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The political economy of austerity in Southern Europe*

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When in 2010 the sovereign debt crisis in the Eurozone spread from Greece to other countries, European leaders responded by demanding austerity in stressed countries – those increasingly unable to service their debt – as a condition for financial support. Alongside Ireland, South European governments were forced or pressed by the EU-ECB-IMF Troika to impose heavily pro-cyclical fiscal consolidation measures, either formally (by signing Memoranda of Understanding) or through implicit conditionality exercised by the ECB. This response was premised on the assumption that the Eurozone's debtor states could successfully pursue a strategy of internal devaluation to rectify external imbalances and eventually grow out of debt. The insistence that anything else – for instance, a combination of internal devaluation in the South and internal revaluation in the North – was unacceptable reflected the bias in favour of export-led growth that underpinned the design of the Eurozone (Matthijs 2016). Austerity fitted this strategy not only because it placed the burden of imbalances in the Eurozone on debtors alone, but also because it repressed domestic demand and depressed wages in these countries.

The EU's demand of pro-cyclical fiscal consolidation at the height of a world financial crisis has been widely criticized for deepening and prolonging the post-2008 economic crisis in the Eurozone's periphery (Frankel et al. 2013; Blyth 2013; Sandbu 2015; Hopkin 2015). The IMF (2012) and the OECD (2014) later admitted that the negative effects of austerity on economic activity in debtor states were much larger than had been expected.

Fiscal consolidation is not of course the only determinant of recent economic performance in

Southern Europe. In Portugal, for instance, the negative shock to domestic demand was mitigated by a considerable rise in exports. By contrast, in Greece, the poor performance of exports revealed further structural flaws in the country's growth model (Matsaganis 2017).

To fully understand the consequences of pro-cyclical fiscal consolidation in the Eurozone periphery, however, we must also consider its impact on the income distribution. Distributional outcomes are of critical interest in and of themselves, for both social and political reasons. But recent studies also suggest that rising inequality negatively affects long-term growth (Berg et al. 2012; Cingano 2014; Ostry et al. 2014), raising doubts about the viability of austerity and internal devaluation (Stockhammer 2015; Onaran and Obst 2016).

This article explores the distributional impact of austerity in the Eurozone's periphery. Our analysis of the experiences of Southern Europe shows that fiscal consolidation policies can be designed in ways that modulate their first-order effects on inequality. However, even where the burden of austerity was allocated more progressively (i.e. hurting the rich more than the poor), the income distribution was compressed downward, simultaneously raising levels of poverty and deprivation. The direct (or first order) effects of many austerity measures was to mitigate inequality. Yet because fiscal consolidation was imposed in such an intensely pro-cyclical way, those inequality-reducing first-order effects were almost everywhere wiped out by their second-order effects on economic activity (which increased inequality). We do find significant variation in the design of austerity policies that we attribute to political and institutional differences. However, we show that social costs have

been high across all countries. We suggest that austerity in Southern Europe may have long-term negative consequences, not yet fully appreciated, for both social welfare and economic growth.

Our argument unfolds in four stages. In the first section, we place the internal devaluation argument that has served to justify the EU's demand for austerity in the context of the recent literature on post-Fordist growth models. We then review the impact of the Eurozone crisis on the distribution of incomes in Greece, Portugal, Italy and Spain. In section three, we examine the role of austerity in these outcomes. In section four, we discuss the extent to which differences in the design of austerity measures can be explained by different political and institutional dynamics. In the last section we conclude by summing up the main findings and our interpretation.

I.   **Growth models and income distribution: implications for Southern Europe**

The decision by creditor states to demand fiscal consolidation as a condition of financial assistance has been attributed to a variety of factors: ordoliberal economic doctrine (Dullien and Guerot 2012; Blyth 2013; Sandbu 2015); the asymmetric power granted to creditors by the Eurozone's design (Matthijs and Blyth 2015); the commitment of governments in creditor states to shielding financial institutions (holding public debt issued by peripheral states) from suffering large losses (Blyth 2013; Thompson 2015). However, the choice of

austerity also conformed to a particular interpretation of imbalances in the Eurozone: one according to which fiscal and current account surpluses of creditor states were a sign of economic virtue, while deficits in debtor states a sign of vice. This view was critical in justifying the demand that debtor states adjust through internal devaluation.

To understand the consequences of internal devaluation through pro-cyclical austerity in the debtor states, it is worth placing the problems of the Eurozone in the context of the current literature on growth models. In transitioning to a services-based economy, advanced industrialized countries follow different macro-economic strategies with different distributive underpinnings and consequences. For authors drawing on Kaleckian economics (Stockhammer 2015; Pontusson and Bacarro 2016, Baccaro and Benassi 2017), the defining feature of these strategies is the principal source of demand driving growth. Export-led growth, relying on external demand, depends on stagnant wages and rising productivity to depress labour costs and maintain competitiveness. A declining wage share, in turn, implies rising inequality, which reinforces the strategy by lowering domestic consumption (as the rich save more than the poor) and keeping prices from rising.[1]

While the focus on demand distinguishes the recent literature, other comparative political economists have developed typologies stressing institutional differences that shape supply-side conditions. Two such factors have received particular attention. One set of authors - drawing on insights from Varieties of Capitalism - emphasize differences in domestic wage setting institutions, suggesting that these rendered some economies more fit for export-led

growth, leaving other economies dependent on consumption or domestic demand (Hancké 2013; Iversen and Soskice 2013; Johnston and Regan 2015; Johnston 2016). According to this view, Eurozone imbalances arose principally from diverging wage dynamics that set core and periphery apart. Stockhammer (2015) suggests that growth in the Eurozone up to 2008 rested on the complementarity between debt-driven consumption in the periphery and a neomercantilist strategy suppressing wages in Germany. Matthijs (2016) argues that, once the crisis arose, the Eurozone's design benefitted current account surplus economies at the expense of debtor states.

