Section II: The Euro Experience

Chapter 8

The Troubled South:

The Euro Crisis in Italy and Spain

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Abstract
The fate of the euro hangs on the outcome of the crisis in the Southern European democracies, but the social and political dynamics behind the crisis are ill-understood. This chapter moves beyond the standard narrative of debtor and creditor nations, and examines the political and distributional consequences of monetary union within the Southern member states. The euro brought big gains to sheltered sectors of the economy, such as construction, retail and parts of the public sector, whilst manufacturing workers actually demonstrated considerable wage restraint. But the policies imposed on the South in response to the debt crisis have come down hard on lower income groups, and particularly the young, whilst protecting politically powerful lobbies who gained in the boom years. Southern Europeans have shown remarkable resilience in the face of economic disaster, and remain largely committed to euro membership. However, the imposition of internal devaluation constitutes a major natural experiment with very high stakes, counting on Southern European citizens maintaining an unwavering commitment to the euro to justify years of sacrifice with no end in sight. The elections held since the crisis began have brought major transformations to what were relatively settled patterns of citizen representation and party competition. The destructive policy mix imposed by the European authorities, the corresponding decline in pro-European sentiment amongst Southern publics, and the tenuous grip on government power of pro-European political forces across the four countries, cautions that the South's commitment to the euro will be tested to the limit in the coming years.

I. Introduction

Southern Europe has been in the frontline of the Eurozone debt crisis that developed shortly after the global financial crisis of 2007-8. Greece and Portugal have both signed up to formal bailouts, whilst Spain has taken European funds to bail out part of its banking system. Italy, which has so far averted a bailout, poses perhaps the greater existential threat to the euro, as the largest crisis economy by some distance, and the third largest stock of sovereign debt in the world, after the United States and Japan. The 'Draghi put' – the ECB's commitment to act as lender of last resort to European governments after rolling out its controversial OMT program in September 2012 – has shored up the Southern European bond markets, but their economies remain mired in deep recession and their political leaderships are shedding credibility at an alarming rate. The fate of the euro hangs on the outcome of the crisis in the Southern European democracies, but the social and political dynamics behind the crisis are ill understood. Perceptions of the South are dominated by an awkward combination of fatalistic stereotypes and over-optimistic expectations of deep economic reform.

This chapter argues that current policy towards the South of the Eurozone is predicated on a set of false premises, and is doomed to failure. Some of these premises relate to the design failures of the euro itself, and are well explained elsewhere in this volume.[1] The contribution of this chapter is to explain the impact of euro membership on the Southern European political economy, and assess the political and institutional parameters of the response to the crisis. In particular, the following sections seek to move beyond the standard narrative of debtor and creditor nations, and to examine the political and distributional consequences of monetary union within the Southern member states. Understanding the nature of the crisis requires an appreciation of the relationship between winners and losers within each country, and the conflictual and contested politics of how to respond to the austerity and reform program imposed from outside. The chapter concludes that the current approach to resolving the crisis is doomed to failure precisely because it lacks such an understanding, and as a result risks undermining Southern Europe's economic future and even the institutional foundations of its democratic systems. By extension, it threatens the very survival of the euro in its current form.

II. Joining the Euro: Mistaking the Starting Gun for the Finish Line?

European integration played a key role in the establishment of democracy in Southern Europe. The polarized and unstable democracy that emerged out of the collapse of Fascism in Italy was bolstered by its Christian Democratic leaders' close involvement in the creation of the European Economic Community, which locked the country into the Western bloc and forced the hand of the powerful Italian Communist Party. In Greece, Portugal and Spain, the prospect of EC membership was crucial in persuading business elites of the virtues of political reform, and the close ties that developed between European socialist parties ensured cross-party support for Europeanization. The economic growth and flows of structural funds enjoyed after entering the Common Market during the 1980s contributed to high levels of popular support for the European project. Joining

[1] See all four chapters in section I of this volume.

the euro was therefore seen as a natural step in a historic trajectory of modernization and convergence with the rich and stable democracies of Northern Europe.

