such side effects are absent, the chances of a successful stabilization are very low. Third, the case studies called into question the significance of fiscal governance, electoral institutions, party political and corporatist arrangements in and of themselves for fiscal performance.

Finally, the society-centred approach shed light on some surprising phenomena. On the one hand, the analysis of the Belgian fiscal patterns and political events revealed a remarkable continuity in the country's fiscal path across the past three decades, despite the common perception that Belgium underwent profound fiscal transformation since the 1980s. In fact, little changed about the substance of Belgian fiscal policies in the past decades and the defining redistributive conflicts that had stood in the way of consolidation in the 1980s survived until the present day. The favourable changes in the country's headline figures mostly reflect an exogenous fall in the interest rates, while the underlying spending and revenue trends are fairly constant. On the other hand, the same case study called attention to unexpected counterproductive effects of the binding external fiscal constraints that the Maastricht criteria placed on Belgian policy makers. Although commonly associated with the abrupt turnaround in the country's fiscal performance, these constraints actually helped to entrench the societal conflict about the consolidation of the social security sector, which had been at the heart of Belgium's fiscal woes since the late 1970s and thereby retarded the resolution of the problem.

This chapter evaluates the findings of the case studies and uses them to demonstrate how the theoretical approach proposed in this thesis enriched our understanding of the politics of fiscal policy making in general and of excessive indebtedness in particular. The second section summarizes the two country narratives elaborated on in the previous chapters. The third and the fourth sections look at the way the two constituent parts of the theoretical framework – Gourevitch's coalition of societal interests approach and the war of attrition model – helped to better understand the concrete cases and how the two cases helped to fill the theoretical frame with concrete meaning. The fifth section analyses the complementarities and contradictions of this theoretical approach with alternative explanations for debt accumulation by critically evaluating institutionalist and ideational studies of Italy and Belgium. The last section enumerates the contributions of the thesis to theoretical, methodological and policy debates.

### **Tracing the politics of debt in Italy and Belgium**

The Italian and Belgian case studies combined Gourevitch's theoretical approach with the insights of the game theoretic model in a framework of iterative analysis. The starting point for each case study was the early 1980s, when fiscal imbalances grew to alarming proportions in both countries. The investigations identified influential



societal groups within the given polity, determined their interests towards public finances, and clarified political ties and oppositions between them. This provided the basis for explaining the initial policy responses given to the growing fiscal problems in both countries. The next step was to analyse – using the insights of the war of attrition model – how the interests of each of these groups evolved as the initial policy responses made their impact felt on the general economic environment and on the wellbeing of each group. This, in turn, exposed new constellations of commonalities and conflicts of interest, which explained observed political realignments and policy adjustments that followed in their wake. The exogenous effect of the euro-accession and of the adoption of fiscal rules in each country was examined in the same iterative framework, starting with the influence of the euro on the interests of specific societal groups towards fiscal policy, leading to a potential reconfiguration of coalitions of interests and triggering a change in policies that would once again impact the constellation of interest and so on. This resulted in a theoretically informed tracing of the process of debt accumulation and decumulation, which discovered sources of stability and change in the sociological context of fiscal policy making in both countries.

In Italy, the analysis identified four major societal groups, whose influence on policy making initially precluded any meaningful response to the escalating fiscal problems. Three of these groups – large enterprises, small businesses and the self-employed, and a clientele network in the South – had leverage on policy makers via their ties to the dominant party in the government, Christian Democracy, whereas the fourth group – organized labour in large enterprises – maintained *de facto* veto power over policy choices via the threat of mass mobilization. Each of the four groups had strong vested interest in some aspects of the extant fiscal arrangements: large businesses were attached to a system of tax exemptions and subsidies, small businesses and the self-employed were dependent on the tacit toleration of tax evasion, the clientele network in the South drew its livelihood from public employment and public projects, whereas organized labour insisted on the maintenance of the social insurance system. As long as the first three groups continued to prop up and hold hostage the dominant party and organized labour refused to relax its resistance, practically no item in the budget could be meaningfully adjusted.

However, since high deficits led to high inflation – which in turn eroded international competitiveness – both the support for the government and the intransigence of unions were weakened by increasing discontent within those sections of business and labour

that were exposed to the negative consequences of declining competitiveness. Eventually, this led to the breakdown of the awkward alliance of large and small businesses with the Southern clientele within Christian Democratic Party and a strategic shift in the labour movement. A new political pole was created around the objective of restoring fiscal equilibrium and international competitiveness. It relied on a coalition of labour with some sections of business and carried out a successful programme of stabilization that placed the burden of consolidation predominantly on the Southern population and on tax evaders. However, the competitiveness coalition disintegrated as soon as competitiveness had been restored and cemented for the long term thanks to Italy's euro accession. The awkward alliance of large enterprises, small businesses and the Southern clientele networks re-coalesced and many of the features of the policies of the 1980s were restored and the fiscal improvements of the 1990s were largely undone. The political forces that used to rely on the support of societal groups with a stake in international competitiveness tried to stage a comeback and won the 2006 election, but they did not have the backing they had enjoyed in the 1990s and government fell in 2008.

This evolution of societal coalitions of interest fully explains the fiscal patterns observed in Italy in the past three decades: the complete policy passivity of the 1980s in the face of alarming debt growth, the astonishing consolidation of the 1990s, the relapse of the 2000s and even the short intermezzo of austerity between 2006 and 2008. Furthermore, it accounts for the curious pattern of policy reversals between the 1990s and 2000s: for the U-turns in tax laws, pension measures, expenditure cuts and so on as governments representing one coalition of societal groups replaced governments standing for the others. Moreover, the societal analysis helps to better understand the momentous political realignment that took place in the early 1990s. Naturally, the collapse of the party system of the First Republic had more varied causes than what can be captured by this narrative. However, the interest group dynamics – and especially the emergence of a division between groups exposed to and sheltered from international competition within the Christian Democratic camp – provides clues to why the electorate of the Christian Democratic Party split and ended up supporting two opposing poles of the political spectrum of the Second Republic.

In Belgium, the investigations revealed a societal context structured by a complicated interplay of class conflict with regional divisions. Throughout most of the 1980s, class conflict dominated policy-making. Business and labour groups had strong ties with

political parties in both Flanders and Wallonia, but it was Flemish labour and business that had a *de facto* veto power over policy making due to their joint control over the pivotal actor in the Belgian political scene, the Flemish Christian Democratic party. These two groups were in conflict over the consolidation of the social security system, which had been dramatically destabilized by the economic shocks of the 1970s and were a huge drain on public finances. Labour was reluctant to make concessions on benefit payments, whereas business refused to pay more to cover the financing gap. At the same time, the two groups were united in their concern for international competitiveness and were eager to avoid that fiscal problems undermine it. This resulted in a curious pattern of fiscal policies. Successive governments enjoyed the support of both Flemish labour and business in retrenching public employment, subsidies and public investment – areas of spending that neither Flemish group had an important stake in – and therefore they were able to impose austerity on the discretionary part of the budget. The huge deficit in welfare spending, however, was left virtually untouched, due to the contradicting interests of the two groups in this issue. In other words, in the Belgian case, societal conflicts only paralysed policies in one area. However, the order of magnitude of problems in this area was so large that retrenchment in collective consumption and investment was insufficient to counterbalance it and restore the balance of public finances. Consequently, the debt continued to grow despite significant austerity measures.

Unlike in the Italian case, persistent fiscal imbalances did not trigger an automatic political adjustment, because successive governments made sure – under pressure from competitiveness-oriented Flemish groups – that fiscal problems never spilled over into monetary issues that could jeopardize the international standing of Flemish industry. Flemish labour and business could afford to persistently disagree over the social security issue, because it caused no direct harm to them. However, the alarming accumulation of debt could not be completely ignored. The Flemish Christian Democratic Party launched a political campaign to redefine the issue as a conflict between Flanders and Wallonia – referring to the imbalances in the amounts contributed to and taken out of the system in the two halves of the country – in order to escape the deadlock in the conflict between labour and business. Splitting social security regionally would have double benefits for Flemish business and labour. If the deficit of the system was Wallonia's problem alone, Walloon business and labour would likely be forced swiftly to come to agreement over consolidation, because the Walloon government would not be able to secure financing for the deficit for long. This would

both resolve the problem and spare Flemish groups from the costs. A process of federalization of public spending was started in the late 1980s, but the advances made by the Flemish were halted when the imperative of early euro-accession and the need to produce the right headline deficit figures made Flanders dependent on Walloon cooperation. The issue of splitting social security was put on ice until Belgium was safely within the euro and the Flemish-Walloon conflict over it culminated in the recent years. For the moment, the deficit of the social security system persists although struggles over it between the regional actors are fiercer than ever. At the same time, the problem itself is more affordable than before since interest rates have fallen, which freed up large amounts of funds in the budget.

The enduring conflict between influential labour and business groups in Flanders over social security explains the lopsided adjustment pattern observed in Belgium throughout the past three decades: the contrast between persistently strict austerity in public consumption and investment and the widening gap in the social security budget. Observers often pointed out this asymmetrical pattern (IMF 1998, European Economy 1993, Reynders 1993), but hitherto no explanation had been offered. The irresolvability of the profound societal conflict over social security also helps to better understand the stakes involved in and the motivation behind the fiscal federalization process underway in Belgium in the past two decades. It sheds light on the progressive intensification of the economic dimensions of the regional cleavage, which became the main axis of the conflict over the issue of how to restore the balance of the system. In this context, the convergence process leading up to euro-accession also gains different connotations from the ones usually attributed to it. Because early accession was of different importance for Flanders and Wallonia due to profound differences in the two economies, Maastricht changed the balance of power between them so that the resolution of the fundamental policy problem was delayed. Flanders could not use its economic and political ascendancy to force Wallonia to pick up the bill of consolidating the social security system. Finally, the society-centred narrative of Belgian fiscal problems also helps to shed light on motivations for the intransigence of political elites in the current political crisis in Belgium and for the lack of compromise over state reforms despite the daunting international economic and financial circumstances.

Last but not least, the Italian and Belgian case studies help to understand the differential performance of the two countries in the past two decades. In Belgium, societal conflict affected – and blocked adjustment in – a specific part of the budget: the

social security sector. At the same time, successive governments enjoyed strong societal support for strict austerity in public consumption and investment. This resulted in a lopsided adjustment effort that involved large adjustments in the discretionary part of the budget, but was not supported either by revenue measures, or by a trimming back of the social security transfers. This effort fell short of the requirements of fiscal consolidation as long as the interest costs on outstanding debt stayed prohibitive up to the early 1990s, but it sufficed to halt and reverse the escalation of the problem once interest rates fell into more moderate ranges. Therefore, the observed changes in fiscal performance took place due to changes in exogenous conditions, without a significant change in the policy path. The austerity campaign that finally yielded results in the 1990s had been launched in the early 1980s and was sustained through most of the period under study. In other words, Belgium was well placed to take advantage of the favourable changes in the international financial markets due to the sustained ability of governments to control and adjust the discretionary part of the budget. At the same time, the social security sector has remained a persistent source of vulnerability ever since it was fiscally destabilized by the oil shocks.