Other authors focus attention on the role of the state in supporting different paths of growth by promoting skills and high productivity. Wren (2013) claims that equitable growth is only possible if governments support high-tech services, arguing that a modern welfare state can compensate for the inherent inequalities of a post-industrial economy by investing on skills (in particular, through early childhood and tertiary education, and vocational training). Beramendi et al. (2015) stresses the importance of states' public investment strategies on education, child care, research and development producing long-term gains in labour productivity. Hall (2017) views broader societal institutions contributing to skill formation as the key determinant of a country's ability to adapt to knowledge-based growth.

Both accounts, centred on the role of demand and public investment as engines of growth respectively, point to significant distributive consequences of austerity in the midst of a major economic downturn – but for different reasons. For the latter, what matters most is

reductions in public capital formation and education expenditure, and effects on fiscal capacity. For the former, any fiscal consolidation that suppresses domestic consumption reduces the wage share and hence increases inequality. Two important questions remain: 1) *whose* disposable income ends up being cut and 2) how much the suppression of domestic demand (both investment and consumption) affects *output*.

Varieties of Capitalism studies emphasizing domestic institutions tend to classify Southern European economies uniformly as consumption- or demand-driven, which is not particularly helpful in explaining variation in austerity policies among these countries. By contrast, the work on growth models, stressing the role of the Eurozone's design and asymmetric power relations, helps focus attention on the particular constraints shaping austerity policies. Thus, for instance, in smaller debtor states (Greece and Portugal) the Troika effectively dictated the terms of austerity programmes. Italy and Spain had more leverage and hence more leeway in choosing their response: they were seen as too large to bail out, while default by either would spell the end of the Euro.[2]

Furthermore, the politics of rapid, pro-cyclical austerity is bound to be substantially different from the self-reinforcing dynamics of producer group coalitions or social block equilibria emphasized in the growth model literature. Resent research suggests that partisanship is less critical to the distributive outcomes of fiscal consolidation than it may be in normal times (Schaltegger and Weder 2014; Armigeon et al. 2016). Governments in Southern Europe faced conflicting incentives: to soften the impact of austerity on the poor (among else, to limit

contractionary effects *via* domestic demand), but also to protect key constituencies. Those not seen as vulnerable to start with, but whose position deteriorated in the course of the crisis, were caught in the middle and risked neglect. In view of that, we expect outcomes to vary by the extent to which the political system allowed organized constituencies to block austerity, and by the ability of party elites to hold sway over public protests, linked to differences in the historical legacies of political transitions in the South.

Lastly, for both political and economic reasons we expect cuts to fall more heavily on public investment than on public consumption. The latter has far more uncertain political pay-offs, likely to be reaped by future governments, while cuts in the former typically elicit stronger political opposition. Thus rolling back public investment represents a path of least resistance when governments operate under strict constraints. The logic of political competition penalizes public investment, notwithstanding the long-term harm this entails in terms of higher inequality and lower growth.

In the next sections, we test these expectations by examining the evolution of household incomes in Southern Europe and the role of austerity in shaping distributional outcomes.

II. Economic crisis and distributional change in Southern Europe

The distributional effects of economic crises depend on the interaction between the (reduced) earnings of those affected, the income and employment status of other members of the same households, and the capacity of the tax-benefit system to absorb macroeconomic shocks (Atkinson 2009; Jenkins et al. 2013). Progressive taxation and generous unemployment benefits help contain the effects of crises on inequality (Agnello and Souza 2012; Fournier and Johansson 2016). On balance, the costs of fiscal consolidation tend not to be shared equally, with lower-income groups experiencing heavier losses (Woo et al. 2013; Ball et al. 2013).

Before we examine the distributional effects of austerity in Southern Europe, it is important to keep in mind that, although all four countries suffered greatly, the recession in Greece was exceptionally severe. In 2008-2013 GDP in Greece declined by 26%. In Spain it fell by 9%, in Portugal and Italy by 8%. Over the same period, the number of employed workers decreased by 24% in Greece, 16% in Spain, 13% in Portugal, and 4% in Italy. Emigration, especially from Greece and Spain (at 0.9% annually in 2010-2015, compared to 0.4% for Portugal and 0.2% for Italy) took some of the pressure off anaemic job creation at home.

In Spain, but also to a modest extent initially Italy, the global financial crisis led to rising inequality from the very start. In Greece, but in particular Portugal (which started with the highest level of inequality of all four), the crisis compressed the income distribution, at least until 2010 when the turn to austerity caused inequality to rise (see Figure 1). The growth in inequality, whether measured by the Gini coefficient (which is more sensitive to changes in

the middle of the distribution), or the income quintile share ratio S80/S20 (which is more sensitive to changes at the two ends of the distribution), has been greatest in Spain over the period.

[Figure 1]

Other inequality measures (such as the S90/S10 and P90/P10 ratios) show a similar pattern. Moreover, comparing the P90/P50 and P50/P10 ratios[3] suggests that in all four countries the rise in inequality over the period was due to greater-than-average income losses at the bottom of the distribution, rather than smaller-than-average losses (not to speak of gains) at the top.

Estimates of income change by decile, using the microdata of EU-SILC (European Union Statistics on Income and Living Conditions), confirm that the rise in inequality in Southern Europe was largely driven by the collapse of low incomes (see Figure 2). In 2008-2013, income loss at the bottom decile in Greece was a massive 51% in real terms, but was also enormous in Spain (34%), Italy (28%) and Portugal (24%). However, real incomes at the top decile also declined: by almost as much as average incomes in Greece (39%), Spain (16%) and Italy (8%), and by more than average incomes in Portugal (17%).

