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AUSTERITY NELL'EUROZONA: UNA VALUTAZIONE
RETROSPETTIVA
AUSTERITY IN THE EUROZONE: A RETROSPECTIVE
ASSESSMENT

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Abstract

What can we learn from the EU sovereign debt crisis of 2010? Was ‘fiscal austerity’ a wrong policy choice that worsened the ‘Great recession’ in Europe? Did it facilitate the rise of populist and national political movements across the Europe? Is it true that under fiscal austerity, economic growth is impossible? Does that imply that the only way to overtake a growth path is by doing deficit spending to boost the economy? Is it really so important to focus on debt/GDP? During every recession, the issue of expanding fiscal policies returns as central one, and so does the old-fashioned thesis that countercyclical fiscal policies can be stabilizing, due to high fiscal multipliers. Such a complex topic requires an analysis far deeper than the one usually proposed on mass-media, and especially during a time of relevant grievances due the economic crisis; the debate is even more superficial than ever, mixed with politicians’ slogans and the generalized desire of fast and easy solutions to complicated problems. After the return to a positive economic outlook since 2014 for the whole European economy, the debate over austerity has lost some interest (with Greece as exception). However, 8 years after the beginning of austerity prescriptions, the theme came back as alive as ever: for the first time in its history, the European Commission rejected the draft budget of one of its member states, Italy, on the ground of an excessive deficit spending and overly optimistic assumptions of growth. This work revisits the most common arguments in the public debate, and aims at dismantling conventional wisdom around the theme.

Introduction

The framework

Austerity represented the central fiscal policy guideline imposed by the 'Troika' (EU commission, ECB, IMF) as a response to the European Sovereign Debt Crisis of 2010. The initial boundaries on fiscal budget management were introduced with the Maastricht Treaty (1992), consisting in a threshold of 3% for deficit/GDP ratio and 60 of debt/GDP ratio; then they were updated with the Stability and Growth path ('SGP', 1997) that included the medium-term target (approximately 3 years) of a close-to-balanced state of public finances if not even a surplus together with stronger measures to control and sanction non-compliant EU members. Neither with those improvements the original Maastricht criteria were seriously observed by various members states and with the EU sovereign debt crisis the necessity for additional rules came out. That was the time for the 'Six pack' and 'Two pack' reforms (2011 and 2013), and for the Fiscal Compact in 2012, all of them with the intent of reinforcing the mechanism of control and prevention and the procedure in case of non-compliance with the limits. The Harsh outcomes of the recession, mixed with a pro-cyclical type of fiscal policy based on fiscal tightening, that requires sacrifices in already-difficult times, made for a spread malcontent among European citizens and their governments, even resulting in riots like the case of Athens. Consolidation policies aimed at government deficit reduction became the central political theme of the debate, saw as the enemy to defeat, as the cause for the continuing of the stagnation in the economy, as the main impediment to growth, considered achievable only with a strong push in the economy through the channel of more, not less, government spending. The debate has been particularly heated by the 2013 IMF working paper "Growth Forecast Errors and Fiscal Multipliers," in which Blanchard, chief economist of the Fund at the time, admitted that an ex-post analysis found bigger fiscal multipliers than the one calculated at the time of the recommendation of fiscal-tightening policies, meaning that the tighten fiscal policy suggested could have been more detrimental to output than what initially estimated. The already superficial level of the debate toward fiscal policies and economic-growth arguments on mass media, together with the difficult environment of the recession in which this study came out, made for the rest: on mass-media the news spread as a clear IMF's admission that its cure-prescriptions were wrong, giving strong credit to the ones against deficit reduction measures and in favor of the opposite: increase in government expenditure to exploit the big multiplier for exiting the recession. The conclusion of the paper was however not so straightforward and quite misinterpreted on the public debate, and in addition to that, one year later, European economy returned to growth at full rhythm, showing a strong and persistent growth path since

2014 on (around 2% annual GDP growth rate, with a pick of 2,8% at the end of 2017¹). That is the reason for this work, the promising economic environment characterizing the European Union economy in the actual scenario (the slowdown that is starting in the last quarter of 2018 and is expected to continue in 2019-2020 is a worldwide phenomenon²) makes for a better contest to objectively evaluate austerity policies: far from the widespread anger and sense of injustice towards the request of cuts and sacrifices during the recession, especially in those countries already suffering the crisis downturn the most, there is now a clear opportunity, in particular for the most extremist positions, to reconsider the role and outcomes of fiscal policies in a more appropriate way, at the net at political bias as much as possible. In particular, the convenience of an ex-post revaluation of austerity policies relies on the fact that almost 8 years have passed since the beginning of the deficit reduction policies, so it is finally possible to observe the outcomes with a long-term (or more properly medium-term) perspective, a time-framework much more coherent with any consideration about economic growth effects than the short-term point of view characteristic of the majority of the austerity critiques. In addition to that, now there is more than ever the necessity to recollect recent empirical literature results and other considerations on fiscal policies as unbiased as possible. At the end of 2018 European Union is indeed close to some events that, mixed together, could open up the space for relevant changes in the way fiscal policies is intended. First, Germany chancellor Angela Merkel announced the intention to step aside from politics at the end of her fourth mandate in 2021 (or even before in case of snap elections before the normal deadline)³; secondly, Italian new elected populist-far-right coalition government ('Movimento 5 Stelle' and 'Lega' respectively) under premier Giuseppe Conte, shows no intention to step back and modify a budget draft already rejected by the European Commission because based on deficit spending; third, Greek has just exited its last bailout program, and is approaching general election with the possibility (and responsibility), for the first time since the beginning of the bailouts programs, of walking on its feet and decide more freely its political path; fourth, the mandate of Mario Draghi is approaching is deadline in the end of 2019. All of this factor theoretically suggests a scenario in which the pro-austerity side in European union will start to lose is 'political power', in favor of more relaxing policies from a fiscal point of view. However, it will be interesting to see how much space is really available to easing fiscal policy considering the high burden of debt of countries such Italy or Greece that desire to radically change route. In particular there is a fifth fundamental factor to add to the list above, and this time in favor of the fiscal consolidation line pursued by EU till now: the announced end of the Quantitative Easing program. This will likely

¹ Eurostat

² Data from OECD Economic Outlook, Volume 2018 Issue 2, chapter 1, table 1.1

³ <https://www.bbc.com/news/world-europe-46020745>

bring deficit spending politics in front of their biggest challenge: being able to convince the markets to finance their deficit spending budget drafts without higher risk premia once the cushioning effect of the Q.E is over⁴.

The aim of this work

The intent is neither to demonstrate the successfulness nor the failure of austerity policies, but rather to improve the level of the debate, trying to collect recent literature contribution, debunk diffused beliefs, and soften radical positions, remembering that the complexity of the argument, with different factors (often underestimated) and relevant intra-countries differences among EU member states, deserve a much more open-minded approach than the one conventionally used by politicians and mass-media. There is an opportunity, for the most extreme austerity detractors, to reflect on the fact that the same growth path they were considering as impossible without an opposite fiscal policy based on deficit pending, has nevertheless started again in 2014, with no fundamental change in the EU fiscal-policy directives. But a critique to the Union, before starting with the analysis, must be made: there has been a lack of proper communication from E.U. institutions: probably austerity measures were sold with exaggerated emphasis on their healing capacity, as a sort of magic recipe for guaranteed growth (in particular with the concept of ‘expansionary austerity’). More emphasis should have been put instead in explaining their real role of stabilizing policies, necessary for avoiding the representation of a scenario similar to the 2010 one, especially making the framework of EU economies ready to absorb economic shocks even coming from outside. With a EU integration still far from being reached from a cultural point of view, it is necessary to think of better mechanism to inform national citizens of EU policies, the reason behind their utility, and their possible benefits. Especially in the case of fiscal consolidating policies, the benefits are much more hidden and long-term projected than the sacrifices requested (the value of avoiding a crisis as the 2010 sovereign debt crisis is huge, but difficult to demonstrate since it represent a what if scenario, while the cost of cuts in expenditure or tax increases are a tangible burden for citizens, especially in the short-term). This alone already makes consolidation policies difficult to comprehend per their nature, and the effect can only amplify if it is considered that they are prescribed from an out-of- national borders institution and the debate on their contents and implications is left mainly to the mass media channel at the national level.

⁴ This is the official position of ECB at the time of this work, confirmed by ECB president Mario Draghi at the ECON committee of the European Parliament on 26/11/2018, who affirmed that the net asset purchases program will end in December 2018, and only monetary policy stimulus will be maintained to support headline inflation in the medium term. However, is not to be completely excluded that things may change if the slowdown of world economy already starting at the end of 2018 will be worse than what expected by ECB.

CHAPTER I: A CONFUSED DEBATE

1.1 The over simplification in the public debate on mass-media

The main reason why the debate over austerity caught the mass-media attention in recent years has probably to be found in the duration of the EU crisis, that continued some years after the beginning of the consolidation measures. Since those measures follow a guideline decided at the EU level, a sense of unfairness and anger started to grow across different European countries, especially the ones who experienced deeper recession, who perceived those policies as an unwanted boundary, externally imposed, that tied Government's hands in deficit-spending decision. In particular, this aspect gave politicians an easy excuse, an external enemy to blame for an underperforming economy, instead of facing problems that, at a deeper analysis, often result to have national roots rather than European ones.

"In Portugal we devised an alternative to austerity, centred on higher growth, more and better jobs, and greater equality. The rise in earnings made economic operators more confident, resulting in the fastest economic growth since the start of the century; and it produced a sustained rise in private investment, exports and jobs."

António Costa, Portuguese Prime Minister, speech to the European parliament, 14 March 2018.⁵

'If there are European constraints that prevent us to spend in order to secure school for our children and highways for our workers, we will consider Italians' safety before everything else'

Matteo Salvini, Italian deputy prime minister, statement to mass-media after the tragedy of Genoa's Morandi bridge collapse, 14 August 2018. (English translation by the author)⁶

*'...Italy is giving 20 billion euro to E.U every year; second, when we are speaking about investment in infrastructures, those are high multiplier investments, for example if investing 1 euro in tourism gives back to the government 16 or 10 euros, than this means that if you invest 1 billion, you get back 10 billion, I don't want to make it simple, but is clear that if you start investing the money you have, you will have money to finance other measures later on.'*⁷

Luigi Di Maio, Italian Deputy Prime Minister, Minister of Economic development and Minister of labor and social policies. Video interview on 'IlFattoQuotidiano' newspaper site, 18 May 2018.⁸ (Translation by the author)

*"... For our country, a fundamental point is to reduce the growth gap with respect to the E.U., moving the fiscal policy towards a stable and sustainable economic-growth prospect...
...Italy is a founder country of the E.U and a net contributor to the European budget. Conscious of this, we will present in Bruxelles our Budget law, just deliberated, on which we are proud willing to discuss without preconceptions. We believe that austerity is no more a viable option. All the measures of the Budget plan, on which*

⁵ <https://www.dfa.ie/media/dfa/eu/Speech-by-Portuguese-Prime-Minister-Costa-at-the-European-Parliament.pdf> (page 2, bottom)

⁶ <https://it.euronews.com/2018/08/15/crollo-del-ponte-di-genova-salvini-colpa-dei-vincoli-europei-esperta-non-e-proprio-cosi> and official twitter account of the minister <https://twitter.com/matteosalvinimi/status/1029429954331725829?s=19>

⁸ <https://www.ilfattoquotidiano.it/2018/05/18/governo-di-maio-coperture-ci-fanno-i-conti-della-serva-ma-noi-in-europa-a-trattare-i-margini-per-spendere-soldi/4365205/> (video-interview; English transcription by the author)

the government is committed and that I will present in detail to the European institutions and our European partners, are centered towards more economic growth and employment”

Giuseppe Conte, Italian Prime Minister, speech to the national parliament, 16 Oct. 2018⁹. (translation by the author)

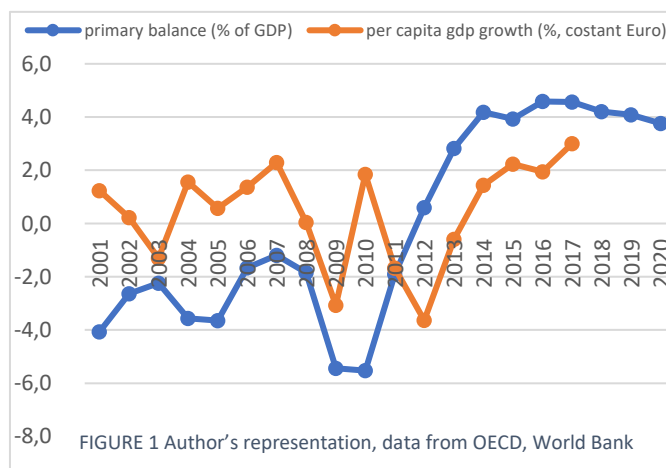
*‘According to rules, current account of Germany cannot be over 6% of GDP. At the present, it is around 9%. It’s a rule infringement that damage all the Europe...
...Many times we underlined this on debating meetings, we want to respect the rules, but all of us must commit. Even Germany. Double standards is a wrong method.’*

Matteo Renzi, Italian Prime Minister 2014-2016. Statement originally appeared on his official web page and then reported by mass-media¹⁰ (translation by the author)

Those official statements from prime ministers are just an example of how easily a complex reality can be reduced into misleading political slogans, not supported by any consistent empirical data, but even based on causal-effect link that sometimes border on the absurd, exploiting the emphasis of tragedies like in the example above for Italy.

Some simple fact-checking, too often forgotten on mass-media channel who reports those anti-European statements, would be enough to show the inconsistent political rhetoric at the base of these arguments. A simple example of debunking for two of the above statements recalled is proposed here.

1.1.1 Political rhetoric Vs facts: is Portugal growing because it ended austerity?



⁹ <http://www.governo.it/articolo/le-comunicazioni-del-presidente-conte-al-senato-e-alla-camera/10147> (english translation by the author)

¹⁰ Here I used a part of the statement reported on the italian business and economic newspaper *IlSole24ore*.

<https://www.ilssole24ore.com/art/notizie/2017-02-02/renzi-germania-rispetti-regole-surplus-commerciale-113017.shtml?uid=AE7UyIM>

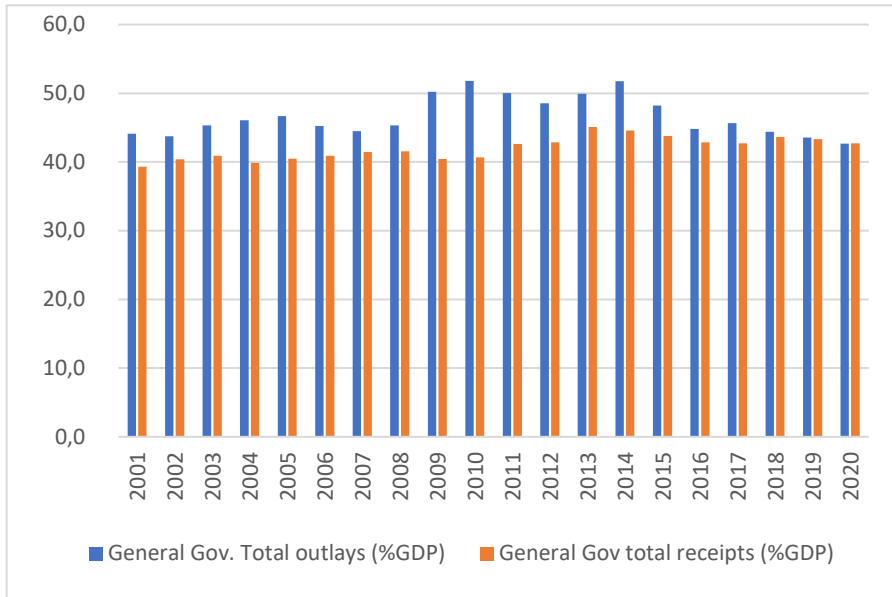


FIGURE 2 Author's representation, OECD data

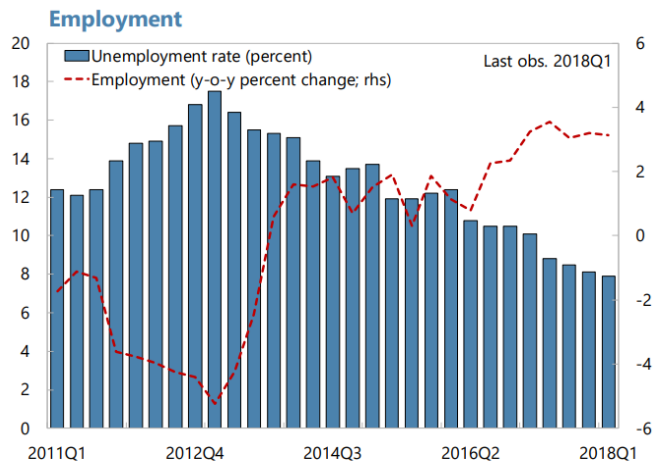


FIGURE 3 Source: IMF country report No 18/273; 21 August 2018. figure 2 page 21

Exports of goods and services (constant Billion Euro).

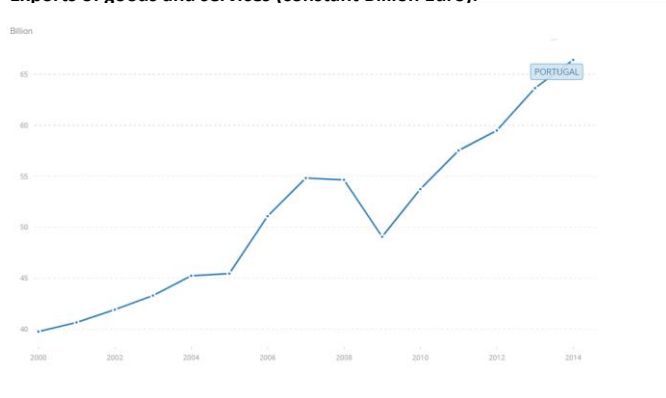


FIGURE 4 source: World Bank data

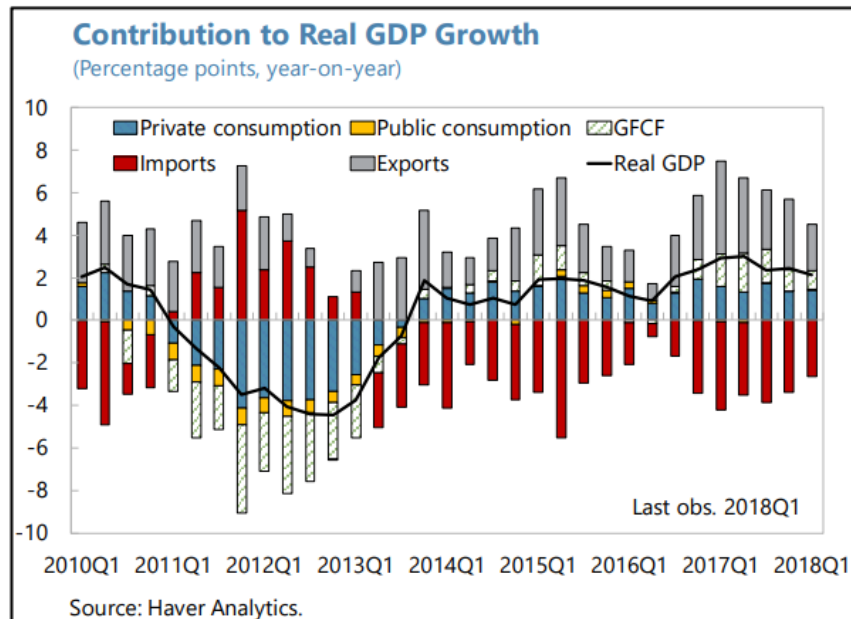


FIGURE 5: IMF 2018 staff report on Portugal, September 12, 2018. Figure from page 4

In the case of Portugal, Prime Minister Antonio Costa assumed the Office in November 2015, and following is claim at the European parliament in 2018, it seems that he radically changed the fiscal path of its country, refusing austerity, and thanks to this the country undertook a strong growth path, underlying that alternative to austerity is the key. Despite the statement above, data seems to tell a different story: the country was coming out from a strong commitment to decrease fiscal deficit since 2010 (as it is possible to see from the primary balance trend, that measure the fiscal balance at the net of interest rate on the debt, so it better describes the modification of public policies), and after 4 years of successful improvement of the fiscal stance, it simply interrupted the increasing trend of the surplus. This stop happened in 2014, almost two years before Costa took the power, and at that time the balance surplus was at a remarkable 4% of GDP (an improvement of 9.5% point from the deficit level of 2010). Not only the stop of additional restricting measures was not his merit, but there was no real end of austerity in exchange of expansionary policies even later when he was in charge: the surplus remained approximately stable on that 4% level till 2018, and with no forecasts of significant changes in future years. So, if anything, there has been from 2014 an end in the additional increment in fiscal tightening, but at a high and stationary level of primary surplus, that is completely different from saying that an austerity alternative has been overtaken. Even from the data on tax revenues in % of GDP is possible to notice no fiscal relaxation ‘alternative-to-austerity’ measure of any relevance, with basically the same level as 2013 under full austerity, and the same is true for total government expenditure as % of GPD, there is yes a small increase

from 2016 to 2017, but levels are even much lower than in the period of harsh consolidation¹¹. Not only that, but even the growth trend, that Costa refers to its ‘new policy centered on growth’, was actually a trend that started in 2013 at sustained rhythm. If anything, Portugal could be described as a case of expansionary fiscal consolidation, not certainly a case where growth started with measures alternative to consolidation. But even this thesis would be misleading: one of the intent of this work is to underline how fiscal policies and economic growth are topics more complex than what they appear on the mass-media narrative. The invite is precisely to avoid, on both sides (supporters and detractors of austerity), cherry picking cases useful to demonstrate the merit/fault of austerity to economic indicators, often based on correlation sold as direct causation. Portugal is a good example for that: it should be underlined that the consolidation slowed down the fast debt/GDP increasing trend, and approximately in the same period the country even experienced economic growth, but an explanation for that could relies elsewhere, in the end it is quite difficult to demonstrate that fiscal consolidation can have such important growth effects after just a couple of years. For example, an explanation for Growth could have been the continuous increasing trend of exports (that led to an improvement of current accounts from -32 Billion \$ in 2008 to +3.6 Billion \$ in 2013¹²) and this is consistent with the IMF chart showing the various sources of contribution to GDP growth. However, even in this case the Portuguese prime minister seems to give the credit of increased exports to its alternative-to-austerity path (which never really happened as just observed). Data tells again a different story: a defined pattern of steady growth of export of goods and services is observable since 2009, with basically no influence by the period of fiscal consolidation.

1.1.2 Political rhetoric Vs facts: European fiscal constraint behind Italian poor public investment?

Starting with the statement of Deputy prime minister Salvini, the tragedy of Morandi bridge, a case of an old infrastructure without adequate maintenance, is in the end somehow used to blame European strict constraints to government expenditure, that won’t allow Italy to freely

¹¹ Of course, government expenditure with respect to GDP is influenced by the state of the economy, so it is true that for the downturn of 2010-2012 the value is higher than on average due to the effect of the decrease in GDP while Government spending remain more stable per its nature. But for example, in the period between 2013 and 2015, during economic growth (so with increasing GDP this time) and pre-Costa electoral mandate, total government expenditure over GDP was still higher than with Costa Government, proving once again the point being made here, that there was no tangible ‘alternative’ to consolidation policy. (Even looking at government primary expenditure would confirm that)

¹² Data from World Bank

spend to secure ‘highways’ and ‘schools’. This is the type of expenditure categorized under investment expenditure (or ‘government gross fixed capital formation’).

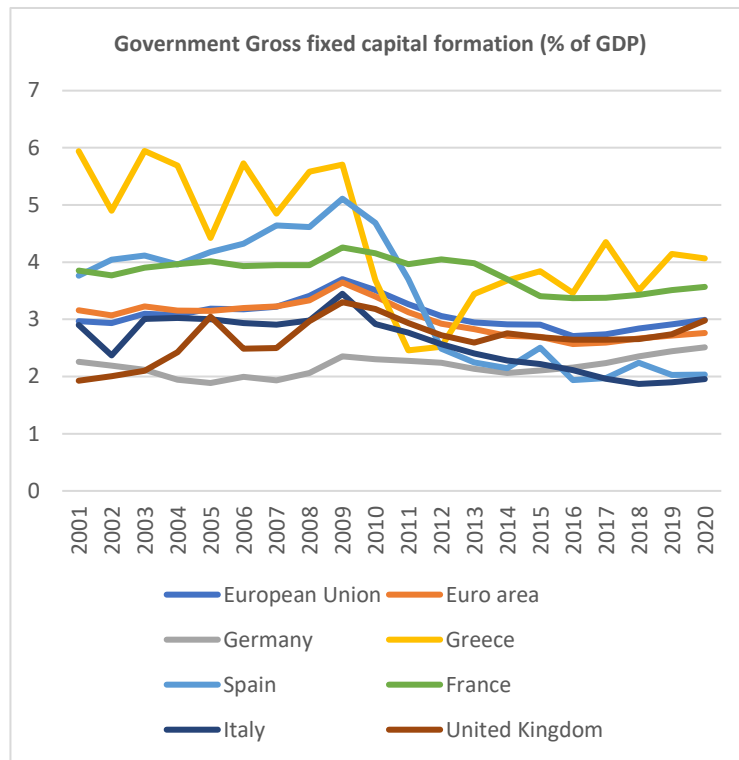


FIGURE 6 Author's representation, Data from AMECO

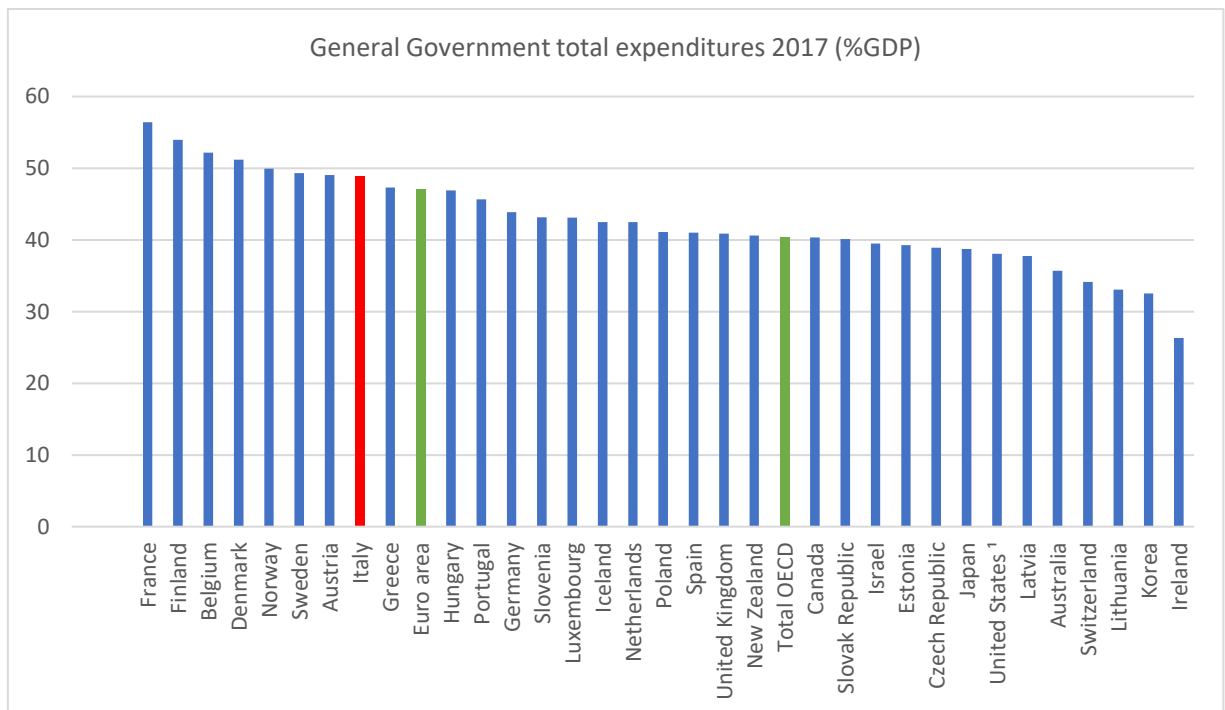


FIGURE 7 Author's representation, OECD data

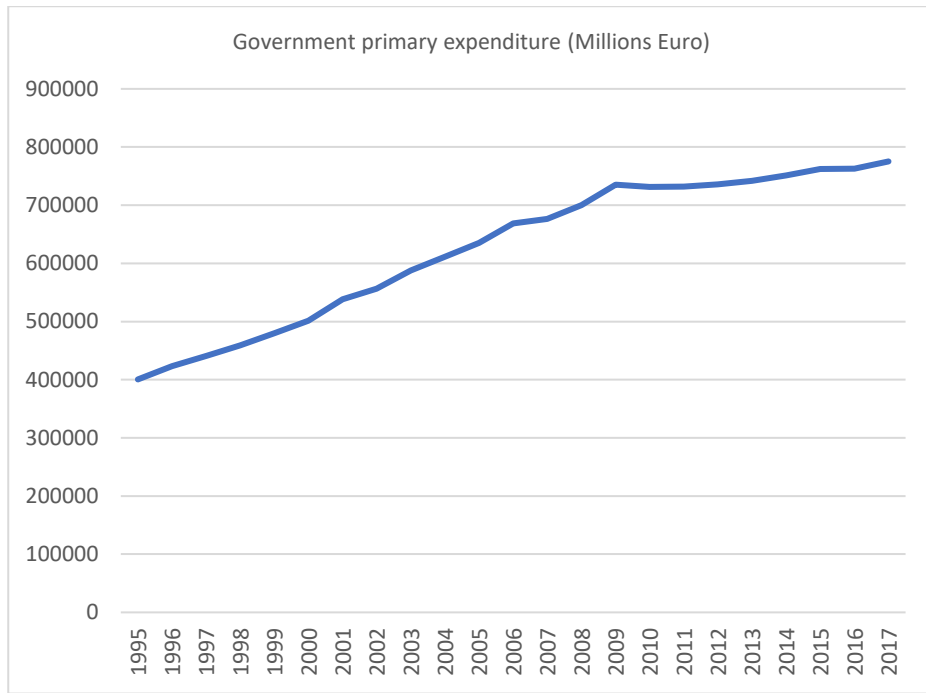


FIGURE 8 Author's representation, ECB database data

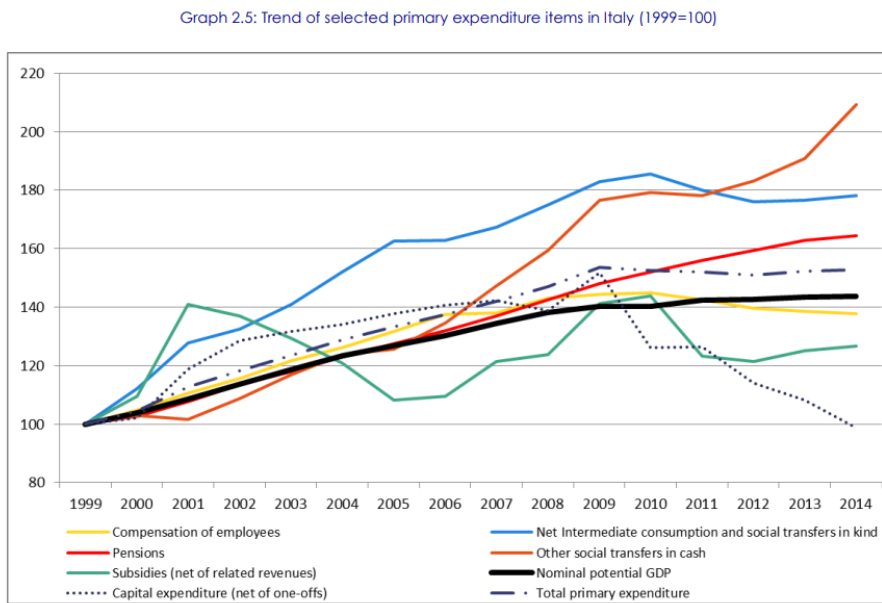


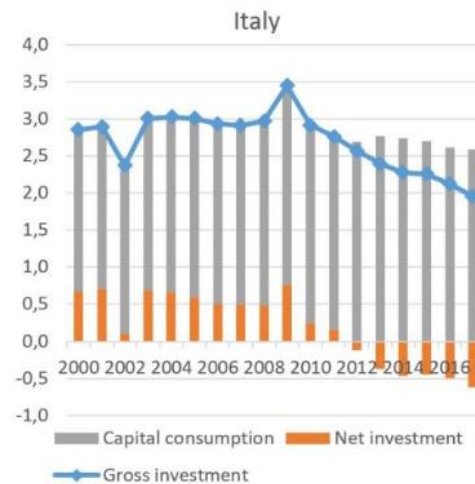
FIGURE 9 Data from AMECO and ISTA. Source: Italy's Spending Maze Runner An analysis of the structure and evolution of public expenditure in Italy; Lorenzani et al, 2015. Figure from p. 11