As a result, the likely consequences of EMU were not the subject of extensive public discussion in Southern European countries until after the euro was created. Whilst countries such as France, Germany and of course the UK engaged in intense debate on the risks and possible benefits of the single currency, in the Southern democracies euro membership was an unquestioned national objective, with only peripheral and mostly extremist political forces offering any alternative view. The overriding sentiment was that participation in monetary union would lock in the gains of EC membership, and spur further modernization and growth. To the extent that the South's past difficulties with inflation and fiscal policy were considered, the dominant view was that euro membership would provide an anchor and *vincolo esterno* (external constraint) to improve institutions and facilitate reforms that would otherwise prove impossible.[2]

The run-up to monetary union provided apparent support for this view. The Southern countries showed a degree of political commitment to the euro project that discredited critics who had dismissed them as the 'Club Med' countries, unprepared for the rigors of monetary union. Spain's Socialist government under Felipe González adopted a tough monetary policy through the 1980s, joining the European Monetary System, building up currency reserves and ignoring the protests of González's union allies at soaring unemployment. When the crisis of the EMS Exchange Rate Mechanism hit in 1992, González absorbed the huge political cost in a (failed) attempt to remain inside the EMS even after Italy and the UK had opted for devaluation. In Italy, after the EMS crisis brought down a longstanding pro-European political elite, a series of technocratic and semi-technocratic governments adopted tough budgetary measures and extensive administrative reforms to stay on track for monetary union.

The social partners played a key role in this process.[3] Trade unions accepted wage restraint and restrictions on public sector spending growth, on the understanding that euro membership would secure investment and employment into the future. The willingness of Southern European voters to bear sacrifices for the sake of the euro held out the prospect of continued reform and successful integration into the monetary union. Deficits, inflation and interest rates converged in timely fashion to meet the Maastricht criteria (the Italian debt-to-GDP ratio of over 100% being finessed away). The smooth switchover to the new currency, with minimal disruption to financial markets and everyday transactions, allayed many of the fears of the skeptics. So why did things go so wrong?

A common response to this question is that European governments, once the key objective of euro membership was in the bag, assumed they could begin to enjoy the

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[2] Maurizio Ferrera and Elisabetta Gualmini, *Rescued by Europe?* (Amsterdam: Amsterdam University Press, 2004).

[3] Martin Rhodes, 'The Political Economy of Social Pacts', in Paul Pierson (ed.), *The New Politics of the Welfare State* (New York: Oxford University Press, 2001), pp.165-94.

benefits of monetary union without facing the political costs of further structural reform.[4] The cross-national econometric evidence for this is mixed,[5] but the European Commission and various European think tanks rebuked Southern European governments for their slow progress in meeting reform targets even before the crisis.[6] Strategies of wage moderation agreed between the social partners in the 1990s were relaxed after euro entry,[7] and after the stringent budgetary measures taken to meet Maastricht criteria on debt and deficit levels, fiscal policy tended to loosen after 1999, although the Southern European countries were not the worst offenders (Germany being the first country to breach the 3 per cent deficit limit imposed by the Stability and Growth Pact).

The narrative of Southern European recklessness has been popular in Northern Europe and in the European institutions, as it fits in with a diagnosis and a set of remedies to the current crisis that are politically roadworthy in Germany (for reasons Abraham Newman explains in chapter 6) and avoid challenging the essential parameters of monetary union. The focus on fiscal austerity and structural reforms places the onus for resolving the crisis on the debtor nations, instead of focusing on cross-national fiscal transfers or coordinated stimulus measures that would shift the burden onto Germany and require costly institutional changes at the European level. The introduction of conditionality into the various bailout measures – commitments to specific structural reforms before funds are released – allows European leaders to establish the principle that financial assistance comes at a price, in the hope of reducing moral hazard. The Southern countries are served notice that they cannot free ride on the inflationary anchor provided by the euro, and will have to reform in order to secure their future within the currency area.