In Italy, on the other hand, all the important aspects of fiscal policy – welfare policy, public employment and investment as well as most items of taxation – were hostage to some powerful societal group that had the policy leverage to protect its vested interests. This prevented meaningful adjustment in any significant field of spending or taxation until a realignment of societal coalitions allowed some groups – those sectors of business and labour that were exposed to international competition – to force large sacrifices on other groups, while also acquiescing in some sacrifices themselves. As long as the competitiveness coalition stayed cohesive, large adjustments – including several structural reforms – were possible and Italy's fiscal performance improved radically. However, as soon as this coalition fell apart and each major societal group regained its ability to fend for its vested interests, the achievements of the previous austerity were eroded. The decumulation of debt stopped despite continuously improving external financial conditions throughout the 2000s.

In sum, while the war of attrition involved every aspect of fiscal policy in Italy, it was limited to one sector of the budget in Belgium. Belgium performed better than Italy once exogenous conditions turned more clement, because its socio-political conditions allowed it to sustain (quite significant) austerity in discretionary spending,

notwithstanding its persistent structural problems with social security. Italy's window of opportunity, however, closed completely once its reform-coalition lost its *raison d'être* after the link between fiscal issues and competitiveness had been cut. The next section disentangles the narratives given here and explains how they helped to fill the abstract theoretical framework with concrete content.

### **Fiscal policy making in hard times: Societal groups, policy influence and coalitions of interest**

This thesis argued – following Gourevitch – that policy choices of a country can be explained by examining the balance of power between coalitions of societal groups behind and against different policy initiatives. While the idea is intuitively appealing, using it to analyse the politics of fiscal policy making in different countries and to explain fiscal trajectories that lead to excessive indebtedness is challenging. Focusing on societal groups as the main unit of analysis is problematic, since societal groups are not “actors” with the capacity to make and carry out decisions and therefore their influence on policy making is not directly observable. It is not immediately obvious which groups within society are relevant from the perspective of fiscal policy making, how the relevant groups exercise influence on policy choices, how coalitions are formed behind and against given policy initiatives and how they break up and realign. This section spells out the lessons of the Belgian and Italian case studies for each of these questions.

The overall conclusion of both case studies in this respect is that despite the problems involved in investigating the preferences and behaviour of societal groups, substituting them with political organizations – such as parties, trade unions or lobbies – is not a good alternative for three reasons. First, there is no one-to-one correspondence between societal groups and political organizations. A single organization can represent several societal groups with different fiscal interests and the same societal group can support different political organizations at the same time. Furthermore, the links between societal groups and political organizations are likely to change through time. Second, the influence of each social group is likely to be manifold: electoral power, lobbying, mobilization capacities and economic leverage are all likely to play a role at the same time and not all of these are wielded through political organizations. Third, coalitions of societal interests do not always correspond to alliances between political actors. The rest of this section elaborates on these three points.

### *Societal groups and fiscal policy preferences*

The basic – and arguably the most difficult – question to clarify is which societal groups are relevant for fiscal policy making in general and for the restoration of fiscal equilibrium in particular. The thesis followed a pragmatic approach in identifying crucial groups in each polity. Instead of working with *a priori* categories like class or sector it analysed extant fiscal policies at the time when fiscal imbalances started to grow to alarming proportions in order to identify societal groups with vested interests in different aspects of the existing arrangements and to detect possible sources of resistance to consolidation efforts. Looking back in recent history at the genesis of the most important spending programmes and/or tax arrangements also helped to clarify which groups had exercised influence on policy making in the past and what kind of political channels they had been using to promote their interests. This preliminary analysis set the scene for explaining the policy responses given to alarming debt growth in the following decades.

In Italy, the results of the analysis of societal interests towards fiscal policy in the early 1980s vindicated the pragmatic approach, because the four key groups identified there were separated along rather idiosyncratic dimensions due to historical factors. Business was divided into two distinct groups according to size. Historically, large business had shared an interest with small enterprises and the self-employed in low taxes. However, when a tax reform increased *de jure* fiscal pressure on personal and corporate incomes, the two size classes reacted very differently. Large enterprises used their economic weight and lobby power to achieve exemptions and rebates, whereas small businesses simply evaded a large share of the new taxes. Therefore, by the time when fiscal problems got truly out of hand in the 1980s, they had very different vested interests. Small business cared about maintaining the tacit toleration of tax evasion, whereas large business was wedded to the system of targeted exemptions. Labour was divided regionally. Workers in the industrial North and the stagnant South had vested interests in very different spending programmes. The extensive welfare system created in the late 1960s and early 1970s limited eligibility to workers with stable employment and therefore mostly benefited labour in the dynamic North. In the South, however, most of the labour force was legally excluded from the benefits because of the dire employment situation in the region. Instead, their livelihood depended on public sector

employment and on public investment projects in the region, both of which were expanded in the 1960s and 1970s.

In Belgium, on the other hand, the structure of societal interests towards fiscal policies was determined along standard class lines at the beginning of the 1980s. Business was focused on keeping taxes and payroll costs low, whereas labour was strongly attached to the generous welfare system that had been created in the 1960s. Public employment and investment did not historically have a redistributive, income-replacing role as seen in the Italian South. After the oil shocks, the number of public employees was expanded to siphon off some of the unemployed from the labour market and the significance of public employment increased, especially in the Walloon region, where other employment opportunities stayed stubbornly depressed. However, due to the availability of unlimited unemployment benefits and generous early and regular pensions, public employment never quite played a role in Belgium like in the South of Italy. Interestingly, the regional conflict of interests that has played such an important role in Belgian politics in the past decades was not coded into the status quo of the 1980s in any way. Instead, it has been constructed politically as a way out of the policy conundrum of unstoppable debt for the Flemish political elite.

While the crucial groups were primarily defined by their economic positions in both polities, it is clear that historical policy decisions – and by implication historical political struggles – also played a role in shaping the societal context in which fiscal consolidation was to take place in both countries. For example, the decision to create an exclusive welfare system divided labour in Italy, or rather, further entrenched divisions between “insiders” in the North and regionally delineated “outsiders” in the South. In Belgium, on the other hand, the inclusive social security system kept the vested interests of Flemish and Walloon workers in the social security status quo in sync despite the strong divergence of their economic positions by the mid-1980s. In fact, this is exactly why the separation of the social security system between Flanders and Wallonia would be key to breaking the solidarity over the social security issue among workers in the two halves of the country. Beyond past policy decisions, historic contingencies also play a role in shaping the societal context of policy making by influencing the economic architecture of the country itself. For example, in Italy, the self-employed represent an unusually large share of the population and, therefore, they (along with small family businesses) embody a significant and powerful cluster of interests. Similarly, the regional economic disparities in both countries are historically



determined. Therefore, while some of the criteria for delineating groups with homogeneous interests towards the fiscal status quo are generalizable, others are country-specific.

### *Influence on policy making*

The clusters of interests towards fiscal policy are important in determining actual policy trajectories insofar as the societal groups holding these interests can influence policy making. The groups identified in the Belgian and Italian cases availed of different channels of influencing policies. Some worked through the standard electoral channels, whereas others were linked to the control of the given group over economic resources. Organized labour exercised leverage predominantly via the threat of strikes in both countries. The electoral weight of workers was secondary, but for different reasons in the two cases. In Italy, organized labour was electorally neutralized in the First Republic due to the exclusion of the Communists from government. Workers' votes only became truly important in the Second Republic. However, even in that period, strikes remained a crucial source of veto-power, especially under centre-right cabinets. In Belgium, organized labour had a strong voice within the pivotal Flemish Christian Democratic party and therefore within government. However, even there, the threat of strikes represented a crucial source of labour's influence, because the Flemish Christian Democrats also had a strong business section, whose weight was primarily kept in check by the strike threat from labour.

Business groups – large and small – promoted their interests in both countries primarily via lobbying the government and supporting right-wing and centrist parties. Importantly, however, the *de facto* power of business to defend its interests exceeded its electoral and lobby influence on the legislative process due to the ability of enterprises to adapt their strategies to new policies. The most telling example of this is the wave of outsourcing and downsizing that took place in Italy in the 1980s, which reflected the efforts of businesses to escape tightened labour regulations and increased fiscal pressure that the reforms of the 1970s had brought about. Clearly, the ability of small businesses to evade taxes reflects a certain leniency of governments that counted on the electoral support of small entrepreneurs and the self-employed. However, the industrial restructuring that made it possible for many enterprises to avail themselves of this tolerance towards small businesses is a forceful illustration of the ability of businesses to shape the policy environment to their needs. In the same vein, in Belgium

the ability of businesses to substitute labour with machines, to relocate abroad or to move capital from productive investment into other forms of savings was an important deterrent against policy choices that would drastically impinge on business interests.

It was the groups without major sources of economic power – like the population of the economically stagnant South in Italy – that relied fully on its electoral position, but even in their case, the electoral leverage they yielded depended more on the balance of power between the different groups than the sheer number of votes the group provided. In the First Republic, this position provided surprisingly large political leverage when the Southern vote became key to maintaining the exclusion of the Communists from government and to keeping the extreme right in check. In the Second Republic, the Southern vote was crucial to the electoral successes of the centre-right. Harnessing the electoral power of this section of the electorate was all the easier because of the traditions of clientelism in the region, which made it possible to specifically target public funds at this section of the population. The established clientele networks in the region played a central role both in gathering votes for and in channelling demands to the parties it supported, i.e. to ruling Christian Democracy in the First Republic and parties in the centre-right coalition in the Second Republic. The presence of this type of “political infrastructure” made it possible for the Southern population to have considerable political weight in Italian politics.

#### *Societal coalitions of interests*

The main clusters of societal interests towards fiscal policy and the power each cluster is able to wield in service of those interests determine the political space in which policies are made. Having explored this space, policy choices can be accounted for by identifying societal coalitions and the balance of power between them. In other words, policy choices can be explained by the way different clusters of interests unite their forces to achieve the political ascendancy needed for putting into place their policy preferences. The case studies showed that such coalitions can appear in the cloak of diverse political phenomena. It can be an alliance among parties representing different societal groups but a single party can also stand for a societal coalition in itself, if it represents different constituencies. A coalition can also emerge as a social pact between employers’ organizations and trade unions in the service of specific policy priorities. The Belgian example demonstrated that establishing a new coalition can even be the objective of a conscious political project. Similarly, the disintegration of a

coalition can be signified by the break-up of a multi-constituency party and its replacement with parties that refuse to enter into alliance with each other, by the abandonment of a party by part of its constituency or by the breakdown of a social pact, and so on.