First it must be underlined how total public expenditure as a % of GDP is still close to 50%, among the highest in OECD countries, in Europe and even Worldwide. It is a little higher than the Euro area average (1,8% points difference), but the gap is expected to increase in 2020 to around 3 points percentage, due to a decreasing trend for the euro area and a slight increase for Italy. This would immediately suggest that if low investments are present, it is definitely not a problem of European upper limits to total expenditure, but it is much more likely to be an allocation problem. This appears even more clear by observing the trend of Government primary expenditure in absolute terms, that shows, at the net expenditures for interest rates, if government applied some austerity in the sense of cuts in public expenditure. Data tells this is not the case, there was only a short period in which it remained stable, between 2009 and 2011, but then it came back to increase year after year, with no sign of spending cuts. At this point should be out-of-question that the problem is an allocation problem. In support of this there is the trend of the primary expenditure divided by destinations: public expenditure for investment declined to favor other type of expenditures, not because of heavy cuts to total expenditure. The level of nominal government expenditure of today, at the same level of 2013, and with a stable trend in the last 5 years, is indeed higher than what it was in 2000¹³, however, government capital expenditure, after increasing at a low rate from 2000 to 2009, decreased very rapidly, returning in 2014 to where it was in 2000. Basically, every type of government expenditure is indeed increased with respect to the level in 2000, while investment, after an increase, came back to the same level of 2000. Political national level choices are behind the decision on where to direct money, not certainly European parameters and austerity rules, so the cause of low expenditure in investments has nothing to do with Europe. The trend of composition of primary expenditure clearly shows governments attitude to prefer expenditure types other than investment, such as pensions, other social transfer in cash, employees' compensation and so on. It is more than reasonable to say that this political choice is in the end at the expenses of investments, because with a little commitment, without increasing the already high level of total expenditures, some resources could have been transferred from one voice to another. Let's consider that Italy Gross fixed capital expenditure is around 2% of GDP since 2015/2016 and it is expected to remain stable in the next couple years, a commitment to increase it of just 1 point percentage would be enough to reach at least the E.U. average, in the meantime expenditure in pensions is around 16% of GDP, the second highest in Europe after Greece and double the level of the OCSE average¹⁴. The situation is even more alarming if it is considered

¹³ Even if considering in terms of Gov.expend/GDP, the same can be said: in 2017 is 49%, in 2000 is around 46,5%

¹⁴ Data from the analysis on Italian pension system of 'Osservatorio Conti Pubblici italiani dell'Università Cattolica del Sacro Cuore', title 'Pensioni: Spendiamo più degli altri?'; 23 Maggio 2018. (Analysis based on OCSE and EUROSTAT values).
https://osservatoriocpi.unicatt.it/cpi-18_Pensioni_23.05.2018.pdf

that the voice ‘Gross government fix capital formation’ does not take into consideration only new infrastructures, but even expenditure for maintenance, the highest part of investment expenditure in many advanced economies, and if the amount of resources for gross investment is too low, it won’t be able to cover the consumption of existing infrastructures, and the public ‘net investment spending’ becomes negative, like in Italy since 2012.



Source: AMECO, 2018

FIGURE 10 Figure from: ‘investment spending and European deficit’ by economist Daniel Gross; article on open.Luiss.it¹⁵

In addition to all of that, it should be considered that European Union, on the contrary, is pushing Italy to spend more on investments, and its contributing on that through the EU budget, and through past exemption in deficit target requirements for certain type of extraordinary expenditure for emergencies and for structural interventions. This was indeed promptly remarked by the EU commission just after deputy prime minister Salvini statement, through its spokesperson Christian Spahr, who clarified that the country was already receiving, over the period 2014-2020, around 2.7 billion Euros for infrastructures, as part of a much bigger European level investment project called ESI (European structural and investment funds) that will give to Italy, in total, 42.77 billion, making it the largest beneficiary after Poland (for different types of development, from employment to education to firms and many others)¹⁶. It must be noted than that there is an additional investment supporting plan that the European Union is giving to Italy (and to its other member States), the so called Juncker Plan’s European Fund for Strategic Investment (EFSI), that approved, through the European Investment Bank (EIB), investment in 2017 for 12.3 billion, of which 2.3 in infrastructure, making Italy the largest beneficiary of this type of funding¹⁷. To prove even more that poor investment is only a national level responsibility is the fact that an analysis for the budgetary department of the

¹⁵ <http://open.luiss.it/en/2018/06/11/investment-spending-and-european-deficit-rules/>

¹⁶ For more details of the investment projects: https://ec.europa.eu/regional_policy/sources/policy/what/investment-policy/esif-country-factsheet/esif_funds_country_factsheet_it_en.pdf

¹⁷ For more details: <http://www.eib.org/en/projects/regions/european-union/italy/index.htm>.

European Parliament list the country among the worst in the ability to effectively spend these European funds, and this is likely explainable with poor administrative capacity, measured through the European Quality of Government Index (EQI) .

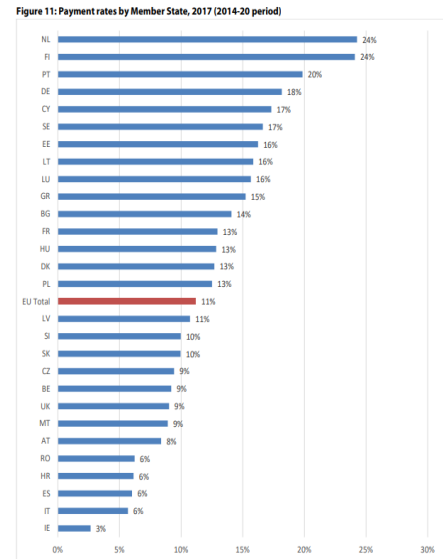
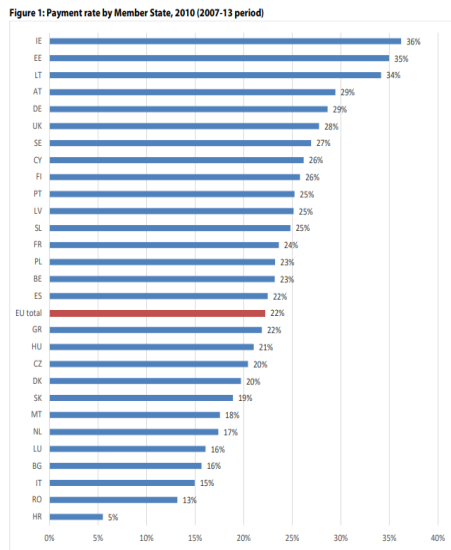
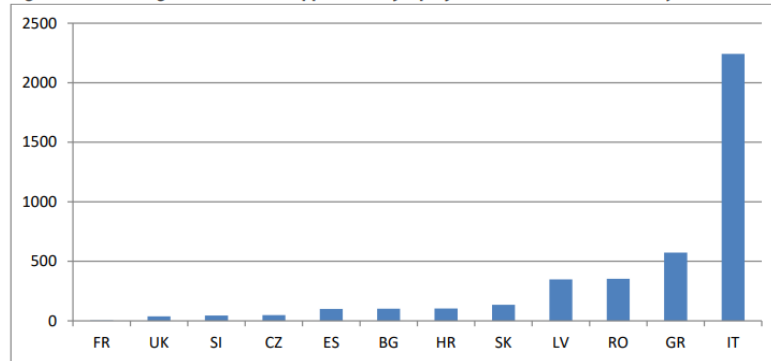


FIGURE 11. Source: Financial implementation of European Structural and Investment Funds; Policy department D: Budgetary affairs, June 2018. Left Image from page 23, right image from page 38

Figure 7: EU funding associated with approved major projects which had not started by 2013



Source: European Commission (2015b) Ex-post evaluation of Cohesion Policy programmes 2007-2013, focusing on the European Regional Development Fund (ERDF) and Cohesion Fund (CF) – Work Package Zero: Data collection and quality assessment, Final Report.

Note: Community amount, EUR million.

FIGURE 12. Source: Financial implementation of European Structural and Investment Funds; Policy department D: Budgetary affairs, June 2018. Image from page 33.

Figure 6: Administrative capacity and Cohesion Policy implementation, 2007-2013



Source: Boijmans P (2014) *Administrative Capacity Building linked to the Management of ESI Funds. Priorities for 2014-2016*. Committee of the Regions, 19 June 2014.

FIGURE 13. Source: Financial implementation of European Structural and Investment Funds; Policy department D: Budgetary affairs, June 2018. Image from page 28

It should be interesting, at this point, to understand the real determinants behind this poor administrative capacity (an explanation could be a mix of corruption¹⁸, poor qualification of politicians and personnel in administrative offices, regulatory quality, inefficiency of bureaucracy and other factors). It should be equally interesting to investigate why such a divergence between expenditure in investment and expenditure in other voices of the public sector has appended. An explanation could rely in the political interest of the various incumbent governments to direct public expenditure where it is more profitable in terms of vote shares, and investment, in particular in infrastructures, is the type of expenditure that requires multiple years to be completed, so may be less electorally catching than direct tangible measures on social transfers and pensions. But if this is a reasonable hypothesis, it should either way be understood why it happened particularly in recent years, that is why in particular in recent years there was a decline in expenditure for investments.

¹⁸ For instance, De Angelis et al. (2018) found a very small yet significant correlation between EU funding to southern Italy single municipalities and the incidence of 'white collar' crimes in those municipalities.

In the end what happens in the public debate is that very few time the attention is really narrowed towards the exact meaning behind the concept of austerity, so towards the health of a certain government public budget and its historical trend, the sustainability of the debt, the content (tax revenues or spending side) and the amount of fiscal consolidation requested, the real factual implementation besides the requests, and the impact on the growth performance of the economy in the medium-long term, at the net of other factors that could bias the result. Much more frequently instead, speaking of austerity becomes a way to discuss on whether it is necessary or not to feed the economy with more public expenditure made in deficit in order to exit a recession. In other words, the austerity debate became a political discussion on whether the recovery from the economic downturn should be state-driven, (the Keynesian vision of more government expenditure as a countercyclical policy), or market driven, with a smaller size of the government in the economy that should diminish the burden of the debt and free-up private sector resources (the neoclassical vision). Fiscal consolidation (austerity) and level of government spending with respect to economic growth are certainly two connected topics, but threatening them as perfect substitute is a superficial simplification, common in the public debate, that leads to hazardous conclusions as result of misleading questions at the beginning.

"The question of austerity is often used as a bit of a code word for other, deeper differences of view about the role of the state.

"Often when people talk about austerity, they're not really talking about just getting the budget deficit down, they're actually talking about the size of the state. People who object to it are basically saying they want a bigger public sector.

"That is a big fundamental question. You can have a big public sector, providing it's paid for with higher taxes. There are costs and benefits of that. There are some states that have relatively large public sectors: the Nordic countries have perfectly reasonable growth rates. There are other countries that have smaller public sectors. Some of them have good growth, some don't.

"The question about the size of the public sector, though, is something that is distinct from the question of the appropriate pace of fiscal consolidation after a budget deficit has opened up, in this case as a result of the financial crisis.

"In principle, somebody who's committed to a small public sector could accept, temporarily, a very large increase in public spending during a deep recession, but in practice, it is usually quite difficult to change direction."

Charles Bean, economist deputy governor at the Bank of England during the financial crisis¹⁹

¹⁹ <https://www.bbc.com/news/business-33270070>

Charles Bean's statement perfectly summarizes the erroneous and diffused tendency to mix together confused questions and different topics when austerity is brought to the public debate, without even considering the relevant structural economic differences between different countries (like, for example, the different starting level of debt/GDP among EU members). Following this line of thought, it is useful to list the main common points of misconceptions that characterize the public debate today, as a general tool for the reader for approaching the discussion on the theme in this contest and in the future.

1.2 Common misleading arguments in the public debate:

- i) **Austerity neoliberal recipe led to extremist and populist parties success.** This argument is constructed on a biased vision of the economy and a simplified socio-political assumption. First, the biased vision of the economy is enclosed in the inflated use of the word 'neo-liberal'. This term, with its negative meaning, is a cue for the biased story-telling around which the thesis in exam will converge: a confused mixture of arguments centered on the necessity of more Keynesian government spending (public sector), less market (private sector), more attention to people interests such as unemployment and less obsession with fiscal rules that respond to financial market interests, and a return to the primacy of politics, symbol of popular will and national sovereignty, over the financial system. This narrative does not consider the vast academic literature on fiscal policies and on the theory of economic growth, for which is nowhere demonstrated that more government is the key to long-term growth; in addition, it forgets to remember that the European crisis, if anything, was exactly the result of too high government debts, results of years of political bad governance. The so hated financial market (even composed, for a good amount, by people savings) was the mean through which politics financed a level of welfare above the means of that time. Secondly the simplified socio-political analysis tends to give too much credit to the Eurosceptic voice, forgetting to remember that the majority of people are pro Europe and in favor of fiscal consolidation and debt reduction, and too much importance to the role of austerity in moving public opinion, forgetting that Eurosceptic and right-wing parties wave was happening even before the crisis and the austerity measures of 2010, and that many other variable are relevant in shaping public opinion. For example, immigration, terrorism, the role of mass-media information, the state of the economy, unemployment, the openness to global trade and China competition, and other country-

specific dynamics (like the desire for political renewal against old political establishment) make vote share dynamics different across countries and not so easy to interpret without micro-level data from surveys. Under certain limits this is the normal mechanism behind the government debt, to finance present welfare with promises of future repayments through tax collection of future economic activity. The case of European crisis was exactly a case of economies over those 'reasonable' limits, if financial markets were guilty of excessive lending based on underestimation of the risk, politics must be considered at least as guilty. An over indebted system, as the case of Greece or Italy, will be always subjected to financial markets reactions, this is not the supremacy of finance over national people voice, is only the necessity of deficit spending governments to find resources after years of mismanagement of budget balances with fiscal deficits.

- ii) **Lack of growth = austerity failure.** A thing is to say that fiscal consolidation can be, in some cases and under certain circumstances, expansionary (positive effects on GDP), another is to consider it a magic receipt for assured economic growth. Once this misleading causal-effect link gains consensus in public opinion, the next erroneous argument is a natural consequence: if, after a couple of years, the economy does not show any sign of recovery, or even worsens, then deficit reduction policies clearly failed. The successful of a fiscal consolidation should not be measured only on visible growth outcomes, but on the long-term stability of the entire union, on the value of the Euro currency, on potential crisis scenario it may have avoided or may help to avoid in the future, those are hidden benefits, not easy to estimate for sure, but nonetheless present.
- iii) **Counterproductive austerity = need for expansionary fiscal policy.** Even accepting the thesis that austerity policies can sometimes worsen even the debt/GDP ratio, especially in the short term, due to recessionary effect on aggregate output that could 'run' faster than the level at which debt is reduced, exacerbating the debt/GDP ratio, this does not automatically imply the necessity for expansionary fiscal policies. The mechanism behind the economy response to consolidation measures is different from the mechanism behind the same economy response to expansionary measures, there is not a single value of the multiplier working in both opposite direction.
- iv) **Following years to judge the outcomes.** The short-term is the predominant point of view in the public debate. Austerity failures are commonly identified every time a worsening of economic indicators (unemployment rate and GDP growth rate in particular) is observable after the implementation of budget consolidations. Those kinds

of observation are usually made in the close years after the implementation of the tightening reforms (one or two years). Short-term observation on economic growth do not represent the proper way to judge the outcomes of fiscal policies reforms. Economic growth is a long run phenomenon, while data on short periods represent fluctuations that are of very poor usefulness for understanding the successfulness of a certain policy. Even supporters for such austerity policies do not deny the possible adverse effect of cuts in the short term, it is quite predictable that an economy with a big public sector will see a lower GDP in the short term if cuts are applied to public employees and salaries, but that is more the sign of a debt-drugged growth than a proof that austerity is growth-detrimental.

- v) **Optima policy = feasible policy.** Not all the cases leave space for the same type of intervention! One thing is to sustain the idea of countercyclical fiscal policies as a general optimal policy (the Keynesian approach), another is to question the feasibility of such policy in the specific case. The level of initial debt, and the velocity requested in an emergency scenario, may leave space only to sub-optimal policies. Many economists recognize indeed the opportunity for countercyclical intervention in general and, at the same time, the necessity of fiscal budget stabilization in specific countries/scenarios. This recent EU sovereign debt crisis represent indeed a perfect example. On one side, it was a cyclical recession that should suggest a fiscal policy counter-action as in the Keynesian theory, on the other it was specifically a sovereign debt crisis, turned on by the global financial crisis. A sovereign debt crisis is a sign of serious and prolonged fiscal account deficits accumulated in previous years. An important point of the countercyclical fiscal policy theory (and often overlooked in the public debate) is that in good times the opposite must be true, that is governments should accumulate reserves in the sense of fiscal surpluses, to be able to use them in bad time.
- vi) **Recession = always a case for 'Keynesian' spending intervention.** The Keynesians thesis that countercyclical fiscal policy made of deficit spending is the real key for boosting demand and so consumption, obtaining then economic growth, requires specific hypothesis relative to the conditions of the economy for the multiplier to be big (dip recession together with strong deflation, and the downturn should due to business-cycle, not to structural problems of the country examined). Often the theory is erroneously used in the debate for situations when those conditions are not verified (right now big Keynesian multipliers are recalled in the debate in favor of deficit spending even if we are clearly outside of the recession and with an inflation close to 2%).

- vii) **Obama fiscal stimulus: more government spending foster Growth.** The comparison between US fast recovery after the Obama Stimulus and the European long-lasting recession is very common in mass media debate. In particular the thesis is used for advocating that austerity measures as cuts to public expenditure lead to recession with no way out, while the courage to increase public expenditure lead to economic growth. By a closer analysis, the argument shows all its superficiality. First of all, European economy, in particular the Euro area, a more appropriate comparison meter with U.S for the single currency, performed almost identically to the American economy in terms of growth, once Italy, a specific case of underperforming economy due to own specific structural problems with old roots, is removed from the equation (there is of course a time lag of two years since the eu sovereign debt crisis happened in 2010). Secondly, the Obama Stimulus is not a proper example of augment in government expenditure: the total amount of expenditure remained the same as before, in this sense it was countercyclical, offsetting the decrease in expenditure at the level of the states, but it is erroneous to use it as an argument for advocating a bigger size of the government to foster economic growth. Third, the level of initial debt matters! U.S had the space for such a countercyclical policy at the time because they had much lower debt/GDP ratio than some EU economies during the EU crisis.
- viii) **Comparing economic indicators pre and post austerity to make conclusions.** The usual comparison of post-reform indicators (GDP growth rate, unemployment rate, salaries, debt/GDP ratio and so on...) with pre-reform ones leaves a lot to be desired from a methodical point of view. First of all, the arbitral choice of starting point (the years from which taking the pre-austerity economic values above mentioned), may profoundly bias the conclusions coming from the comparison, potentially hiding old structural problems characteristic of a certain economy (e.g., for Italy, taking data from only few years before austerity introduction would completely conceal the profoundly long-lasting chronic diseases concerning the debt dynamic and the labor-productivity). Secondly, but not of less importance, a counterfactual analysis is always missing. A proper comparison should answer to questions like ‘what would have been the state of the economy without the bailout intervention, how much and for how long interest rates would have continued to rise? How many billions of euros would have been necessary to repay those interests the first year, the second year, the third year and so on. Where would they have been taken from?’ In extreme scenarios, like the one of Greece, a proper analysis should go even further asking ‘What would have been the state of the economy in case of sovereign debt default declaration?’ and ‘How many years would

have been necessary to recover?’. Those question are missing in the public debate, and this helps a lot to draw a picture of really bad outcomes from austerity policies. The main risk of not considering a counterfactual analysis is that negative economic outcomes are attributed to austerity policies whereas they are usually the ‘tail’ of all the damage that a sovereign debt crisis, preceded by a world financial crisis, can cause.

- ix) **Austerity = the same recipe everywhere.** The specific type of austerity measures implemented is fundamental for better understanding the implications on the economy and for comparing different countries. On the debate, the inflated use of just the word ‘austerity’ completely remove the possibility to understand if we are talking about tax increases or cut expenditure, or even a mix of the two. This choice, beside possible recommendation, remains a political national level decision, and different mix are relevant different implications, since, as found in literature with quite strong consensus, the outcomes from tax increases are generally more recessionary than the one based on spending cut.
- x) **The causal link is valid only for recessions.** There seems to prevail, in the public opinion, a one-way limited cause-effect link between austerity and growth. During bad times, anti-austerity supporters, in particular Krugman and Stiglitz among all of them, with their relevant position of ‘noble price economists’, were promptly active to intervene in the debate with strong positions, underlying bad economic outlook indicators, like negative GDP growth and high unemployment rate, to sustain the thesis of austerity failure. When, starting from 2014, EU economy returned to growth, the unquestionable and direct cause-effect link between austerity and the state of the economy seemed disappeared. If fiscal policy are so detrimental to the economy, how is explainable European steady recovery since 2014? I.e., why shouldn’t be reasonable to question if this average 2% growth rate was possible thanks to the stability of the system allowed by fiscal restraint? (Just to remark, the intent here is not to proof that consolidation is the key to growth, but rather to underline the methodological inconsistency of supporting the strong link between fiscal policy and growth in bad time, and forgetting it in good times).
- xi) **The multiplier is what really matters.** Every time the discussion against austerity develops towards the (rather theoretical and sterile) multiplier and deficit spending arguments, not only the attention is moved from the real structural country specific reforms needed for long term growth, but there is also a missed opportunity to properly criticize austerity on much stronger and tangible problems in the way it was conceived at the European level. It is very unlikely to find the public debate discussing about the

lack of a fiscal unified planning that took into consideration the timing of the various reform requests (which is the negative spillovers from consolidation policies simultaneously applied to economies that trade between each-other), or about the inability to opportunely differentiate spending cut austerity measures from tax increase austerity ones, forward-guiding governments towards the firsts (as suggested by academic literature), or again the unequal redistribution effect that consolidation policies can have on the population.

- xii) **More Investment is the real key to GDP Growth.** When the deficit-spending argument is supported, the classic way to do it is by claiming for the necessity of more investments. This idea is so broadly accepted that seems to represent the strongest point in common between people pro- and against- consolidation. The common thesis is that the E.U. should remove the component of public expenditure for investment from the total amount of public expenditures when controlling for governments' respect of the 3% deficit/GDP threshold of the Maastricht Treaty. However, even accepting the validity of this point, yet too many flaws are present in the concept of investment spending: no consideration at all is made in specifying what type of investment, what cost-opportunity analysis has being made, and most of all, the already existent level of capital stock in that economy, the non-utilized one, the marginal productivity of additional one and the level of corruption (not-surprisingly the last two things are connected), the type of human capital needed for that type of investment and if it really is available and non-utilized. Even more, investment expenditure is a type of government commitment that gives returns in the long term, that is they are not a real countercyclical fiscal policy because in the negative business cycle of the economy they are not promptly able to smooth the demand reduction in the 'Keynesian' way.
- xiii) **Germany current account surplus is as bad as other EU members fiscal deficit.** When advocating for austerity refusal, there is a widespread tendency to blame Germany for being the actor behind European obsession on fiscal discipline and austerity. A really common expedient to attack Germany (especially in Italy, but not only) is that even Germany should be equally prompt, because maintains an 'excessive' current account surplus, that is considered to be harmful for the others EU economies. There are three important fallacies in this argument: first, technically there is no rule infringement, that current account should be diminished is a recommendation, there is no specific rule as for deficit and debt limits; second, the surplus is, for the greatest part by far, with respect to the rest of the world, not with the EU; third, a great part of the surplus is from private firms profits, it's not clear what the government should do

(punish them?), and the complaint that with such surplus German internal demand is depressed and so reduces others EU countries possibility to export is not true because German internal final consumption, both private and public, as always increased since decades.

CHAPTER II: Austerity as a central reason for populist and nationalist far-right movements across Europe?

2.1 The Political Climate of turmoil in Europe

Whether or not National Government should reduce its deficit in difficult times has become widely debated argument among great part of the European union since the beginning of the adoption of the Troika austerity package. Certainly, the most evident and concerning image the popular opposition against those contractionary policies was achieved in the numerous public demonstration and violent riots in Athens, with the escalation culminated in the Greek bailout referendum of July 5, 2015, where the population strongly refused the solution of an international bailout. At that point, with the streets of the Greek capital full of people manifesting against austerity requests, an image diffused all over the news on European and even extra-EU mass-media, European Union seemed to be facing its biggest challenge in term of trust and support. Even leaving apart Greece, for the rather extreme and exceptional case it represents, a general common sentiment of populist protest growth and developed all over the Europe during the crisis. Interestingly this phenomenon not only characterized countries with particularly difficult situations, like 'PIIGS' for example, but even countries where austerity was certainly not imposed by EU, like France, or countries where the economy situation was promising (Sweden Austria, Netherlands, Belgium,), if not prosperous, like Germany, or where EU membership was always considered beneficial, like Hungary and Poland. The post crisis economics difficulties, mixed with the concern for the two 'new' phenomena represented by terrorism and immigration, made for a perfect environment for the rise of new political parties collecting populists and/or nationalistic ideas, with a common fil rouge of anti-establishment against old political parties but also against the European Union and in particular its bureaucratic aspect concerning Austerity decision and the Euro single currency. [Emanuele and Chiaramonte \(2016\)](#) measured the level of innovation in the party system of 19 western European countries from 1945 to 2015, and they found a persistent stability pattern in general, but a rapid increase for some countries, especially the one who suffered the 2008 crisis the most, like Italy and Spain, with 35% of preferences obtained by new parties at last general election, and Greece and Iceland with 25% and 22%. Among the main parties representing the rising of this national/populist/Eurosceptic wave we can mention 'Front Nationale' in France, 'Ukip' in Britain, 'Danish People party' in Denmark, '5 Star Movement' and 'Lega Nord' in Italy, 'Syriza' in Greece, 'Sweden Democrats' in Sweden, 'AfD' in Germany, 'Podemos' in Spain, 'Fidesz' in Hungary, FPÖ in Austria, 'PiS' in Poland. These represent only a part of the

total political renewal across all over the euro: according to the Eurobarometer study of 2018, since 2013, 70 new political entities are born, and 43 of them were able to obtain seats in the national parliaments (with this regard, the major results are represented by ‘La République En Marche’ in France with 308 seats in the Assemblée Nationale, ‘Movimento Cinque Stelle’ in Italy with 222 seats and representing the actual government coalition together with Lega Nord, , and Podemos coalition in Spain with 71 seats).

New parties 2013-2018 with seats in National Parliaments							
	2013	2014	2015	2016	2017	2018	Total Parties by MS
BE							0
BG				2	1		3
CZ			1				1
DK	1						1
DE							0
EE	1						1
IE			2				2
EL	1						1
ES	1			1			2
FR				1			1
HR			2				2
IT					3	1	4
CY	1			1			2
LV		2		1	1		4
LT				1			1
LU							0
HU	1						1
MT							0
NL			1	1			2
AT					1		1
PL			2				2
PT							0
RO	1	1	1				3
SI	1	1			1	1	4
SK	1	1			1	1	4
FI					1		1
SE							0
UK							0
Total	2	9	11	9	9	3	43

FIGURE 1 Democracy on the move', Eurobarometer Survey 89.2 , 2018, page 48

However, the Eurobarometer analysis is limited to register this phenomenon quantitatively, while the qualitative analysis does not go beyond questions concerning people general attitude towards these new anti-establishment parties/movements, i.e., if they are perceived as a threat for democracy, a hope for real change, and a mean to find new solutions better. Those types of question are not of any particular help to understand and isolate the role of anti-austerity sentiment in the increase in popularity of those parties, because this political wave of protest and renewal is a complex phenomenon. Other determinants enter in the game, with possible different weights for each country; we already mentioned immigration and terrorism concerns (that indeed result the first two main concerns at the EU level as will be showed later), but even the sentiment of rejection for the ‘old’ political establishment plays an important role and is much stronger in some countries than in others. The problem in the end is the difficulty to understand the role of austerity at the net of these other really important factors. For sure it contributed to exacerbate the climate, for example [Ponticelli and Voth \(2017\)](#), analyzing a panel

data of 24 EU countries from 1919 to 2018, found indeed a positive correlation between austerity measures based on spending cuts and social unrest (measured as an instability index called 'CHAOS' which sum various form of protests like riots, strikes, demonstrations and political assassination). This positive correlation is not present for moderate cuts, but starts to show up over a threshold of 3% of GDP cuts, with the frequency of protest rising from the average 1.4 events per country-year (in times where expenditure is increasing and during moderate cuts when remains unchanged) to 2.6 events, and arriving up to 4 for a level of cuts equal to 5% of GDP. However, this just gives an idea of the general turmoil moved by anti-austerity sentiment, but it yet remains very difficult to have an answer, European-wide valid, on the role of austerity policies in moving this wave of populist and nationalist parties. It should be taken into consideration the hypothesis that a generalized European-level answer may even not exist at all, considering the relevant economic, historical and cultural differences among different EU members, able to hide a wide variety of different explanations for the shape in electorate political opinion.

2.2 Country-specific determinants: austerity not always a central political driver.

To give an example of the variance in the way austerity played a role in the new political wave across different EU countries we can look at the political dynamics in 4 different countries: Greece, UK, Italy, and Germany. If austerity can be reasonably considered the main driver (or a key player) in the case of Greece thanks to the referendum of 2015, such a straightforward resource is not available for interpreting political opinion dynamics in United Kingdom and Italy. Germany, the most pro-austerity country we can think of, is an example of the fact that a healthy state of the economy, in conjunction with sounding fiscal stance, is not necessarily a deterrent to the born of a new successful populist extreme right-wing party.