Beyond its popularity in Brussels, Frankfurt, and Berlin, this narrative is in fact surprisingly widely accepted in the Southern European countries themselves.[8] Pew research recently revealed that even after several years of austerity-induced recession, a majority of voters in Italy, Spain and Portugal wished to remain in the euro and most favored spending cuts as the best policy to deal with their governments' debt problems.[9] Political and business elites have shown a remarkable degree of commitment not only to the euro project, but also to the measures demanded of them by the European institutions, even though even the IMF has rejected these measures as entirely counter-productive.[10] Moreover, there has been a surprising lack of interest amongst the debtor governments in coordinating their efforts within the European arena to obtain a more favorable policy

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[4] Jesús Fernández-Villaverde, Luis Garicano and Tano Santos, 'Political Credit Cycles: The Case of the Euro Zone', NBER Working Paper No. 18899, March 2013.
[5] Alberto Alesina, Silvia Ardagna and Vincenzo Galasso, 'The Euro and Structural Reforms', NBER Working Paper 14479, 2008. http://www.nber.org/papers/w14479
[6] See for example, the Centre for European Reform's annual 'Lisbon Scorecard', which regularly identified Southern countries as 'laggards' in the reform process:
http://www.cer.org.uk/publications/archive/report/2010/lisbon-scorecard-x-road-2020
[7] Ibid.
[8] See for instance Sebastián Royo, *Lessons from the Economic Crisis in Spain* (Basingstoke: Palgrave, 2013).
[9] 'The New Sick Man of Europe: The European Union', *Pew Research Global Attitudes Project*, 13 May 2013. http://www.pewglobal.org/2013/05/13/the-new-sick-man-of-europe-the-european-union/
[10] Oliver Blanchard, and Daniel Leigh 'Growth Forecast Errors and Fiscal Multipliers', IMF Working Paper, WP/13/1 (Washington DC: International Monetary Fund, 2013).

mix, in part due to the reluctance of France to play a leadership role for reasons explained by Mark Vail in chapter 7 of this volume. The kinds of loose, proto-Keynesian attitudes attributed to the South in various quarters are in fact hard to detect in either public opinion or the political debate.

What is more, the Southern European countries have in fact made considerable efforts to reform their economic institutions in line with the recommendations made by the European leadership and the policy consensus in organizations such as the OECD and the European Commission. Price controls, restrictions on entry into domestic markets, state ownership of industrial companies and labor market protections have all been significantly reduced across the Southern economies, and on many measures of regulation they have come close to converging with core countries such as France and Germany (see Figure 1). Considering the South's history of political control over markets and its legacy of legalistic[11] economic regulation, this constitutes a major transformation of its institutions of economic governance.

<Figure One About Here>

Badly regulated product and labor markets and inefficient public spending have certainly been a drag on competitiveness and an impediment to adjustment, making response to economic shocks difficult. But the Southern problem is far from a case of foot-dragging and resistance to reform. If anything, reform has at times been too hasty and has undermined the case for market liberalism, as illustrated in the case of Italian privatizations.[12] Not only did the reforms of the 1990s make less of a difference to the sustainability of the euro project than policy-makers believed, but in some ways euro entry entrenched some of the most important weaknesses of the Southern European political economy.[13] The rest of this chapter will illustrate how the euro has changed the political economy of Southern Europe, and assess how these changes are shaping the political reaction to the crisis.

III. Mediterranean Workers: From Restraint to Stagnation

The proximate causes of the crisis in Southern Europe are now so well understood that it is difficult to recall how oblivious policy-makers were of the risks that were building up in the early years of the euro. In 2005, at the height of Spain's construction boom, the European Commission triumphantly claimed that 'the story of the Spanish economy in

[11] Jonathan Hopkin and Mark Blyth, 'What Can Okun Teach Polanyi? Efficiency, Regulation and Equality in the OECD', *Review of International Political Economy* 19(1): 1-33 (2012).
[12] Marcello de Cecco, 'The Euro and the Italian Economy', *The International Spectator* 33:2 (1998), pp.33-42.
[13] Marco Simoni, *Senz'alibi. Perche' il capitalismo italiano non cresce piu'*. Venice: Marsilio, 2012.