[Figure 2]

Relative poverty began to rise steadily in Spain from 2007 on. In the other three countries it

declined initially (up to 2009 in Greece, 2010 in Italy and 2012 in Portugal), rising thereafter

in the period when the harshest austerity measures exerted their effects. However, relative

poverty rates are calculated based on a threshold related to the median income, and when

the median income falls rapidly the change in the relative poverty rate does not tell the

entire story. When income change is rapid, people tend to compare their situation not only

to that of others in society (the rationale behind focusing on relative poverty), but also to

their own situation before the rapid income change occurred. 'Anchoring' the poverty

threshold at the start of the crisis gives us a better sense of the actual deterioration in living

standards. The poverty rate anchored to the 2007 median income adjusted for inflation

rose far more significantly in 2009-2013 in all four countries, most so in the case of Greece:

from 18% to 48% (see Figure 3).

[Figure 3]

Comparing the average income of a given decile at two points in time using cross-sectional

data (as in Figure 2 above) is informative but can also be misleading because the population

of each decile is not identical across time. Re-ranking, i.e. accounting for the changing

composition of income deciles as the relative income position of households changes

(leading some to move between deciles), is an important part of the story in Southern

Europe.

Matsaganis and Leventi (2014) offer estimates of the re-ranking of households across income

deciles in Southern Europe for the period 2009-2013 based on a microsimulation model.

That study suggested that the re-ranking effect is quite important in understanding how

income losses were distributed during the years in which the largest austerity measures

were taken. Those who found themselves in the poorest decile in 2013 (the new poor) had

experienced far larger income losses in 2009-2013 than those who were in the same decile in

2009 (the old poor). Longitudinal data now available from the EU-SILC panel[4] through 2012

confirm the pattern identified in that study, only more spectacularly so. In Greece, while

those in the bottom decile in 2012 had suffered massive income losses relative to 2009 (-

71% on average), those who belonged in the bottom decile in 2009 actually saw their

incomes *increase* by 2012 (+22% on average). A similar pattern prevailed in the other three

countries. Those in the poorest 10% of the population in 2009 improved their incomes over

the next three years by 72% in Italy, by 47% in Spain, and by 30% in Portugal. In contrast,

those in the poorest 10% of the population in 2012 had experienced huge losses during the

three previous years: -49% in Portugal, -46% in Spain, -41% in Italy (see Figure 4).

[Figure 4]

Some part of the diverging fortunes of the new vs. the old poor can be attributed to the

tendency of extreme values to converge (known as 'regression towards the mean').[5] What

matters for the political economy of austerity in Southern Europe is (i) that the new poor are

considerably poorer than the old poor had been, and (ii) that the new poor include

significantly more unemployed workers (particularly so in Greece and Spain) and significantly

fewer pensioners. For example, in Greece the share of pensioners in the general population

increased between 2009 and 2013 (from 21% to 25%), but their proportion among the poor

decreased (from 16% to 10%). In Spain only 4% of the poor were pensioners in 2013 (from

8% in 2009), in Italy 9% (from 12%), in Portugal 14% (from 20%).[6]

This is not to imply that pensioners were "better off" in 2013 than in 2009: they merely lost

less than other groups, so their relative position improved. This outcome is consistent with

our expectations that governments would try to limit the impact of austerity on the poorer

segments of society, but that they would principally protect established benefit recipients.

III. Austerity and income distribution

Estimating the role of policy in distributional outcomes is not straightforward. Fiscal

consolidation affects incomes directly by changing taxes, benefits, and public sector wages

and employment. However, it also has indirect effects via its macroeconomic impact on

aggregate demand, which in turn affects market incomes (e.g. gross earnings in private firm).

Direct and indirect effects can be at odds with each other. For example, higher taxes may

compress the income distribution and hence reduce inequality in the first instance, but

deepen the recession and cause more job losses, increasing inequality further down the line.

Conversely, cuts in public consumption may be more regressive to start with, but affect

economic activity less and therefore cause fewer job losses, containing the effect on

inequality (OECD 2013, Ball et al. 2013). In addition, cuts in public investment, health or education may have few immediate consequences, but lower productivity growth and raise inequality in the longer term (see Table 1). It seems reasonable to assume that the logic of democratic politics makes governments more keenly attuned to the first-order distributional consequences of their policies than to their second-order and longer-term effects.

[Table 1]

Using the EU tax-benefit microsimulation model (EUROMOD), Matsaganis and Leventi (2014) offer estimates of the direct impact of various types of fiscal consolidation policies from that of other macroeconomic developments (such as the rise in unemployment).[7] Their results suggest that the first-order effect of many austerity measures was to reduce inequality by compressing incomes while simultaneously causing low incomes to fall, thereby raising poverty (anchored to an earlier threshold). Indeed, the direct effects of austerity policies were responsible for the bulk of the estimated rise in poverty (except for Greece), while the reduction in inequality due to first-order effects of austerity was wiped out by second-order effects (except for Portugal). This is shown in Table 2.