The sociopolitical analysis of the anti-austerity role in shaping political opinion is so country-specific and influence by other factors that not only has different weight in different EU member states, but can be even embraced by parties of completely opposite political alignments, and in some cases, it can fuel vote for extreme nationalist parties in the sense of desire for more, not less, respect of fiscal consolidation rules. In UK, the anti-austerity sentiment is collected by Nigel Farage extreme right-wing party, in Greece, at least initially (till the referendum), by Tsipras left-wing government, in Portugal is represented by the actual left-wing government of Antonio Costa, and in Italy is instead an argument able to find common consensus indiscriminately, from the far-right to the far-left passing for all the parties in the center and the populist party 'M5S'.

2.2.1 The case of Greece

In the case of Greece, the analysis seems rather straightforward, being the famous 2015 referendum precisely aimed at refusing the bailout in return of which austerity policies were demanded as mandatory conditions. Even more, to suggest the centrality of austerity issue in shaping Greek electoral consensus, there is the huge falling for SYRIZA party's support just after the referendum. This huge loss of electoral consensus can be considered a good proxy of anti-austerity sentiment, since it all happened just few days after the referendum (and the steepness of the curve describe an all-of-a-sudden phenomenon), when it was clear that Prime Minister Tsipras, promoter of the referendum, was going to negotiate for the bailouts terms, reneging his referendum campaign and voters will²⁰ (the result was 61% to 39% in rejecting bailout agreements, and so, additional austerity measures included with it).

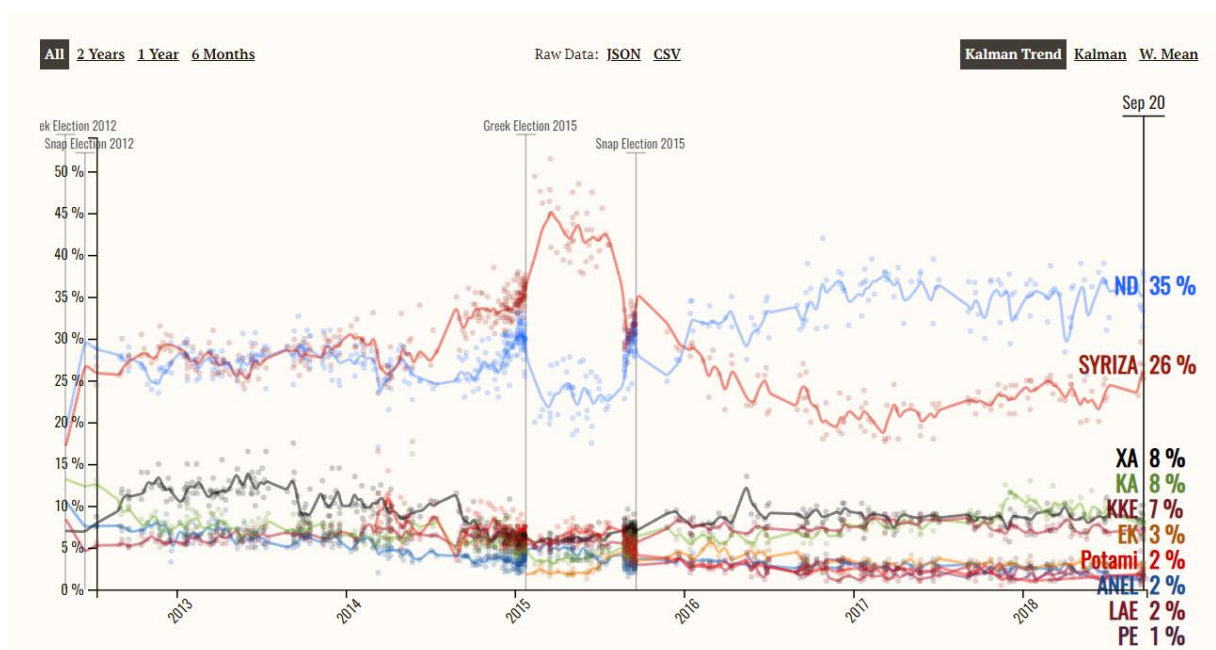


FIGURE 2. Source: <https://pollofpolls.eu> Aggregation of data from the main opinion-polling agencies of the country. Aggregation made with Kalman Trend with linear interpolation (best suited for picking up changes over time)

This generalized malcontent of Greek citizens is consistent with an analysis of the Pew Research Center (Eva Matsa, 2015)²¹ on Greek people opinion of Alexis Tsipras on the social network Twitter. 98.000 Tweets in Greek language collected and analyzed immediately after the referendum, when it started to be clear that Tsipras was indeed open to negotiations with the Troika, show how 75% of the tweets are of negative view over the Prime Minister.

²⁰ <https://www.telegraph.co.uk/news/worldnews/europe/greece/11733777/Bewildered-Greeks-left-wondering-what-happened-to-referendum-No-vote.html>

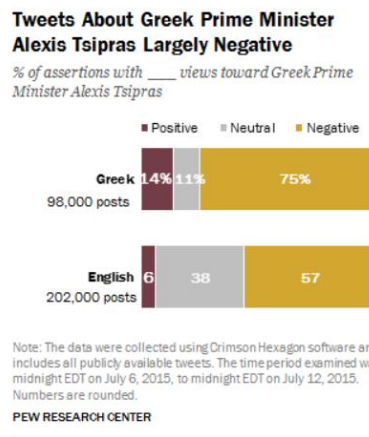


FIGURE 3 Source: K. Eva Matsa, ‘Twitter users turn critical eye toward Greek prime minister after referendum’, Pew research center²²

The analysis, as the author underlines, does not pretend to represent a substitute of scientific public opinion pooling, but still remain quite indicative of the Greeks public opinion on the subject, since it has been found by the Eurobarometer that almost 1/3 of the Greek population uses social networks (Twitter included) on a near-daily base. Even more, to strengthen this thesis, that the Syriza ‘U turn’ with respect to austerity measures was the trigger for people malcontent that rapidly shaped public opinion, was the fact that the electorate abandoned Syriza far-left party in favor of the main opposition center-right conservative party ‘New Democracy’, whose propaganda developed towards Tsipras acceptance of austerity. The substitution effect between the two parties vote share seems pretty strong looking at the previous chart on opinion-polls: SYRIZA was 19% points over New Democracy in consensus at the time of referendum, in just two months the gap reduce to only 2% over, and 3 months later New Democracy surpassed Tsipras party, becoming the first political movement of Greece, as it is nowadays with 9% margin. New Democracy propaganda against Tsipras austerity acceptance is clearly observable by the numerous critics of Kyriakos Mitsotakis, New Democracy party leader, on the way the Greek Prime minister managed the austerity situation. The party leader attacked Tsipras hypocrisy in publicly claiming of fighting austerity and then secretly seat to the negotiation table with the Troika accepting harsh measures. The conservative party leader defined²³ indeed Tsipras a ‘Prime minister of perpetual austerity’, who, thanks to austerity policies based on pension cut and tax hikes, put the country in a recessionary loop.

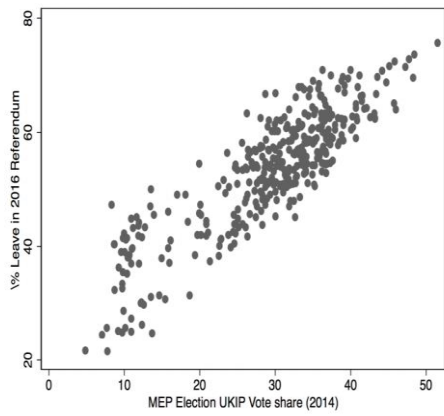
²² <http://www.pewresearch.org/fact-tank/2015/07/15/twitter-users-turn-critical-eye-toward-greek-prime-minister-after-referendum/>

²³ <https://www.thenationalherald.com/145266/mitsotakis-says-tsipras-perpetual-austerity-prime-minister/>

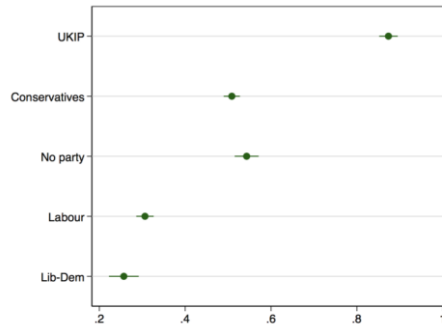
2.2.2 The case of United Kingdom

For U.K. the analysis is a bit more complex: the referendum concerned the exit from the European Union, a broader theme than the bailout centered referendum for Greece, so it is not reasonable to directly use referendum vote shares as a proxy for anti-austerity sentiment. [Fetzer \(2018\)](#) tried to overcome this by making a step back analyzing the situation prior to the referendum, and yet he found a result not too far from the consideration already made here for Greece: austerity is a key driver for the comprehension of the reason that brought to Britain referendum and to the 'leave' victory. The study analyzed the increasing support for Nigel Farage's populist independence party 'UKIP', an anti-establishment party, since 2010 (the beginning of Austerity reforms under David Cameron's coalition); the party was used as a proxy for anti-EU sentiment, since there is a strong link between geographical area that supported the Brexit and the UKIP vote shares ([Becker et al., 2017](#)). It came out that districts with the harshest austerity measures (there is high variance in cuts across districts²⁴) were much more likely to vote UKIP than districts not exposed to severe cuts. The stronger difference is when considering 2015 local elections, with 11.6% points higher vote share; instead. Combining this with the strong correlation between UKIP vote and an area support for leave, the author concluded that the referendum leaving share could have been 9.5% points lower, resulting in a victory of the 'remain' side. Knowing that aggregate data may conceal other influencing variables, the study considered also panel data at the individual level, able to capture individual exposure to welfare cuts. Results go in the same direction: people subjected to cuts in benefits from welfare austerity reforms shift their support towards UKIP party, and welfare cuts were also the engine of a general phenomenon of dissatisfaction with political institutions in general.

²⁴ Institute for Fiscal Studies, Volume 36, No. 3, September 2015, pp.303-325

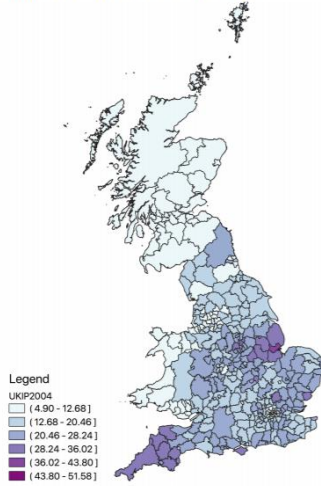


Support for Leave in EU referendum by respondent's political party (sample averages of Leave support in Wave 8 of the USOC survey)

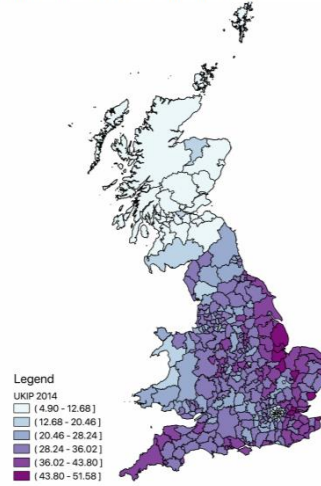


UKIP vote share in the EP elections in 2004, 2014 and the Leave share in the 2016 EU referendum

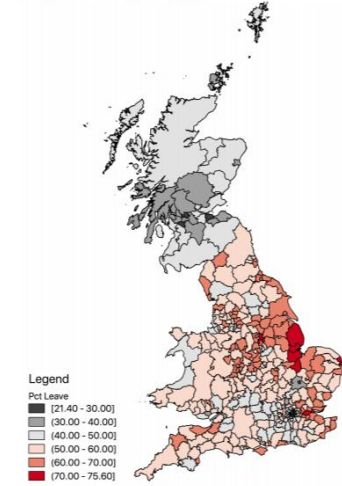
Panel A: UKIP vote in 2004



Panel B: UKIP Vote in 2014



Panel C: Leave share



Distribution of austerity shock across local authority districts across the UK

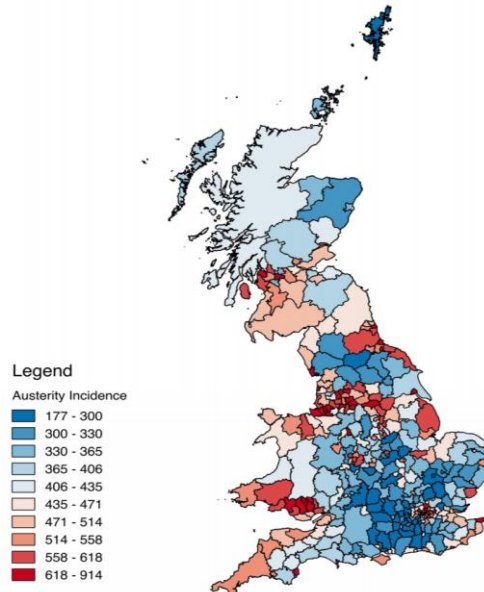


FIGURE 4 Source of all images: Becker et al; 2017 'Did Austerity Cause Brexit?' upper figures from page 47 and page 5 of the Online appendix, centre figure from page 48; bottom figure from page 51.

However, there may be more much more than austerity behind Brexit vote. In an article²⁵ on the British online newspaper 'The Independent', McKay and Bailey claim austerity did probably have a much less central role than the one estimated by Fetzer. First of all they point out how Fetzer study itself found a consistently lower average value of 3,6% (of increased UKIP support in districts affected by austerity) when considering 2014 European election instead of 2016 local election, and it used the latter to conclude that Brexit vote could have been 9,5 points percentage lower if austerity didn't happen, because elections closer to the referendum date. Yet for example, General Westminster electoral results of 2015 show a UKIP support much closer to 2014 European election than the 2016 local election. Since austerity measures begun in 2010 in UK (as Fetzer itself underlines), the 'austerity burden' should have been already perceived by people in 2014, or in the general Westminster elections of 2015, there is no particular reason why it should have been noticed much more in 2016, suggesting that additional vote share increase for UKIP in 2016 local election should be found in factors other than mere austerity. Secondly, McKay and Bailey recall other factors that could weaken austerity role in influencing UKIP support (and therefore referendum outcome). On one side, there was a relevant change from the supply side (Ford and Goodwin, 2014), that is the party moved the target from educated middle class conservatives to people of lower class and with less education (i.e., the one who suffered the crisis the most), actively reaching those people to their doorstep with the propaganda. This is relevant, since it is usually taken for granted that populist parties are the natural response to people political discontent for the establishment, considering them as the passive subject of the equation. Yet, political active role in shaping public opinion is often underestimated, then political discontent could actually be not only the cause, but even the consequence of the propaganda from the supply side (Rooduijn, van der Brug, de Lange, 2016). The case UKIP propaganda could be a good example of this phenomenon²⁶, with its leader Nigel Farage strategy to use different type of rhetoric populist argument with respect to different contest, for example concentrating on immigration and lack of borders control due to EU integration in speeches before 2014 EU elections, and then moving to attack old elite establishment in face of national 2015 elections (Pareschi and Albertini, 2018). On the other side, it seems that even the information channel could have played an important role in shaping political preferences. Murphy and Devine (2018) observed the relation between UKIP support and media coverage through the newspaper channel between 2004-2014 period, and they found, through a vector auto regression analysis that controlled for

²⁵ <https://www.independent.co.uk/voices/brexit-austerity-ukip-nigel-farage-identity-general-election-a8537161.html> (14 September 2018)

²⁶ 'In turn, it seems that on immigration Farage wants a bit less to represent an existing consensus through catchphrases and a bit more to build it through arguments.' Andrea Pareschi, Alessandro Albertini: **Immigration, Elites and the European Union: How UKIP Frames its Populist Discourse (2018)**. Quote from Page 18, line 20-21.

other factors like immigration, election results and other important moments in UKIP's coverage, that print media coverage boosted UKIP support, while there was no evidence for the inverse case (that is media coverage for the party increased following the party's augmented popularity). Even if the overall effect in the end was yet small, it has to be remembered that the study focused only on the press channel, similar analysis should be investigated with respect to internet and in particular social media channels, where UKIP, according to google search trends, gathered more attention than any other parties and leader in 2015²⁷, or with respect to television news, where Farage appeared more than other parties in the 2014 elections, and in addition to this, television coverage in 2014 was dominated by two central argument of UKIP campaign as Brexit and Immigration. (Cushion et al, 2015). In addition to all of that, it's important to notice that UK represent a specific case in which it's really difficult to consider austerity as policy path externally suggested (for sure not 'imposed', since Uk and Czech Republic leaders were the only EU leaders who didn't endorse the fiscal compact in 2012) the by the European union, so even if it is taken for good Fetzer thesis on the relation between people subjected to austerity and propensity to vote for UKIP (which then represented an important player in Brexit vote), it yet remains difficult to read in the Brexit vote a clear voice of protest against European consolidation policies. This is due to the fact that austerity measures in UK were basically a national level autonomous decision of the Coalition government in charge since May 2010, and this with an initial wide range of support both from elites and from public opinion, support that then increasingly deteriorated with the worsening of the economic conditions, that indeed appeared to be closely related with political support (Whiteley et al, 2013). The state of the economy, as already stated in the introduction, does not necessarily coincide with austerity, the only case would be if it is possible to demonstrate that the UK state of the economy deteriorated only due to austerity measures, otherwise affirming that the state of the economy guides people political opinion, a result not new in literature, does not say a lot on the effect of fiscal consolidation role alone.

²⁷ <http://www.electionanalysis.uk/uk-election-analysis-2015/section-6-social-media/ukip-the-webs-darling/>

2.2.3 The case of Italy

Italy represents an interesting case study. First of all, it is undeniable that austerity is a tangible and lively argument, and this not only because of the recent challenge on the budget draft, out of deficit European parameters, moved by the Italian government against the European Commission, but even because investigating into people opinion show an interesting swap in ideology. Looking at the data collected in two different surveys in 2013 and in 2017 by a study from the University of Siena and the Institute for International Affairs²⁸, it is observable a radical change in opinion in just 5 years over the question whether that debt should be reduced. The question is so targeted that could be perfectly considered a proxy of people sentiment towards austerity measures imposed at the European level: the wording used explicitly includes the constraint of sacrifices like tax increases and/or spending cuts, ruling-out any possible bias, if no other specification is made, that could occur due to people that could respond favorably to debt reduction, but with the implicit belief that the best way to do that is by expansionary fiscal policies through a high multiplier (i.e., they will appear as favorable to fiscal consolidation when in reality they are on the opposite side).

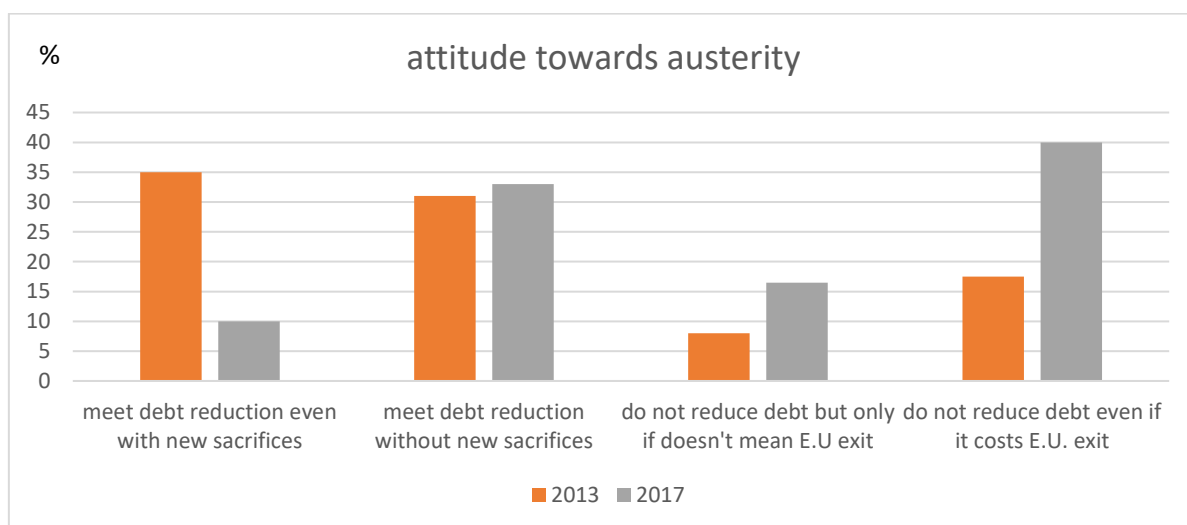


FIGURE 5. Author's representation²⁹ of data from 2 surveys (same institution, different year): **A** 'Italians and Foreign Policy'; CirCaP/LAPS (University of Siena) and IAI, 2013 and **B** 'Gli italiani e la politica estera'; DISPOC/LAPS (University of Siena) and IAI, 2017

On one side, according to the same 2017 survey previously mentioned, it appears that different political alignment represents also an electorate with different opinion concerning the European

²⁸ 'Gli italiani e la politica estera'. (-'Italians and foreign policy'-); DISPOC/LAPS (University of Siena) and IAI; 2017

²⁹ This representation is based on the same exact graphic representation of Isernia P. and Piccolino G. found in the 'Washington Post' online article 'Italians are tired of living under austerity. That could be a big problem for Europe', but with calculus correction for a small error in the original post. Some simplification for data aggregation had been made: data is taken from **A**) figure 10, page 31, and from **B**) figure 18 and 19 page 22, 23. In particular in the survey **B** question are slightly different in wording, so simplification has been made to compare data from the two periods to see the evolution (anyways content of the questions remained the same for the purpose of the investigation on opinion towards austerity)

Union. The ones who believes in the integration even with the difficulty of existing differences among countries are more characteristic of the left-wing, while the ones represented by the populist party ‘M5s’ and by the center right ‘Forza Italia’ and far right ‘Lega Nord’ are instead, for a consistent majority, pessimistic on the belief of a sustainable European unification.

European unification impossible due to diversity. Net-result (agree-disagree) for main vote intentions (%)

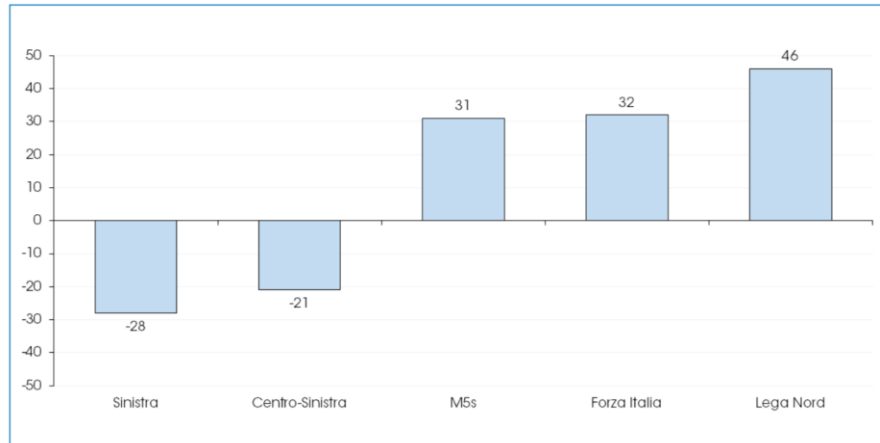


FIGURE 6. Source: ‘Gli italiani e la politica estera’. (-‘Italians and foreign policy’-); DISPOC/LAPS (University of Siena) and IAI; 2017. page 19, figure 13. From left to right: left parties, centre left parties, populist party, Centre-right party, far-right party.

Similar results, showing a relevant difference in opinion toward E.U. in general between different political wings, is found by asking on the vote preference on a hypothetical referendum about exiting from the E.U and exiting from the Euro: the electorate against Europe is by far on the populist and centre-right – extreme right side.³⁰

³⁰ However, it is important to underline that in the same survey the majority, in absolute terms, voted for remaining both in U.E (61% for remaining, 31% for exiting and 8% non-voting) and for remaining in the Euro (55% for remaining, 36% for exiting, 9% non-voting)

In a referendum on exit E.U. and exiting the Euro what would you vote?

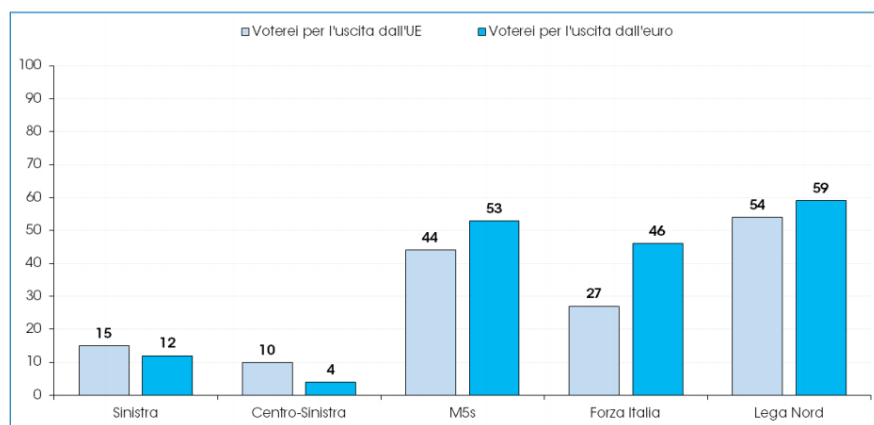


FIGURE 7 'Gli italiani e la politica estera'. (- 'Italians and foreign policy'-); DISPOC/LAPS (University of Siena) and IAI; 2017. page 21, figure 16. light blue: would you vote for exiting from E.U?; dark blue: Would you vote for exiting the Euro?

However, on the other side, if the theme of the debate is the opinion towards EU austerity (including in it everything that has to do with fiscal consolidation, so the opinions over the fiscal compact and on the Maastricht criteria) the curious thing is to notice how magically, the desire to strongly oppose in Bruxelles to austerity prescriptions is a point that makes everyone agree, from the far-right to the far left, passing through the populist wing. The best way to notice this is by a brief qualitative analysis that directly looks into the content of public statements/interview in recent years from the leaders of the main political parties, for vote share, since general election of 2013. The convenience to choose this date is because it's just after the end of 2 years of premier Mario Monti technical government, an emergency government strongly requested by European Union to calm the out-of-control spread crisis during the last period of Government Berlusconi. Such technical government is remembered for the harsh measure requested to citizens, such as the substantial pension reform ('Fornero' reform) to overcome an unsustainable situation due to many years of deficit in the pension system, and some tax increases and reduction of wage for salaries in the public sector (even if it was unable to reduce the total level of public expenditure as originally planned), together with some unsuccessful attempts to liberalize some sectors. All of this, together with the fact of being a government backed (if not almost 'imposed') by European Union, and not the result of an electoral mandate through general elections, made it the perfect emblem of an austerity type of government for the Italian public opinion.

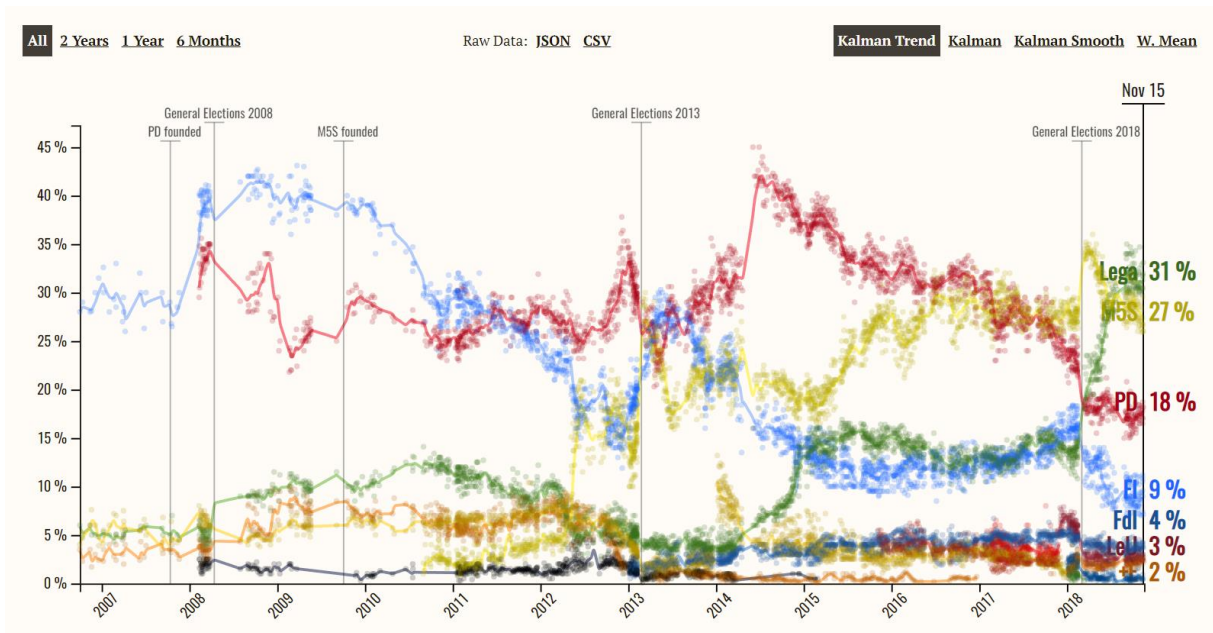


FIGURE 8. Source: <https://pollofpolls.eu> Aggregation of data from the main opinion-polling agencies of the country. Aggregation made with Kalman Trend with linear interpolation (best suited for picking up changes over time).

From the graph above on electoral pools it is clear that the main parties to focus the analysis on since 2013 are ‘Partito Democratico’ (center-right), ‘Lega’ (far-right), ‘Movimento 5 Stelle’ (populist-wing), Forza Italia (centre-right), Fratelli d’Italia (far-right): all of them together represent, for the whole period considered, more than 80% of the vote share, so their leaders’ propaganda is a good proxy of the whole Italian political system attitude towards fiscal retrenchments.

- **PD (‘Partito Democratico’) opinion on austerity through its leader voice:**

“Our government’s aim is to underline that the policy based on austerity and strictness rather than growth and development has clearly showed its limit and it’s over, even for the one who supported it.”

Matteo Renzi, ex leader of left-wing party Partito Democratico and ex Italian prime minister (2014 - 2016), speech at 2014 G7 meeting, 5 June. (English translation by the author)

“...The senseless advent of fiscal compact in 2012 make for the return to Maastricht criteria (3% deficit/GDP for having a 2% growth) a sort of a progressive manifest. We think that Italy has to impose a veto to the introduction of Fiscal Compact on the treaties and to establish a long-term path...A strong agreement with European institutions...In which Italy commit to reduce the debt/GDP ratio through both a stronger growth and an operation on assets studied by ‘Cassa Depositi e Prestiti’ together with the Ministry of Economy and Finance, but that need to be improved... This can be proposed to European union only with a government agreement and in exchange of the freedom to return, for 5 years at least, to the Maastricht criteria with the deficit at 2,9%. This will allow our country to have 30billions euros for the next 5 years to reduce the tax burden and reshape the growth strategy...Before, we couldn’t afford to do this. When we arrived (-in 2014, the beginning of Renzi government - A/N) the watchword was reputation. We had to prove we were able to make reforms...the tax reduction, the spending review... they proved that Italy can make it. But it’s not enough now. Next Government, whenever starts, will need to put on the table a clear exchange in Europe: we lower the debt, but the way to do it is growth. So we need to lower taxes. End of the story. This target, that will lead to a deficit anyway lower than Spain and France

one, and will bring a structural reversal of the debt/gdp curve, represent the basis for the next political agenda of Partito Democratico in the next elections. Even more, is a target widely supported by the main international private investors and towards which there is widespread consensus: without a great bet on growth, Italy will never get back on.”