EMU is a dazzling one.'[14] Whilst Italy's economic performance was far less dazzling, there was surprisingly little pressure on the Italian governments of the early 2000s to exploit a favorable interest rate environment to significantly reduce its stock of public debt. It has since become clear that the rapid financial integration spurred by monetary union, added to the questionable decision by the European Central Bank to treat all Eurozone government debt as equally valid for collateral, created bubble-like conditions for sovereign debt in the South.[15]

These conditions played out very differently across Southern Europe, as they were refracted through varying domestic institutions and economic structures. But what the different cases have in common is that monetary union did not have the desired effects. By smoothing transaction costs the euro was supposed to complete the single market for finance, 'facilitating the efficient allocation of savings to the most profitable investment opportunities and allowing market participants to partly diversify away the risk of asymmetric shocks.'[16] The rapid convergence of Eurozone interest rates around those of the low-inflation economies of Northern Europe meant a dramatic easing of credit conditions in Southern Europe. Policymakers assumed that financial institutions were capable of allocating capital efficiently, and that flows of money to the Southern countries reflected real prospects for growth through productivity-enhancing investment. This assumption proved to be a glaring flaw in the euro's design.

Rather than encouraging economic reform and growth, easy credit in fact did little to bring about the kinds of investments needed to make real productivity gains. The large flows of capital from North to South did provide an injection of demand that fueled growth, thus attracting more capital in a classic bubble cycle, particularly in Greece and Spain. But productivity growth remained elusive and much investment was directed into traditional non-traded sectors such as construction (particularly in Spain), or channeled by government and private sector borrowing through to consumption, as in Greece. In Italy falling interest rates facilitated the servicing of its very high public debt levels despite low growth rates. In short, it has become clear that the assumptions of allocative efficiency in Eurozone financial markets were way off the mark. Capital flows instead reflected a 'convergence trade,' which in the short run made money for banks, but created the conditions for ruinous capital flight when conditions changed.

The boom conditions created in parts of the South by the great wave of money flowing from the North allowed Greece and Spain in particular to build huge imbalances on their current accounts, pushing up real exchange rates.[17] The main beneficiaries of these new circumstances were not, in fact, unionized workers in the industrial sector, whose wage

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[14] European Commission, 'Country Study: Spain in EMU: A Virtuous Long-Lasting Cycle?', *Occasional Papers*, No.14 (Brussels: European Commission Directorate Generale of Economic and Financial Affairs, 2005).
[15] Mark Blyth, *Austerity: The History of a Dangerous Idea* (New York: Oxford University Press, 2013), Ch.2.
[16] Speech by ECB President Jean-Claude Trichet, 'Governance and structure of European finance after EU enlargement', Frankfurt, 9 March 2005. http://www.ecb.int/press/key/date/2005/html/sp050309.en.html
[17] Paul Krugman, 'European Crisis Realities', *Conscience of a Liberal* blog, New York Times http://krugman.blogs.nytimes.com/2012/02/25/european-crisis-realities/

demands remained moderated by market pressures (and the awareness that competitive devaluations were no longer possible), but producers in the non-traded sector of the economy. Although it has become common to blame unions and labor market regulation for the breakdown of wage restraint after euro entry, this ignores the obvious point that employers and governments can also defect on collective agreements, and that workers' wage demands are not the only source of inflation. In fact, the unsustainable conditions of the early 2000s did not favor unionized core production workers, but instead advantaged economic sectors which were for the most part inimical to the labor movement.

In Italy, the restraint and reforms of the center-left governments of the 1990s gave way to the election of an uncompromising right-wing government under Silvio Berlusconi in 2001, which dramatically changed the political climate. The Berlusconi government set out to divide the union movement, striking deals with the centrist federations UIL and CSIL and marginalizing the main left-wing union, the CGIL. The employers' federation Confindustria – long dominated by large industrial firms – also had a change in leadership in 2001, with the election of a representative of the small and medium-sized enterprise sector. In consequence, Confindustria collaborated with the Berlusconi government in an attempt to dismantle national-level bargaining in favor of firm-level agreements and reduce labor protections, leading to a rift with the CGIL.[18] Ironically, this had the effect of relaxing wage moderation, as firms were unable to resist the pressure to set wages in line with productivity gains, after the period of wage stagnation immediately prior to euro entry. Even so, real wages in Italy declined in the 1999-2006 period.[19]