In the 1980s in Italy, the two business groups and the proletariat of the South formed an awkward coalition by jointly supporting the dominant Christian Democracy and its perennial junior partners in government. This enabled them to continue to block the Communists – and thus labour – from government and thereby to retain low *de facto* fiscal pressure for business and to secure clientelistic benefits for the South. However, since labour possessed an implicit veto over policies via its capacity to mobilize and cause economic disruption, this coalition was unable to take on welfare policies or raise the fiscal pressure on labour. In the absence of space for adjusting either revenues or expenses, the fiscal imbalances inherited from the seventies persisted. By the early 1990s, however, the awkward coalition was fraying as the electoral support of the Christian Democracy declined.

Adjustment took place when large business teamed up with labour in the early 1990s. This coalition was originally formed as a series of agreements between employers and trade unions in a party-political vacuum under technocratic caretaker governments. Later, it took the form of party-political cooperation within the centre-left coalition, but negotiations between the social partners continued to be an important element. This coalition managed to push through a series of austerity measures that drastically cut spending in the South and increased the tax pressure by introducing taxes that were difficult to evade. The groups disadvantaged by these policies could not put up any immediate resistance as they had no representatives in government and no non-electoral sources of influence. They united politically under the centre-right umbrella, but they were unable to firmly recapture government until the coalition of large business and labour disintegrated. The drifting apart of labour and business was evident in the breakdown of talks between trade unions and employers after 2000. In the 2000s, the coalition of large and small business with Southerners was restored under a series of centre-right governments. However, just as in the 1980s, this societal coalition was only able to put into place some of its preferred policies, due to labour's veto on welfare adjustments. Under these conditions, conflicts over spending and taxation overflowed into debt accumulation once again.

The Belgian case is peculiar from the perspective of societal coalitions because both of the large societal groups – business and labour – have historically been represented in every government, via the cross-class Christian Democratic parties in coalition with either the Liberals or the Socialists, and via a Liberal-Socialist government between 1999 and 2007. In a sense, the two sides have formed a permanent all-encompassing societal “grand coalition” that reflects the balance of power between the two sides. This balance is present both electorally and in terms of economic interdependence. The permanent power sharing explains both why the social security issue has been so intractable in the past three decades and why retrenchment in other areas of spending encountered so little resistance. The campaign of the Flemish political elites to redefine the fiscal – and within it the social security – issue as a Walloon-Flemish conflict has been directed at opening up a new front along which the problem could be tackled. It created a Flemish societal coalition in opposition to Wallonia.

The investigation of the evolution of the coalitions between different societal groups thus helps to account for the observed stability and change in politics and policies in Italy and Belgium. It shows that fiscal stabilization only happens when a strong enough societal coalition can agree on a given austerity package and can enforce it, even in the presence of protest from groups outside of the coalition. However, an investigation that stops here only registers the reconfiguration of supporters and power behind government policies and fails to explain why some coalitions last and others give way to new ones. Why did the curious coalition of business groups with the dependents of the state in the South last throughout the 1980s in Italy, disintegrate in the early 1990s, only to be reassembled a decade later? And why did the coalition of large business and labour last for a whole decade in between? Why has the “grand coalition” lasted in Belgium in the past decades? Why do labour and business permanently “agree to disagree” over social security while agreeing about austerity? What did the success of redefining the social security issue as a Flemish-Walloon conflict depend on?

The societal coalitions approach presented here has difficulties explaining changes in the configuration of coalitions, because it concentrates only on the vested interests of the different sections of society in extant fiscal arrangements, in existing spending programmes and tax practices. These automatically generate a force for the preservation of the status quo – in policies as well as in coalitions. Fully understanding the preferences of societal groups towards fiscal policies – and the conflicts and commonalities of interests between different groups – requires taking into

consideration the potential losses that a group suffers from maintaining the status quo. In the presence of large imbalances, the fiscal status quo is practically equivalent to the persistent deterioration of the country's public finances as debt grows and interest expenses mount. The next section uses the war of attrition model to analyse under what conditions the accumulation of public debt induces societal groups to rethink their allegiance to an existing societal coalition in favour of another one.

### **Political reconfigurations and wars of attrition over fiscal stabilization**

The war of attrition model does not directly relate to societal coalitions. It treats social groups as isolated actors and explores the conditions under which it is rational for a given group to take upon itself (some of) the costs of stabilizing public finances – by paying more into or taking less out of the public purse – even when it has the power to defend itself against policy changes that encroach on its interests. At the same time, the model's findings can be easily extended to explain the motivation of groups to form or break up coalitions. The coalitions of interests approach underlines that the ability of societal groups to defend their vested interests is rooted in their capacity to form powerful coalitions. Therefore, the results of the war of attrition model can be used to answer the question under what conditions it is rational for a group to dissolve an existing societal coalition that ensures the defence of its vested interests and enter a new one that promises to restore the balance of public finances, even if the new coalition involves compromises on the group's fiscal preferences.

The model shows that a group is ready to sacrifice its vested interests in existing policies if it suffers considerable harm from the fiscal imbalances and is convinced that if it does not pay the price of consolidation, no other group will. In a societal coalitions context, this can be read to mean that it is rational for a group to abandon a coalition that provides it with the necessary political clout to protect its vested interests, if the group has a large stake in consolidation but the political status quo clearly does not allow for a breakthrough in fiscal matters. This section looks at how this prediction of the war of attrition model helped to understand the changes in the politics of fiscal policies and the realignment of coalitions in Belgium and Italy.

The two case studies showed that the negative side effects of the fiscal problems are indeed a very important factor in engendering political change and a reconfiguration of societal coalitions of interests. In both countries, the most relevant side effects arose in

the form of pressures on international competitiveness. In Italy, the erosion of the international competitiveness of industry in a high-inflation environment played a crucial role in the rapprochement between large business and organized labour at the beginning of the 1990s. The loss of manufacturing jobs and the shrinking of employment possibilities led to discontent and even defection among younger union members exposed to these unfavourable changes, forcing unions to start to cooperate with business in finding solutions. Business in the exposed sectors was open to striking deals for the sake of restoring price competitiveness and profits. Compromise involved large sacrifices on both sides – business acquiesced in higher taxes, whereas labour accepted cuts in future welfare payments and made concessions in wage bargaining – but it also allowed the two groups to wield the necessary power to foist large sacrifices upon groups that were not concerned with international competitiveness. In Belgium, concerns about international competitiveness became intense when the country faced major difficulties in maintaining exchange rate parity within the European Monetary System in the early 1980s. This led to a temporary realignment of coalitions of interests. Labour solidarity was briefly compromised as Flemish-dominated Christian unions made concessions on the social security system despite the protest of Walloon-led Socialist unions under the effect of a (secret) deal with business over a stabilization package.

Conversely, the case studies also underlined that insulation from the negative side effects of fiscal problems enhances political stasis and the intransigence of societal groups over changing the policy status quo. In Italy, the older generations of organized workers whose employment was protected by stringent redundancy laws and whose wages were indexed against inflation were immune to the problems generated by the monetization of deficits. They remained a major obstacle to reform. Even in the 1990s, when business and labour achieved great breakthroughs in fiscal consolidation, the deals struck between the two sides had to make special arrangements to protect the entitlements of older workers, without whom the competitiveness coalition could not have functioned. This finding underlines the curious intertwining of political and institutional power in the context of the struggle between different societal groups over fiscal consolidation. The job and wage protection systems protecting older workers were a major source of advantage, because they allowed these workers to dig their heels in indefinitely in the conflict over social security reform. At the same time, the ability of these workers to secure these privileges and then to defend them through the

decades suggests that even these institutional advantages are just manifestations of the underlying political clout of labour.

In Belgium, practically the entire economy was insulated from the effects of fiscal problems after the start of austerity in 1982, because successive governments resisted the temptation to monetize the deficits. Therefore, neither labour nor business was under pressure to soften up its resistance to reform and neither did. Paradoxically, the policy choices that allowed for persistent stalemate were the outcome of the shared interest of labour and business in protecting international competitiveness from fiscal problems. They reflected the ability of the two sides to use their unified political influence to achieve such outcomes. This sheds important light on the deeper sources of the political problem in Belgium, namely the complete balance of power between the two sides and the interdependence of their economic fates. Interestingly, in Italy, it was the euro accession that created a similar situation in the 2000s. It allowed labour and business to guarantee for the long term that their joint interests in monetary stability be protected. As soon as this was achieved, they rediscovered their conflicts of interests concerning fiscal policy and the competitiveness coalition disintegrated.

In sum, both case studies suggest that the harmful side effects of deficits can make societal groups rethink their allegiances to existing socio-political coalitions and form new ones capable of resolving the issue, even if such realignment comes at the price of painful compromises. Conversely, if a group incurs no private costs from the public problem, there are no incentives to change its political strategies. The war of attrition model allows for even more concrete predictions about when a group would be induced to accept sacrifices. Even when a group suffers from the consequences of fiscal problems, it has an interest in remaining passive if it is likely that consolidation will be carried out in the foreseeable future at the cost of other groups. It will only be induced to give up on (some of) its vested interests if it is convinced that consolidation is dependent on its contributions. Strictly speaking, this is an untestable and unobservable prediction, but it is interesting to note that in both the Italian and the Belgian cases, major political changes started when the chances for meaningful reform were lowest. In Italy the breakthrough came after groups in the sheltered sectors gained dominant control over the government, making it less likely than ever that stabilizing reforms will be made. In Belgium, the campaign of the Flemish Christian Democrats for federalization started after the demise of the St. Anna Plan for pension

reform and the fall of the Christian Democratic-Liberal coalition had signalled the end of labour-business cooperation in fiscal matters.

Combined with the insights of the war of attrition model, the societal coalitions approach helps to better understand the underlying mechanism driving changes in politics and in policy choices in Italy and Belgium by uncovering the societal pressures for and against given policy options and the evolution of these pressures. At the same time, this theoretical approach paid little explicit attention to many other aspects of and actors involved in policy making that other theories focus on in explaining fiscal outcomes. The governmental machinery of policy making as a whole received little attention. The institutions structuring the decision making process and the bureaucratic-technocratic aspects of policy making were mostly missing. The next section addresses these issues and evaluates the lessons of the case studies in light of alternative explanations.

### **Competing and complementary theoretical approaches**

The narratives built in the empirical case studies weaved together the analysis of constellations of societal interests and power with the discussion of several institutional, ideational and international factors. They elaborated on the strategic position and ideological outlook of parties, trade unions and employer organizations; on the rules guiding the functioning of the state and on the international environment in which policies were made, in order to provide all the details needed to understand the political and policy developments that accompanied excessive debt accumulation and episodes of stabilization in Belgium and Italy. This section is aimed at disentangling the different elements of the stories told above and analyse them from the perspective of the possible independent or secondary effects of institutions, ideas and international constraints on the evolution of fiscal policy in the two countries.

#### *Fragmented governmental decision making*

By choosing societal groups as the primary unit of analysis in explaining excessive debt accumulation, this thesis expressly took a side in the long-standing controversy among society-centred and state-centred approaches towards explaining policy choices. However, the society-centred analysis of the case studies has some interesting lessons for the government-centred approach as well. This subsection discusses state-centred



theories that concentrate on the structures of the decision making machinery of the state in explaining policy choices. It focuses on the role of government fragmentation and the rules governing budgetary decision making. The next presents approaches that explore the extent to which policy makers are able to make decisions autonomously of societal pressures.