Matteo Renzi, newspaper interview on ‘IlSole24ore’ 9 July 2017³¹ (English translation by the author)

- **M5S (‘Movimento 5 Stelle’) opinion on austerity through its leader voice:**

‘...Where are the funds (- to cover Government programme; A/N -)? Two concept are underestimated: first being the margins in Europe that we’ve got to get back in order to be able to spend money... from June the new government has to think about the economic planning of the next seven years of the European budget, and there is where to find money that we must take back home, since Italy is giving 20billions euro to E.U every year; second, when we are speaking about investment in infrastructures, those are high multiplier investments, for example if investing 1 euro in tourism gives back to the government 16 or 10 euros, than this means that if you invest 1 billion, you get back 10 billions, I don’t want to make it simple, but is clear that if you start investing the money you have, you will have money to finance other measures later on.’³²

Luigi Di Maio, Italian Deputy Prime Minister, Minister of Economic development and Minister of labor and social policies. Video interview on ‘IlFattoQuotidiano’ newspaper site, 18 May 2018.³³

‘...We cannot wait two-three years to fulfill (electoral, A/N) promises’... it is necessary to draw on some deficit in order to reduce the debt the next year or 2 years from now... Our focus is not to reassure the markets, but increase citizens life quality...’

Luigi Di Maio, interview appeared on ‘LaStampa’ newspaper, 19 september 2019³⁴

- **‘Lega’ opinion on austerity through its leader voice:**

“We are against the enemies of Europe -- Juncker and Moscovici -- shut away in the Brussels bunker... “The politics of austerity of the last few years has increased Italian debt and impoverished Italy. ”

Matteo Salvini, Italian Deputy Prime Minister and leader of far-right party Lega. 8 october 2018³⁵

‘The only way for a country to cancel the Fiscal Compact is to ask for a revision of the treaties... Lega was the only party to vote against Fiscal Compact in 2012’

Matteo Salvini, interview on 11 July 2017³⁶

³¹ http://www.ilsole24ore.com/art/notizie/2017-07-08/la-sfida-renzi-ue-deficit-29percento-cinque-anni-231710.shtml?uuid=AEaMTNuB&refresh_ce=1 (interview in Italian, English translation by the author)

³² <https://www.ilfattoquotidiano.it/2018/05/18/governo-di-maio-coperture-ci-fanno-i-conti-della-serva-ma-noi-in-europa-a-trattare-i-margini-per-spendere-soldi/4365205/> (video-interview; English transcription by the author)

³⁴ <https://www.lastampa.it/2018/09/19/italia/di-maio-attingiamo-a-un-po-di-deficit-e-rientriamo-del-debito-in-uno-o-due-anni-kvNsAhK0V4GwVtoGVPWQSK/pagina.html>

³⁵ <https://www.bloomberg.com/news/articles/2018-10-08/salvini-says-juncker-s-austerity-regime-europe-s-real-enemy-jn05rora>

³⁶ https://video.repubblica.it/economia-e-finanza/deficit-2-9-per-cento-salvini--o-rivediamo-tutti-i-trattati-o-la-proposta-di-renzi-e-aria-fritta/280748/281332?refresh_ce

- **FI ('Forza Italia') opinion on austerity through its leader voice:**

'It is said that the E.U. doesn't allow it [to stop the increase in the VAT and substitute it with a deficit increase; A/N] because we would exceed the 3% deficit/GDP ratio. Let's go over the Fiscal Compact and the debt. Someone at the government must find the courage and the authority to tell to those men in Brussels: we are in this condition thanks to you and your damned policy of austerity. We have to fix problems, from now on you'll have to forget the 3 debt/GDP limit'

Silvio Berlusconi, interview appeared on the newspaper 'Corriere della Sera' 17 June 2013

- **FdI ('Fratelli d'Italia') opinion on austerity through its leader voice:**

'Tsipras is far away from our ideas and I don't agree with many of his positions and some statements on the way he intend to solve problems, for example reinforcing the euro. Anyways, I'm glad that an anti-austerity movement won (- Greek general election in 2015; A/N), Tsipras represent people request of help against the failure of Troika policies.'

Giorgia Meloni, leader of Fratelli d'Italia (FdI). Interview appeared on 'Iltempo' newspaper, 27 January 2015³⁷

The content of those statement should clearly demonstrate how austerity is negatively perceived and fought by all the main political forces, so it is an argument, or probably the only argument, that it's akin to all parties, making it very unlikely to be considered a driver behind the desire of populism and far-right nationalism that lead to the electoral success of the 'Movimento 5 Stelle' and 'Lega' political forces. To strengthen this thesis, of broad intra-party consensus that European Union should loosen the wise fiscal parameters and, on the contrary, allow Italy to make expansionary measures, comes in help a detailed analysis on the content of the programs of all the political forces in the last election, from a quantitative point of view this time. The analysis, made by the 'Observatory of Italian public accounts', an independent institute, specialized in economic analysis of everything that has to do with Italian fiscal accounts and budget draft, found that all the parties in the last general election of 2018 based their manifesto on measures way more expensive that the amount of financing sources. Even if some consistent differences exist in the net result across parties, yet it appears clear a generalized tendency to promise much more than what resources allow, that suggests a certain cultural common background for which fiscal consolidation is not a problem in Italy.

³⁷ <https://www.iltempo.it/politica/2015/01/27/news/giorgia-meloni-sono-contenta-perche-ha-vinto-un-movimento-anti-austerita-966440/>

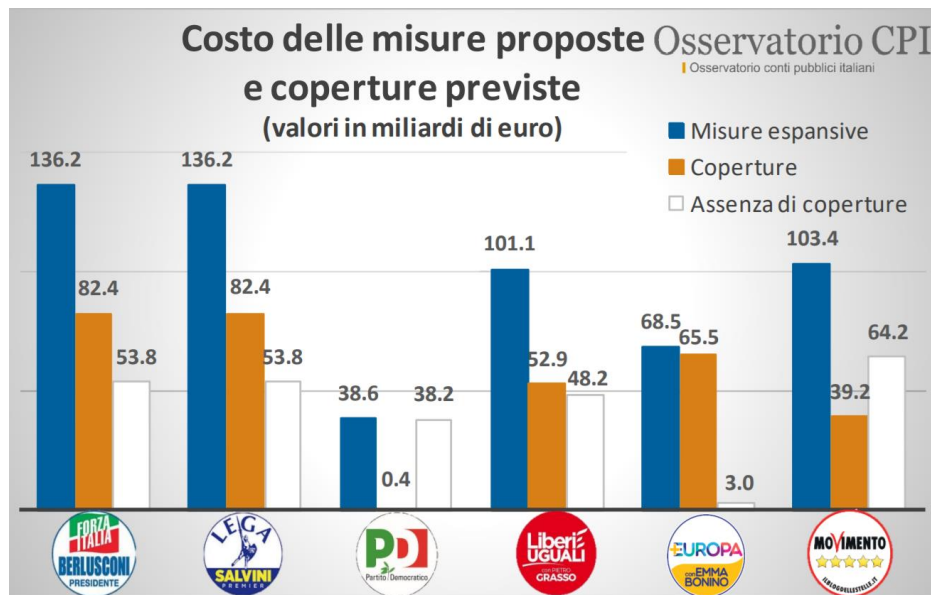


FIGURE 9. Source: [https://osservatoriocpi.unicatt.it/cpi-Presentazione_Tavole_Confronti_\(1\).pdf](https://osservatoriocpi.unicatt.it/cpi-Presentazione_Tavole_Confronti_(1).pdf). parties in order from left to right: centre-right party 'Forza Italia', far-right party 'Lega', centre-left party 'Partito Democratico', left party 'Liberi Uguali', pro-europe party '+Europa' (in the centre-left coalition with PD at 2018 elections), populist party 'Movimento 5 Stelle'. Blue bar = expansive measures; Yellow bar = sources of financing; white bar = difference not covered (= deficit spending). Values in billions Euro. Estimated effects after 5 years

2.2.4 The case of Germany

Germany is probably the strongest example of the fact that country specific determinants need to be investigated to understand political vote dynamics across EU members state, avoiding making generalizations by searching for a common denominator, as austerity for example, that should explain populism and radical-right support all over the Europe.

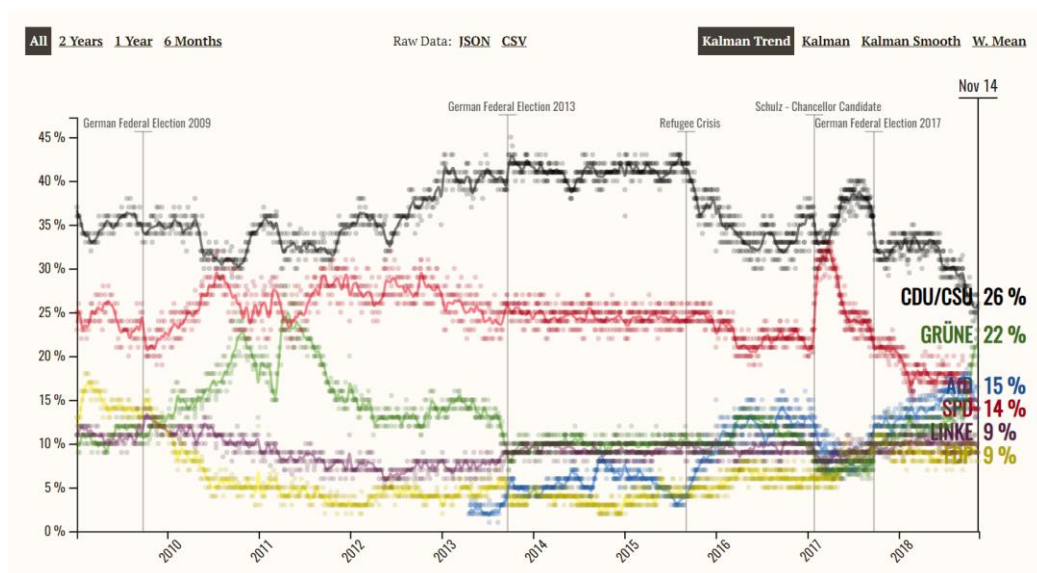


FIGURE 10. Source: <https://pollofpolls.eu> Aggregation of data from the main opinion-polling agencies of the country. Aggregation made with Kalman Trend with linear interpolation (best suited for picking up changes over time).

The relevant success of the newly born (2013) far-right party Alternative for Germany (AfD), able to reach 15% of the electoral support in just 5 years, representing the first far-right political force able to enter Parliament since World War 2, is indeed a phenomenon non-certainly explainable by the grievances that are usually referred to austerity measures. Germany is indeed the classic example in Europe of a wealthy economy able to growth with sounding fiscal accounts, so austerity is definitely a non-existent issue in this case. If anything, the level of the debate that could exist around fiscal consolidation is on the opposite side than the one usually considered on mass-media and in countries with fiscal imbalances like PIIGS, that is if austerity could have played any role fueling the support for AfD, it would have be in the sense of the desire for even more of it, not less: this far-right nationalist party could have given electoral space to German citizens particularly annoyed of European assistance bailouts, and time bonus with additional chances, to countries unable to fulfill their fiscal account commitments.

"We can have a common currency with the Netherlands, Austria, Finland or Baltic states. They have similar cultures of stability like ours...

...the political culture of France and the southern European states was different from Germany's... They don't want austerity at all...

...France is the Eurozone's second biggest economy after Germany, but has been struggling to reduce unemployment and national debt.'

Joerg Meuthen, co-leader of the Alternative for Germany, interview for the daily Frankfurter Allgemeine Zeitung, April 2016 ³⁸

'Alternative for Germany' was indeed founded in 2013 as a Eurosceptic party with the main intent³⁹ to challenge the Eurozone bailouts to fiscal irresponsible countries like Greece.

"We don't want to be a populist party," said Mr Lucke. "There are parts of the German media that try to communicate this idea that we are a Right-wing populist organisation, but we argue against that because I think we have serious and realistic goals. Not populist goals. We are dissatisfied voters of all major German parties who long for the dissolution of the euro."

Bernd Lucke, founder of AfD, interview appeared on 'The telegraph' ⁴⁰

³⁸ English version of the interview used in this contest is: <https://www.dw.com/en/germanys-populist-afd-party-wants-france-excluded-from-common-european-currency/a-19211490>

³⁹ <https://www.dw.com/en/afd-what-you-need-to-know-about-germanys-far-right-party/a-37208199>

⁴⁰ <https://www.telegraph.co.uk/news/worldnews/europe/germany/9975766/Bernd-Lucke-interview-Why-Germany-has-had-enough-of-the-euro.html>

Only later on, when the recovery of the entire euro area economy was evident, and the Euro was no-more able to capture public opinion interest, the party radically moved its propaganda toward anti-immigrant contents. Due to this relevant shift to the right towards a populist and anti-immigrant direction of AfD, the original founder left, together with other party's member no more in agreement with the new course of the party, and from this split was born in July 2015 what today is called 'Liberal Conservative Reformers' (LKR)⁴¹. This split is useful for the analysis of this contest because, considering that LKR is supposed to collect the share of AfD supporters interested in the original topics, the ones against Europe and against bailouts (that is against loosening of austerity measures for the sake of the argument here), the remaining electorate faithful to AfD after the split can be almost certainly considered a far-right voice moved by themes as immigration, not certainly by fiscal consolidation thematic. This is even consistent with the sharp rise in consensus observable immediately after the refugee crisis in the end of 2015.

2.3 EU citizens attitude towards austerity: against conventional wisdom

The examples of Greece, UK, Germany, Italy and has been used here to underline how across European countries different explanations could be found in explaining the rise of political protests movements, and austerity is not always a central factor, and even when it is certainly important, is not easy to isolate it from other influencing forces that guide people electoral behavior. On the other side, a country specific socio-political analysis for every single it's a way too long procedure for investigating general European citizens attitude towards the concept of austerity, yet the question remains quite relevant, since for the European Union is important to understand to what extent its policy prescriptions are accepted by its citizens or instead perceived as unfair or wrong. Whith this regard, a useful approach is to look at the data collected from the 'Standard Eurobarometer' (the coordinated survey by the European commission that monitors the public opinion in the European Union every semester). If European austerity is so central in shaping people's political opinions, and if it's failure is such a matter of facts commonly accepted across all over the Europe, to the point of being considered the main reason why EU economy did not promptly recovered (a diffused storytelling on mass-media, anchored on Krugman and Stiglitz vision), it should be reasonable to observe the majority of Europeans against the Union, (because if not, it means that or austerity is not so widely perceived as the

⁴¹ The original name was '*Alliance for Progress and Renewal*', but it lasted only one year due to a name litigation with another movement

cause of economic downturn, or that even if it's considered negatively, is yet not so important in people opinion to being able to offset the positive aspects of the Union). At a general first glance, there seems to be some evidence that give credits to the mass media storytelling that sees European Union under serious threat for its survival in the future, due to its poor choice of fiscal consolidation prescriptions that worsened the already tough economic conditions, paving the way for populists and nationalist anti-European movements. In particular the percentage of people that do not trust the European Union seems consistent with this view: from the end of 2009 it surpassed, for the first time, the number of Europeans who Trust the E.U., and the Gap became rapidly huge and long-lasting (between 2011 and 2014 it ranges from 20 to 30 percentage points).

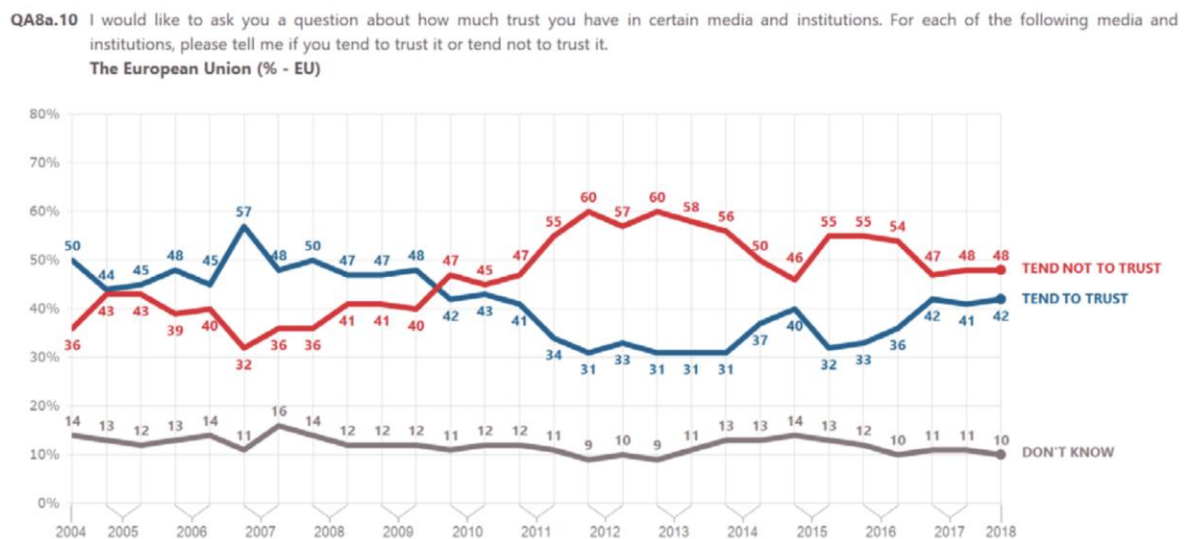


FIGURE 11. Standard European barometer 89 spring 2018, page 103

Considering that 2010 is the period in which European Union started to respond with Austerity policies to the crisis, it could be reasonable to interpret that tangible loss of trust in E.U as a clear sign of European citizens widespread disapproval of such policies. However, this would not explain either the period from the beginning of 2014 to the beginning of 2015, where the gap consistently diminished from 25 points percentage to just 6, or the following period, where it initially increased again (remarkably, from 6% to 23% only inside the 2015 period) and then decreased coming to the close 6 points-difference in the present. Since in those years there was no relevant change in fiscal policy guidelines at the central European level, additional reasons other than attitude towards austerity alone should be found in explaining that movement in trust propensity. In addition to that, it is important to complement the above data of the generic trust in the European union with data showing the contemporary level of trust in institutions at the

national level: since the fiscal tightening path was decided at the European level (so has been perceived by people as an external mandatory policy, out of national government responsibility), if it's true the thesis that austerity is European-wide hated and at the base of people reunion in anti-European movements, it should be reasonable to observe a substitution of trust in the European Union institution with trust in national level type of institutions. Austerity is indeed perceived as something not nationally decided: on one side, it is observable by various governments prime minister and politicians' public statements against European fiscal rules, described as the cause of government cuts, tax increases and lacking growth, but on the other side the same Europeans opinion collected by the Eurobarometer seems to confirm this view:

'On the positive side, the EU is seen as business-friendly, an influential player on the international scene and an institution that protects its citizens. On the negative side, it is perceived by a majority of Europeans as being over-bureaucratic, responsible for austerity, unfair and ineffective in tackling what Europeans consider as two key issues, namely employment and purchasing power'

[Standard Eurobarometer 81, 'Public Opinion in the EU', Spring 2014. Pag.104](#)

Having explained why it should be taken for granted that austerity is perceived as European Union decision, if really Europeans citizens find it so unfair and such a central issue, the faith they lost at the European level should be, at least in part, offset by a gain in faith in national institutions, as a form of protest. This is indeed an important common aspect of the propaganda of all the RRP (radical right parties) and other anti-European and anti-establishment parties in general (populist and left-side ones), to pursuit a return to a generalized National sovereignty, ranging from the freedom to decide the level of deficit, to the immigration law, and in the most extreme cases even arriving to the desire of euro exit for a return to national currency. However, as observable by the data collected from the Eurobarometer, the gap between trust in the E.U institutions and the trust in the main national institutions (government and parliament) has indeed diminished in the post-2010 period relative to the pre-2010 period, but only because of diminishing trust in the E.U union, the level of trust in national institutions remained almost flat since 2004, a substitution effect is absolutely not present. More than that, despite the non-negligible rise of the political wave of nationalist-populist-Eurosceptic parties already mentioned previously, the trust in national institution has always been, even during the most difficult part of the recession, below the trust in the European union.

QA8a I would like to ask you a question about how much trust you have in certain media and institutions. For each of the following media and institutions, please tell me if you tend to trust it or tend not to trust it.
 (% - EU - TEND TO TRUST)

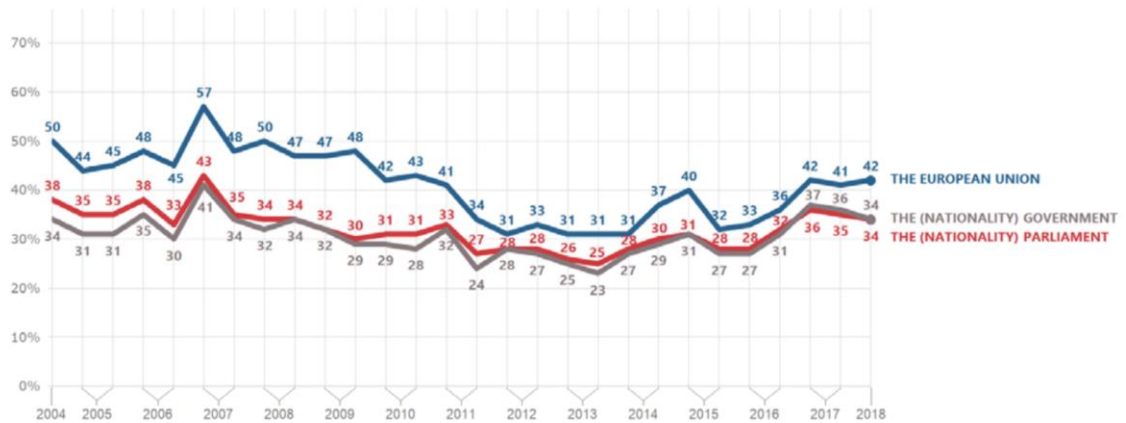
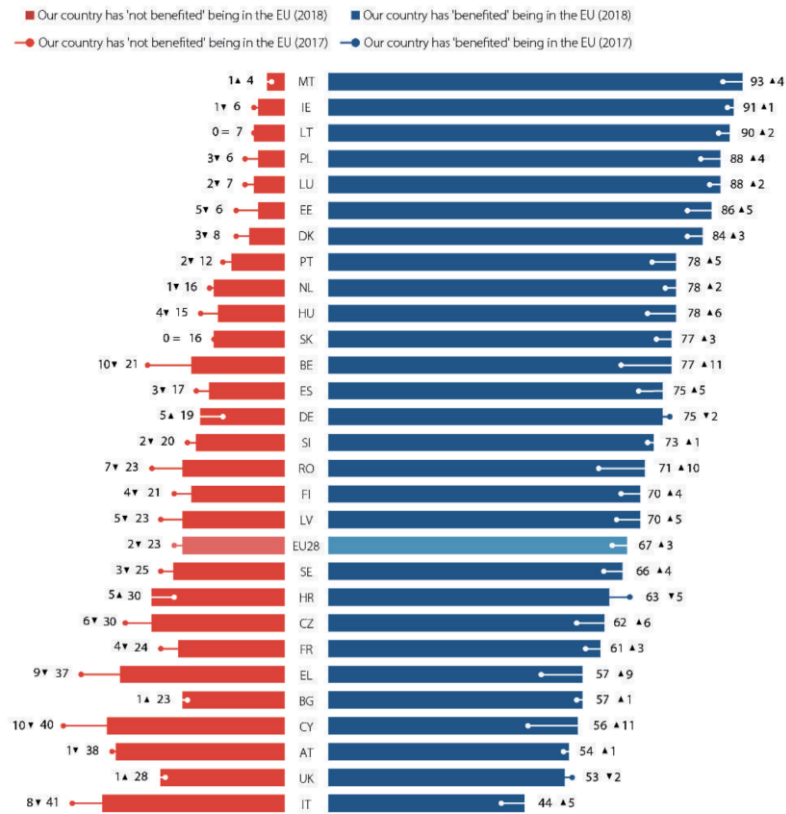


FIGURE 12 Standard European barometer 89 spring 2018, page 41, upper chart.

This is additionally reinforced by another survey present in the EU barometer, that shows how consensus over Europe has indeed never being stronger: 67% of the people interviewed in 2018 think that their own country has overall benefitted from having entered the E.U., and this result is the highest registered since 1983.

Q Taking everything into account, would you say that (OUR COUNTRY) has on balance benefited or not from being a member of the EU? (%)



Source: Eurobarometer 2018 89.2, QA24

FIGURE 13. Democracy on the move' Eurobarometer survey 89.2, 2018, page 25

These results are important, they underline a still strong belief in the European Union and its institution, an aspect that appears to be not adequately represented in the mass media narrative, usually more prone to describe the negative aspect and the pessimistic view⁴² of the future of the union (at least for mass-media of countries who suffered the crisis, and so the consolidation measures, the most, but even for some of the major U.S. mass media, who may suffer from a certain bias due to the political interest in exaggerating the European Union's and in particular the Euro area's problems).

E.g., I'm referring to the pessimistic and warning tone on European Union future and the Euro currency commonly present in press articles like:

<https://krugman.blogs.nytimes.com/2015/01/05/europes-trap/>
<https://www.nytimes.com/2015/07/20/opinion/paul-krugman-europes-impossible-dream.html>
<https://www.theguardian.com/business/2018/jun/13/euro-growth-eurozone-joseph-stiglitz>
<https://www.ft.com/content/c33864a2-7949-11e8-bc55-50daf11b720d>
<https://www.mediapart.fr/journal/international/050918/joseph-stiglitz-l-europe-est-au-bord-de-l-abime>
<https://www.telegraph.co.uk/finance/financialcrisis/8039041/Joseph-Stiglitz-the-euro-may-not-survive.html>
https://elpais.com/diario/2010/04/18/economia/1271541604_850215.html

In the 2014 EU barometer ‘austerity’ appears, as already showed before, among the negative aspect of the E.U. as long as people perception is concerned. The conclusion however is not so useful to understand people opinion towards austerity policies. The question was indeed a bit generic in the way it was designed: asking for the ‘responsibility’ of austerity potentially include also respondents who do not necessarily think negatively about austerity, but yet are convinced that it is something decided for their government at the European level. Even more, this, in conjunction with the one of 2013, was the only Eurobarometer to explicitly use the word ‘austerity’ in the survey. So, in order to better comprehend people opinion on tightening fiscal policies, and their role on the exacerbate political climate, the information inside the Eurobarometer have to be found in the questions concerning the attitude towards public finances and government debt issues, this can indeed be considered a quite good proxy of the political opinion towards ‘austerity’. An intuitive result should expect to show austerity as a central reason for the strengthen of anti-EU sentiment, being the request of sacrifices measures during a downturn a really unpopular choice. However, the answers collected show a more complicated reality. First of all, according to the answers, 17% of EU citizens consider the situation of the EU member’s public finances among the two most important issues the EU should be concerned about among a list of thirteen problems to face. This translate in a cumulative result in which the problem of government’s public finances ranks in 4th position, just after immigration, terrorism and the economic situation in general. The clear implication here is that the debate on fiscal policies is far from over, even now, inside a very promising growing scenario.



FIGURE 14 Standard Eurobarometer 89 spring 2018 page 26

QA5 What do you think are the two most important issues facing the EU at the moment?
(% - EU)

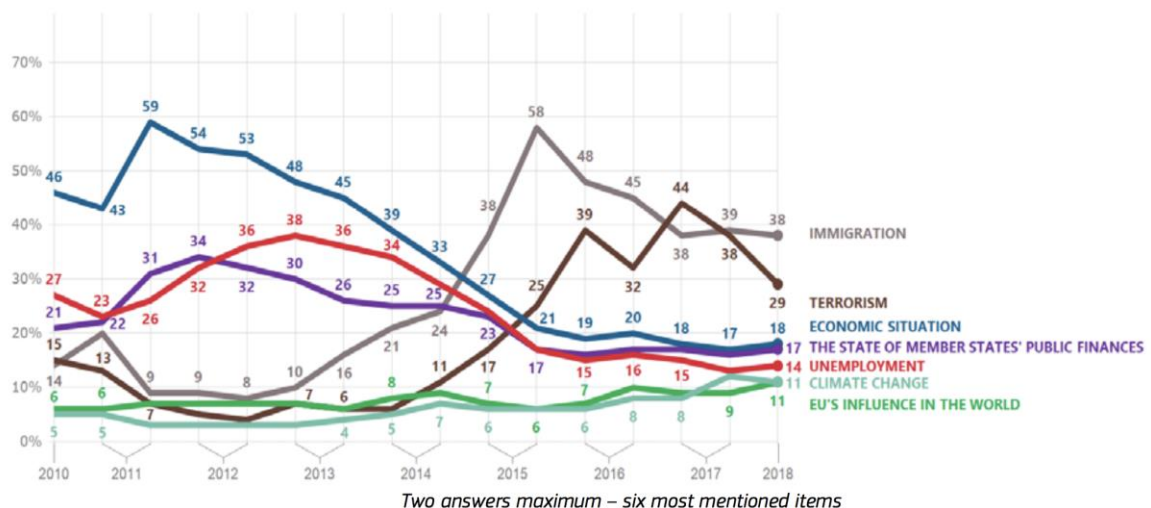
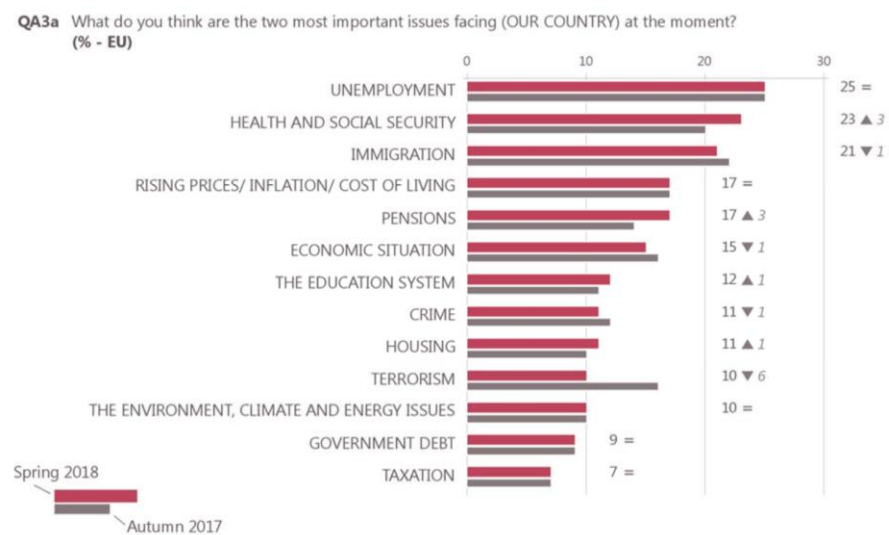


FIGURE 15. Standard European barometer 89 spring 2018, page 27

On the positive side, 17% is half the relevant pick of 34% registered in 2012, suggesting that the gradual improvement of economy conditions (visible even by the blue-line trend representing the concern towards the economic situation in general) should help towards a less skeptical vision of the system of the EU. This may reveal what is reasonable to expect: the anger against contractionary policies is stronger inside the crisis, where the sacrifices from spending cuts and tax increases are perceived as even more unfair than in normal times, while when the situation recovers, trust in the Union and its benefits is in part re-established, and the burden of the same sacrifices is partially-offset by the positive outcomes of economic growth. However, the recovery of the economy may not be the only or central explanation: due to the way the questionnaire was implemented, with a maximum of two answer per person, the decrease in concern about fiscal budget imbalances may be mainly explainable by the contemporary increase of the immigration phenomenon first, and the terrorism phenomenon a little bit later, both of which gathered the main people attention, as clearly captured by the answers given (grey line and brown line respectively). It is also interesting to observe a clear stable trend from 2015, meaning that the concern is there, persistently in 4th position and doesn't show anymore signs of decrease in relevance. But all of this does not say anything about the positive or negative attitude towards contractionary fiscal policies. It is indeed necessary to do an additional step, moving the point of view from the EU level to the national one: the same EU citizens worried for the EU capacity to face members' public finances imbalances, find the issue much less concerning (9% against 17%) if related to their country (at the national level the question is not about 'state of member public finances' but about 'Government Debt', however for the intent of this survey and for the argument here, it is reasonable to consider both

as the same concept of public budget balances issue, being the public debt the sum of all the fiscal deficits over time). The interpretation of this different opinion between the European and the national contest should probably rely on the variance in terms of public debt management among European countries: citizens of highly indebted EU members countries are reasonably expected to be concerned for their government's imbalances, while citizens of EU members with a virtuous fiscal system will not see debt has a national problem, but in the meantime they will still remain worried at the European level for the imbalances of the non-virtuous members (E.g., German citizens will not be worried by the sustainability of their government debt, but will be worried of the EU ability to manage the problems connected with the high debt of Greece and Italy for example).