[Table 2]

Looking at the effects of austerity by type, we see that changes in taxes and social contributions had the largest inequality-reducing impact (except for Greece). The large effect

attributable to tax policy changes in Portugal in 2013 is particularly striking (although social

spending cuts that same year worked in the opposite direction). Public sector pay cuts also

reduced inequality across countries,[8] as civil servants tend to be in the upper half of the

income distribution (Koutsogeorgopoulou et al. 2014). Figari et al. (2016) confirm that the

effect of public sector pay cuts on the distribution of incomes was progressive across all four

countries. Pension policies were sometimes progressive (e.g. the benefit cuts in Portugal in

2012, and in Greece in 2010 and 2012), and sometimes regressive (e.g. the cuts across the

board in Greece, and the reversal of earlier cuts in Portugal, both in 2013).[9] This is shown in

Table 3.

[Table 3]

How are these distributional outcomes likely to affect the future trajectory of Southern

European states? Post-Keynesian approaches suggest that poverty and inequality will

compound the demand problems of post-Fordist capitalism in the periphery, given that

lower income groups have a higher propensity to consume. In particular, insights from the

literature on the role of public investment in upgrading skills bode ill for future growth

prospects. In 2009-2012, public investment was cut back by 58% in Spain, 55% in Greece,

48% in Portugal, and even 26% in Italy (where the size of fiscal adjustment was much

smaller). [10] Spending on education also suffered heavily, falling by 19% in Spain, 18% in

Greece, 13% in Portugal, and 5% in Italy. [11] Under pressure from creditors demanding pro-

cyclical fiscal consolidation, and from pressure groups lobbying to escape austerity cuts,

Southern European governments opted to axe public investment, thereby guaranteeing lower growth and greater inequality in the future.

IV. Labour market developments and distributional outcomes

While austerity programmes caused poverty to rise across Southern Europe (relative to a pre-crisis benchmark), changes in inequality varied more in the four countries. To what extent can the observed pattern be attributed to differences in the design of fiscal consolidation measures?

Beyond the policies reviewed in the previous section (affecting public sector pay, taxes and social contributions, and pensions and other social benefits), austerity programmes also contained the commitment to carry out structural reforms. In theory, that includes both product market liberalization as well as labour market deregulation. In practice, as in Greece, business interests resisted the former more effectively than labour unions did the latter (Matsaganis 2017). As a result, labour markets in Southern Europe were transformed. The reforms pursued were explicitly designed to facilitate internal devaluation and restore competitiveness, e.g. by limiting collective bargaining, decentralizing wage setting, and lowering dismissal costs (Myant et al. 2016).

Labour market reforms were sometimes justified as attempts to reduce labour market segmentation – as in Spain and Portugal, where temporary employment was widespread.

However, their actual effect was often to reduce overall wage shares while maintaining segmentation by allowing even more precarious employment conditions. As shown by Cardoso and Branco (2017) and Santos and Fernandes (2016), this was the case in Portugal. But it was equally true in Spain, where firm-level agreements were allowed to override more centralized collective bargaining, creating a large incentive for firms to outsource to less-regulated contractors (Uxó et al. 2016; Horwitz and Myant 2015). And it applied to Greece, where the radical cut in the minimum wage and the loosening of employment protection as the economy was in free fall led to a negative feedback loop between job destruction and economic depression (Theodoropoulou 2016). Nonetheless, the reforms proved less successful at engineering the anticipated employment recovery (OECD 2017). Indeed, earnings diverged between those who kept their jobs during the crisis and those gaining employment more recently.

Italy was a partial exception. The Berlusconi government had at first relied on an expansion of short-work schemes (analogous to the German *Kurzarbeit*) to limit employment shedding (Perez and Rhodes 2015). When the Monti governments attempted a radical reduction of employment protection in 2012, the Fornero law was effectively neutralized in parliament. It was only with Renzi government's "Jobs Act" legislation in 2015 that labour market reform in Italy truly kicked into effect. At the same time, deregulation was accompanied by a significant expansion of unemployment insurance (Agostini et al. 2017).

While the pace and balance of labour market reforms, along with the more limited fiscal

consolidation, helps account for the smaller rise in inequality in Italy, it does little to further our understanding of the contrasting experiences of Portugal and Spain. By all accounts, labour market deregulation in Portugal was as radical as that carried out in its Iberian neighbour – and yet trends in income inequality diverged (Arnold and Farinha 2015; Goerlich 2016). There is evidence that the size of employment destruction is a key determinant. Job losses have been estimated to explain as much as 80% of the rise in inequality in Spain (Goerlich 2016; Domenech 2016). Between 2007 and 2014, total hours worked fell by 18.6% in Spain and 23.4% in Greece, compared to 9.8% in Portugal and 7.5% in Italy (Myant et al. 2016). This is consistent with the higher rise in inequality and poverty in Greece and Spain.

V. The role of national politics in shaping austerity policies

Differences in the magnitude and design of austerity policies help explain some of the observed contrasts in distributive outcomes. It is easy to see why fiscal adjustment was greater in Greece: the country had a larger deficit to address, and enjoyed less credibility with creditors. Conversely, the much smaller size of the Italian adjustment helps explain why Italy experienced a smaller rise in income inequality and a lower level of employment destruction over the period. Nevertheless, questions remain. Clearly Italy was too big to fail (and too big to bail out), which gave Italian governments significant leverage vis-á-vis creditors. But this was true for Spain too: a Spanish public debt default would also have spelled the end of the Euro.

Why was Italy's fiscal consolidation effort in the period so small in comparison to Spain's?

Why did Spain implement a more intense austerity programme than Portugal? And why did

Portugal rely on more progressive measures in bringing down the fiscal deficit?

The colour of the respective governments is an obvious candidate, but left-right partisanship

fails to offer a clear explanation. The contrast between centre-right governments

(Berlusconi, Rajoy, Passos-Coelho, Samaras) and those led or supported by the centre-left

(Papandreou, Socrates, Zapatero, Monti) does not match the pattern of variations in the

distributive impact of austerity. A more plausible explanation can be found in other features

of politics in Southern Europe. These include the differing degrees to which traditional

parties were constrained by party patronage politics; the extent to which the institutional

structure of governments allowed those affected by cuts to block austerity measures; and

political legacies that helped shape the responsiveness of governments to domestic protest.