As shown in the introduction, the large majority of theories about public borrowing concentrate on the institutional features of decision making within the state. A first group of theories within this category focus primarily on the effect of fragmented decision making within divided governments on deficits. They claim that coalition governments are likelier to run deficits because the different parties will have difficulties in reconciling the interests of their specific constituencies<sup>129</sup>. According to this reasoning, the large fiscal problems of Italy and Belgium in the 1980s are not surprising since both countries had fragmented coalition governments throughout the past three decades. However, this argument is at odds with the observed facts. Italy underwent astonishing consolidation in the mid-1990s after its governments became even more fragmented than they were in the 1980s in the wake of electoral reforms in the early 1990s. In Belgium, the drastic austerity programme – which started in 1982 and improved the primary balance by more than a tenth of the GDP over the course of the 1980s – was adopted and ruthlessly carried out by a succession of fragmented coalition governments. Similarly, consolidation continued throughout the following decades under four-party (at times six-party) coalitions.

Another group of theories investigates to what extent fiscal targets, procedural rules, the centralization of decision making and surveillance help to contain the collective action problem involved in budgetary decision making<sup>130</sup>. The Italian and Belgian cases provide interesting insights on this issue, because both countries implemented a series of fiscal institutions in the last three decades in order to gain better control over borrowing and both subjected themselves to the external rules of the euro-convergence process. While the adopted rules, procedures and targets undoubtedly were important devices in managing the budgetary process when societal support for fiscal stabilization was there, they were of little use in and of themselves for budgetary discipline as long as most governments were unable to adjust major items in the budget

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<sup>129</sup> See for example Roubini and Sachs (1989), Grilli et al. (1991), Alesina et al. (1998), Padovano and Venturi (2000) and Balassone and Giordano (2001).

<sup>130</sup> See for example von Alesina and Perotti (1995), Hagen and Harden (1996), Perotti and Kontopoulos (2002), Lagona and Padovano (2007).

in the face of resistance by influential interest groups. The main lesson of the two case studies in this respect is that well-functioning domestic budgetary institutions are epiphenomenal to the redistributive conflict between different societal groups. Budgetary institutions work well only when the conflict is settled.

For example, a range of budgetary innovations was adopted in Italy in the 1980s to subject budgetary decision making in the parliament to discipline<sup>131</sup>. However, as long as a powerful coalition of interest made most of the spending and revenue items untouchable, the majority of parliamentarians and the dominant party had no interest in enforcing the rules and sticking to targets at the cost of hurting that powerful coalition. In contrast, the budgetary institutions worked and targets were met in the 1990s, because of the electoral dominance of the competitiveness coalition, which strongly supported austerity. Similarly, in Belgium, the committee created to manage budgetary coordination between the different federated levels could not ensure budgetary discipline up to the early 1990s, because of the irreconcilable conflicts of interests between the different regions and communities. However, when it became urgent for the Flemish to appease Wallonia for the sake of winning its cooperation in the run-up to the euro, the results of the committee improved greatly in managing and enforcing targets.

The most recent research on fiscal decision making within governments by Hallerberg and others<sup>132</sup> provides a synthesis of these two approaches and seeks to answer the question under what political circumstances governments are willing to adopt and able to successfully operate coordinative devices that allow them to overcome their collective action issues and keep deficits under control. First of all, they underline that political actors within the government – parties participating in the coalition as well as individual ministers and legislators – need to have an electoral incentive to be attentive to fiscal problems in order for them to be willing to constrain their spending preferences for the sake of fiscal discipline. Therefore, meaningful electoral competition is a precondition for moving away from what they call the *fiefdom*

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<sup>131</sup> As described in Chapter 3 above, some of these reforms were aimed at ensuring better planning, such as the introduction of a standardized format for presenting the budget as a single law (Legge Finanziaria) in 1978, or the launching of comprehensive economic-financial planning in 1988. Other procedural adjustments were aimed at enforcing discipline on the members of parliament. From 1983 and 1985, the budget would be debated in separate, designated sessions in the Chamber and the Senate (Ferrera and Gualmini 2004 p64). In 1986 secret voting on budgetary issues was abolished to stop „snipers“ (franchi tiratori) from undermining the government’s fiscal plans (Padovano and Venturi 2001).

<sup>132</sup> See Hallerberg and von Hagen (1997), Hallerberg (2004), Hallerberg and Yllaoutinen (2008), Hallerberg, Strauch and von Hagen (2009).

approach to fiscal government (i.e. the unfettered pursuit of particularistic spending preferences by individual actors). From this perspective, Italy's and Belgium's poor fiscal track record of the 1980s can be explained by the *de facto* lack of competition for domination of the government due to the entrenched position of Christian Democratic parties of both countries as dominant actors in the parliamentary sphere (Hallerberg 2004 pp 131 and 183).

When strong electoral incentives are present for restraining deficits, parties within a coalition constrain themselves either by entrusting the finance minister with the power to defend the balance of the budget against spending pressures from ministries (this is what Hallerberg et al. call the *delegation* approach to fiscal governance) or by committing to a set of fiscal targets laid down in a contract between the parties (this is the *commitment* or *contract* approach). It depends on the ideological distance of parties within a coalition, which of these two approaches is more effective in a given case. The delegation approach is expected to work better with single-party governments or coalitions of ideologically strongly aligned parties, whereas a contract is the only viable solution in the case of coalitions of considerable ideological dispersion. In this framework, Italy's remarkable recovery in the second half of the 1990s is a clear example of the successful centralization of budgetary decisions under a strong finance minister in a cohesive electoral coalition, whereas Belgium's good performance presumably reflects the presence of binding contracts amongst dispersed coalitions. Importantly, in both cases, the electoral significance of fiscal balance is greatly magnified by the euro-accession process in the 1990s and by both countries' experience with fiscal crisis in the early 1990s, enhancing the adoption and entrenchment of the new fiscal governance institutions (Hallerberg 2004 pp 133-135 and 189-195, Hallerberg et al. pp126-129).

The fiscal governance framework of Hallerberg and his co-authors emphasizes that government fragmentation does not necessarily have repercussions on fiscal discipline and that the effectiveness of fiscal institutions depends on the political will to operate them. Thereby, it successfully corrects for the shortcomings of the literatures on political fragmentation and on fiscal institutions. At the same time, it does not incorporate the full range of forces that determine whether there will be enough political will to restore fiscal balance even at the expense of strong particularistic interests in a given polity, as it only focuses on the incentives and constraints of actors

within the narrow governmental sphere. Due to this omission, it is at odds with many of the specific features of fiscal policy making in Belgium and Italy.

First of all, the case studies show that in both countries conflicts amongst coalition partners were not the main source of the lack of political will to restore fiscal balance at the cost of hurting particularistic interests. Therefore, coalitional strife cannot be made the principal culprit for the fiscal problems of the 1980s. The conflicts of interests that paralysed policy makers in the face of the escalating fiscal situation and allowed the deficits to persist emanated, on the one hand, from *within the dominant party of the government* itself<sup>133</sup> and, on the other hand, from *outside of the governmental and parliamentary sphere*. In Italy, Christian Democracy had to cater to three very diverse sets of interests, which excluded the possibility of increasing revenues and significantly constrained the options for cutting collective consumption and public investment expenditure. In Belgium, too, major conflicts of interests between labour and business were housed within the ranks of the Flemish Christian Democratic party, tying the government's hands in cutting welfare entitlements or increasing revenues. Consequently, even if these parties had governed alone, their room for manoeuvre would have been equally constrained by the conflicts of interests within their own constituencies. Furthermore, in both countries major obstacles to adjusting welfare expenditure, the largest single spending item within the budget, arose from extra-parliamentary sources – from the threat of labour mobilization – rather than from intra-governmental or intra-parliamentary vetoes. Therefore, certain avenues for restoring fiscal balance were ruled out irrespective of coalitional agreement about the issue.

Furthermore, the assertion that deficits were caused by unbridled spending pressures under a fiefdom approach to budgeting throughout the 1980s suggests that discretionary spending was out of control in this period in the two countries. The upward drift of expenditure observed in Italy in these years is compatible with this interpretation. In the Belgian case, however, this depiction of fiscal policy making stands in marked contrast with the drastic retrenchment of spending achieved by successive governments throughout the 1980s. Public consumption and investment expenditure was cut back by more than 11 per cent of the GDP in the period and the primary balance improved by an astonishing 13 per cent. The governments that achieved these results were able to keep almost all of the important areas of the budget

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<sup>133</sup> This finding confirms Balassone and Giordano's (2001) intuition discussed in the Introduction.

in check. Fiscal tightening took place in every domain except in social spending. The real drivers of debt accumulation in Belgium were the automatic snowballing of debt and major imbalances within the social security sector rather than problems with discretionary expenditure. Consequently, a blanket assertion about problems with spending control – and the concept of fiefdom approach to spending – fails to capture the essence of the deficit problem of the 1980s in that country.

Finally, it is questionable to what extent the concepts of delegation and contract governance can illuminate the two countries' fiscal experiences in the 1990s and the 2000s. According to Hallerberg, Belgium successfully transitioned to contract governance in the early 1990s by endowing the High Council of Finance<sup>134</sup> with the authority to coordinate and influence agreements about fiscal targets between different levels of government. These targets served as the basis for intra-governmental agreements about fiscal policy (Hallerberg 2004, p133). Through these institutional changes and the strengthened electoral incentives for fiscal discipline, spending control was supposedly achieved.

Two main observations contradict this account. On the one hand, the path to consolidation in the 1990s relied overwhelmingly on the exogenous fall of the interest costs and on revenue increasing measures – including one-off measures such as privatization and the selling of the central bank's gold – rather than on retrenching primary expenditure through tightened spending control. Furthermore, in the 2000s fiscal policy was noticeably relaxed and primary spending expanded, albeit the rapid dwindling of primary surpluses were to a great extent counterbalanced by the continued fall of interest costs and therefore the overall budget stayed in balance<sup>135</sup>.

On the other hand, the role and effectiveness of the High Council of Finance diminished in the years after the euro accession. Not only were its recommendations less closely adhered to by the different levels of government, but its operation was *de facto* suspended in the years when the government made consequential spending decisions that would have likely raised too much controversy within the Council, such as the bailing out of the state railway company in 2005 and 2006 and of troubled banks<sup>136</sup> in

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<sup>134</sup> Or more accurately, to the Public Sector Borrowing Requirement of the High Council of Finance.

<sup>135</sup> Notably, the original intention was that governments should capture the windfall gain of decreasing interest rates and produce surpluses to fill up the so-called Silver Fund as a precautionary measure to counterbalance the imminent effects of population ageing. In this sense, the relaxing of the budget cannot be seen as a natural response to easing external financing conditions.