¹⁰ QA3a. What do you think are the two most important issues facing (OUR COUNTRY) at the moment?

FIGURE 16. Source: standard Eurobarometer 89 spring 2018, page 19

This result is important because show the existence of a non-irrelevant part of Europeans that may be on the opposite side of the anti-austerity movement, hoping for more rigidity rather elasticity in fiscal imbalances and government debt control. At this point, someone would reasonably assume that this part is indeed only represented by EU members with already sounding fiscal budgets and who are not so inclined to contribute to the E.U budget if other members show fiscal irresponsibility, while on the other hand the vast majority of citizens of countries with fiscal imbalances and subjected to austerity measures will be against those measures, considering the short-term grievances that tightening measures bring in a time of crisis. However, quite surprisingly, the answer collected by the EU Barometer describe a scenario in which the part of European citizens who believes on the necessity of fiscal

tightening is by far the majority across all over the Europe. Even if the trend shows a continuous decrease since 2011, the percentage of respondents who believes that restricting measures for deficit and debt reduction could not be postponed for their country is 49% points more than the ones who strongly believe the opposite.

QC2a.1 For each of the following statements, please tell me whether you totally agree, tend to agree, tend to disagree or totally disagree.
Measures to reduce the public deficit and debt in (OUR COUNTRY) cannot be delayed (% - EU)

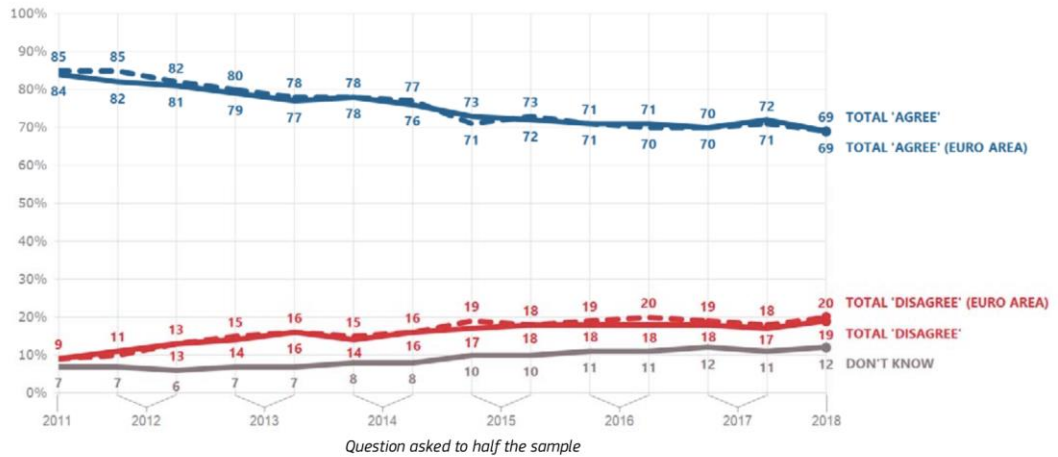
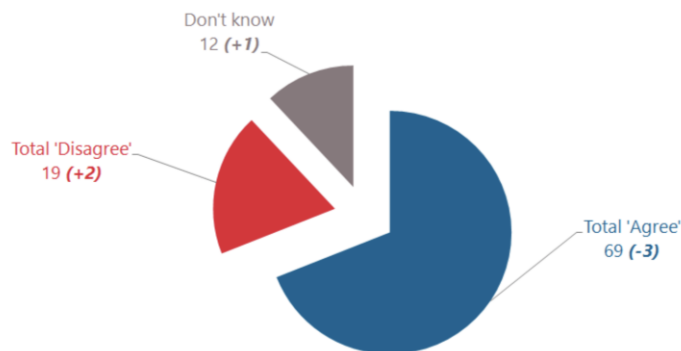


FIGURE 17. Source: standard Eurobarometer 89 spring 2018, page 214

QC2a.1 For each of the following statements, please tell me whether you totally agree, tend to agree, tend to disagree or totally disagree.
Measures to reduce the public deficit and debt in (OUR COUNTRY) cannot be delayed (% - EU)



(Spring 2018 - Autumn 2017)

Question asked to half the sample

FIGURE 18. Source: standard Eurobarometer 89 spring 2018, page 214

QC2a.1 For each of the following statements, please tell me whether you totally agree, tend to agree, tend to disagree or totally disagree.

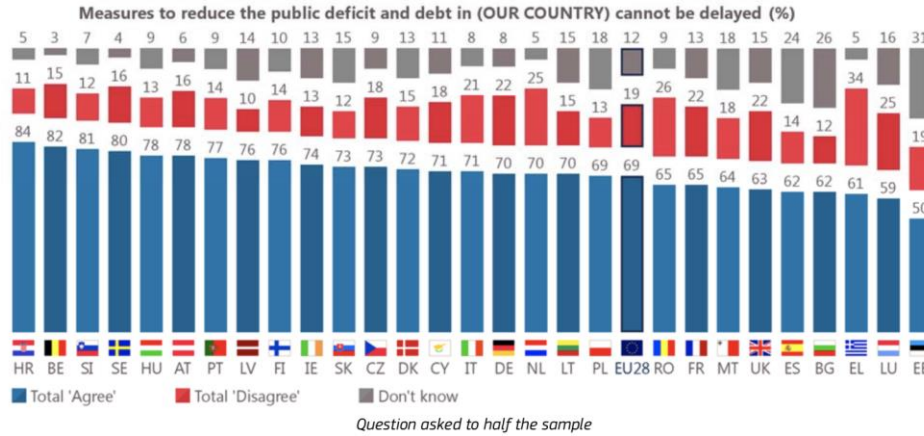


FIGURE 19. Source: standard Eurobarometer 89 spring 2018, page 214

Proceeding with the analysis, another interesting thing to notice is how countries like Greece, Ireland, Portugal, Italy, usually taken as the example, in the public debate, of countries under heavy austerity, still maintain a consistent majority of people that seems to be not prone at all to deficit spending anti-austerity measures. Much less is the difference in opinion when a similar problem is investigated using negative wording (that is ‘measures to reduce public deficit and debt are not a priority’).

QC2a.2 For each of the following statements, please tell me whether you totally agree, tend to agree, tend to disagree or totally disagree. Measures to reduce the public deficit and debt in (OUR COUNTRY) are not a priority for now (% - EU)

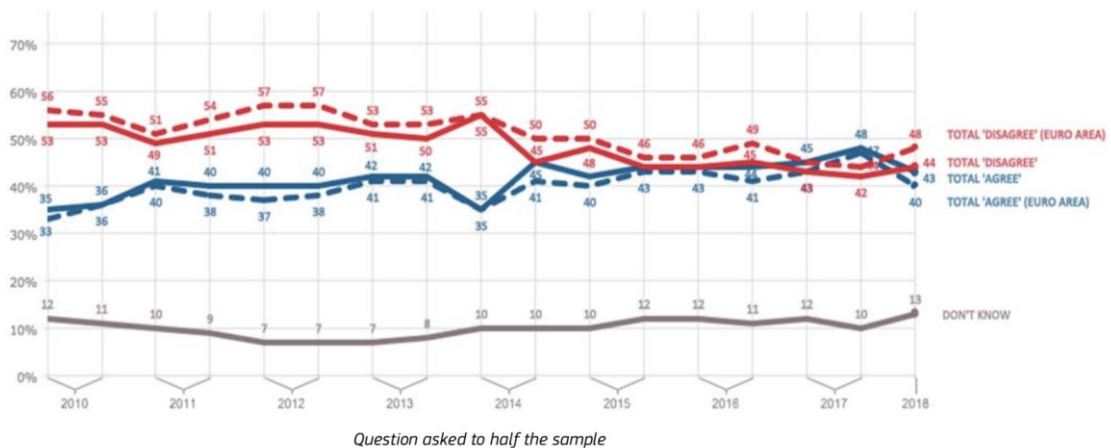


FIGURE 20. Source: standard Eurobarometer 89 spring 2018, page 214

However, this almost half-half division in agreement does not necessarily contradict the precedent results, being the word ‘priority’ a methodic choice that may leave space to other issues considered more serious by people, like immigration (e.g., someone can consider fiscal

consolidation impossible to postpone, but at the same time not a priority relative to other problems, for example in terms of effort and resources to reserve for it). Actually, the thesis being supported here is even strengthened, if anything, by this last chart: there is a consistent number of Europeans, the majority according to the answers collected, that does not desperately invoke the end of fiscal tightening, even if it doesn't publicly manifest this position as the anti-austerity part does (in part probably due to lack of attention from mass-media, as already assumed before).

2.4 A possible bias from the negative meaning behind the wording 'Austerity', and the role of newspaper.

This result is of particular interest because it raises the traditional level of the debate over austerity to a level not enough investigated. First of all, it clearly suggests a diffused inability of mass media coverage to properly give space to this pro-consolidation voice in the debate, as already supposed previously about the voice of the ones strongly in favor of the European union. This is because if someone should make an estimation of the general idea of Europeans concerning deficit and debt reduction just by looking at the way austerity is treated on press coverage, television news, internet and so on, it wouldn't be certainly the one observable in the Eurobarometer data, but most likely the opposite, a consistent majority of people tired of restricting fiscal policies and eager of increase deficit spending to offset the downturn of the crisis. On the other hand, this result also suggests that there could be a potentially influential wording-choice problem deriving from the negative meaning that is automatically connected with the word austerity.

"I call it balancing the budget. Everyone else is using this term austerity. That makes it sound like something truly evil."

[Angela Merkel, German Chancellor, April 2013 interview⁴³](#)

It could be that even if the consistent majority of people in every of the EU member state (excluding Estonia where exactly half of the people think alike) think that public deficit and public debt should be reduced with no delay, the same people could answer negatively if the question limits to ask an opinion toward 'austerity'. Since the two things are a different wording for the same question, contrasting answers by the same respondents would be the sign that the

⁴³ <https://www.telegraph.co.uk/finance/financialcrisis/10013814/Angela-Merkel-Austerity-makes-it-sound-evil-I-call-it-balancing-the-budget.html>

word ‘austerity’ suffer from a negative-bias⁴⁴. In order to find such a contrasting answering behavior, future Eurobarometer surveys should further investigate by adding a new survey that explicitly uses the word ‘austerity’. As previously observed, since now this word has been used by the Eurobarometer only twice, in its 2013 and 2014 editions, and not in a way able to directly catch a direct value judgment by people. However, taken for good that the 2014 Eurobarometer correctly interpreted the ‘European is responsible for austerity’ answer as an opinion that implicitly intends ‘in negative way’, this is a first sign of this pattern of contradictory answers, that calls for further investigation. Another hint in support of this idea is by comparing the answer given by Italians to the Eurobarometer survey of 2017 and to a 2017 survey by University of Siena and the Institute for International affairs.

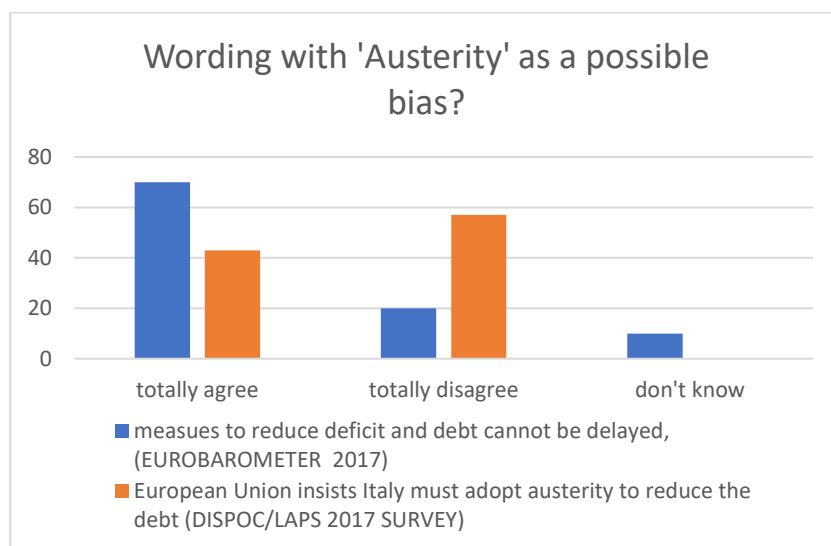


FIGURE 21. Author's representation, with little simplification to match data for comparison⁴⁵

Results clearly show discording opinion of Italian population toward the same argument, with the propensity to refuse to consider debt a big problem if in the question the word austerity is used.

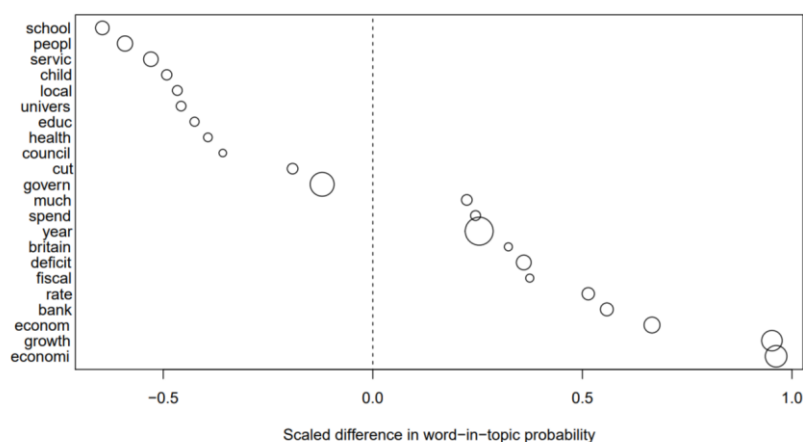
If robustness to this hypothesis is being found, that is if the austerity indeed contains a negative meaning on its own that influence answering pattern, it would be interesting to understand the

⁴⁴ It is assumed here that the theory of the multiplier effect for which an increase in deficit spending will increase the aggregate GDP so much that the final debt/GDP ratio will actually decrease is not taken into consideration by the majority of ‘normal’ citizens who answer to the Eurobarometer type of questionnaire. Without this assumption, someone could answer negatively about austerity, and positively about the necessity to reduce debt, and the two answers wouldn’t be in theory contrasting. Anyways the assumption of excluding this seems reasonable: first of all this considerations are more on a technical level that is not so diffused among common people, secondly, even if the idea of a big multiplier could be diffused among people due to politicians slogan and mass-media, the question in the eurobarometer specifically explicitly asks also about deficit reduction and not only debt reduction alone, this direct question should obtain a direct answer from the respondent, out of any additional consideration based on multiplier effects.

⁴⁵ Data from Eurobarometer 88 Autumn 2017 page 192; data from ‘Gli Italiani e la politica estera’, DISPOC/LAPS and IAI, October 2017, page 22 figure 18. I simplified only the yellow survey, by aggregating to ‘totally agree’ the ones who answer yes to ‘... European Union insists Italy must adopt austerity to reduce the debt, for you with this debt Italian economy has no future, we need to apply to reduce it even at the price of new sacrifice’ ; then aggregating with totally disagree the ones answering yes to ‘ European Union insists Italy must adopt austerity to reduce the debt, for you Debt is not a priority and Italy already did too many sacrifices.

reasons behind that. An interesting approach for future research for example could utilize machine learning algorithm for text classification to analyze a wide database of press articles and social media coverage across EU countries in order to understand the percentage of articles against austerity and the percentage of article in favor: if for example mass media coverage appears to negatively describe austerity, this could be an explanation of the negativity in the austerity concept supposed here. This type of investigation could give some useful information to understand political attitude towards deficit reduction policies, since media coverage can have an active role in shaping public idea towards an argument, and media coverage is not new to have political endorsement pattern for a certain side that can influence the way news are reported (Larcinese et al; 2011). A literature specific example of how different press storytellings over fiscal deficit argument exist and have the ability to influence readers idea on the argument is a study by Barnes and Hicks (2018) for UK. First the authors examined all articles containing fiscal policy topics form two main UK newspaper, ‘The Telegraph’ and ‘The Guardian’, between the period 2010-2015. They found a difference in the way the argument was threated: for example with respect to the topic of ‘austerity trade-offs’, ‘The Guardian’ shows a clear tendency to talk about public services (School, health, education, people services), suggesting the intent to underline the negative aspects that spending cuts can have, while on the other hand ‘The Telegraph’ seems to focus more on the macroeconomic aspect of the austerity, with words like ‘economic growth’, ‘bank’ ‘rate’, probably suggesting the intent to underline the necessity of consolidation from a broader view and despite the grievances it may cause in the short term.

Relative frequencies of most common words within respective topics, scaled such that low values indicate more disproportionate numbers of appearances within The Guardian and high values likewise within



(b) Austerity Trade-Offs.

Figure 22. Source: Making Austerity Popular: The Media and Mass Attitudes Towards Fiscal Policy, L. Barnes, T.Hicks. November 27, 2017. Image from page 19, figure 3 (paper edition from the author academic webpage

<https://ucl.academia.edu/LucyBarnes>, the peer reviewed version of 2018 on the 'America Journal of Political Science' may have a different page)

After having found this narrative difference in treating fiscal topics, the authors conducted a survey experiment with a control group receiving factual information, and two treatments group, receiving the same information but with an additional frame, respectively with 'The Guardian' more used topics and with 'The Telegraph' more used topics from the previous analysis. By controlling for many factors, like pre-existent political inclination, pre-existent tendency to automatically prefer a newspaper with similar political opinion, and level of income, they found that a causal effect between newspaper type of storytelling and readers attitude towards deficit, with those in the 'Guardian' treatment being less incline to deficit reduction.

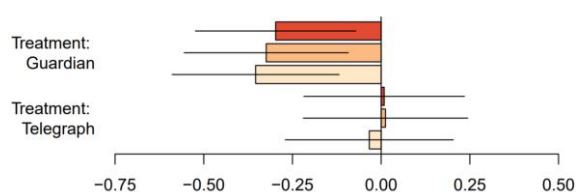


Figure 4: Coefficient plot illustrating treatment effects from Experiment 1 for a range of specifications. The top (darkest) bars of each trio are estimates from models with no controls, middle bars from models controlling for newspaper read, and bottom (lightest) bars from models including newspaper, income and 2015 vote. Black lines indicate 95% confidence intervals. Higher values indicate greater priority on deficit reduction.

FIGURE 23. Source: Making Austerity Popular: The Media and Mass Attitudes Towards Fiscal Policy, L. Barnes, T.Hicks. November 27, 2017. Image from page 23, figure 4

2.5 Does Higher education translate into higher propensity for fiscal consolidation?

One interesting question is whether the attitude towards more 'responsibility' in fiscal account responsible management is correlated or not with the level of education. The idea behind is that it could be expected that more educated people are aware of the fact that public finances and public debt more in general are in the end a matter of budget constraint, that is they are less prone to believe in electoral promises in the field of the 'free-lunch', that is political campaigns and slogan based on commitment for expansionary measures, that will ease the state of the economy and so people condition, without clear resources of financing.

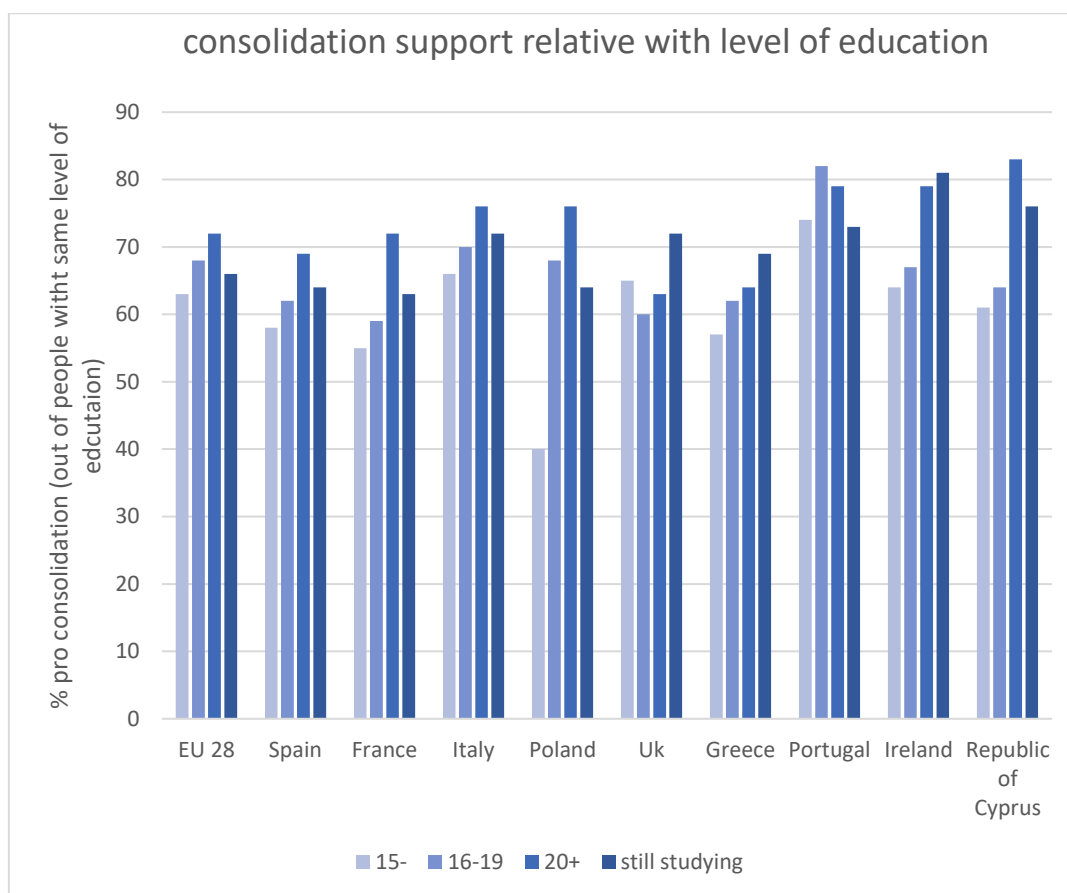


FIGURE 24. Author's representation of data from standard Eurobarometer 89 spring 2018, page 219, upper table

However, looking at empirical evidence is not easy to find such a defined pattern. In the graph above is reported the situation for the whole EU 28 (average), for the five largest EU member's (excluding Germany because debt and deficit consolidations are not an issue at all so it makes little-sense the question) and for the countries that received (or are still receiving) EU support for the financial and economic crisis. Both at the European level, and for all the states examined excluding UK and Portugal, it is possible to observe that an increase of education from 15 years old level to higher education level (20+ years old) lead to an increase in the propensity to consider fiscal consolidation a necessity. In particular the jump in opinion between people remained at 15 years of education and people of the 16-19 years-of-education group is remarkable in Poland. UK and Portugal behave a little bit on their own: in the former the relation holds, but only starting from the second group, and even so, yet the second and the third group show lower propensity to 'totally agree' than people in the lower bound of educational level; in the latter, there is an increase in consensus only from primary to secondary educational level people, but then the support for austerity diminish with the increase in education. Yet the main thing that does not allow to make any easy conclusion about the connection between education and positive attitude towards sound fiscal accounts is the fact that, for EU on average, and for

6 out of the 9 countries considered here, the last bar representing the highest level of education show a percentage inferior to the level of education just before, representing an inverse trend than what described before, that is a negative correlation between additional education and support for austerity measures. It is difficult then to judge the net result, a deeper investigation with more data and more specific questions is needed in this field.

2.6 A result not new in literature: fiscal consolidation not necessarily punished by voters

The public opinions with respect to fiscal consolidation just observed from the Eurobarometer survey seems quite a counterintuitive result, especially if we considered that even the countries with though economic conditions, where austerity should have been perceived the most, yet show the majority of citizens aware of the fact that consolidation on public balances is necessary and impossible to postpone. It is reasonable to expect that the sacrifices requested with a policy of austerity, especially inside an already difficult environment where people are suffering the grievances of the economic crisis, represents a remarkably unpopular policy choice, while the opposite, that is a propaganda based on promises of government expansionary intervention, to help citizens offsetting the negative effect of the economic downturn, is expected to be a much more vote-catching policy to undertake. Following this conventional and intuitive wisdom, it should be observed during time a trend in which deficit reduction policies are expensive in term of electoral support. The common misleading idea that it is obvious the electoral preference towards politicians who promise more spending and less taxation, is what is called, in the public choice school, ‘fiscal illusion’. This theory assumes that voters care only about the present, because they do not understand the concept of government intertemporal budget constraint⁴⁶, i.e. they do not take into consideration that a tax cut today translate, *ceteris paribus*, in a tax increase tomorrow (or an increase in spending today translate, *ceteris paribus*, in borrowing through the debt channel, over which higher interest rates will have to be paid tomorrow). One hypothesis could be that without the comprehension of this mechanism, they will be more likely to reward political parties prone to deficit spending agenda, since they should guarantee more

⁴⁶ The government intertemporal budget constraint implies that if government cut taxes by a certain amount x in the present, it has to increase them in the next period by the same amount $x +$ the interest rate of that future period, this to re-enter in the intertemporal constraint necessary to maintain bonds holders trust. If households are aware of this, as predicted in the Ricardian equivalence, they will not spend the part of tax reduced by the government, because they know they will face a future tax increase, so they will save the amount for facing the future tax increase, and the government will not have the desire effect of a demand boost in the economy. However, the effect is not so granted according to empirical evidence, even because a certain variable share of consumer is the so called hand-to-mouth consumers, that is people with low income who tend to consume all their disposable income. For those people, a tax cut policy translate in an increase in consumption

public services, benefits, jobs opportunities and/or bigger salaries in the public sector. This view probably tends to oversimplify electoral mechanism, whether because it assumes too ignorant or too irrational voters, or just because it gives too much relevance to the theme of fiscal deficit in the final choice (for instance: [Lewis-Beck and Stegmaier \(2000\)](#): government in charge is punished for high-unemployment), that is probably the reason why literature did not come to broad consensus on the empirical evidence in support for this thesis. The main recent studies in support for this idea of politically punished austerity policies are [Talving \(2017\)](#), and [Nyman \(2014\)](#): the former, analyzing a sample of 24 EU members from 2004, 2008 and 2014, found in fiscal austerity a choice that, in the specific case of the post-crisis period, costs governments significantly lower incumbent support; the latter studied a sample of 27 countries between 1974 and 2013, regressing the changes in vote share for each party between two elections on the size of the accumulated change in structural budget balance implemented during the time the party was in charge, and found that for every percentage point of GDP decrease for improving the budget balance, the government party lost 1% of vote share. On the other side, many studies show results in different direction: [Alesina, Perotti and Tavares \(1998\)](#) used opinion pools and cabinet changes to monitor the electoral effects of fiscal consolidation policies on a sample of OECD countries, and they found no evidence of negative correlation, but rather a (weak) positive one; same lack of evidence of negative correlation has been found lately by [Alesina, Carloni and Lecce \(2012\)](#), but this time they looked at the effects of fiscal austerity directly on electoral results rather than some proxies; [Brender and Drazen \(2008\)](#) similarly found that the probability of renewal of the electoral mandate (weakly) decrease if the leader had opted for deficit-enhancing actions; [Arias and Stasavage \(2016\)](#) observed no effect of expenditure cuts on leader turnover on a sample of 32 countries over a time period from 1870 to present: the results are consistent using two different empirical methods: the first based on OLS to regress the change in political leadership on the change in expenditure, taking into account country fixed effect as well as year fixed effects and other observable variables, the second (in order to overcome a potential selection bias in the first method, that is the possibility that leaders, in flexible scenarios, chose austerity measures only when they are sure they will not lose their office) based on an instrumental variable found to be statistically significant predictor of expenditure changes (that is a situation where trading partners have a shock in GDP growth and, in addition to that, cost of capital in the market is high, so the government suffer a pressure on its fiscal balances, due to lower revenues from trade and difficulty to borrow from market, and this lead to cut expenditures). These findings, going almost in the opposite direction of what the ‘fiscal illusion’ intuitive argument would suggest, seem consistent with the Eurobarometer answers previously observed. [Ponticelli and Voth \(2017\)](#) was mentioned at the

beginning of this chapter to underline how austerity policies seem to increase the propensity of people to manifest through protests and riots, even violently; this result may appear, at first, in contrast with the literature just mentioned here, but at a deeper evaluation this is not necessarily the case. It should be read as a complementary result: it found indeed a cross country people attitude to protest to relevant tightening measures, that is not enough to imply the government/leader responsible for such policies will not be re-elected, but anyways suggests a possible interesting explanation to the reason why political parties may still be reluctant to consolidate fiscal balances and, even when they decide to do that, they may prefer tax increases rather than spending cuts, (against ample literature evidence on the more contractionary effects of the former type of consolidation).