Comparing the austerity programmes of Greece and Portugal, Afonso et al. (2014) show that

important aspects of fiscal consolidation in Portugal were decided in a co-operative manner

among the major parties in 2010 and 2011. Even after its victory in 2011, the conservative

(PSD) government attained the support of the socialists (PS) in drafting key measures in

2012. By contrast, the authors attribute the antagonistic style of politics in Greece to the

critical role of public sector employment as a source of party patronage (see also Pappas

2009; 2013). This made spending cuts affecting pay and employment in the public sector a

major stumbling block, weakening the position of Greek governments *vis-à-vis* the Troika.

Such patronage linkages, the authors argue, were less strong in Portugal, allowing more space for compromise among political parties, whose co-operation allowed Portuguese governments to maintain greater control over their austerity programme and distribute the costs of fiscal adjustment more progressively

Can this argument be extended to the Italian and Spanish cases? Comparative studies of the use of public employment as a form of party patronage suggest that political parties in Italy and Greece rely more heavily on this type of patronage than those in Spain and Portugal (Hopkin 2001; Kitschelt 2011; Kopecky et al. 2012). Accordingly, spending cuts would have been more difficult to enact for Italian governments than it was for Spanish governments, irrespective of their political orientation. This may help explain why Italian governments relied more heavily on revenue measures than on spending cuts in their austerity program (Pina 2016). Yet it does not quite explain why Spanish governments would chose to impose as heavy an austerity program as they did.

We have noted that the two larger countries had more leeway in dealing with the crisis than the two smaller states. The Rajoy government in 2012 applied for a line of credit from the EFSF to recapitalize failing savings banks and signed a memorandum of understanding. Yet the concrete conditions spelled out in that agreement pertained to the restructuring of the banking sector, not fiscal consolidation. Moreover, the size of the banking recapitalization needed (estimated at €60 billion at the time, with only €44 billion drawn in the end) represented but a small fraction of Spain's GDP (less than 5%). Indeed creditor governments

intensely sought the agreement with Spain as a way to put a quick end to bond market contagion just prior to the 2012 Greek election. This put the Spanish government in quite a different position when it signed the EFSF agreement in Spring 2012 than had been the case for Portugal (which received loans amounting to 44% of its GDP in 2011) or Ireland (40% of GDP in 2010) when these governments negotiated their sovereign bailout programmes.

In spite of the similarity of their positions, the response of the Spanish governments differed sharply from those of Italian governments. In 2010, the socialist (PSOE) government of Zapatero was much more responsive to demands by creditors for a turn to austerity and structural reforms than the Berlusconi government and would move more aggressively than even the Monti government (Perez 2014). Although it initially responded to the world financial crisis through stimulus measures to revive the economy, the Zapatero government promptly reversed course following the May 2010 Eurozone summit. In contrast, the Berlusconi government not only resisted the kind of adjustment demanded by creditor governments in 2011. It continued to do so even after the ECB attempted to make a more radical adjustment program a condition for its support of Italian public debt through its SMP program in Fall 2011. Indeed, it was conflict over a proposed freeze in public wages, and a cut in pension spending, both demanded by the ECB, that eventually spelled the end of Berlusconi's tenure in November 2011 (Perez and Rhodes 2015). The importance of pensions and public sector employment as a source of electoral support for political parties in Italy may have contributed to this contrast with Spain.

The Spanish austerity program was premised on a significant cross-party consensus, just as it did in Portugal. In spite of intense antagonism with the conservatives (PP), in 2011 the Zapatero government enlisted the opposition's support to pass a highly unpopular constitutional amendment (Article 135) that committed the Spanish state and its regional governments to comply with public deficit limits established by the European Union. This remarkable concession paved the road for the PP to implement an even harsher austerity programme after it came to power with an absolute majority at the end of 2011. As a result, the magnitude of the Spanish fiscal adjustment (in relation to GDP) surpassed that of Portugal in 2010-2013 (Pina 2016), notwithstanding Spain's much greater leverage vis-à-vis creditors.

Cross-party cooperation in Spain did not imply a more progressive design of austerity measures, as was the case in Portugal. Nor can clientelism (and the associated aversion to spending cuts) explain why Spanish governments did not try to form a common front with Italy to force a more growth-friendly approach in the Eurozone, even after the Monti government became an advocate for such a change. We must therefore look elsewhere to understand differences in the size of fiscal consolidation (between Spain and Italy) and in its content (between Spain and Portugal).

A key aspect of the politics of austerity in Portugal was that important measures were abandoned in the face of social protest or were reversed by the Constitutional Court. It is likely that this limited the burden of fiscal adjustment on lower-income groups. Social

mobilization contributed to the rejection in parliament of the first two austerity packages of

the Socrates (PS) government in 2010 and 2011. It also prevented Passos-Coelho's

conservative government from passing a large payroll tax increase in 2012. Other measures

were declared unconstitutional by the Portuguese Constitutional Court, including cuts to

survivor pensions and higher taxes on unemployment and sickness benefits. Fishman and

Everson (2016) have argued that this responsiveness by Portuguese governments to public

protest reflects the prevalence of public norms that emerged from Portugal's revolutionary

transition to democracy, which led Portuguese political elites to accept protest as a

legitimate aspect of the democratic political process.