<sup>136</sup> These decisions worsened the budget by 2.4 and 7 per cent of the GDP, respectively.

2008 (Coere and Langenus 2010). Therefore, Belgium seems to have neither credibly entrenched its institutions for fiscal commitments, nor improved its spending control in the past two decades.

In Italy, the successful shift to a delegation form of governance is attributed to the formation of cohesive electoral blocks – in which parties have joint electoral fates and are therefore willing to cede control to a single person – and the centralization of decision making over the budget in a single ministry created from the Ministry of the Budget and the Treasury in the second half of the 1990s (Hallerberg 2004, pp191-192). After 2000, both of these factors were strengthened. The centre-right, which won the 2001 elections, was characterized by much greater ideological unity than the centre-left had been in 1996 and two of its three main parties headed towards merger (Conti 2010). Moreover, institutional centralization was increased when the Ministry of the Economy was merged into the Ministry of Finance, creating a single “superministry” under the Lega’s finance minister in 2001 (Hallerberg 2004, p195). However, these developments failed to enhance spending control. Primary expenditure swiftly increased under the centre-right government and deficits grew. When the centre-left – which had also consolidated internally in the 2000s – took power again in 2006, primary spending was reined in once again and the balance of the budget improved. In other words, fiscal performance oscillated wildly after 2000, even though the hypothesized conditions for delegation steadily improved.

The discrepancies between the predictions of the fiscal governance framework and the observed Italian and Belgian performance in the 1990s and the 2000s cannot be satisfactorily explained even when factoring in the changes in the external pressure from the evolving European fiscal architecture. In *Fiscal Governance in Europe* (2009), Hallerberg et al. argue that after the launch of the euro, the shift towards closer surveillance but less stringent enforcement under the Stability and Growth Pact was more compatible with the commitment than with the delegation form of fiscal governance. This argument, however, does not tally either with the weakening of commitment in Belgium or with the volatile – sometimes deteriorating, sometimes dramatically improving – results of delegation in Italy. One could also argue that the loss of a credible European punishment mechanism after accession translated into a decreased political salience of fiscal discipline and therefore weaker incentives for

policy makers to cooperate<sup>137</sup>. This claim is at odds with the brief period of drastic fiscal consolidation in Italy under the 2006-2008 centre-left government. More importantly, however, it implies that in the absence of a strong external incentive all the other hypothesized conditions for successful fiscal governance – increased electoral competition, past experience with fiscal crises, a suitable institutional infrastructure for coordination and the necessary party-political characteristics – are not sufficient for producing the expected fiscal results.

In sum, while the fiscal governance approach undoubtedly captures a crucial interplay between political factors and the performance of the fiscal decision making machinery of the state, those features of intra-governmental collective action problems that it focuses on do not in themselves account for the ebb and flow of political determination to overcome fiscal problems in Italy and Belgium over the past three decades. The case studies demonstrated the crucial importance of extra-parliamentary struggles over the distribution of fiscal pain. Thereby, they underlined the limits of exclusively focusing on the parameters of decision making within the structures of the state and alerted to the need to take into consideration more directly the constellation of societal interests that determine the availability of broader societal support for fiscal sacrifices.

### *State autonomy*

Societal constraints on the autonomy of the state play a central part in theoretical approaches that explain variation in fiscal performance via varying levels of autonomy of the state. This version of state-centred theories acknowledges the role of societal pressures in influencing fiscal outcomes and ask the question under what conditions the state can sufficiently insulate itself from particularistic demands and gain sufficient authority to gear policy towards the public good of fiscal stability. This line of reasoning rests on a view of policy making that accords autonomous role to administrative elites in forming government policies that is independent of the particularistic societal interests (Skocpol 1985).

In the context of the evolving fiscal performance of Italy and Belgium, this approach has been used to explain the policy problems of the 1980s with the extraordinarily high permeability of state structures to diverse societal interests and the recovery of the

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<sup>137</sup> In fact, in 'Domestic Budgets in a United Europe' (2004 p136-137 and p195), Hallerberg makes a similar argument when he contemplates the importance of the euro accession in the temporary success of the institutional changes in Italy and Belgium.

1990s with a sudden empowerment of state actors (Della Sala 1997). Authors promoting this argument link the change in the level of state autonomy between the two decades to the overriding national determination to fulfil the Maastricht criteria in time for the first round of euro accession. The gist of this so-called *vincolo esterno* argument<sup>138</sup> is that by committing themselves to the euro-accession – and thereby subjecting policies to strongly binding constraints like the Maastricht deficit criterion – governments gained power vis-à-vis powerful societal groups, which enabled them to carry out painful but necessary policy adjustments, such as the stabilization of public finances (Dyson and Featherstone 1996, Della Sala 1997, Pochet 2004, Quaglia and Radaelli 2007).

Neither of the two case studies seems to bear out the external empowerment argument. In Belgium, the technocracy – if anything – was weakened by the binding Maastricht criteria. For example, the High Council of Finance – assumed to be an important bulwark of technocratic influence and neutral enforcer of fiscal discipline due to the strong institutional role of the representatives of the central bank within its committees – was compromised in this role as soon as the Maastricht criteria gave Wallonia a trump card that it could (and did) use to extract concessions and achieve the loosening of its fiscal constraints in yearly negotiations about the fiscal targets. In Italy, the technocracy did gain quite substantial influence in policy making in the run-up to the euro. However, this influence was conferred on technocrats by a powerful coalition of interests that entrusted them with the task of carrying out fiscal retrenchment. Importantly, the influence of the technocracy was very tightly circumscribed by the interests and sensitivities of the coalition on behalf of which it acted. This is well exemplified by the limited pension reforms carried out in this period in Italy. In this sense, the technocratic elite was not so much empowered, but entrusted with the task of restoring fiscal balance (within the above-mentioned limits). In both cases, the influence of technocratic elites remained dependent on and constrained by the balance of power between different clusters of societal interests even in the Maastricht years.

At the same time, even if the empowering effect of Maastricht is questionable, the *vincolo esterno* argument directs attention to an important shared characteristic of the two countries: the marked weakness of the state in both cases. Many authors note the

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<sup>138</sup> The term was originally coined by Giavazzi and Pagano (1988) to describe the credibility effects of belonging to a fixed exchange rate system like the European Monetary System, but it was then used by (Dyson and Featherstone 1999) to describe the effects of the constraints created by the euro-accession process on government policies.



extreme strength of parties *vis-à-vis* the state, the permeation of all aspects of the state by partisan interests and the lack of politically independent technocratic bureaucracies in both countries (e.g. Anderson et al 2007, Marier 2008, Della Sala 2007). The manifest weakness of the Belgian and Italian state raises a particularly important question that has bearing on the scope and interpretation of the present findings about the crucial importance of societal groups and their self-seeking alliances in determining policy choices. Is it the weakness of the state that allows these societal groups such strong influence on policies or is it the structure and conflicts of interests within the polity that prevents the formation of an autonomous power centre in the shape of an independent technocratic bureaucracy? Answering this question requires looking at the relative importance of institutions that structure the interaction of societal groups with the state versus the role of the structural characteristics of societal conflicts of interest and balance of power.

#### *Corporatism, party systems and consociational practices*

It is beyond the scope of this study to definitively evaluate the chicken-and-egg problem of weak states and influential societal groups even for the case of Italy and Belgium. At the same time, the case studies do supply some interesting detail about how electoral and party systems, corporatist and consociational arrangements – i.e. institutional factors that influence how particularistic policy demands are channelled into decision making within the state – are linked to the structural power of different societal groups within each polity. The findings suggest that the ultimate source of policy leverage of given societal groups is typically the power resources they can mobilize outside of the institutionalized channels of influence. Therefore, the permeability of the state to special interest seems to have depended on the distribution of these resources among different coalitions of interest in both countries.

A clear example of the primacy of structural sources of policy leverage over institutional position is the role trade unions played in shaping the politics of fiscal stabilization in the two countries. Both case studies emphasized their crucial influence on policy choices, primarily their ability to block – or at least significantly water down – attempts at welfare retrenchment for most of the past three decades. This influence had some of the trappings of institutionalized power in both Italy and Belgium, but the analysis clearly showed that it was the implicit or explicit threats of devastating

industrial action that endowed unions with the observed weight in policy making and gave labour interest strong representation.

In Italy, the workers' movement of the 1960s and 1970s wrestled a few institutional functions from the state for unions – such as the operation of the welfare system and some consultative rights – but the *de facto* leverage of unions depended on successful strikes. Given the threefold division of the trade union movement – between Communist, Christian Democratic and Socialist – success hinged on their unity of action, although the largest, Communist unions had overwhelming importance in leading strikes. Since the three unions represent slightly different constituencies of dependent employees, their ability to cooperate and therefore their influence on policy making have been a function of the commonalities or conflicts of interests between blue-collar, white-collar workers and public employees. The unions' lack of unity famously led to a failure to prevent the adjustment of the *scala mobile* in the early 1980s and to the passing of labour market and pension reforms under the centre-right government in the early 2000s. Their unified action, on the other hand, achieved the dramatic welfare expansion of the late 1960s and 1970s, forced the Amato government to back down on pension reform in 1992 and kept successive technocratic and centre-left governments at the negotiation table for the rest of the 1990s (Regini and Regalia 1997, Baccaro, Carrieri and Damiano 2003).

In Belgium, unions have a say in economic policy through their places in the National Labour Council and the Central Economic Council, and in the field of welfare policy through their role in administering the social security funds (Hemerijck, Berger and Visser 1999, Marier 2008). However, neither of these institutionalized channels of influence played a significant role in the struggle over welfare retrenchment. This is best demonstrated by the differential leverage that the different unions – Christian Democratic, Socialist and Liberal – exercise on policy. Since effective nationwide strikes are only possible with the participation of the largest, Christian Democratic unions, the other two organizations are practically powerless in themselves, despite their equal institutional roles. Christian Democratic unions exercised their influence over policy mostly outside of the institutionalized consultation fora. They botched retrenchment attempts either by striking (as in the case of the Global Pact of 1993) or by informally pressuring the government (e.g. St. Anna Plan of 1986). Characteristically, on the one occasion, when they acquiesced in retrenchment in 1982, this, too, was done in a secret, informal setting between the leaders and government politicians.

In sum, institutionalized corporatist arrangements do not seem to play an important role in the ability of unions to assert workers' interests in the policy making domain in either country. Rather, their political leverage arises from capacity to mobilize a majority of workers. It is also interesting to note that both in Italy and Belgium, unions have been influential despite their historic institutional development that led to a three-way organizational division as well as to divergent ideological outlooks and organizational cultures (Baccaro, Carrieri and Damiano 2003). These organizational divisions only impeded their capacity for united action, when their different constituencies had different preferences on a given issue.