2.7 Concluding remarks

The intent here, all of these considerations being made, is to remember that it is not easy to judge the role of Austerity alone in the rise of new political protests movements/parties, country specific analysis are needed, sometimes austerity is central or important, as seen for Greece and UK respectively, sometimes is mixed with other determinants like immigration, globalization and loss of competitiveness, difficult economic scenario and disaffection for old political establishment. In those cases, it is really difficult to isolate Austerity ‘hate’ and consider it a central driver. If any consideration can be made at the European level, is by interpreting European citizens opinion expressed in the Eurobarometer, and this actually describes a contest in which the majority of Europeans are still pro Europe and pro consolidation policies, this seems almost counterintuitive if compared with the general way austerity is threatened in the mass-media debate. This should suggest a critique to mass-media channels of information: probably anti-establishment and anti-European movements, riots, and protests against fiscal consolidation grievances in a period of already difficult economic conditions are naturally able to capture mass-media interest, but the mass-media side can exaggerate and fuel those movements if proper space is not given to the part that silently support European union and sound fiscal accounting, but that yet represents the majority of European citizens! This appeal is particularly important if we consider mass-media capacity to influence public opinion formation: previously in this chapter the case of newspaper pushing UKIP support in U.K. has been mentioned, but for instance there is evidence of a similar mechanism in other countries: [Vliegthart, BoomGarden and Spanje \(2012\)](#) found, through a time-series analysis for six parties in Belgium, Germany and the Netherlands, that there is a strong effects between the

media visibility on the news given to anti-immigrant parties and in particular to leaders and their success, and, as for Murphy and Devine U.K analysis, the inverse relation is not observable (that is, there is no evidence that the media coverage increases for those parties after their success). This is a field of research that may need particular attention in the near future, especially considering the flow of information and politic propaganda on social-media.

CHAPTER III: The reasons for fiscal consolidation

3.1 Uncontrolled debt can be a problem

3.1.1 A moderate level of debt/GDP can improve intertemporal welfare

First of all, before investigating of whether the theory that countercyclical fiscal policy is a better solution (or the only working solution, as lot of anti-austerity supporters claim) to reduce the debt to GDP ratio, by exploiting the multiplier effect of deficit spending, it should be clarified if high debt/GDP is a real problem for the economy that should concerns policy makers. At moderate levels government debt is an improving welfare factor. It is based on the fact that life-time of individuals is limited, but lifetime across generations goes on in the long term, and the same non-finite lifetime is a characteristic of the government, as an institution that indeed continuous over time indefinitely. This simple concept allows to understand how government is in the privileged position to smooth welfare across time for its citizens, that is, to anticipate some future welfare in the present time, knowing that it will be always able to collect tax revenues from future generations. In this sense, it is able to get indebted for a certain amount of resources that intend to transfer to its citizens in the present time, knowing that it will be always able to repay that debt through tax revenues not only on present, but also on future activities indeterminately. This system can be interpreted as a continuous movement of the burden of present expenditures to future generations, and this is actually true, but it should be also considered that through economic growth and technological development, future generation are, in theory, expected to live better, so the idea that the government exploits its position of inter-generations agent, with monopoly on tax revenue, to raise society's intertemporal welfare, has its own reason.

3.1.2 But there is a limit, in the end there is always an intertemporal budget constraint

However, over a certain limit, some negative outcomes happen, the allocation of resources can become inefficient, there is more space for corruption, a too large public sector can crowd out private investment, and especially, government debt becomes so high that investor who finance debt emission by purchasing government bonds, start to be skeptical on government's ability pay the promised interest rates. In particular the situation worsens when it is clear that the

government is repaying its debt by printing money (debt monetization, no more possible with the division of governments from central banks, and no more possible in the euro area of course) or by Issuing new debt. This last option is still theoretical possible, but it should be avoided, since repaying debt with new debt it's a Ponzi-scheme, that when is discovered, make the entire system collapse. More in details, this means that the government has a limit in the quantity of money that can borrow through debt emission, and is possible to explain that with a simple model of intertemporal budget constraint as the following:

$$b_{t-1} = \sum_{j=1}^{\infty} \frac{t_{t+j-1} - g_{t+j-1}}{(1+r)^j}$$

This is the intertemporal government budget constraint equation, where the left term represents the current stock of debt, 'j' is the time period, (t-g) represent the fiscal balance that is total tax revenues minus total government expenditure, and 'r' is the interest rate to pay on debt obligations. This equation assumes, considering the infinite time horizon, no Ponzi-game, that is no possibility to repay outstanding debt by issuing additional debt as source of financing, because in the long term it would trigger a crisis (the government cannot increase its borrowing at a faster rate than the rate of interest). The equation meaning is that the total amount of debt at a certain time (left part) is sustainable only if the economic agent who holds it at the current rate, expect that the future flows of government fiscal surpluses (positive difference of t-g), discounted for the respective rate of interest, is able to repay that debt. This imply that if government cut taxes by a certain amount x in the present, it has to increase them in the next period by the same amount x + the interest rate of that future period, this to re-enter in the intertemporal constraint necessary to maintain bonds holders trust.

3.1.3 The debt 'threshold' and the excel error in the austerity Vs anti-austerity fight

Even if different studies tried to individuate a certain threshold over which the burden of the debt become detrimental to the economy of a country, it remains difficult to clearly identify a precise value that represent the 'U' turning point over which the debt/GDP will slowdown growth in every economy. However, this should not be confused with the idea that high debt cannot be considered a problem. In this sense, there is indeed wide consensus in literature based on empirical evidence research. The most famous work on the topic is 'Growth in a time of

debt' by [Reinhart and Rogoff \(2010\)](#), where it was found, in a multi-country empirical analysis of 44 countries, including both advanced and emerging economies, over a time-period of 200 years, that for 'normal' (they consider 3 cases, debt/GDP below 30%, from 30 to 60%, and from 60 to 90%) level of debt the relation with growth is weak, however, over 90% of debt/GDP level, the median growth rates of such economies is around 1% lower than otherwise, and the average growth rates almost 4 % lower. The results go even further by differentiating between domestic debt and gross external debt (both public and private owed), in the case of emerging markets, there is a relevant difference, with the threshold of the gross external debt (almost entirely denominated in foreign currency), being 30 points percentage lower than the total public debt: after that 60% debt/GDP level, annual growth declines about 2%, while after a level of 90%, growth rate is cut in half. In trying to explain the reason behind the non-linearity of the growth in response to debt when the debt reaches certain levels, the authors claim that when economies approach a certain level of debt 'tolerance ceiling', the markets suddenly starts to rise the rate, asking for heavy adjustments. The paper became famous because the authors are two eminent Harvard economists, the topic was of never-ending interest (for academics, mass-media and policy makers), concerning the issue of the proper size of the public sector, and it came out after the 2008 financial crisis, when public debt/GDP ratio was rapidly increasing in many economies, as the author themselves underline in the paper. The problem was that the paper conclusion in individuating a single threshold was ambitious, and such results should be taken with care, but this is definitely not the case with the public debate on an argument with such strong implications on public policies (similarly to what happened with [Blanchard and Leigh \(2013\)](#) on the underestimation of the multipliers). In the end, the result was that strong emphasis has been given to this 90% debt/GDP threshold, especially from the part standing in favor of the austerity necessity.

'For some EU member states, like Greece, there has simply been no choice to fiscal consolidation. If you are shut out from the private debt market, you need to put your fiscal house in order to regain access to market financing. For other member states, it is obvious – and in fact confirmed by economic modelling exercises – that fiscal prudence is positive for growth and employment in the medium to long run.'

The impact of debt on growth can also be looked from another angle. Carmen Reinhart and Kenneth Rogoff have coined the "90% rule", that is, countries with public debt exceeding 90% of annual economic output grow more slowly. High debt levels can crowd out economic activity and entrepreneurial dynamism, and thus hamper growth. This conclusion is particularly relevant at a time when debt levels in Europe are now approaching the 90% threshold, which the US has already passed'

Olli Rehn, European Commissioner for Economic and Monetary Affairs. Speech n.11/407 at the Council for Foreign Relations. 1 June 2011⁴⁷

⁴⁷ http://europa.eu/rapid/press-release_SPEECH-11-407_en.htm

On April 2013 a student named Thomas Herndon discovered an excel spreadsheet calculus error in the paper (wrong cells selected for calculating the mean), and the omission of 5 countries from the calculus. Reinhart and Rogoff immediately recognized the mistake, adding also that anyways that version of the paper had to be considered the old state of the research on the topic, since they also did a 2012 new study (Reinhart and Rogoff, 2012) in which such errors were not present and results were basically the same. In the meantime, the student who discovered the mistake came out with its paper (Herndon et al., 2013) that corrected the errors and weighted countries differently for the calculus of the mean, stating that results contradict R&R findings. The news was groundbreaking, especially on its capacity to heat up the debate: immediately the anti-austerity side was much stronger than ever and European austerity started to be profoundly questioned. The debate became a pure austerity vs anti-austerity political fight, with the clearest example of them being Krugman article in the opinion column of the 'NewYorkTimes' from the title 'The excel depression'.

*'...So, did an Excel coding error destroy the economies of the Western world?
...So the Reinhart-Rogoff fiasco needs to be seen in the broader context of austerity mania: the obviously intense desire of policy makers, politicians and pundits across the Western world to turn their backs on the unemployed and instead use the economic crisis as an excuse to slash social programs...
...The paper came out just after Greece went into crisis and played right into the desire of many officials to "pivot" from stimulus to austerity...
... What the Reinhart-Rogoff affair shows is the extent to which austerity has been sold on false pretenses. For three years, the turn to austerity has been presented not as a choice but as a necessity. Economic research, austerity advocates insisted, showed that terrible things happen once debt exceeds 90 percent of G.D.P....
...Policy makers abandoned the unemployed and turned to austerity because they wanted to, not because they had to...'
... So will toppling Reinhart-Rogoff from its pedestal change anything? I'd like to think so. But I predict that the usual suspects will just find another dubious piece of economic analysis to canonize, and the depression will go on and on.'*

Paul Krugman, 'The Excel Depression' NewYorkTimes

This piece is a perfect example⁴⁸ of what mentioned at the beginning of this work, how the debate over austerity can fall to such a low level to assume the tone of an electoral fight in political campaign, in which strong language is used to almost suggest how insane is the opponent's idea.

⁴⁸ Note how politically biased is Krugman in all the article. It is not so clear why there must be so 'evil' policy makers that decided to turn their back on unemployed because they 'wanted', describing them as a sort of hard-hearted insensible people desperately waiting for an academic research like the one of R&R to support their wickedness and leave Greece in pain. It is even less clear what is the implicit alternative to articles such politically tilt on one side (similar to many Stiglitz articles on the austerity debate), what is the real alternative, in this case, for Greece, that the author implicitly assumes is obviously better, deficit spending? Exactly after a crisis of uncontrollable public finances with the aggravating of false accounting of the public sector? Or the implicit solution was just the write off of debt, basically a default on debt with all its consequences. Is it really so easy to sustain that a debt default at that time would have decrease unemployment and brought Greece out of the tunnel?

The same Herndon et al (2013) moved the argument on a critique towards austerity, concluding that since their results were different from the ones of R&R 2010, then austerity policies should have been revisited both in E.U. and in U.S.A. Yet things are more complicated than that, and certainly the mass-media space is not the right place for a detailed debate on the technical details of academic studies concerning such a heated topic as public debt during time of crisis. On the contrary, a perfect example of a detailed and politically unbiased analysis of the Herndon et al. Vs R&R, is an article from the Italian economics online think-tank ‘noisefromamerika’⁴⁹, where it is showed, without necessarily defending R&R conclusions on the debt-threshold, that the results of Herndon et al. are actually not so different from the ones of R&R. Basically the article carefully explain that on one side Herndon et al sustain that with their error correction and their more appropriate method of weighting different countries in different periods, the result is significantly different in the sense that high debt/GDP is not so growth detrimental, but on the other side, looking at their paper, the general results that high debt/GDP is not good for growth is not any particularly different from the one of R&R, so it is not so clear why it should be used as proof of something in the anti-austerity debate. Going in the details, while R&R 2010 sustain that the median growth rate for countries with more than 90% of debt/GDP is a little over 2%, and instead it is a little over 3% for countries under that 90% threshold, ‘Herndon et al.’ find instead a similar 1% difference but with respect to the mean this time, and without calculating the median at all. Even R&R calculated the mean in the 2010, but they found a value just under 0%, since it was more sensible than the median to the excel omission, and this ‘radical’ difference is the one that bring ‘Herndon et al.’ to attack R&R and reopen the austerity debate. But in the end, as the author of the article explain, we are talking of a study (Hardon et al) that, If anything, represent a robustness check to R&R research: once ‘Herndon et al.’ make their corrected calculation, their mean (the authors do not calculate the median at all) appeared similar to the median of R&R 2010 paper, basically confirming the main result of that study (it is like they showed how with no error and even a different weight, the mean value came out close to the median value and not below zero as in the original R&R work), and this value is even consistent with mean of R&R more recent work that was already available (Reinhart and Rogoff , 2012) at the time of excel ‘scandal’, and with other R&R researches. In the end, the austerity vs anti-austerity debate over the ‘excel depression’, using Krugman definition, is no more than a classic example of mass-media, public debate, politicians, and in this case even a part of the academic-world, oversimplification. A research work erroneously took as the scientific proof of the reason to pursue austerity policy at the beginning, and then, after the error

⁴⁹ <http://noisefromamerika.org/articolo/quick-dirty-extreme-piace-cosi>

came out, used as the proof that austerity should be entirely reconsidered once for all. All of this despite the main point, that both authors of the calculus revision, the original R&R, and other empirical research on the theme, find the same main result that too high debt/GDP ratio damage the growth rate. For instance, [Cecchetti et al, \(2011\)](#) on a sample of 18 OECD countries from 1980 to 2010 found that the level at which government debt/GDP ruin the growth path is around 85%, while [Bitar et al, \(2018\)](#) confirmed the results of R&R, and even the work that will be analyzed here below, concerning some European economies, found a very similar threshold.

3.1.4 A specific study on the European contest.

A recent work concerning the European contest is [Checherita and Rother \(2010\)](#), in which the authors used a panel of 12 European economies for 4 decades since the 70, and through a panel fixed effect, corrected for heteroscedasticity and autocorrelation, taking into account the reverse causation that negative per capita GDP growth rate can lead to higher debt burden, found that there is indeed, on average, a turning point between 90% and 100%. Over such level debt/GDP ratio show a negative effect on per capita GDP growth, and this is robust even taking into account cyclical fluctuations in the long term by substituting per capita GDP growth with potential GDP growth and with trend GDP growth. Interesting is that among the countries considered, there is the so called ‘PIIGS’ group, made of all countries which faced, or are still facing, problems in terms of fiscal balances and debt/GDP ratio, and where the austerity debate is somehow still alive with the idea that more government spending should be the solution.

$$g_{it+k} = \alpha + \beta \ln(GDP / cap)_{it} + \gamma_1 debt_{it}^2 + \gamma_2 debt_{it} + \delta saving / inv.rate_{it} + \phi pop.growth_{it} + other\ controls\ (fiscal; openness; interest\ rate) + \mu_i + \nu_t + \varepsilon_{it} \quad (eq.1)$$

where g_{it+k}	= the growth rate of GDP per capita, k = 1 or 5 (three different measures are used in the empirical estimation: annual growth rate g_{it+1} ; 5-year cumulative overlapping growth rate $g_{it/t+5}$, where t takes annual values; and 5-year cumulative non-overlapping growth rate g_{it+5} , where t takes the values at the start of each half-decade);
$\ln(GDP/cap)_{it}$	= natural logarithm of the initial level of GDP per capita
$debt_{it}$	= gross government debt as a share of GDP
$saving/inv.rate_{it}$	= saving or investment (gross capital formation) as a share of GDP (the variables are used in the empirical estimation in aggregated terms, total national saving/investment rate, as well as on a disaggregated basis, as public and private saving/ investment rate)
other controls	=> see description in the text above
μ_i	= country fixed effects
ν_t	= time fixed effects
ε_{it}	= the error term.

FIGURE 1. The impact of high and growing debt on economic growth, Checherita and Rother, working paper n.1237 ECB. Pag 13. (Basic estimation equation used)

Appendix 2: Direct relationship between debt and per-capita GDP growth

Table 1: Fixed effects (FE) models

FE models	Annual growth rate		Cumulative 5 year overlapping growth rate		Cumulative 5 year non-overlapping growth rate	
	model 1	model 2	model 3	model 4	model 5	model 6
<i>gov_debt</i>	0.1198*** (.0410)	0.1291*** (.0412)	0.5236*** (.1294)	0.4066** (.1649)	0.6462*** (.1396)	0.5032** (.2095)
<i>gov_debt_sq</i>	-0.0006*** (.0001)	-0.0006*** (.0002)	-0.0025*** (.0006)	-0.0020*** (.0008)	-0.0031*** (.0007)	-0.0026** (.0011)
<i>gov_rev_ca</i>	-0.0511	-0.094	-0.3112	-0.1906	-0.3297	-0.2227
<i>gov_cab</i>	0.2484***	0.3083***	1.1756***	0.9392**	1.3120***	1.1244
<i>ln_GDP_cap</i>	0.5403	-0.0036	-9.704	-20.5168**	-7.9847	-14.2007
<i>pop_growth</i>	-1.3086***	-1.1997**	-3.6186***	-2.7678*	-3.6534**	-3.9632*
<i>gfcf_total</i>	0.0087	-	-	-	-	-
<i>gfcf_gov</i>	-	0.3988***	0.6483	-	0.4319	-
<i>gfcf_priv</i>	-	-0.047	-0.4018**	-	-0.4034*	-
<i>saving_pub</i>	-	-	-	-0.4572	-	-0.4535
<i>saving_priv</i>	-	-	-	0.0601	-	0.0266
<i>openness</i>	0.0307**	0.0341**	0.1975***	0.1643***	0.1622*	0.1338
<i>LT_real_i</i>	0.0234	0.0017	0.1974	-0.1935	0.0758	-0.3489
<i>Year dummies</i>	Included (38) (1971-2008)	Included (38) (1971-2008)	Included (36) (1971-2006)	Included (36) (1971-2006)	Included (7) (1975-2005)	Included (7) (1975-2005)
<i>Country dummies</i>	Included (12)	Included (12)	Included (12)	Included (12)	Included (12)	Included (12)
<i>_cons</i>	-0.8206	-0.0238	37.1960**	61.3611**	33.9344	46.2412
N	412	406	382	314	81	68
R2-within	0.62	0.62	0.73	0.76	0.84	0.85
AR correction	lag(2)	lag(2)	lag(5)	lag(5)	lag(2)	lag(2)
debt turning point	97.8	103.1	104.5	99.9	104.6	98.2
95% CI bootstrap						
- normal-based CI	(75; 120)	(83; 124)	(94; 114)	(85; 114)	-	-
- percentile CI	(73; 116)	(81; 123)	(93; 114)	(83; 112)	(77; 149)	-
- bias-corrected CI	(70; 114)	(79; 121)	(72; 114)	(87; 114)	(73; 138)	-
95% CI nlcom	(76; 118)	(82; 123)	(86; 122)	(80; 118)	(85; 123)	(75; 121)

Note: The dependent variable is the economic growth rate (annual; cumulative 5-year overlapping, and respectively, cumulative 5-year non-overlapping). The abbreviations for the explanatory variables are explained in Table 1, Appendix 1. Countries included in the analysis: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. The table shows the estimated coefficients and their significance level (*10%; **5%, ***1%). For the main variable of interest—government debt—and its square, standard errors (SE) are also shown in parentheses. The confidence intervals (CI) of the debt turning point are generated through bootstrapping based on (i) a normal distribution; (ii) percentile distribution; (iii) bias-corrected distribution. Where CI are not shown, the bootstrapping procedure rendered unstable CI or an estimation of the bootstrapped SE was not possible due to “lack of observations”. The *nlcom* command implements the delta method to calculate CI.

FIGURE 2. The impact of high and growing debt on economic growth, Checherita and Rother, working paper n.1237 ECB. Pag 27.

In the end, instead of the pointless R&R debate on mass media on a technical error that should explain why austerity was big mistake, much more interest should have been given to understand that the main literature finding is that, despite a precise threshold, in general exaggerated debt is not good for the economy, and a more interesting question would have been to investigate if there is a causal correlation in the sense that more debt is the cause to slower growth or if there may be an endogeneity bias, and if the threshold is quite a reliable value in general even today (i.e., if this value around 90% olds in general for different economies in different times, or for instance, maybe in recent times, with different economies and much more trade and interconnected dynamics, is difficult to replicate such value?). For what concerns the causal relation, critics of R&R may have a point: the causal relation was not the conclusion of the R&R paper, but probably was the implicit way in which they passed the idea when interviewed, and this should be avoided considering the easy way in which politics and journalists summarized the research. With this regard, it is difficult to find a clear one-way causal correlation, because it can be on both direction: countries with poor growth rate (due for various possible reasons like low TFP, rigid job market, low education, elderly population) usually have a less efficient economy, a less competitive market and so on, and this could leave space for an increase in the size of the public apparatus, an increase in the inefficiencies of certain type of public expenditure, subsidies and other mechanisms. In this case the relation is inverse, is the poor economic growth that cause an increase in the size of the government which transform then in the burden of the debt/GDP ratio.

3.2 With high deb/GDP the ‘uncertainty’ effect is enough for credit restriction to real economy.

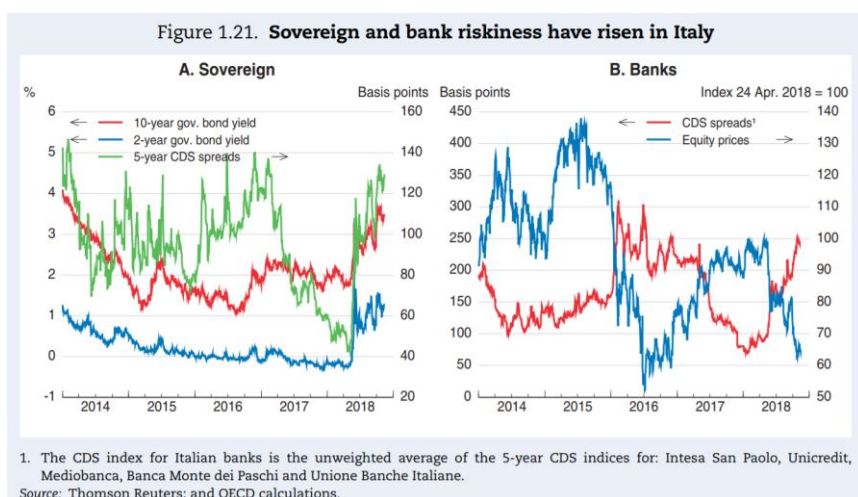
When the debt is high the government is more susceptible to market pressure on the risk premia, since every important reform, especially the annual budget draft, is carefully evaluated on its effect on the sustainability of outstanding debt. For high level of debt, risk premia can rise quickly, in part for funded reasons, in part for the self-fulfilling phenomenon for which bad sentiment spread from one market operator to the other, increasing itself autonomously in this process but with no real deterioration of the fundamentals of the economy. This aspect is criticized by a certain diffused narrative in the public debate for which this system allows markets and financial speculation to have, through the mechanism of the ‘spread’, the power to threaten governments’ political choice, that is to have the supremacy over people auto determination principle expressed through democratic elections. This thesis is inconsistent,

since assumes that the market is an external entity, out of citizens life and disinterested of the real economy, but in reality, government debt is a vital part of the real economy. For instance is present in pension funds, where 'normal' citizens put their savings, for which it represent a form of investment with 'theoretical' low risk (if a government debt is sustainable indeed), is present in the balance sheet of insurance companies, with which almost every citizens get in touch, and most of all is present in commercial banks' balance sheet, as an important part of the assets that allow to have adequate capital requirements to be able to finance firms and citizens with loans and mortgages (the credit activity). All of these operators, together with other smaller subjects, continuously monitor the government politic dynamics and intentions, in particular in situations of high level of debt/GDP ratio. The system may not be the perfect one of course, it may happen that under certain circumstances the sentiment play an overemphasized role with respect to the real fundamentals of the economy, yet it must be otherwise observed that no really better alternatives to the judgment of a multitude of agents can be imagined. Every other solution would require a certain level of centralized control of information, a sort of single agent with the role of making an outlook on the debt sustainability of the government that must be the one to consider, and this should avoid for unjustified spread of negative self-fulfilling sentiment between operators. It is clear that such a system is a monopoly of information, with obvious less efficiency in collecting useful information than a multitude of operators, it will be always more susceptible to corruption from private speculative financial agents with large funds to move, and most of all will be naturally inclined to stand on the government side, underestimating the risk of any fiscal policy with inadequate source of financing, a pure case of moral-hazard for the government. In the end the judgment of the market as a multitude of agents, with the system of the risk premia, remains the best way available. The only possible government way to avoid any kind of 'speculative attack' from markets and rating agencies outlooks is to maintain a moderate level of debt with respect to its economy, to avoid being too dependent on debt issuing as a source of financing. In the opposite scenario, when you need continuous source of financing for maintaining very high level of expenditures with respect to the size of the economy, political and fiscal stability become fundamental factors, and every departure from them, small or not, temporary or not, can have tangible effects on the real economy through the rise of interest rates on debt. The transmission mechanism through which policy uncertainty in high indebted countries could end-up in influencing the real economy, passing through the banking sector, is the following: the country future economic performance and its ability to repay its debtors is seriously questioned by the market, this bring to a sell-off of sovereign bonds and a rise in interest rates, which are inversely related with the nominal value of the bonds, and since government bonds are a part of bank

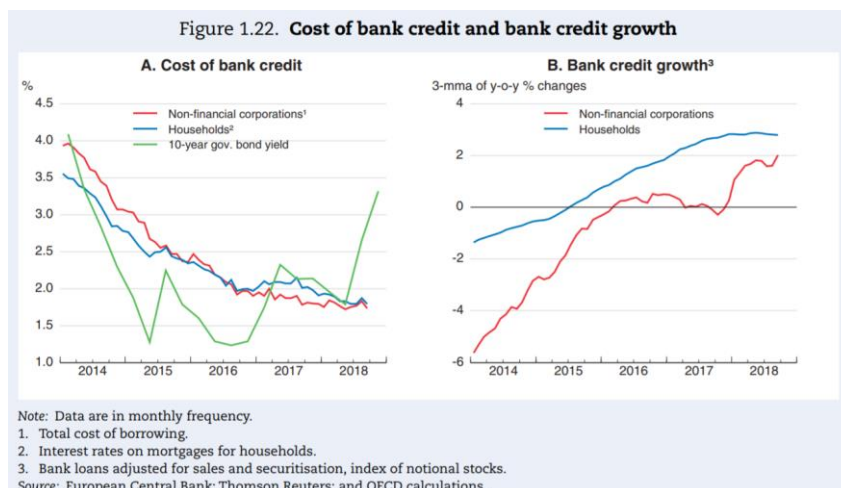
assets, this lower value will erode the bank capital, deteriorating the balance-sheet. In addition to this lower value, there is another negative effect, and it has to do with the riskiness: government bonds are held among other assets even for their low risk, able to counterbalance other form of capital with higher risk. In a scenario of higher risk premia on debt, Banks should intervene not only by searching for resources to cover the capital loss of depreciated bonds, but even for diminishing the higher risks now perceived over them intended as 'firms'. The consequences at this point are two: first it is expected a deterioration in confidence in those banks, that translate in a decline in the equity prices of those banks, and secondly, to offset those negative effects on the balance sheet (in particular because they have to respect minimum capital requirements for banking activity), banks restrict commercial activity to grants credits, raising the interest rates required to clients (firms and households). This credit supply restriction in particular is expected to happen because a non-expensive way for banks to re-establish desired capital ratios (able to face future shocks), in a scenario where equity prices are low and replenishing capital would be expensive, is to shrink their balance-sheet.

However, if the first effect usually happens pretty quickly, the credit restriction to the private sector may requires some time to manifest ([Albertazzi et al \(2014\)](#), estimated that a temporary 100 basis point increase in BTP-BUND is transferred in half to firm credit cost after a quarter, while one year is the time for a permanent increase in spread to be entirely transferred; [Zoli, \(2013\)](#) found that in 3 months around 30 to 40% of the increase in spread on sovereign bonds is transmitted to firm, and after 6 months it reach level from 50 to 60%, with stronger transmission on small loans). This is because mortgages at variable rate for instance, are decided according to the Euribor rate, that ECB decide on the base of the economy state and the inflation in the whole Euro area, so there is no direct correlation between (but yet, when the loss of capital in banks' balance sheets starts to weight, the banks will begin to raise interest rates on the private sector). This is the key part of the transmission mechanism, once credit activity is restricted, the effects start to spread in the real economic activity: many firms and individual will be unable to pay higher level of interest rates, there will be less investment from the firm sector and less demand from consumers, as a result the economic activity as a whole will shrink. Even another negative consequence is transmitted to the real economy follow the increase in the risk premia of bonds: 10 year bonds are considered the safest type of financial investment of a country, so their interest rate represents a sort of target value that influence the interest rate of many other financial investment products, in particular this can be the case of the corporate bonds, that represents an important source of financing both for private and public firms. Once again, the case of Italy can be used as a perfect example of this scenario. Since the moment the new Government 'Conte' in 2018 announced a fiscal policy based on deficit

spending, investors started to question the sustainability on public balances of additional expenditure on such an already high debt/GDP ratio (in particular, considering additional aggravating factor as poor economic growth, the slowest in the Eurozone, poor growth forecasts, low labor and total factor productivity, very low fiscal capacity to increase taxes, with a tax rate level already high, a recent history of ever-increasing trend of total public expenditure by different Italian governments, and even the external factor of the world economy slowdown). Bank equity price diminished, and the banks with more government bonds will be more exposed to this negative effect on balance sheet (Albertazzi et al, (2014) estimated that in a spread increase between 10 years Italian BTP and German Bund the negative effects are magnified in the five biggest Italian Banks, since they are the less capitalized, have a bigger incidence of bad loans and are more dependent to non-commercial banking activity). The effect on the increased price for the private credit is yet not visible, but according to the past empirical evidence of the spread BTP-Bund crisis of 2011, it should happen with a time-lag of some months.



Source: OECD ECONOMIC OUTLOOK, volume 2018 issue 2, preliminary version. Figure at page 37



Source: OECD ECONOMIC OUTLOOK, volume 2018 issue 2, preliminary version. Figure at page 38

3.3 Possible effects with the end of low interest rates and Q.E.

Another problem to not underestimate for high indebted countries of the Eurozone is that those real economy effects described above for Italy, results of just sentiment of uncertainty (e.g., at the time the Italian deficit-spending budget draft has not been definitively approved yet) could be somehow even worse when the cushion effect of the ECB Asset Purchases Program will be over. The greatest part by far of that program consisted in public sector purchase program (PSPP), with the stated intent to ‘allocate 90% of the total purchases to government bonds and recognised agencies’⁵⁰. The stated intent was to ‘address the risks of too prolonged a period of low inflation’.