Massive anti-austerity protest, of course, also took place in Spain, as iconized by the

*indignado*s movement in 2011. Neither the Socialist government of Zapatero nor the first

Rajoy government, however, altered their course in response. This lack of responsiveness

was reflected in the slogan of the *indignados* - "they do not represent us" – which would be

picked up by the anti-austerity *Podemos* party that in the 2015 elections broke the

longstanding duopoly of the PP and PSOE in national politics. According to Fishman (2012)

the traditional parties' lack of responsiveness to protest illustrates a the tendency of Spanish

political elites to disregard protest as a legitimate input to democratic governance. This is

particularly true when it comes to matters of macro-economic policy. The first PSOE

governments embraced economic orthodoxy early on and imposed the first two major fiscal

adjustment programs after the transition to democracy (in the 1980s and the mid 1990s)

despite large scale social protest (Perez 1997, 1999; Ban 2016). The Zapatero government's

decision to opt for full compliance with external demands in 2010-2011 represented a clear

return to this norm.

However, the larger fiscal consolidation in Spain compared to Italy also turned on differences

in the two countries' political systems. Italy's strong bicameralism, requiring governments to

maintain support in both the lower and upper houses, presented a particularly strong

obstacle to a more aggressive austerity programme. Even under Monti, whose government

attempted a more comprehensive programme of tax, pensions, and labour reforms, key

measures were rolled back as they went through parliament or were stopped by the

Constitutional Court (Perez and Rhodes 2015). Renzi's failure in 2016 to enforce a

constitutional change that would empower the executive to pass more radical reforms

confirmed this pattern. In short, Italy's fiscal consolidation proved smaller both because

governments held out longer against external demands for pro-cyclical spending cuts and

because institutional features prevented them from passing such cuts later on. By contrast

Spain's quasi-majoritarian system and its "constructive vote of no-confidence" rule - which

protects incumbents lacking an absolute majority (Field 2016) - allowed even the minority

government of Zapatero to pass a more radical adjustment program Massive social

mobilization by those affected by fiscal consolidation (such as public teachers and medical

staff) thus failed to block austerity, at least until the shake-up of the traditional party system

by *Podemos* in 2015.

VI. Conclusion

Recent studies have argued that fiscal consolidation is likely to deepen a recession by reducing domestic demand more than can be compensated for by increased exports, and also to undermine long-term growth by forcing governments to cut public investment more than public consumption. Furthermore, internal devaluation is likely to increase inequality by reducing the wage share in GDP and by limiting the contribution of public investment on education and training to more equitable growth in the long term.

Our review of the experience of Southern Europe shows that spending cuts fell most heavily on public investment, which is expected to result in lower growth and greater inequality in the long run. As for taxation, by prolonging the crisis pro-cyclical austerity reduced the tax take, even as it increased the share of taxes in GDP.

Our evidence suggests that domestic policy makers did have some room to shape the distributive consequences of fiscal consolidation. National governments made some attempt to limit the impact of austerity on inequality by designing spending cuts and tax increases in a more progressive manner. Nevertheless, even when modulated to limit their first-order impact on lower-income households, austerity measures had pernicious second-order effects on demand, depressing economic activity, causing business closures and job losses. Except in Portugal, the first-order effects of austerity policies (often reducing inequality) were more than offset by their second-order effects (always increasing inequality). Moreover, while the old poor (e.g. pensioners) suffered significant income losses, the new

poor (e.g. the unemployed) lost even more and were offered less protection. As a result, austerity caused poverty to increase (relative to a fixed threshold) in all four countries.

Distributive outcomes have also been influenced by regulatory reform, ostensibly intended to reduce labour market segmentation, but in fact producing even more precarious employment (especially in Spain and Portugal). In Italy, more jobs may have been saved at the cost of declining productivity, raising questions about the ultimate impact of the crisis. In all four countries, the social protection system has failed to prevent the expansion of the ranks of the poor.

On the other hand, political factors shaped responses to austerity in the four countries. Greece's fiscal imbalances and loss of standing explains its absolute powerlessness vis-à-vis creditors intent on making an example of the country. Yet political conflict over public sector cuts also prevented Greek governments from taking control of the austerity programme. In Portugal, public employment did not play such a central role in party politics, while political elites (formed in the country's more radical transition to democracy) were more responsive to public protest. In this context, a measure of compromise was possible that resulted in a more progressive mix of tax and spending measures. In Spain, compliance with creditor demands irrespective of the government's political orientation resulted in larger fiscal consolidation than might have been expected given the country's leverage. An embrace of economic orthodoxy by traditional Spanish party elites was reinforced by the way the constitution empowers minority governments to enact unpopular policies. Finally, in Italy,

the logic of bicameralism, coupled with political fragmentation and intense conflict over public employment and pensions, both central elements of party patronage, placed insurmountable obstacles to austerity. The result was softer fiscal adjustment and a slower pace of labour market reforms.

These observations raise serious doubts about the logic of internal devaluation in debtor states. Austerity interrupted secular trends towards greater equality and inclusion across Southern Europe in previous decades. Rising inequality and social exclusion now threaten to become lasting features of the social landscape. Emigration, while presenting a safety valve for some, also implies a significant brain drain and aggravates demographic problems. In the absence of a strong recovery, equitable growth seems elusive. Re-balancing macro-economic governance so that both core and periphery countries can prosper remains Europe's greatest challenge.