Another often-emphasized way in which particularistic interests permeated policy making in both countries was the presence of factionalized, interest-group driven parties at the helm of governments, who kept strong partisan control over the state machinery (Della Sala 1997, Pasquino 1997, Hooghe 2004, Marier 2008). Although these parties acted as institutionalized "transmission belts" for particularistic interests into governmental decision making, the case studies suggest that the extent to which different groups were able to "upload" their preferences into policy making also depended on the resources they were otherwise able to mobilize in their struggle with other groups.

In Belgium, the intertwining of societal groups with parties – not only the Christian Democratic but also the Socialist and to some extent the Liberal parties – is attributed to the historical development of the pillar system, in which each party "family" grew strong roots into society by developing tight links with societal and civil organizations, from trade unions to smallholders' associations, to women's leagues and the like (Delwit 1996). In the Flemish Christian Democratic party, for example, this led to an organizational structure in which the different *standen* – business, labour and smallholders – had the right to delegate their own representatives into a predefined number of the decision making positions and thereby directly determine the party's policy stance all the way until the early 1990s (De Winter 1996). However, throughout the 1980s – when the policy hegemony of the Flemish Christian Democrats was pronounced – both labour and business refrained from using this channel to attempt to force the hands of the party, for fear of triggering a painful reaction from other groups. Business feared strikes at a time of great economic vulnerability, whereas labour worried about undermining international competitiveness and causing business to

relocate in the medium and long run (Jones 2008 p170). Therefore, both groups used their institutional influence on the party within the limits circumscribed by the other's tolerance. Interestingly, the institution of internal delegation weakened considerably by the 1990s and later it was completely given up (De Winter 1996). This suggests that the party and the *standen* acknowledged the irrelevance of such arrangements themselves.

In Italy, the electoral system is most often blamed for the development of Christian Democracy into a strongly factionalized party, excessively given to particularistic considerations, to pork-barrel politics and to clientelistic practices. The system of preference votes used up to 1993 provided strong incentives to individual politicians to distinguish themselves from each other and the general party line by securing targeted benefits to their constituents and by being especially attentive to local demands and concerns (Carey and Shugart 1995, Cox and McCubbins 2001). At the same time, the party's strategy towards the proletariat of the South shows that these incentives did not always work with the same intensity, and the ability of party factions to secure particularistic benefits to their specific constituencies also depended on the strategic position of that constituency within societal struggles. The needs of the Southern proletariat were largely ignored prior to the workers' movement of the late 1960s and early 1970s. Later, however, this group of voters turned into an influential constituency of the DC, after the riots in the South and the strikes in the North demonstrated the potential danger of a two-front war for the DC with anti-system parties from both ends of the political spectrum and for business with worker groups in different parts of the country. Existing clientele networks in the South were then extended to the proletarian stratum of the local population and beefed up with new resources to cater for this important new constituency. The faction operating these networks thereby gained increased influence within the party. In sum, the incentives emanating from the electoral system worked in conjunction with the balance of power between different societal groups. Furthermore, it is also interesting to note, that the clientele networks were kept alive by centre-right parties even after the shift to majoritarian electoral system in the early 1990s, since they could thereby reach voters whose ballot was crucial in ensuring a centre-right majority (Hopkin and Ignazi 2008).

Finally, special power sharing institutions between regional and linguistic groups in Belgium merit particular attention due to their potential to influence policy struggles between Flemish and Walloon interests. These institutions were built to ensure equal

power to both sides despite unambiguous Flemish dominance in terms of both economic resources and electoral numbers, via a series of vetoes and rules guaranteeing parity of numbers in key decision-making fora (Deschouwer 2009). In the past decades, these institutional arrangements have clearly provided the Walloon side with some protection against Flemish policy initiatives. However, they did not stop the gradual devolution of important resources and decision making authority to the regional level, where economic disparities are free to exercise their effect. In the question of splitting social security, the Walloon veto has so far been successful in averting a major setback to Walloon interest, but the fierce determination of Flemish politicians to achieve a breakthrough in this matter and the electoral support that the most radical Flemish parties could muster in the past years suggests, that Flanders might be ready to dismantle the power sharing institutions altogether for the sake of having its way in this issue. In sum, while the importance of institutional arrangements in channelling Flemish-Walloon conflicts of interests is unquestionable, their longer-run effect in halting the Flemish tide and their eventual survival is far from certain.

Clearly, this brief overview of institutional factors could only look at a few, most often emphasized features of the Belgian and Italian political systems that determined how particularistic interests gained effective representation in the policy making sphere. The examples illustrate, however, that over the longer time horizon, these institutional factors played relatively minor role in shaping the incentives and constraints of political actors representing different clusters of interests. Instead, their impact tended to be subject of the balance of power between different societal groups and their evolution through time reflected the changes in this balance of power.

#### *Ideology and political entrepreneurship*

While the above discussion of union, party and ethno-linguistic politics concentrated on institutional-organizational features, another important aspect that bears on the characteristics of interest representation in a polity is ideological division between the different interest representing actors. From this perspective, a crucial question to ask is to what extent ideological convictions and commitments enhance or compromise the ability of these actors to effectively represent the interests of societal groups and to

foster the formation of powerful coalitions between them by creatively redefining commonalities and conflicts of interests<sup>139</sup>.

The case studies suggest that the evolution of policy preferences and structural sources of power have overriding importance over ideological considerations in defining societal coalitions and determining the eventual policy choices advocated by different political actors. On the one hand, significant shifts can take place in the policy preferences of interest-representing organizations – to adapt to the changing preferences or the changing balance of power of groups within their constituency – without obvious changes in their ideological outlook. On the other hand, ideologies are sometimes explicitly adopted and adapted by interest representing organizations in order to cater to the evolving preferences of a given societal group or to assume the representation of an emerging societal coalition. In this latter respect, political and policy entrepreneurship is important in giving political shape to emergent coalitions, as enterprising organizations harness new commonalities and conflicts of interests in order to win over a new societal base. However, this type of political innovation tends to be rooted in materially given cleavages and often responds to existing discontent in a societal segment with its existing representative organization.

In Italy, scholarship has emphasized the role of extreme ideological division of society in the post-war decades between Communist and anti-Communist forces. This emphasis on separate Christian Democratic and Communist “subcultures” within society suggests that ideology defined societal coalitions in that period as well as the policy choices of the anti-Communist government coalition<sup>140</sup>. However, the co-operation of Communist and Christian Democratic trade unions during the years of worker upheaval in the late 1960s and early 1970s – enforced mostly by pressure from their grassroots – suggests that ideological divisions were at times eclipsed by the underlying commonality of worker interests. Furthermore, the firmness of the ideological commitment of anti-Communist governments to certain policy choices is put into question by the observed shift in policies from a business-friendly neoliberal approach resting on spending restraint, balanced budgets and monetary stringency in the 1950s and 1960s to the debt-financed expansion of spending and the monetization of deficits from the 1970s.

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<sup>139</sup> On the role of parties shaping cleavages within the electorate – rather than being shaped by them – see Sartori (1969). On the role of ideas as the basis of coalition formation (Blyth 2002).

<sup>140</sup> On political subcultures, see Trigilia (1986). For a review and a refutation of the ideology-centred view, see (Tarrow 1977)

In Italy's Second Republic, the role of ideological "engineering" – i.e. the tailoring of political messages to fit the policy preferences of specific societal groups – is tangible in both shaping the emergent party system and in the cobbling together of societal coalitions behind the opposing electoral blocks. The most ingenious example of how new conflicts and commonalities of interests are harnessed by policy entrepreneurs, is the Lega's success in carving out a sizeable electoral base from the constituency of the – then still existing and relatively strong – Christian Democracy in 1980s. The Lega discovered the fundamental congruence of interests across classes in the industrial districts of the North in international competitiveness, low taxes and employment flexibility, and it managed to tap into a pool of discontent of Christian Democratic voters of the North with the government's inability to provide favourable exchange rates. It achieved this by building an ideology that is territorially defined, with its targeted territory covering the areas where the industrial district mode of production is most prevalent. Interestingly, this ideology – centred on the conflict of interests between North and South – did not prevent the party in later years from entering coalitions with a strong Southern force, the AN (Diamanti 2007). Compared to the Lega's innovation, Forza Italia's ideological engineering is somewhat more conventional, since it is based on market research to identify the ideological "selling points" that appeal to the largest possible sections of the constituencies of the defunct DC (Thompson and Price 2009b). Finally, the AN and parties of the left followed an even more conventional strategy in targeting the societal groups they inherited from the former Communist and post-fascist parties and "watering down" their previously extreme ideologies to be able to cater to these electorates in the new political context.

In Belgium, economic policy preferences of the big parties corresponded quite closely to their ideological commitments up to the most recent times. What is interesting in the Belgian case, however, is how the respective – Christian Democratic, Socialist and Liberal – ideologies have waned in political relevance due to the emergence and strengthening of the Flemish-Walloon divide. Parties are now competing to a great extent on their ability and willingness to defend and further the interests of their respective regions, rather than on traditional policy platforms. As a result, previously inconceivable government configurations and policy mixes have become possible, as old ideological dividing lines have weakened.

This displacement of ideological strife by the Flemish-Walloon conflict is a hugely interesting political phenomenon that raises the issue of what role political entrepreneurship plays in (re)defining commonalities and conflicts of interests between different groups in society. Even though division between the two halves of the country had historical roots and gained more pronounced institutional shape in the 1970s and 1980s, it was due largely to a campaign by the Flemish Christian Democrats that the rift between the two regions gained such strong distributive overtones and became the centre of political conflict over fiscal policy. The Flemish Christian Democrats decided to direct attention on interregional transfers and educate the Flemish electorate about the imbalances of cross-regional taxation and social security payments, in an effort to deflect attention from the conflict between labour and business over social security, which had put great strain on its own supporter base. Interestingly, this strategy built on an existing structural division between the two regions rooted in disparities in economic dynamism – one which had already temporarily counteracted the class divide in the early 1980s when Flemish labour and business compromised over austerity measures – but it approached the division from the angle of taxation and welfare transfers, an aspect that was not immediately obvious to citizens. In this sense, although the basis for the new definition for conflicts and commonalities of interest was objectively given, its rise to political relevance is connected to a political entrepreneur's strategic behaviour.

### *European constraints*

A final question to address with respect to explaining fiscal policy choices in Italy and Belgium in the past decades is to what extent these choices can be understood by focusing on the domestic policy arena and to what extent they derive from international incentives and constraints. This issue is especially relevant in light of the ever-closer European economic and political integration that took place during these decades, with far-reaching consequences for market conditions as well as for the range of possible policy options in both countries.

While the case studies provide ample evidence of the importance of Europe for policy developments, they also show that the effect of changes at the European level is by no means pre-determined or straightforward. In some cases, the policy influence of European developments is truly exogenous in the sense that new constraints arise and are enforced independently of the domestic political struggle. At other times, such



developments become significant only because of the specific policy preferences of certain groups within the given polity. In other words, the decision to take on commitments and to comply with them can be an outcome of the domestic political struggle, rather than an unavoidable consequence of the country's position within European integration. Consequently, the impact of external developments on the domestic political conflicts also varies according to the specific domestic context.