APP monthly net purchases, by programme

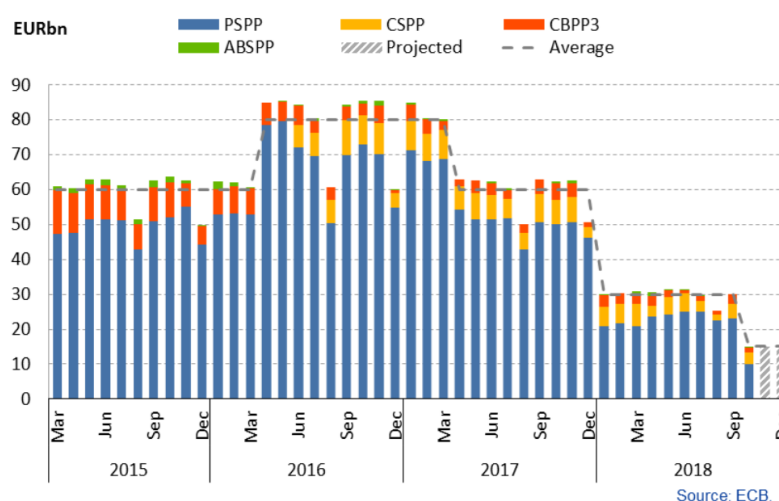


FIGURE 4. Source: ECB website, page on asset purchase program

However, an indirect effect is also that some stress is removed from banks balance sheets full of government bonds in their assets. This can act as a cushion effect in the case there is higher risk premia due to government uncertainty, since a great quantity of government bonds know to have anyways strong buyer (the ECB use the national central banks to buy sovereign bonds). What would happen at the end of this massive purchase program of (mainly) sovereign bonds if then those bonds are perceived as risky and there are no interested investors to buy them? Italy is a perfect example of such a scenario: without a stable political contest and the government commitment to follow a responsible fiscal path, it is reasonable to image a worsening of the actual situation. This for different reasons: Italy was the third biggest beneficiary of the ECB purchase program, the program is expected to end exactly in the same moment Italian bonds are being perceived as not desirable by investors, and the ECB, through

⁵⁰ <https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html#pspp>

the Italian Central Bank, was by far the greatest buyer since the beginning of the QE⁵¹, and last but not least, despite all of this ECB intervention, Italian banks are still heavily exposed on sovereign debt, having way too much Italian bonds with respect to Core Equity Tier 1. An increase in risk premia will have the same effects described before, with the final transmission on credit to the real economy.

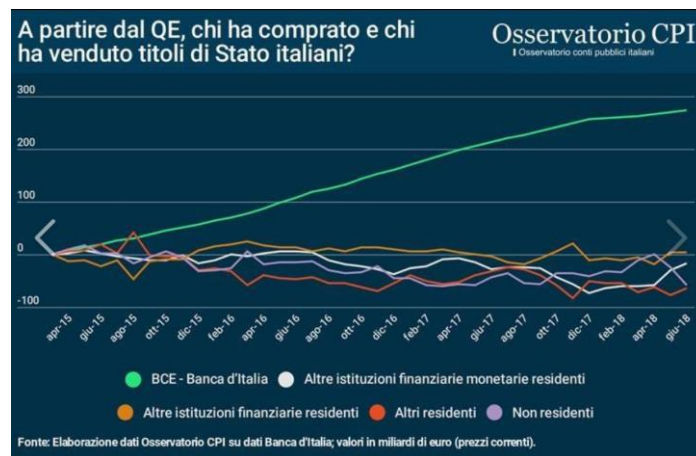


FIGURE 5. Italian bonds since QE, sellers and buyers? Source 'Osservatorio Conti Pubblici Italiani OCPI' based on data from Banca d'Italia

⁵¹ ECB, since the beginning of QE, has bought 273 Billion Euros of Italian government bonds, while Italians residents have sold 78 billions and non-residents 59 Billions. (OCPI based on data from Banca d'Italia)

Box 1.3. Vulnerabilities of Italian banks (cont.)

Figure 1.23. Italian banks remain exposed to sovereign debt

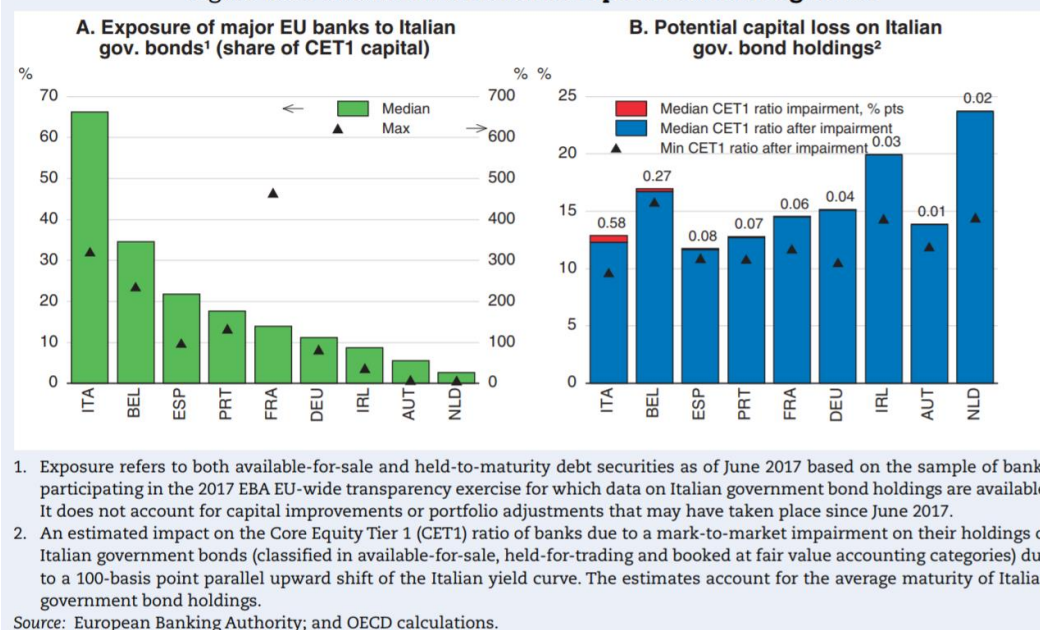
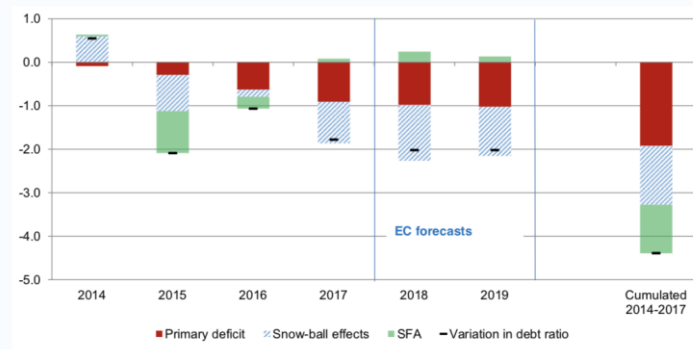


FIGURE 6. Source: OECD ECONOMIC OUTLOOK, volume 2018 issue, preliminary version. Figure at page 39

For what concern the risk connected with a return to a ‘normal’ monetary policy (that is ‘non - accommodating’ policy of low interest rate), the mechanism through which there could be some effects is different and passes through the so called ‘snow ball effect’. The recent policy of low interest rate indirectly allowed government to gain time and resources for their fiscal consolidation, thanks to the reduction (or control) of the burden of their debt. Low interest rate and, low inflation and real GDP growth counteract all together to the debt/GDP dynamic: this is the ‘snow ball effect’. It can have positive or negative effect on the debt/GDP, depending, for each country, on the weight of each of the three factors it encloses. For instance, in Germany, it had been negative on average in recent year, on the contrary in Italy largely positive due to high risk premia and slow growth mixed together. However, as a whole for the Euro area it accounted for almost 1/3 of the debt/GDP reduction, with the other biggest factor being the effect of primary deficit.

Graph 1: Change in the debt ratio in the euro area, by main component (pps. of GDP)



(1) The relatively high negative value of SFA in 2015 (-1% of GDP) mainly corresponds to sales of financial assets.

Source: AMECO, Commission services

FIGURE 7. European Commission, Debt sustainability monitor 2017, pag 41

According to the European commission⁵², interest rates are expected to rise in the 10-year forecast with respect to the actual situation, since, beside the world economy GDP slowdown expected on 2019-2020, monetary policy is expected to normalize considering inflation on target. At this point the question to ask is if there is somehow some transmission mechanism even in this case. This time there seems to be less concern, since market interest rates are expected to converge to normal level very slowly in the next decade, and the burden to the public sector is transmitted even more slowly. This has to do with the maturity of sovereign bonds of governments, that has increased in recent years because governments exploited the low interest rate opportunity to lengthen the maturity structure of their debt. The higher is the maturity structure of the public debt for a country, the slower the rise in markets interest rates would feed into implicit interest rates.

⁵² European commission debt sustainability monitor 2017

Table 2: **Impact of an increase of market interest rates (+1 pp.) on the implicit interest rate vis-à-vis baseline scenario, and key statistics on debt structure, by selected country**

	Impact on IIR after...				Share of short-term public debt (% debt)	Share of long-term public debt maturing every year (% LT debt)	Avg residual debt securities maturity (years)
	t+1	t+5	t+10	t+20			
BE	0.3	0.6	0.8	1.0	8.1	9.5	8.8
DE	0.3	0.6	0.9	1.0	9.0	15.7	5.8
IE	0.2	0.4	0.6	0.9	12.1	5.2	11.1
ES	0.3	0.6	0.9	1.0	8.9	13.7	6.6
FR	0.3	0.5	0.8	1.0	11.1	8.8	7.1
IT	0.4	0.6	0.9	1.0	14.0	12.2	6.8
CY	0.1	0.2	0.6	0.9	4.4	12.6	4.8
LV	0.2	0.6	0.8	1.0	4.2	7.8	5.7
LT	0.4	0.7	0.9	1.0	5.1	12.8	5.5
LU	0.2	0.3	0.6	0.9	6.6	6.8	6.7
MT	0.2	0.5	0.7	0.9	5.3	8.0	9.4
NL	0.3	0.6	0.8	1.0	10.5	10.9	7.0
AT	0.2	0.5	0.7	1.0	6.1	8.5	8.6
PT	0.3	0.6	0.8	1.0	14.7	10.5	6.4
SI	0.3	0.6	0.9	1.0	4.8	10.8	7.6
SK	0.2	0.3	0.6	0.9	1.3	9.7	6.7
FI	0.3	0.6	0.8	1.0	9.6	9.6	5.9
EA	0.3	0.6	0.8	1.0	10.2	12.0	6.8
HR	0.4	0.7	0.9	1.0	7.4	12.0	4.1
HU	0.4	0.7	0.9	1.0	15.9	10.4	3.9
UK	0.3	0.5	0.7	0.9	14.6	5.8	14.6
EU-28	0.3	0.6	0.8	1.0	10.9	11.0	7.7

(1) The share of short-term public debt corresponds to the average over the period 2014-16 (Eurostat). The share of long-term debt securities maturing every year corresponds to the average over the period 2012-17 (ECB, CDSB). The average residual maturity of debt securities corresponds to the one in December 2016 (ECB, CDSB).

Source: Commission services, Eurostat, ECB (CDSB)

FIGURE 8. Debt sustainability monitor 2017, pag. 42

However, after many years, the cumulative impact for the whole euro area public/debt ratio would be substantial according to the European commission, with an impact of 4,5% of GDP on the euro area in 2028, and in such a scenario, in case of shock in risk premia, highly indebted country would be required very high fiscal adjustments to stabilize the debt/GDP ratio.

Table 3: **Change in the required fiscal adjustment to stabilize the debt to GDP ratio vis-à-vis baseline scenario, by selected country (pps. of GDP)**

	Standard shock (+100 bps.)	Enhanced shock (+200 / +100 bps.) in highly indebted countries
BE	0.5	1.2
DE	0.4	
EE	0.1	
IE	0.3	
ES	0.6	0.8
FR	0.4	0.8
IT	0.8	1.0
CY	0.3	0.6
LV	0.2	
LT	0.3	
LU	0.1	
MT	0.3	
NL	0.3	
AT	0.4	
PT	0.7	1.4
SI	0.4	
SK	0.2	
FI	0.3	
EA	0.5	
HR	0.5	
HU	0.4	
UK	0.4	
EU-28	0.4	

(1) The required fiscal adjustment to stabilize the debt to GDP ratio measures the gap between the initial primary balance and the primary balance that would stabilize debt in the medium-term (2032) at its initial level. It corresponds to the 'Initial Budgetary Position' component of the S1 indicator.

Source: Commission services

FIGURE 9. European Commission, Debt sustainability monitor 2017, pag. 43

3.4 The value of the Euro depends also on the fiscal stance of its members' public balances.

The value of the Euro currency depends on the sustainability of the fiscal stance of the members state who use that currency as their national currency, with the same mechanism as the value of a national currency of a country is based on the country sustainability of public accounts. The reason has to be found in the basic mechanism of the fiduciary value of the 'Fiat' currency. In order for a material item with low intrinsic value (paper for cash money, metal for coins), to be accepted as a mean of payment in an economy for goods or services with much bigger intrinsic value in terms of materials and labor, there must be some trust in the fact that such mean of payment that the seller receive will have a symbolic value that will be recognized by other sellers in the system to buy goods or services that contains a similar level of material and labor than the good or service just exchanged. That is why this system is a system based on trust. For instance, trust in the past was based on the gold standards, by which (a part of the) currency was covered by a collateral consisting in gold reserves ready to be exchanged at a fixed value guaranteed by law⁵³. In modern economies, where gold standard is no more in place, a fundamental part of the 'trust' in the value of the currency is played by governments fiscal stance. Even if monetary policies in the euro area are exclusively of ECB competence, control of interest rates and the quantity of the money in the market remain dependent to the sustainability of public finances of the single members in the system, and this depends on national level government policies. The simple mechanism at the base, that connect the value of the euro to the trust of single members' state public finances is the following: the currency 'fiduciary' value is founded on the principle that it is recognized as a legal tender, that is a mean of exchange that by jurisdiction cannot be refused as a mean of payment to extinguish a debt. In order for that to be possible, there must be a central authority that act as a guarantor. Since this currency will need to be accepted, immediately from the time of its introduction, for all the transactions in an economy, the total amount of contracts stipulated will be huge, then the guarantor must be a credible subject of huge dimension and with a centralize power. That role is exactly represented by the government, that through taxation, in the moment in which decides to accept that currency as the only mean of payment for taxes, automatically creates trust in that currency. But the mechanism is not over. In order for a currency to be accepted as a mean of payment, it must be perceived as something with a relative fixed value, particularly in the short

⁵³ For instance, in 1913 in U.S the Federal Reserve has the law requirement to hold gold equal to 40 percent of the value of the currency it issued, and to exchange at a fixed rate of one ounce of pure gold at \$20.67. With the Bretton Wood System 1944, (that became operational in 1958), the exchange was fixed at 35\$ and many countries agreed to keep their currency fixed to the dollar, with only small adjustable space. The convertibility of Dollar to gold ultimately ended with president Nixon in 1971, when U.S. gold stock were no more able to fulfil conversion at the fixed rate with the reserves available.

to medium term, otherwise no operator in the economy will accept for payment something that for instance the next month will give him 20% less purchasing power. In order for the value of the currency to be reasonable stable, central governments must avoid utilizing the method of printing money to repay debt obligations that they are not able to repay through tax revenues. Here is the key of the argument. The debt/GDP ratio should be at a reasonable level, meaning for reasonable that the size of total government expenditures should be to a level that, considering the dimension of the economy, its growth rate, and the fiscal capacity available (that is how much the government can raise taxes), the government has enough revenues to cover a great part of its expenses and is even able to convince investor to renew debt obligations, by ‘passing the idea’ of being always able to keep faith to debt obligations by enough tax revenues in the future from an healthy economy. Instead of controlling the fiscal sustainability of public finances, in the past there there was the possibility, for government, to use the expedient of printing money to repay debt obligations (what is called debt monetization), creating currency devaluation, that lead to inflation, that in the end is a tax on citizens. It is clear than that choosing this path to repay the debt, instead of consolidating public balances, will devalue the currency of that country. With the introduction of the Euro, printing money to repay outstanding debt⁵⁴ is no more an ‘emergency’ option for governments of the euro area. However, the problem at the base remains, that is if governments do not find the way for sustainable public finances, in the end their debt/GDP will increase, their credibility in convincing markets that they will be able to repay that debt through future growth and future tax revenues will be questioned (especially considering there is no remaining fiscal capacity for many EU countries, tax rates are already really high), and in the end the value of the euro currency will decrease, because the fundamental trust system at the base of the currency value will be eroded. Of course, while in case of sovereign currency the loss of value of a currency following a sovereign debt crisis or a big debt monetization could be really high, in the case of the Euro the effect will be much lower due to its nature of currency representing 19 economies.

⁵⁴ The expedient of devaluating the exchange rate could have been used before the euro even for other aims, for instance in Italy was widely used for covering low labour productivity and low TFP and sustain the export sector. This is a temporary remedy that doesn’t solve the competitiveness problem at the roots and in the meantime, is a way to maintain high level of export but at the expense of reduced real-wages of workers.

3.5 Politic cycles and the cultural factor... the propensity to delay consolidation.

Accepting the validity, under strict circumstances, and under certain limits, of the theory that an optimal fiscal policy should be countercyclical with respect to the business cycle, in the way that it can 'artificially' help to overcome temporary negative effects of some market imperfections that could enlarge during the crisis, there is an often-underrated problem to overcome: the conjunction of this theoretical economic idea with politics reality. For the economic theory, a countercyclical behavior should require to save resources running fiscal surpluses during good times, in order to be able to have the emergency toolkit of these disposable savings to spend in the event of a negative business cycle or an extraordinary crisis. The problem is that business cycles and crises are impossible to precisely predict, so political forces, continuously fighting for electoral consensus, cannot base their strategy, whether it is communication strategy or even government agenda in case of success, on the estimated phase of the business cycle. If a government decided a-priori for a deficit spending type of policy, augmenting for example job opportunities in the public sector, salaries, subsidies, and so on, the fact that the economy, for pure contingency, happens to enter in a boom phase of the business cycle, can very unlikely lead the government to rethink its policies, if anything because a growing scenario brings optimism in the present, and if a certain cultural background of fiscal responsibility (as could be the case for Germany and other northern EU countries) is not diffused, there is not much political good reason to slow down on the public expenditure side by saving resources, despite the same Keynesian theory predicts that. This is one of the reasons for which some kind of fiscal rules are necessary, as an impediment that should make more difficult the political tendency to loosen the reins on the fiscal stance when things look good in the present. This especially considering that the government budget constraint is an intertemporal budget constraint, but the incumbent government is judged in the present, so may have a moral hazard to do expansionary fiscal policies by financing through the debt channel, that is by augmenting welfare of its citizens in the present (its electors) under its mandate, at the expenses of future generations, out of its interest. In the end, it may happen that the result is a never-ending spiral of different governments that continuously postpone the burden of a reorganization of public finances, relying on the hope that another government will be in charge when no more delay is possible. Basically, every economic downturn became a good opportunity for reviving, in politics debate and in mass-media coverage, the necessity of a Keynesian countercyclical expansionary intervention, while a time of economic growth is almost never the proper time for fiscal retrenchment, throwing away basically half of the Keynesian theory of countercyclical policies. A practical example of this scenario is once again the case of Italy in recent years.

Taking aside the peculiar case it represents, since the Italian economy is a case of non-growing economy due to serious and ancient structural problems, not connected with the business cycle (that can temporary worsen or cover the structural disease) and so where, the argument of expansionary fiscal policies in downturn does not hold (especially adding also the high debt/GDP ratio factor), the interesting thing is to see how in recent years fiscal deficit reduction targets were always missed. In Every year the government has committed with the European Union for a certain target level, and the target was regularly missed; in theory, financial penalties are present in this case, but every time the government requested additional time to reach the target with no penalty as the intention of deficit reduction was there; the situation continued like that for some years till the present time, with the new 2018 incumbent government. Now the new government, whose campaign was based on deficit spending measures, has no intent and interest to remain faithful to the previous government commitment with the European union, so presented a budget draft not only out of the target of deficit reduction decided in previous years with the European Commission, but on the completely opposite nature, based on a consistent increase in deficit spending. A continuous delay of fiscal reorganization became in the end, a case of fiscal expansion.

Deficit as a % of GDP, forecasted vs effective

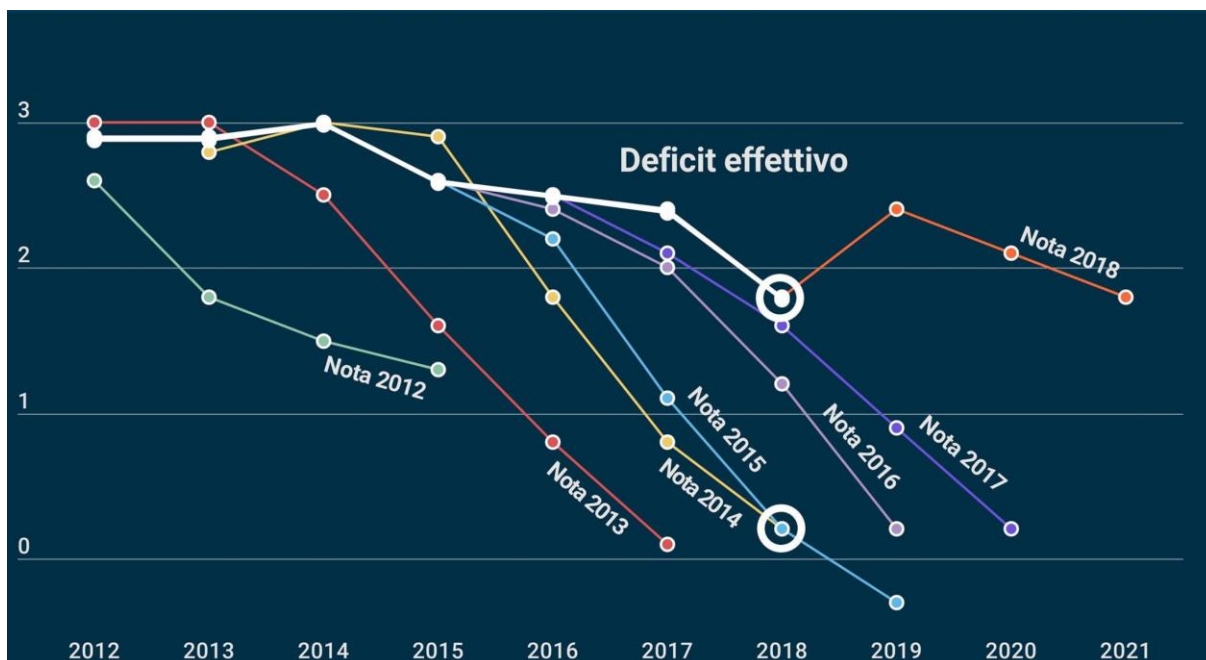


FIGURE 10. Source: Italian Observatory of national Accounts (OCPI; Catholic University of Sacred heart), based on data from the yearly update notes of the relation of the Italian Minister of Economics and Finance (MEF). Every colored line represent the projections of deficit contained in every 'update note' of the MEF relation. The white line is the effective Deficit and show how previous targets since 2012 where never respected.

Government debt projection in successive programmes (% of GDP)

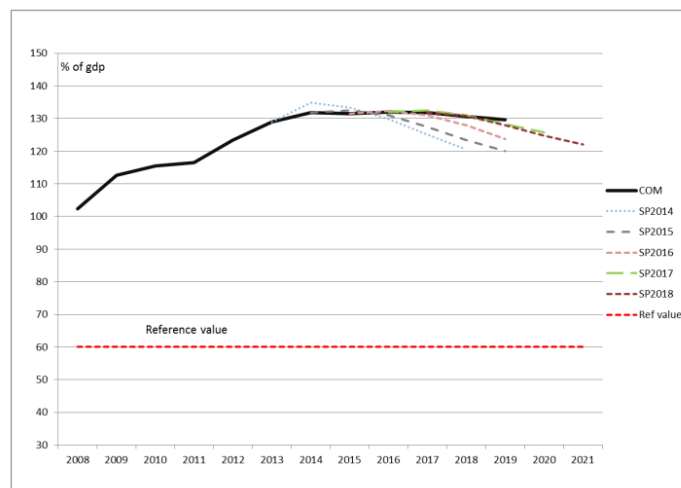


FIGURE 11. Assessment of the 2018 Stability Programme for Italy; 23 May 2018; EU Commission. figure 2, page 13

This kind of recidivist non-compliance behavior should be enough on its own to demonstrate the necessity for strict fiscal rules, together with clear infringement procedures. Here an hypothesis of political dynamics nature has been suggested, that is, in particular countries and under particular circumstances, the Government party in charge find electorally convenient to continuously postpone fiscal-retrenchment measures, despite of any consideration on the business cycle, asking for more elasticity to European Institution (in particular to be exempted by financial sanctions), and, if anything, uses excuses such as the business cycle only in downturns, when it is functional to justify relaxation on deficit limits. In such a scenario, as it happened with Italy in recent years, even during growth time, no financial resources are saved through budget surpluses for facing future bad scenario, and the final result is a pro-cyclical pattern of government expenditure. Another hypothesis, always connected with politics, could explain the tendency of fiscal policies to be pro-cyclical: [Abbott and Jones \(2013\)](#) found for OECD economies, through a public choice analysis, that a certain pressure for increase in public spending is able to explain the pro-cyclical behavior of government expenditure. A different yet complementary possible explanation could rely on a more eradicated factor of cultural nature, for which different countries may have different propensity towards fiscal responsibility. In this view, political parties are more a passive actor, a representation of the people's idea and behavior towards public debt in general. To strengthen this hypothesis of cultural determinants, eradicated in the society, behind the propensity to be fiscally coherent or not in spending only till the amount of tax revenues collected, is useful to compare, for instance, the Italian case with the behavior of individual Member States in U.S.A. On one side Italy is not only able to ask yearly exemptions and delay commitment to the point of transforming a promise of consolidation in a deficit manoeuvre, but is even able to continuously complaint (as

we saw from the politic statements in chapter 2) about the value of the EU deficit threshold despite being in a period of economic growth, together with the whole EU area. On the other side, in the case of U.S., the decision to emit new debt to finance deficit policies is exclusively of Congress competence, so only at the federal level deficit is allowed, while at the individual member States level fiscal balance is the norm. However, there is in theory some space to circumvent this ‘rule’. As is possible to see from the National Conference of State Legislatures (NCLS) report, the nature of states balanced budget requirements is a complex discipline since it depends on the law of every state and the specific budget requirements included. Balanced budget requirements can be included in the state constitution in different ways, e.g., in Michigan the constitutional requirements refer to ‘unavoidable deficit’ that must be resolved in next fiscal years, in Virginia the constitution says that the governor must keep spending within revenues, in other cases balanced budget requirements are the result of constitution and statutes interpretation rather than explicit statements. In theory some space to blend the rules is present: in the case of Michigan, there is no definition of ‘unavoidable’, in the case of Virginia there is no binding enforcement mechanism to support the rule, however, the general behaviour across all the states, despite the strictness or non-strictness of the various constitutions, is to maintain anyways a balanced fiscal stance per ‘tradition’, underlying how the cultural factor can be an important explanation of the attitude towards fiscal consolidation.

‘For the majority of states, however, the most important factor contributing to balanced budgets is not an enforcement mechanism or a provision specifying how a shortfall will be resolved. Rather, it is the tradition of balancing the budget that has created a forceful political rule to do so. Although states with enforcement provisions emphasize their importance, the expectation that state budgets will be balanced is the most important force in maintaining a balanced budget.

... Considering the lack of specific constitutional mandates and enforcement structures, state compliance with the principle of a balanced budget is notable. Restrictions on debt play a part, but are an insufficient explanation for the fact that even states that can legally carry a deficit from one year to the next try to avoid doing so. It appears that the political convention that state budgets are supposed to be balanced is its own enforcement mechanism.’

NCSL Fiscal Brief: State Balanced Budget Provisions, October 2010⁵⁵

⁵⁵ <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>

3.6 In the long term, fiscal discipline is the only way to reduce debt/GDP ratio

To understand why the only possible path to reduce debt/GDP ratio is consolidating fiscal accounts it's necessary to confute the theory around the fiscal multiplier, since it's the main argument used against consolidation. There is no empirical evidence to prove that deficit spending has ever being able to improve the debt/GDP ratio. If indeed can be accepted the idea that too much consolidation can be counterproductive, especially in the short term, in the sense that, by exaggerating in restrictive measures, the economy will shrink more than the resources saved in the fiscal balance, making the debt/GDP ratio even worse, this does not imply anything on the opposite, meaning that there is no reason to sustain that expansive fiscal policies can reduce the debt/GDP ratio. A great literature review around the subject that should put an end to the use of the argument of big multiplier to justify deficit spending is [Batini, Eyraud et al. \(2014\)](#). The authors collected a multitude of the main recent studies with all the different possible methods used in literature, and in general the value of the multiplier is below 1, sometimes it is over 1 during recession and deflation, very few study estimated a multiplier of around 2 during recession and only for the spending multiplier. All of these values diminish after the first year, meaning that the higher values are in the short term (it should be noted that this is another relevant problem, since if the effect doesn't last, and total tax rate on GDP in modern economies can arrive at maximum around 40% or 50%, the additional euro spent in deficit will not be 'recovered' by taxation even with a multiplier bigger than 1). When there is a very rare high multiplier, it is only in the zero lower bound case and only for temporary and small deficit spending (than they will rapidly decline).

TABLE 4. FISCAL MULTIPLIERS OVER THE BUSINESS CYCLE						
	Spending			Revenue		
	Expansion	Linear	Recession	Expansion	Linear	Recession
Auerbach and Gorodnichenko (2012a), United States, 6 quarters	0	0.4	1.7	N/A	N/A	N/A
Auerbach and Gorodnichenko (2012b), OECD, first year	-0.2	0.2	0.5	N/A	N/A	N/A
Auerbach and Gorodnichenko (2014), Japan, 4 quarters ^a	1	1.2	2.4	N/A	N/A	N/A
Batini and others (2012), 4 quarters ^b	0.82	0.93	2.08	-0.08	-0.17	0.08
Baum and others (2012), 4 quarters ^c	0.72	0.79	1.22	-0.04	0.29	0.35
Canzoneri and others, 2012, DSGE, United States, impact multiplier	0.89	1.3	2.25	N/A	N/A	N/A
Hernandez de Cos and Moral-Benito (2013), Spain, 4 quarters ^d	0.6	0.65	1.3	N/A	N/A	N/A
Owyang, Ramey, Zubairy (2013), United States, 2 year multipliers ^e	0.7	N/A	0.8	N/A	N/A	N/A
Owyang, Ramey, Zubairy (2013), Canada, 2 year multipliers ^e	0.4	N/A	1.6	N/A	N/A	N/A

FIGURE 12. source: Batini, Eyraud et al (2014), Fiscal Multipliers: size, determinants and use in macroeconomic projection (IMF technical notes and manuals 14/04). Image from page 8.

CHAPTER IV: USA vs EU, Obama stimulus as a successful case against EU austerity?

'America has yet to achieve a full recovery from the effects of the 2008 financial crisis. Still, it seems fair to say that we've made up much, though by no means all, of the lost ground. But you can't say the same about the eurozone, where real G.D.P. per capita is still lower than it was in 2007, and 10 percent or more below where it was supposed to be by now. This is worse than Europe's track record during the 1930s. Why has Europe done so badly?'

...what stands out from around 2010 onward is the huge divergence in thinking that emerged between the United States and Europe. In America, the White House and the Federal Reserve mainly stayed faithful to standard Keynesian economics. The Obama administration wasted a lot of time and effort pursuing a so-called Grand Bargain on the budget, but it continued to believe in the textbook proposition that deficit spending is actually a good thing in a depressed economy.

...In Europe, by contrast, policy makers were ready and eager to throw textbook economics out the window in favor of new approaches. The European Commission, headquartered here in Brussels, eagerly seized upon supposed evidence for 'expansionary austerity' rejecting the conventional case for deficit spending in favor of the claim that slashing spending in a depressed economy actually creates jobs, because it boosts confidence.'