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Figures

Figure 1
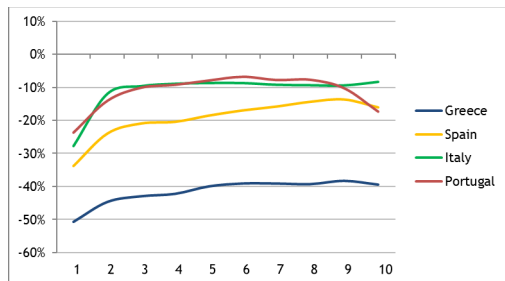
Inequality (2007-2014)
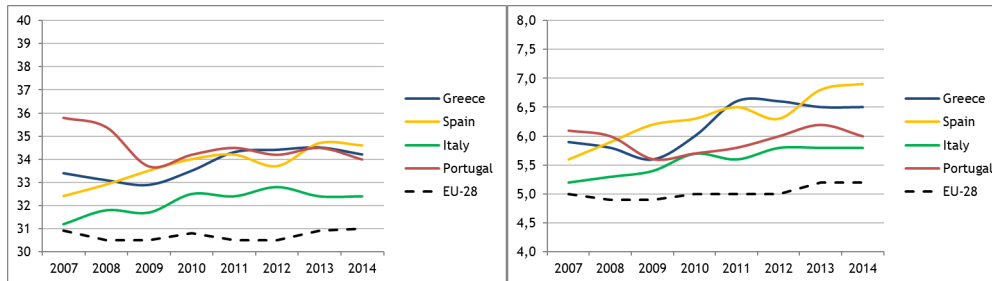
Note: Left-hand panel: Gini coefficient (scale from 0 to 100) of equivalised disposable income [ilc_di12].

Right-hand panel: S80/S20 income quintile share ratio [ilc_di11]. EU-SILC survey data. Income

reference years.

Source: Eurostat (extracted on 11 April 2017).

Figure 2

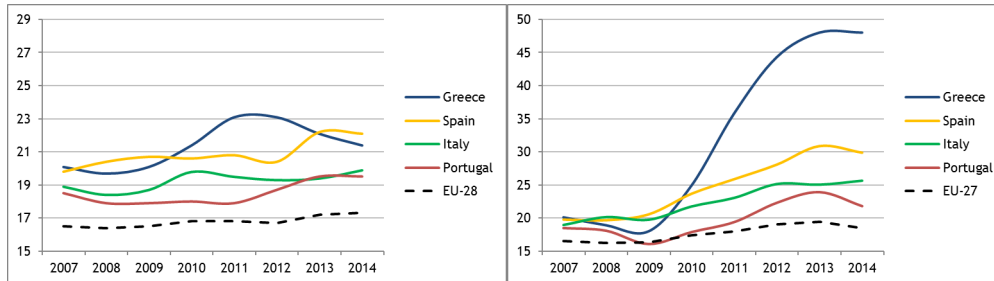*Income growth by decile (2008-2013)*

Note: Change in equivalised net disposable household income, in 2013 relative to 2008, in constant

prices, by decile (1: poorest; 10: richest). Income reference years. Negative incomes set to zero.

Source: Own elaboration of EU-SILC cross-sectional dataset.

Figure 3

Poverty (2007-2014)

Note: At risk of poverty rate (cut-off point: 60% of median equivalised income after social transfers).

Left-hand panel: moving poverty threshold [ilc_li02]. Right-hand panel: poverty threshold

anchored in 2007, adjusted for inflation [ilc_li22b]. EU-SILC survey data. Income reference years.

Source: Eurostat (extracted on 11 April 2017).

Figure 4

Income growth by decile (2009-12)
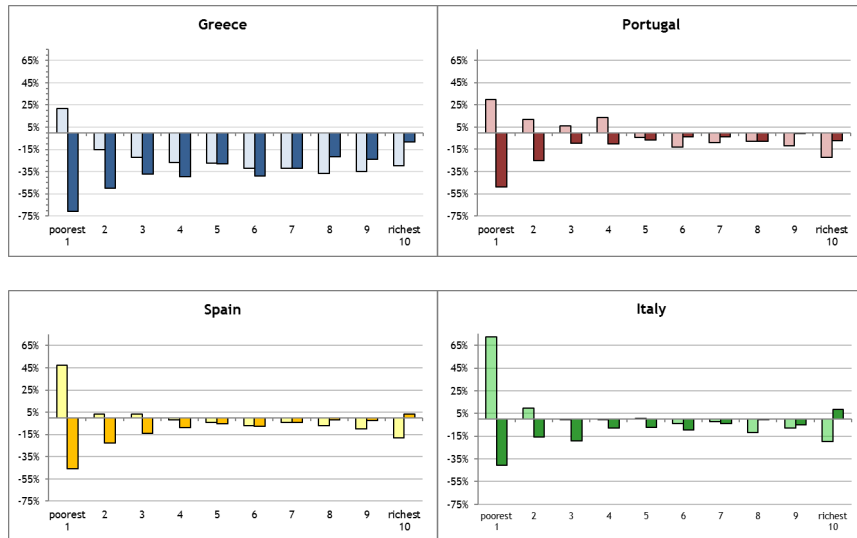
Note: Change in equivalised net disposable household income, in 2012 relative to 2009, in constant prices, by decile. Households ranked as in 2009 (light bars) and as in 2012 (right bars) respectively. Income reference years. Negative incomes set to zero.

Source: Own elaboration of EU-SILC longitudinal panel.

Table 1

Expected effects of austerity on disposable incomes, inequality and growth

First Order	*Second Order (short term)*	*Long Term*
Direct and immediate effects of austerity policies (higher taxes, lower benefits, public wage cuts or freezes, public sector job losses).	Fiscal multipliers: lower consumption and lower investment depress economic activity, profits, wages, and employment.	Cuts in public spending (infrastructure, education, health) undermine future productivity.