For example, the case studies demonstrated that exchange rate constraints under the European Monetary System played an important role in shaping the political context of fiscal policy making in both countries throughout the 1980s. However, while in Belgium adherence to the EMS was the choice of a powerful domestic coalition, it was a constraint imposed by external pressure in Italy. For groups exposed to international competition in Belgium, exchange rate stability – and primarily favourable exchange rates with the German currency – was a first priority. Therefore, when Belgium was threatened with exclusion after manifest difficulties with keeping the required parity in 1982, the obvious choice for governments supported by these groups was to subject monetary policy fully to the requirements of maintaining parity – which translated into an end to the monetization of debt, low inflation and high real interest rates – even if this decision came with prohibitive interests on public debt and therefore a deterioration of the fiscal problem (McNamara 1998, Pochet 2004). The insistence of the Belgian government on complying with its commitments in the EMS was a way to insulate exposed business and labour from the negative effects of fiscal problems, even though it had detrimental consequences for the ability of the country to deal with those problems. The EMS thus had a threefold effect on the politics of fiscal stabilization in Belgium. First, it accelerated the snowballing of debt due to higher real interest rates. Second, it elicited agreement amongst the exposed sectors about the need to radically cut public consumption and investment. Third, it allowed powerful social groups to dig in their heels in the conflict over the consolidation of the social security system. In other words, the constraints of the EMS were to a great extent voluntary and influenced the evolution of the political struggle over fiscal policy in highly complex ways.

Italy, on the other hand, was coaxed into joining the EMS by external diplomatic pressure largely against its will (as shown in Chapter 3.). Even though it received preferential treatment within the system in the form of wider volatility margins for its exchange rates, no interest group was clearly in favour of fixing the exchange rates. Successive governments later managed to achieve adjustments in the parity, but such

changes were subject to the agreement of Italy's partners within the EMS and thus the exchange rate became a source of exogenous pressure on the Italian policy environment and an important factor in making the economic side effects of persistent deficits painful for groups exposed to international competition. Thereby, it gave a crucial impetus to the evolution of the preferences of these groups towards fiscal stabilization and thus to rethinking existing societal coalitions and political alignments.

Joining the Economic and Monetary Union was an elective choice for both countries. In fact, their omission from the first round would have been automatic, had they not managed to reduce their fiscal imbalances in time. The choice to make the required sacrifices reflected the preferences of dominant societal coalitions in both countries. However, this choice still influenced domestic struggles in the two countries in different ways, because it affected the policy leverage of the dominant coalitions differently. In Italy, the decision to join the EMU – and therefore to comply with the Maastricht criteria – had little independent effect. The competitiveness coalition – composed of large businesses, a section of the small entrepreneurial class and parts of labour – that this decision favoured due to its exposure to international competition had already seized control over policy making. It was both determined and had the political leverage to consolidate the budget irrespective of monetary integration. In fact, by the time the decision to join the euro was made, this coalition had set into motion most of the significant stabilizing measures that put debt on a declining path in the 1990s. Therefore, consolidation happened largely independently of the euro.

In Belgium, the decision to fulfil the Maastricht criteria favoured Flanders to a much greater extent than it did Wallonia, due to the much tighter integration of Flemish industry into the European economic circulation. However, since Walloon cooperation was indispensable for reaching the deficit targets, the race for the euro gave Wallonia strong blackmailing power. This change in the balance of power between the two regions resulted in a series of policy compromises that allowed Wallonia to withstand Flemish efforts to resolve interregional disputes by gradually starving Wallonia of funds. In this sense, the Maastricht rules intervened in the Belgian domestic redistributive conflicts in a way that delayed their resolution and thereby postponed the solution to the structural problems of Belgian public finances.

The creation of the European Monetary System and later the launching of the Economic Monetary Union are just the two most important channels through which the evolving

European integration affected domestic political struggles over fiscal policy. The reduction in market fragmentation and the prohibition of state aid under the Single Market project are further examples of how European decisions influence economic conditions that impinge on the policy preferences of different groups and how they limit the policy options of governments. The two case studies sought to show that while these external developments had tangible effects on policy choices in both countries under consideration, these effects were not *a priori* obvious, because they were refracted by the domestic political and economic context with which they interacted<sup>141</sup>.

*Conclusion: domestic structures versus institutions, ideas and international constraints*

This section attempted to disentangle the complex interaction between structural factors – i.e. the constellation of policy preferences and political leverage – and institutional, ideational and international aspects in determining the evolution of debt accumulation in Belgium and Italy. It emphasized the primacy of socio-economic factors in determining the chances of fiscal consolidation by showing that the explanatory mechanism posited by the society-centred model can be clearly traced out behind political and policy developments in both countries without the need to make limiting assumptions about the institutional structure, the ideational environment or the international context in which the mechanism played out.

Thereby, it reinforced the conclusion that the likelihood of successful consolidation in a country plagued by persistent fiscal imbalances should be universally expected to depend on the evolution of the struggle of different socio-economic groups over who is to bear the sacrifices required for restoring the balance of public finances. The outcome of such a struggle, in turn, is determined by the polarization of policy preferences between different groups, the extent to which these groups are able to insulate themselves from the negative economic side effects of the fiscal problems and on the political coalitions they form in defence of their interests. The next, concluding section evaluates the implications of these findings and discusses the theoretical, methodological and policy-related contribution of this thesis.

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<sup>141</sup> It is perhaps worth noting that the case studies forewent reflecting on other potentially important international factors beyond European economic integration that might have had significant effects on the evolution of domestic political struggles in both countries. The international system changed tremendously since the beginning of the 1980s, but it is beyond the scope of this thesis to evaluate to which extent the end of the Cold War played a part in the radical transformation of the political regime in Italy in the early 1990s or in the intensification of regional conflict – and the more tangible possibility of the eventual splitting of the country – in the past two decades in Belgium.

## Contributions

The present crisis highlighted the vulnerabilities that debt creates. The failure of many countries – such as Greece, Portugal, Hungary or Italy – to get their debt levels under control in the past decades now has dire consequences for their chances of coping at a time when markets are nervous and financing is scarce. In the present situation, the question of how countries end up in such desperate situations is raised with renewed urgency. This thesis proposed an answer to this question and used it to explain two historically stubborn cases of alarming indebtedness. While the research design applied here does not allow for sweeping conclusions, the findings provide important theoretical, methodological and policy-related insights. In the wake of the present protracted economic recession and the European sovereign debt crisis, when many European countries are bracing themselves for difficult years of having to deal with dangerous levels of debt, these insights can be useful in understanding how different countries cope with their old or new fiscal challenges.

### *Contributions to the theoretical debate and methodological aspects*

One of the main theoretical contributions of this thesis is its choice of theoretical approach. Although the society-centred approach to explaining observed policy trajectories has a venerable tradition in political economy, it has not been applied to the field of fiscal policy before<sup>142</sup>. By looking for explanations for disastrous debt accumulation in the socio-economic context of policy making, the thesis considerably broadened the scope of inquiry and explored factors that were inaccessible to the existing, government-centred explanations for sovereign borrowing.

A second theoretical contribution is the infusion of the society-centred approach with the insights of a dynamic game-theoretical model. The static society-centred approach was not directly applicable to the issue at hand. Policy analysis in the “coalitions of interests” tradition has so far always concentrated on comparative statics: it focused on explaining policy choices at important junctures in a country’s economic history by exploring the constellations of societal interests under the given economic

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<sup>142</sup> The approach has been used to explain trade policies (e.g. Kindleberger 1951, Frieden and Rogowski 1996), industrial policies (Frieden 1991), monetary and exchange rate policies (e.g. Henning 1994, Frieden 2002) and complex policy packages integrating several elements of different issue areas (Gourevitch 1986).

conditions<sup>143</sup>. The issue of debt accumulation, on the other hand, is inherently dynamic. The task was to understand why and how long it is allowed to grow and why and how long the economic pressures and financial risks are tolerated before effective action is taken to eliminate fiscal imbalances. Therefore, the thesis imported into the society-centred framework of analysis a dynamic game that modelled exactly this question. While Alesina and Drazen's war of attrition model has been a widely cited in the literature, its empirical applications have been very limited both in number and scope, likely because of its dynamic nature, which makes testing it in a large-n statistical model impossible. Using this model in a qualitative study helped to gauge the empirical relevance of the model's predictions about the expected behaviour of societal groups in the presence of large problems with public finances.

Marrying the two very different theoretical frameworks allowed for a diachronic analysis of the socio-economic context of policy making that is both rigorous and at the same time rich with sociological and historical detail. It allowed for a close mapping of the endogenous evolution of the socio-political context of fiscal policy making by tracing the changing structure of interests and preferences as the fiscal problems escalated and made their effects felt. Understanding how the constellation of interests evolved is key to explaining both the change from borrowing to balancing the budget and the specific composition of adjustment. Therefore, this theoretical approach gave a fuller and more accurate picture of the factors driving episodes of excessive debt accumulation and consolidation in these two countries than existing, government-centred theories. It also allowed for evaluating the relative importance of structural factors compared to institutional and ideational aspects as well as for incorporating the role of international constraints on domestic policy making.

This dynamic, society-centred theoretical framework can also be of use for answering important questions beyond the one presented here. In particular, it could be applied in the field of fiscal sociology and in the scholarship on welfare state reform. The two case studies clearly showed that increasing pressures from fiscal problems and the realignments of societal coalitions are key factors in determining the willingness of societal actors to acquiesce in higher taxation or to give up on social security entitlements, on the one hand, and their abilities to defend themselves against unwanted reforms, on the other. The need to treat questions of taxation and social

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<sup>143</sup> Gourevitch (1986), for example, explains the different policy responses of different countries to major economic crises. Frieden (1991) analyses the policy reactions of different Latin-American countries to significant changes in the conditions on the world financial markets.

expenditure in a single framework has been underlined by Pierson (2001). The theoretical approach presented here goes one step further than that by providing a dynamic framework where taxation and social expenditure are investigated in relation to the country's evolving overall fiscal position. Furthermore, the case studies have drawn attention to the fact that fiscal compromises often involve non-fiscal side deals, such as the redesigning of wage bargaining as well as liberalization measures on the labour and product markets. This suggests that the combination of the societal coalitions framework and the war of attrition model can provide useful insights for analysing these policy areas, too.

From a methodological perspective, the approach taken here was somewhat unusual in that it consciously forewent defining *a priori* the expected empirical content that the key units of analysis would assume. Instead, it was one of the objectives of the empirical case studies to clarify the way in which the abstract concepts of the theory manifest themselves in the concrete cases, in an effort to use the empirical material to further develop the theory. Although this methodological choice limited the range of applicable research designs – i.e. it forewent rigorous testing of the theory by excluding the possibility of closely controlled comparisons between cases and a more quantitative treatment of the evidence – it greatly enhanced the theory-building potential of the case studies.