Paul Krugman, Opinion post on 'The New York Times' : April 17, 2015⁵⁶

'in the last years Europe has chosen the wrong path...

...Shortly, in 8 years of democratic presidency, U.S. have bet on growth, investments, innovation. Europe have bet on Austerity, Currency, strictness. Economically speaking, U.S. are better off than 8 years ago, Europe is worse. To say in a newspaper title or a tweet: Obama did well, Barroso didn't.'

Matteo Renzi, Italian Prime minister 2014-2016. Letter to the newspaper La Repubblica. 11 February 2016.⁵⁷ (English translation by the author)

A widely diffuse idea in the mass-media debate is that European recession lasted more than the American one because the EU persisted on the wrong path of consolidation, while U.S. opted for more government spending, showing how this is the key for successful recovery and growth. The idea is that instead of perseveration with austerity and government cuts, the European union should have opted for a similar public expenditure stimulus as the one signed by Obama in 2009, the so called 'American Recovery and Reinvestment Act' (ARRA). This is another example of superficiality in the public debate when such fiscal policies are implemented: one thing is debating whether or not the stimulus was useful in offsetting some negative outcomes of the crisis, another is to use this stimulus as proof that more government spending is the key

⁵⁶ <https://www.nytimes.com/2015/04/17/opinion/paul-krugman-that-old-time-economics.html>

⁵⁷ https://www.repubblica.it/politica/2016/02/11/news/renzi_lettera_a_repubblica_ue-133162994/

to growth, so cuts in public expenditure are the route to deeper recession. Let's see the main flaws behind this whole idea that European Union should have followed the U.S. path.

4.1 Did U.S. economic growth outperform European growth?

First of all, the thesis assumes that American economy grew at a rhythm that outperformed the European one. However, this is a common mass-media story-telling that does not hold at a closer analysis.

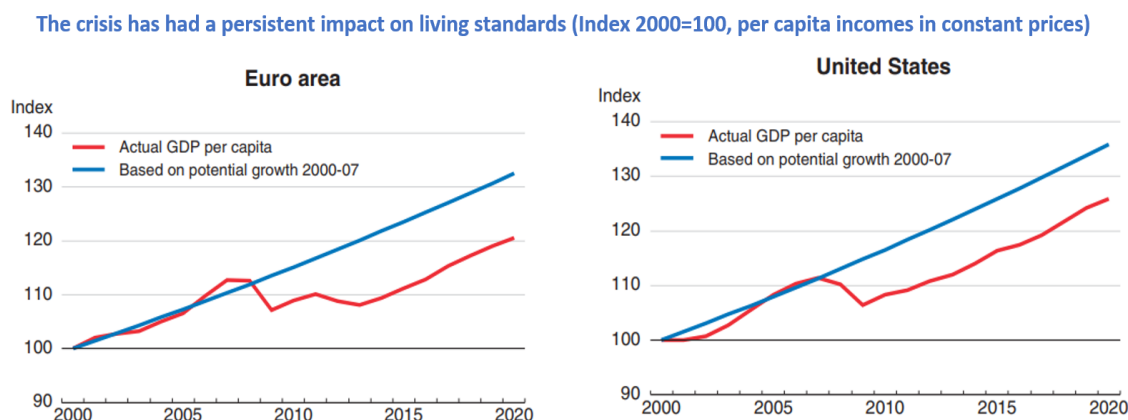


FIGURE 1. Source: OECD ECONOMIC OUTLOOK, VOLUME 2018 ISSUE 2 – PRELIMINARY VERSION, figure 1.5, page 19. Note: The blue line shows a linear projection based on the average annual growth rate of potential GDP per capita in the 2000-2007 period for all countries, apart from Japan where the 1996-2007 average is used to ensure a comparison between cyclical peaks. Source: OECD Economic Outlook 104 database; and OECD calculations.

If the comparison is made by taking into consideration the euro area, in order to have a common monetary policy as a background, making the group of EU economies more homogeneous for the comparison with American economy, it is possible to notice how, after the similar permanent reduction of living standards from the crisis, the steepness of the red line, representing the growth rhythm of the actual GDP per capita, is the same for both the two areas, in line with the pre-financial crisis trend. The only (yet relevant from a welfare point of view) difference is due to the fact that the catching up to pre-crisis level of GDP per capita growth started quite later for the euro area than for the U.S. but this has to be expected, since in that period Europe was the theater of the EU sovereign debt crisis of 2010. Looking carefully, it is interesting to notice how, before the beginning of the EU sovereign debt crisis, the red line of the Euro area was showing the same pattern of the American one (the slope between 2009 and 2011 is the same between the two graph), suggesting that, without such a specific crisis, the response to the slowdown was almost identical to the American one even in terms of velocity. The fact that the euro area slowed down again after the initial response, and needed to wait till

2013/2014 to undertake that initial growth rhythm, translate in a non-irrelevant reduction of living standard, and since it is widely stated that fiscal consolidation could have long-lasting effect on the economy, much more relevance should be given to this graph, which underlines on the other side how costly, in terms of lost years of growth, can be a crisis from over indebted public finances (speaking for the EU case of course). The analysis become even more interesting in showing how well Eurozone actually performed in the post crisis if from the data of the Euro area is removed the performance of Italy, a country with a sluggish economy due to eradicated structural problems that are country-specific, old, and in no way connected with anything that has to do with E.U fiscal austerity directives or the Euro currency adoption.

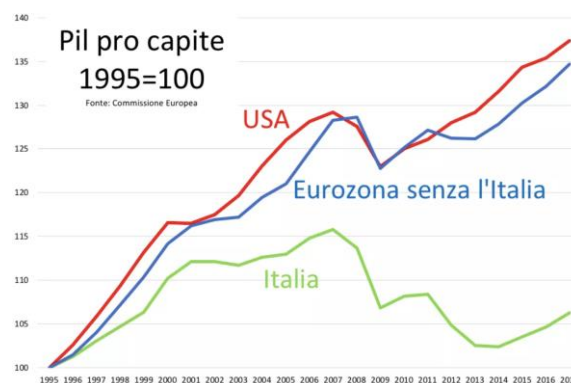


FIGURE 2. Source: Giampaolo Galli⁵⁸ on data from European Commission, data showed: GDP per capita, index 100 = 1995

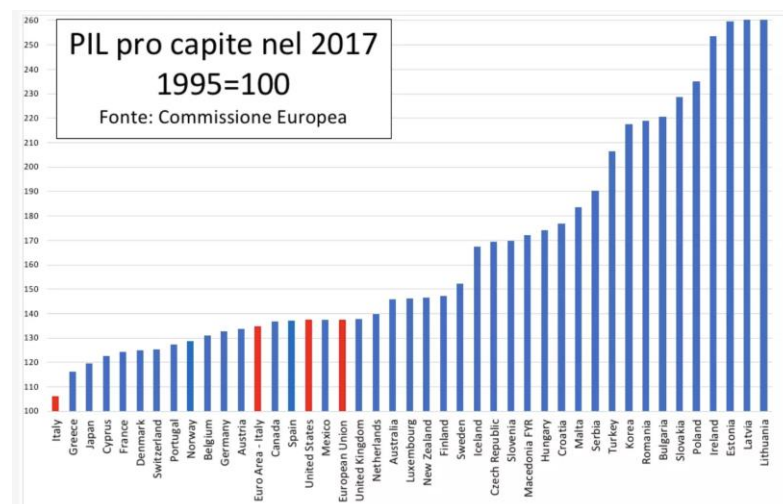


FIGURE 3. Source: Giampaolo Galli⁵⁹ on data from European Commission, data showed: GDP per capita in 2017, index 100 = 1995

⁵⁸ Economist now working at Osservatorio Conti Pubblici Italiani (OCPI). Image from its personal website, at <https://www.giampaologalli.it/2018/04/la-bassa-crescita-dellitalia/>

⁵⁹ <https://www.giampaologalli.it/2018/04/la-bassa-crescita-dellitalia/>

4.2 The stimulus as a case for claiming more government expenditure

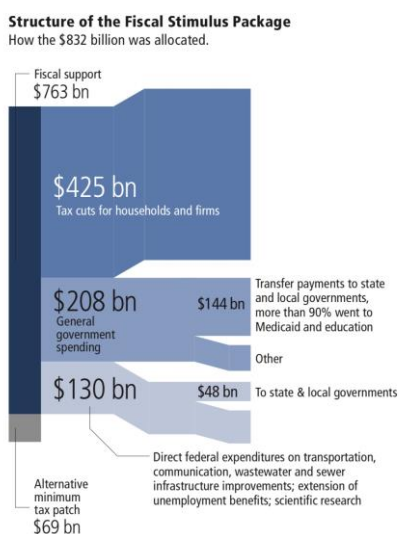


FIGURE 4. Source: 'did the fiscal stimulus work?' A. Carlino; Federal reserve bank of Philadelphia research department, first quarter 2017- Figure 1 pag.7

The main mistake from the supporters of more government spending is to use the Obama stimulus package as an example that more government spending is the key to growth and the reason for the American success in recovery, and so European Union should have chosen that path. This is a widespread view, especially among public opinion, probably due to the impact effect that can have on mass-media such a big number (an estimated 840 billion \$ budget deficit increase for the entire period 2009-2019⁶⁰) and the fast economic recovery, that easily lead to think of a causal-effect link. First of all, leaving apart for now the effect of the stimulus on aggregate output, it is completely erroneous to put this public policy at the same level as the request of European countries for deficit spending to EU. The two unions of states systems work in totally different way. In the case of U.S.A., the 50 states are subjected to a federal fiscal mechanism much more restricting than the one regulating EU members' States: they are not allowed to have fiscal accounts in deficit (there are some exception, for the example for certain investment expenditures, but they are almost insignificant), which means that they can only spend how much they collect from tax revenues. This is then counterbalanced at the central level, where the Federal Government is allowed to spend in deficit through debt emission. There is clearly much less freedom in fiscal decisions than the one permitted by the original Maastricht criteria for E.U members, who can have a deficit of up to 3% of GDP. What this clarification is evident how in the end the idea of a fiscal deficit threshold like the one requested from the

⁶⁰ "Estimated impact of the American Recovery and Reinvestment Act on Employment and economic output in 2014". Congressional Budget Office, February 2015

European Union to its members is not anything of particularly difference with the U.S. reality: In the first case the central institution has not, per its nature, central fiscal power with the ability to emit debt, so it cannot run deficit, and then allows its members to do that, under certain limits; in the second case, the central institution (the ‘Federal’ Government) is the only one, per its nature (i.e., per law), allowed to issue new debt, so to run deficit, and local government are bound to spend only what they collect through tax revenues. In the end, was the historical trend of U.S federal government deficit so much bigger than the 3% (of GDP) European boundary, so disputed for being too strict by some EU members⁶¹? Not so much looking at the graph below.

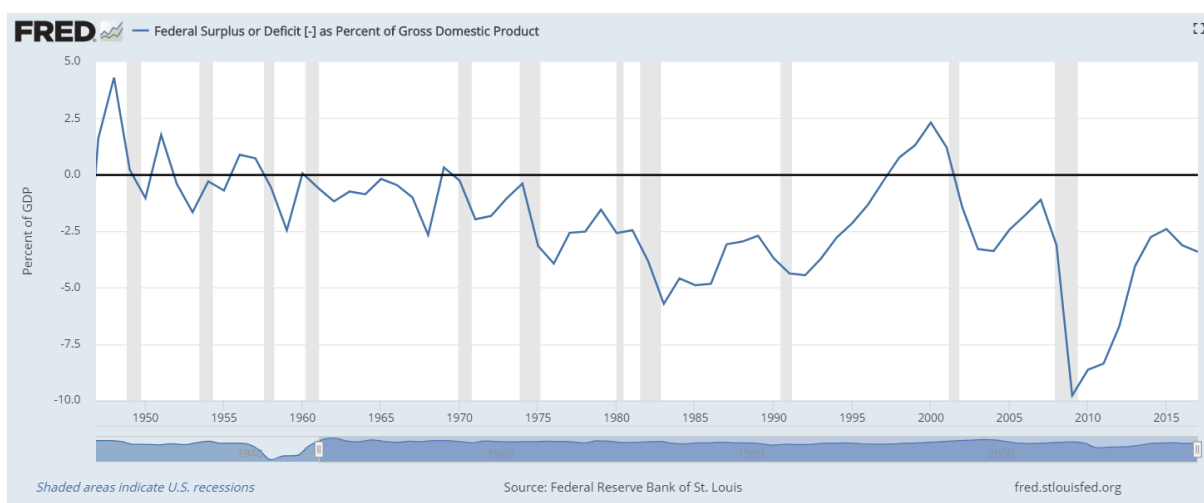


FIGURE 5. Source: Fred

What happened with the ‘A.R.R.A’ intervention, recalling an insightful article of economist Michele Boldrin⁶², is exactly this: the American States had to heavily cut their expenditures during the crisis, due to the lower tax revenues collected with the GDP decrease and the prohibition to have a deficit position in fiscal accounts, so the American Government, at the federal level, counteracted with its own federal expenditures increase and with transfers to the governments. In the end, the net effect was mainly a compensation, at the central level, of the various decrease in expenditures at the singular states level. The fact that we are talking about a compensation, at an aggregate level, rather than a nominal increase in aggregate government expenditure, is consistent with data. Conley and Dupor (2013) reported on a scatter plot each

⁶² <https://www.nextquotidiano.it/boldrin-spesa-pubblica-usa/>

state losses in budget position (due to tax losses and Medicaid increases) relative to 2008 pre-crisis government revenues, versus Federal Government aid received, through March 2011.

T.G. Conley, B. Dupor / *Journal of Monetary Economics* 60 (2013) 535–549

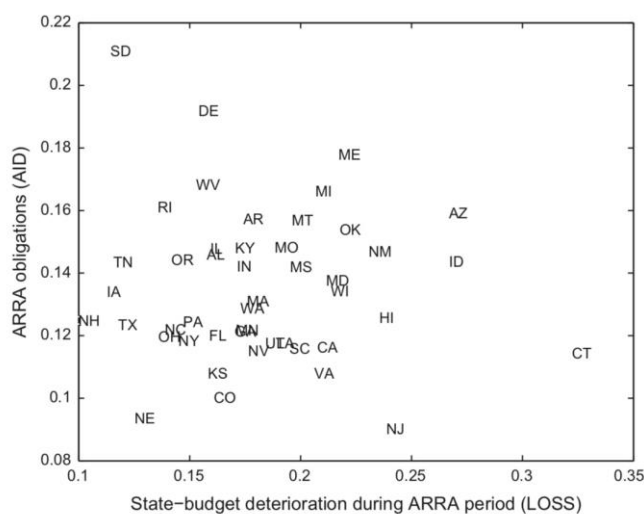


Fig. 2. Each state's revenue loss net of Medicaid increase and ARRA obligations, through March 2011, relative to its pre-recession revenue, i.e. *LOSS* and *AID*. Notes: Excludes four smallest states.

FIGURE 6. Source: Conley and Dupor (2013), figure n.2 from page 541 of the peer reviewed version for *Journal of Monetary economics* 60.

Even noticing a relevant variance across States in Federal decision on how to distribute money (e.g., Connecticut -CT- saw a huge budget deterioration of approximately 33% points with respect to its 2008 position, and received a budget aid of around 11% points of its 2008 government revenues, whereas South Dakota -SD- on the opposite side received much more federal resources than the losses suffered in lower tax revenues, always relative to 2008 situation, with a final positive offset of around 9% points). The A.R.R.A stimulus was not that expansionary measure that many pro-spending supporters claim is missing in EU approach, but rather a countercyclical measure to mainly offset the out-of-ordinary reduction of expenditures at the single states Level (that is why the scatter plot in the image above shows that distribution pattern, and if anything, since the distribution is quite homogeneous but the x axis has bigger values, it suggests that the transfers given were in total less than the amount of state budgets deteriorations). Some may argue that the graph below does not consider other level of federal expenditure stimulus different than the aid transfers to each state. To overcome this, it is convenient to look at Total government expenditure, in order to have in the same curve any expenditure at the local states level and also any kind of central federal expenditure, that includes consumptions, investments, transfers to states and, in this case, even an extraordinary financial expenditure voice, the TARP (trouble asset relief program) measure of 2008 Bush

administration, which alone has been estimated in a disbursement of 444 Billion \$ according to the Congressional Budget Office report.

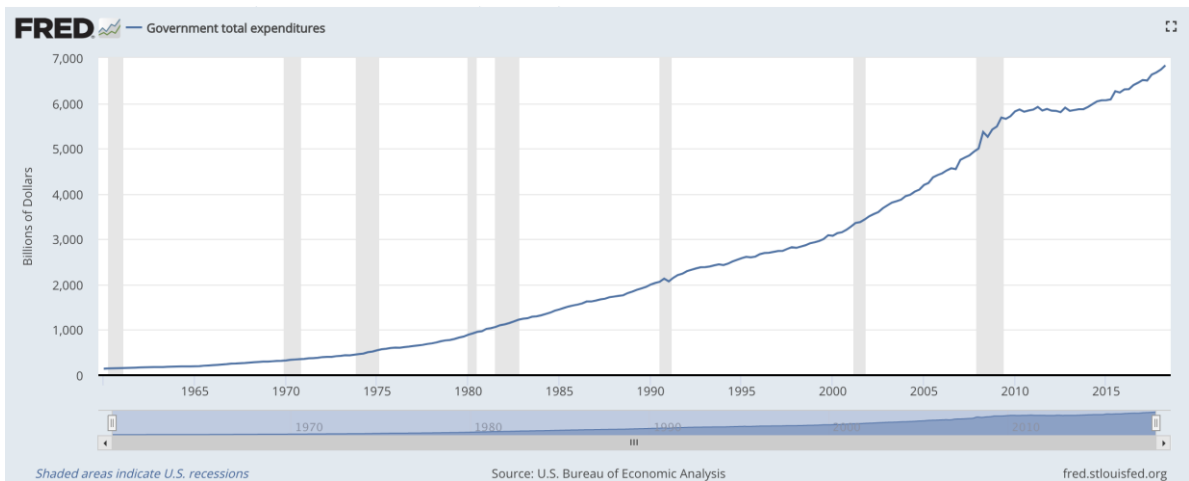


FIGURE 7. Seasonally adjusted, annual rate, quarterly data, grey area are recessions. Source: Fred

Even taking into consideration such an exceptional expansive intervention as the TARP, for the first time since the 70’s there has been a clear flat trend that lasted 4 years, from the beginning of 2010 till the end of 2013, again testifying that even with A.R.R.A stimulus into account, it is erroneous to talk of the Obama administration as a proof of the benefits of a government expenditure based policy (on the contrary, in that period, correspondent to his first mandate, Obama resulted the slowest federal-spending president since Reagan, and by far).

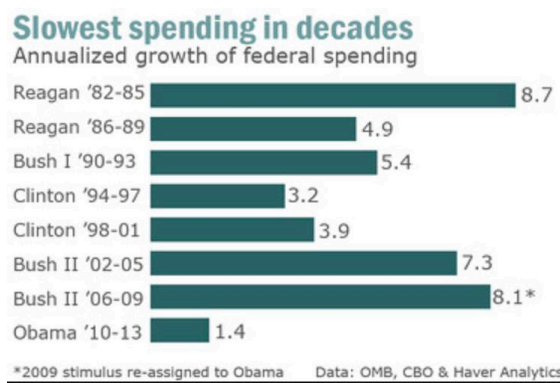


FIGURE 8. Source: <https://www.forbes.com/sites/rickungar/2012/05/24/who-is-the-smallest-government-spender-since-eisenhower-would-you-believe-its-barack-obama/#727c5c7c25cf>

The Government total expenditure graph, once accompanied by the GDP trend, becomes even more powerful in rejecting the idea that U.S economy growth was only possible due to the multiplier effect of expansionary fiscal policy.

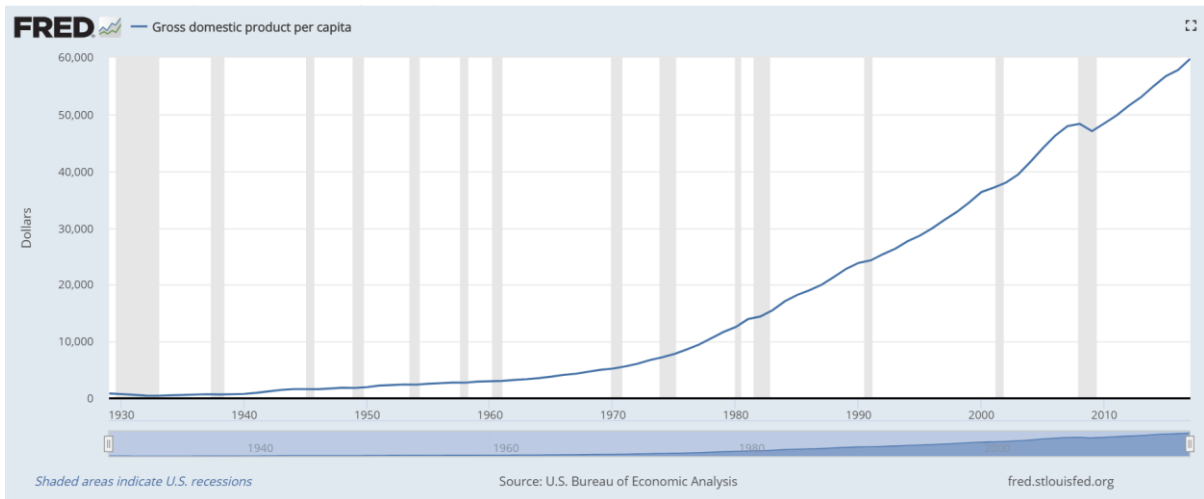


FIGURE 9. Annual, not seasonally adjusted

It is possible to see how GDP per capita trend (better instrument than just GDP trend alone for analyzing economic growth, since it is not biased by population dynamics), shows a persistently stable growth trend, that halted and diminished during the crisis (consistently if compared with other recessions) but then came back to growth with almost the same rhythm⁶³. Total government expenditure instead, as already observed, remained flat for 4 years after the crisis, and this for the first time since the 70's. This suggest that the engine of American economic growth has to be found elsewhere than in government spending. The graph is in nominal term, so it doesn't take into account the rate of inflation, however the comparison of the two curves still hold being both of them in nominal term (that is the inflation has the same influence on each of them). But to cancel out any possible objection, we can come to the same conclusions by considering, in real term this time, only the government consumption expenditure and gross investment. Since the idea behind the multiplier effect rely on the mechanism through which the public expenditure increase should stimulate aggregate demand and employ idle productive resources (labor and capital), it is even more convenient to concentrate only on the 'G' variable of the total government expenditure equation, that include even public investments, but do not consider financial exceptional measures like the T.A.R.P. that nothing have to do with the

⁶³ To be precise, in the graph, the part just before the crisis show a steeper curve than, suggesting that the pre-crisis rate of growth was a little bigger. This is not the case, the difference in inclination is due to inflation, since the graph above is in nominal term for an homogeneous comparison with the graph of Government total expenditures. If 'real GDP per capita' is observed, the slope of the curve pre and post crisis is the same, suggesting that the economy indeed recovered exactly at its previous rhythm.

multiplier mechanism in the Keynesian theory, and neither transfers to local government, that are not necessarily used in in correspondent G component at the local level⁶⁴.

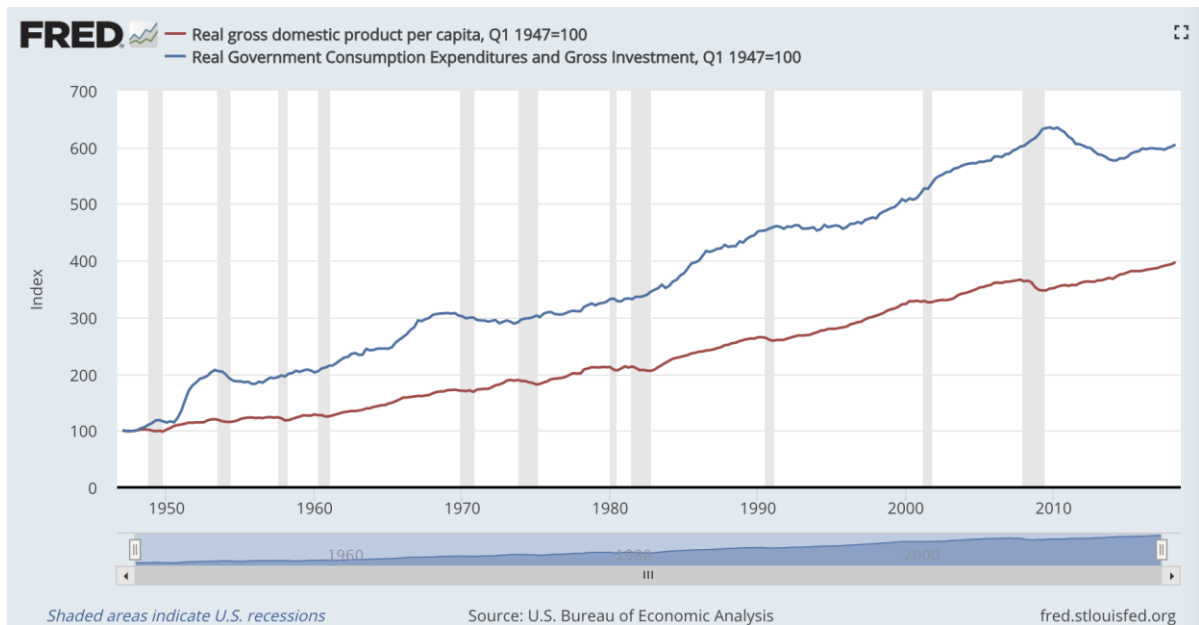


FIGURE 10. both chained 2012 dollars, seasonally adjusted annual rate. For government consumption expenditures and gross investment, the index is intended in Billions Dollars. Source: Fred

If anything, the result is even stronger than before, because this time the curve for public expenditure does not flatten but actually decreases from Q2 2010 to Q1 2014 (and even after, increases a little bit but yet remaining at the pre-crisis level). The economic recovery of U.S. economy, so frequently emphasized by anti-austerity articles, both on the European side and the American side itself, is clearly not explainable by a boost in the public sector, and neither, to be more precise, by a boost of those components of public sector expected to have the biggest ‘Keynesian’ push effect on aggregate demand. Actually, on the contrary, exactly due to the unusual decrease we can observe after the recession, the contribution of government consumption expenditures and gross investments to the % change in GDP is even negative for the entire period 2010-2014, something that wasn’t happening, in similar amount and duration, since the period around 1970.

⁶⁴ Many transfers are indeed automatic, meaning that they are entitlements decided by law and with a long-term duration, that nothing have to do with countercyclical fiscal policies.



FIGURE 11. Source: Fred.

All of these considerations are not meant to sustain that the Obama stimulus was of no utility at all. It may have helped in protecting employment in certain sectors and it may have helped to maintain a certain level of trust in the economy that can be useful during the recovery. But using it as an example that the key to growth after a recession is by pushing government spending is misleading. If anything, Obama maintained a fixed level of total expenditures in the years following the recession, and yet the economy continued undisturbed its growth path, that is an historical growth path going at the same rhythm since 1970-1980. And even in this case, that should represent the modern stereotype of a successful Keynesian fiscal policy, is not possible to see, after some years and so with an ex post perspective, any multiplier effect able to boost the economy through deficit spending so much to reduce the debt/GDP ratio. Once again empirical evidence shows that with the increased deficit, the net effect on the debt/GDP ratio is an increase. A very consistent one in this case, considering that between 2009 and 2013, when the great part of the ‘A.R.R.A’ stimulus was already spent, the debt/GDP ratio passed from 80% to 100%.

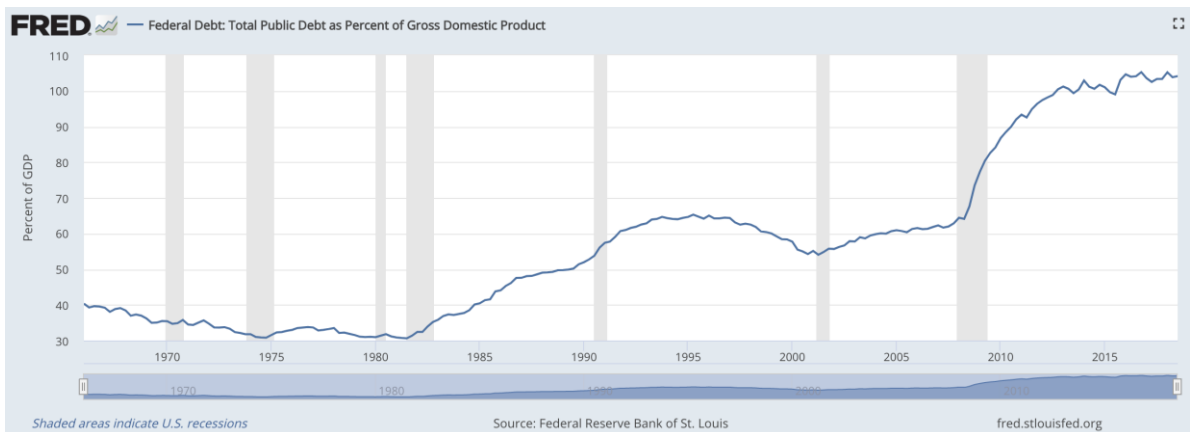


FIGURE 12. Source: Fred

CONCLUSIONS

The public debate towards austerity is too often populated by confusing arguments, political-biased ideas, and thesis inconsistent with the facts. The common necessity, for people, politics and mass-media seem to be the finding of easy answers to complex problems, as in the case of the European Sovereign debt crisis and the sustainability of public finances. Austerity is usually described in the common narrative as a complete failure of the European union, as the cause of difficult economic conditions that strengthen populists and far right party's around Europe, or as the reason for the lack of growth with respect to the American economy and the Obama fiscal stimulus. The usual thesis is that more government spending is the key to growth, and we should stop worrying too much about reducing the debt/GDP. This work tried to investigate deeper in those arguments, and found answers much different from the common storytelling. The great majority of Europeans are still worried about public finances sustainability, suggesting that anti-austerity parties and movements may be central for mass-media coverage, but remains a clear minority. It is impossible to generalize that austerity increased the support of populists and far right parties across all over the Europe: every country has its own different story in terms of complex dynamics that move public opinion. Austerity is usually described as the cause of every disease: with two simple fact-checking examples, Portugal and Italy, it has been showed how easy is to dismantle those arguments. Public debt remains a matter of intertemporal budget constraints, and there is a limit over which more debt is damaging, even beside the research of precise values as in literature. Even more, high debt/GDP ratio brings some hidden risks, connected with banks' balance sheets and so in the end to the real economy, that can be activated just by some sentiment of uncertainty in the markets. Fiscal multiplier should be left aside from the argument towards debt/GDP reduction, empirically there has never been a case of debt/GDP improvement thanks to Keynesian deficit spending. In particular it must be remembered that recent literature finds in general low values of the multipliers, completely in contrast with politics propaganda. In the final part, it is showed that the comparison between USA and EU is misleading since the two Unions are based on different fiscal rules, and in the end, the Euro area grew like U.S., or even slightly better if removing Italy from the equation. The hope with this work is that in the end the reader will face austerity arguments on the public debate with a different approach, desiring to go over the cheap storytelling often proposed.

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