Table 2

Estimated effects of austerity on inequality and poverty in Southern Europe (2009-2013)

	2010		2011		2012		2013		2009-2013	
	A	B	A	B	A	B	A	B	A	B
Greece										
inequality	-0.4	1.1	-0.3	1.1	-0.1	1.9	0.1	1.0	-0.7	5.0
poverty	3.1	3.0	3.6	3.6	0.9	6.4	1.7	3.5	9.3	16.5
Spain										
inequality	-0.3	0.3	0.0	0.2	-0.5	0.3	0.0	0.4	-0.8	1.1
poverty	0.1	0.5	2.0	-0.5	0.8	0.3	1.3	-0.1	4.3	0.2
Italy										
inequality	0.0	0.4	0.0	0.1	-0.2	0.1	-0.2	0.0	-0.3	0.7
poverty	0.6	0.5	1.3	-0.3	1.6	-0.4	0.0	-0.3	3.5	-0.5
Portugal										
inequality	-0.2	0.0	-0.1	-0.1	-0.7	0.0	-0.2	0.1	-1.2	0.0
poverty	0.4	-0.5	3.5	-0.1	0.8	1.2	1.1	-0.1	5.8	0.5

Notes: *A*: First-order effect of austerity in year t+1 relative to year t. *B*: Full effect of recession in year t+1 over and above A. *Inequality*: Change in Gini coefficient (scale from 0 to 100) of equivalised disposable income. *Poverty*: Change in share of population with equivalised disposable income below 60% of 2009 median, adjusted for inflation. Results of microsimulation using EUROMOD version G1.0.

Source: Re-elaboration of Figures 4 and 5 in Matsaganis and Leventi (2014).

Table 3

Estimated effects of austerity on inequality by type of policy in Southern Europe (2009-2013)

	2010	2011	2012	2013	2009-2013
Greece					
public sector pay	-0.19	-0.03	-0.11	-0.19	-0.52
taxes and social contributions	-0.28	-0.04	0.02	0.35	0.06
Pensions	-0.10	-0.02	-0.15	0.33	0.06
other social benefits	0.11	-0.06	0.09	-0.54	-0.40
Spain					
public sector pay	-0.04	-0.04	-0.07	0.00	-0.15
taxes and social contributions	-0.15	0.01	-0.35	-0.01	-0.49
Pensions	-0.02	-0.01	-0.01	-0.01	-0.05
other social benefits	-0.09	0.00	-0.07	0.02	-0.15
Italy					
public sector pay	0.02	0.00	0.01	0.00	0.03
taxes and social contributions	0.00	-0.16	-0.13	0.00	-0.29
Pensions	0.00	0.00	0.00	0.00	0.00
other social benefits	-0.01	-0.02	-0.02	-0.06	-0.12
Portugal					
public sector pay	0.00	-0.17	-0.33	0.29	-0.20
taxes and social contributions	-0.13	-0.63	-0.19	-1.18	-2.12
Pensions	-0.05	0.00	-0.36	0.21	-0.21
other social benefits	-0.06	0.62	-0.04	0.35	0.87

Notes: *Inequality*: Change in Gini coefficient (scale from 0 to 100) of equivalised disposable income. First-order effects only. Results of microsimulation using EUROMOD version G1.0.

Source: Re-elaboration of Table 3 in Matsaganis and Leventi (2014).

[1] Pontusson and Baccaro (2016) argue that, alternatively, in Britain domestic demand was propped up through an expansion of private debt, while in Sweden the state sustained wage-led growth by supporting high productivity sectors.

[2] *Financial Times* November 17, 2010 and Sandbu (2015) pp. 145-159.

[3] S90/S10 is the ratio of the average income of the 10% richest to the 10% poorest. P90/P10 is the ratio of the upper bound value of the ninth decile (i.e. the 10% of people with highest income) to that of the first decile, P90/P50 of the upper bound value of the ninth decile to the median income, and P50/P10 of median income to the upper bound value of the first decile. The OECD publishes estimates of these indicators in a number of countries (see https://data.oecd.org/inequality/income-inequality.htm).

[4] The EU-SILC longitudinal dataset is a rot ating panel, where one quarter of the sample changes every year, so that each household remains in the sample for at most four years.

[5] Even when average incomes are quite stable (which they were certainly not during the period of interest), individual incomes will fluctuate over time. Some part of the total variation may be systematic (e.g. incomes generally rise with experience and skills acquired), some other part may be random (e.g. associated with losing or finding a job). Because of the tendency of extreme values to converge, known as 'regression towards the mean', random variation will cause some of the exceptionally high (conversely: low) incomes observed in the start year to fall (rise) in later years.

[6] The poor are defined here as individuals and families in the bottom 20% of the income distribution. Figures derived by our elaboration of the cross-sectional dataset of EU-SILC.

[7] Matsaganis and Leventi (2014) used the European tax-benefit micro-simulation model EUROMOD on data from EU-SILC 2010, reporting incomes earned in 2009. A full list of the austerity policies assessed can be found in the online appendix of that paper (http://dx.doi.org/ 10.1080/13608746.2014.947700).

[8] The inequality-increasing change in public sector pay in Portugal in 2013 involved a reversal of earlier cuts**.**

[9] Cuts in social benefits often increased inequality (as in Portugal in 2011). Yet they were sometimes designed so as to shield the worst off, helping to reduce inequality (as in Greece in 2013).

[10] Gross fixed capital formation by general government (adjusted for inflation using the GDP deflator). Source: Eurostat, Government revenue, expenditure and main aggregates [gov_10a_main].

[11] Total expenditure on education by general government (adjusted for inflation using the GDP deflator). Source: Eurostat, General government expenditure by function (COFOG) [gov_a_exp]. See also Pina (2016).