The choice was arguably vindicated by the findings. The cases provided evidence for the same underlying mechanism posited by the theory, yet they also displayed considerable variety in the key explanatory variables: the underlying redistributive arrangements which polarized the fiscal preferences of different societal groups about how to change the policy status quo, the ability of groups to insulate themselves from the negative side effects of deficits, the balance of power between them and the type of societal coalitions they formed. Furthermore, the choice not to pre-determine the empirical content of the key variables also allowed for registering interesting variations in the institutional, ideational and international context in which the posited mechanism played out. Further case studies are necessary to test the empirical relevance of the theory more broadly. In the coming years, the fiscal difficulties of many developed countries are likely to provide ample relevant material for such studies.

### *Policy implications 1: Italy and Belgium in the crisis*

The latest waves of the crisis have shaken both Italy and Belgium and engendered some important political changes. These have raised high hopes that the present crisis might become an opportunity in the hands of technocratic elites to resolve decade-long problems. The analysis of their past experiences with fiscal troubles provided in the thesis helps to understand the policy responses of each country's governments to the new challenges and to evaluate the chances of a breakthrough in stubborn policy issues.

The rapid escalation of the sovereign debt problems in other European countries and the attendant nervousness in financial markets raised the spectre of serious trouble in both countries – primarily through the rapid increase of the risk premium on government bonds in Italy and the threat of rating downgrades in Belgium. This emergency caused a suspension of “politics as usual” in both countries and created political situations that closely resemble the ones observed in the early 1990s. In Italy, a strong coalition of interests emerged supporting fiscal consolidation – and the attendant sacrifices – whereas in Belgium, feuding societal forces decided to put their conflicts on ice until conditions are safer.

In Italy, the last centre-right government<sup>144</sup> reluctantly introduced retrenchment measures in July and August of last year under pressure from looming danger of default. It was clear that if Italy wanted to appeal for European support in financing itself, harsh austerity and immediate savings were unavoidable. The measures included cuts to local spending – mostly affecting public employment – higher health co-payments and tax increases on top incomes and financial investments. Some of these measures were highly unusual for the centre-right coalition given the dependence of a large part of its electorate on public employment, as well as the aversion of another part to taxation. They quickly brought the coalition under stress, especially because it became clear that more pain was necessary. By October-November the constituent parties preferred to bring the government down and give way to a technocratic cabinet.

This new, unelected government – under an erstwhile European commissioner, Mario Monti – is currently governing with a cross-parliamentary support uniting both poles of

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<sup>144</sup> This government is mostly composed of the successor party of the erstwhile Forza Italia and the National Alliance as well as the Lega.

the political spectrum. Thanks to this support, the technocratic government has been able to take on some of the most sensitive issues of the past decades, inflicting great fiscal pain on previously untouchable interest groups. Labour is affected by a major pension reform (the raising of the retirement age, the end of indexation and the separation of pension payments from past earnings) as well as a planned reform to job security. Small entrepreneurs suffer from a crackdown on tax evasion, the reintroduction of property tax and the reform of protected professions (such as lawyers, notaries, taxi drivers etc.). Public employment has already been targeted by the summer package, which drastically cut back spending on staff in local administrations. At the same time, larger corporations have been spared of tax increases. Strikes and demonstrations have duly followed, but the government's approval ratings have remained high so far, its parliamentary support is stable and negotiations are still going on with unions. These measures have been passed in Parliament, but their implementation will take longer. It remains to be seen whether pressure from financial markets can sustain societal support for this range of overdue reforms and consolidation measures long enough for them to take root and eliminate some of Italy's most stubborn problems for the longer term<sup>145</sup>.

In Belgium, similar pressure was applied on political actors by the menace that the country's sovereign bonds would be downgraded due to the extended delay in government formation. Although Belgium has been amongst the lucky countries whose bonds continued to sell at moderate risk premiums, a rating change could have easily triggered deterioration in the market sentiment, especially in light of markets' anxiety about developments in Greece and Portugal. Higher interest costs on the large outstanding debt stock would have been a very dangerous development. Therefore, after more than a year of fierce debate over transforming the relations between Flanders and Wallonia, some Flemish parties decided to give up on a definitive settlement of these issues and thereby made the formation of a new government possible. As so many times in the past, Belgian political actors agreed to put their disagreements temporarily on hold for the sake of dealing with international pressures. Although compromise was achieved in the question of another round of state reform – the permanent sore point of the Brussels-Halle-Vilvoorde electoral district was once again addressed, and the transition of some regional responsibilities was agreed on –

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<sup>145</sup> "Monti takes axe to Mussolini-era guilds to bolster Italian economic growth", Bloomberg Jan. 20, 2012; "Monti's budget plan gets final approval in Italy Parliament", Bloomberg Dec. 22, 2011; "Italy's main political parties hold fire on Monti's emergency budget plan", Bloomberg Dec. 6, 2011;



the breakthrough in interregional redistribution that the largest Flemish parties were campaigning on was definitely not achieved.

The current Di Rupo cabinet – led by Walloon Socialists – quite clearly represents a temporary solution meant to address the present situation, rather than a lasting settlement. The compromise reached for the sake of making government formation possible fails to reflect the policy preferences and the balance of power between different societal groups within the polity. It certainly ignores the strong societal support among the Flemish – who have numerical as well as economic ascendancy over the Walloon – for definitively transforming Flemish-Walloon relations. Coalitional negotiations could be concluded only by excluding the currently largest party, the separatist New Flemish Alliance from government. Thus the ballot of third of the Flemish voters was disregarded. Furthermore, by compromising on their original demands, the other Flemish parties that do participate in the current government reneged on some important campaign promises. The fact that a Walloon party leads the government for the first time in several decades is also indicative of the exceptional nature of this settlement. It is of course an open question how long the regional issues will be kept on ice this time, but it is quite clear that the government formation crisis of 2010-2011 was not the last episode of interregional feud in Belgium<sup>146</sup>.

In the meantime, the austerity measures agreed by the new government follow the old recipe of concentrating largely on non-contentious items. Military and other federal public investment as well as international aid has been cut, and taxes on company cars, investment products and tobacco have been raised. The balance of the social security sector is not about to be addressed – in fact the new prime minister explicitly rejected the raising of the retirement age – except for minor adjustments, like the recent measures to discourage people from early retirement<sup>147</sup>. Major reforms in this field are especially unlikely as long as the government is headed by Walloon Socialists. In sum, the policy problem that has been at the root of Belgium's fiscal woes of the past decades is currently unlikely to be resolved.

Very much like in the early 1990s, the two countries are currently responding to pressing fiscal demands quite differently. In Italy, the fiscal issues are being addressed

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<sup>146</sup> "Belgium Gets Six-Party Coalition Government After Record 18-Month Standoff", Bloomberg Dec. 5, 2011; "Belgium's Di Rupo Starts Six-Party Talks to Form Government", Bloomberg Oct. 15, 2011; "Belgium Moves Toward Forming Full-Time Government After 488-Day Deadlock", Bloomberg Oct. 14, 2011;

<sup>147</sup> "Economic malaise forces Belgium to extend austerity", Reuters, March 11, 2012; "Belgium PM: Won't Raise Legal Retirement Age", Wall Street Journal, January 31, 2012;

in the broader context of competitiveness and the consolidation measures rest on the support of a societal coalition that is trading compromises for the sake of systemic changes in the economic regime. In the early 1990s, the abolition of the *scala mobile* and the relaxation of some labour market rigidities accompanied major reforms to public administration and privatization. Now, austerity measures go hand in hand with new efforts to make labour markets more flexible, the liberalization of protected professions and regulated markets as well as attempts to retrench the welfare system and to make local administrations leaner. In Belgium, the fiscal problems have been isolated from the rest of the economy's performance for so long now, that dealing with the persistent structural fiscal imbalances (emanating from the social security system) cannot be made easier by appealing to the general economic interests of different societal groups. Instead, the government manages headline deficit figures by cutting discretionary expenditure.

#### *Policy implications 2: The European fiscal architecture*

Finally, from the perspective of the policy debate, the main contribution of this thesis is a cautioning note against the unintended consequences of institutional fixes to policy problems, especially of externally imposed rules. In response to the crisis, the European Commission has attempted to put together a better fiscal architecture. This has two main elements. One is a set of more strongly binding rules about deficits and debt reduction, a so-called "Fiscal Compact" signed in March 2012 by twenty-five of the Member States. The other is a new procedure – the so-called European Semester – that was put into practice last year for closer coordination between EU authorities and national governments and parliaments in fiscal decision-making. It is supposed to enhance longer-term fiscal planning in the domestic policy making sphere, ensure the consistence of yearly budgets with the longer-term commitments and give more oversight to EU authorities over domestic budgetary decision-making at each stage of the process. These measures have questionable utility in light of the lessons of this thesis.

At the time when the Maastricht deficit and debt criteria were laid down and later when the Stability and Growth Pact was designed and then redesigned several times, the regime of rules, targets, procedures and surveillance received a lot of scholarly

attention and almost as much criticism<sup>148</sup>. A large share of the criticism was directed at the potentially perverse effects of the rules on government behaviour. Authors claimed that governments would engage in creative accounting, will be too focused on the short run at the expense of longer term sustainability and so on. From the point of view of a society-centred approach, the real danger of the Maastricht criteria and the rules of the Stability and Growth Pact lay in their unpredictable effect on the balance of power in the struggle over fiscal policies in the domestic political contexts. While the Italian case suggested that the Maastricht rules had little independent effect in themselves, the Belgian case study clearly demonstrated the potential for externally imposed rules to have counterproductive effects for the resolution of structural problems and to fundamentally intervene in the socio-political conflicts of a country.

From a society-centred perspective, the new European rules and procedures do not improve on the old system. On the one hand, the reforms to domestic economic governance under the European Semester are still fixated on fiscal institutions and focus exclusively on the narrowly understood governmental and parliamentary sphere. The thesis has shown the crucial influence of non-parliamentary and non-governmental actors – such as trade unions, employers’ organizations and other interest representing associations – on fiscal outcomes. Since the European Semester leaves out of consideration a host of actors that have leverage on fiscal outcomes, it renders domestic-EU coordination on fiscal policy largely meaningless, because plans agreed between the European level and domestic governments might still face insurmountable difficulties in the implementation phase.

The system of binding rules and tangible penalties of the “Fiscal Compact”, on the other hand, might have the potential to interfere with the domestic societal struggles that determine the longer-term ability of a country to deal with its fiscal imbalances. The thesis has shown that such external constraints interact with the domestic context in complex and unpredictable ways and – as the Belgian case study demonstrated – sometimes might even delay the resolution of persistent structural problems. Therefore, at a time when the European Commission is thinking of adopting a better, stronger system of European rules to deal with the daunting fiscal problems of the member states, they should not neglect the possible socio-political side effects.

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<sup>148</sup> See for example: Beetsma and Uhlig (1999), Easterly (1999), Buiters and Grafe (2002), Coeure and Pisany-Ferry (2005). For an overview see Fischer et al (2006).

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