In Spain too social pacts had played an important role in meeting the convergence criteria, with public sector workers accepting a pay freeze to meet the Maastricht deficit target and industrial workers signing up to non-inflationary agreements.[20] But boom conditions in the early 2000s, driven by a doubling of foreign direct investment in the first half of the decade and easy credit, relaxed the pressure on unions and employers to curb pay rises, and rapidly falling unemployment increased workers' bargaining power. The lead sector driving growth was construction, as a housing bubble drove reckless over-investment in new builds, with a consequent boom in demand for low-skilled labor.[21] In these heady circumstances, nominal wage growth outstripped productivity growth, and the ready availability of low-skilled jobs sparked both an acceleration of immigration and a decline in demand for further education.[22] As in Italy, the sheltered services sector was able to exploit buoyant demand conditions to hike prices, limiting real

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[18] Lucio Baccaro and Valeria Pulignano, 'Employment Relations in Italy', in Greg Bamber, Russell Lanbury and Nick Wailes (eds.), *International and Comparative Industrial Relations* (London: Sage, 2011).

[19] See Malin Andersson, Arne Gieseck, Beatrice Pierluigi and Nick Vidalis, 'Wage Growth Dispersion Across the Euro Area Countries: Some Stylized Facts', ECB Occasional Paper Series, No. 90, July 2008, Table 5, p.22.

[20] Sebastián Royo, '"Still the Century of Corporatism"? Corporatism in Southern Europe. Spain and Portugal in Comparative Perspective', Centre for European Studies Working Paper Series 75 (Cambridge, MA: Harvard University, 2001), p.14.

[21] At one point, a quarter of all Spanish male workers were employed in construction: Fernández-Villaverde *et al*, 'Political Credit Cycles', p.13.

[22] Ibid., p.12.

wage growth despite nominal wages rising faster than productivity.[23] Spain's boom in consumption was financed by cheap credit and the 'wealth effect' of rising house prices rather than growing real incomes.

In both Spain and Italy, unit labor costs ended up rising rapidly relative to Germany and the Eurozone average, despite workers making relatively limited gains in living standards. The available econometric analysis of wage growth in the Eurozone[24] suggests that our understanding of the reasons for Southern Europe's loss of competitiveness needs to be refined. Although unit labor costs did rise faster in the Eurozone periphery than in the core countries, these rising costs did not reflect an unsustainable rise in real wages. Instead, with the exception of Greece, real wage growth in most of the South was only out of line compared to Germany, and remained in keeping with the rest of the Eurozone.[25] The ECB's analysis also reveals that nominal compensation in the industrial sector (the most exposed to competitive pressure) remained stagnant in Spain and barely increased in Italy.[26] So the emerging imbalances cannot be explained in terms of simple story of union militancy and government profligacy. Instead, the largely neglected role of business elites and other conservative interests needs to enter the equation.

IV: Entrenching a Conservative Coalition: The Unequal Gains of Monetary Union

The experience of economic reform in Southern Europe prior to and after Monetary Union reveals a paradox. The prospect of euro entry galvanized Southern political leaders and social partners to deploy the standard policy tools to address their historic problems of high inflation and periodic devaluations. Euro entry, ironically, implied the dismantling of the institutional arrangements which had secured low inflation in the run-up to the euro: a national central bank with a credible threat to raise rates if wages did not behave, and a government committed to a tight public deficit target. Joining the euro meant that inflationary price hikes or wage rises would no longer necessarily elicit a policy response from the monetary authority.[27] Given the weak state of the German economy in the late 1990s and early 2000s, ECB policy not only would not act to restrain inflation in the Southern periphery, but it adopted what amounted to an aggressively pro-cyclical policy. Not only did this expose the South to a violent downturn after 2007-8, but it had major distributional consequences within Southern societies.

As we saw in the previous section, core production workers in Southern Europe did not make significant gains in living standards during the period of the bubble economy prior to 2008. Neither, contrary to the standard narrative, did the public sector go on an unprecedented spending binge. Instead, the big winners from the resulting boom were to be found in the sheltered sectors of the economy: construction, the services sector (retail,

[23] Royo, *Lessons from the Economic Crisis in Spain*, p.49.
[24] See Andersson et al, 'Wage Growth Dispersion Across the Euro Area Countries'.
[25] Ibid, Tables 3,4, p.19.
[26] Ibid, Table 8, p.29.
[27] Bob Hancké, 'Worlds Apart? Labour Unions, Wages and Monetary Integration in Continental Europe', Working Paper 128 (Vienna: Institute for Advanced Studies, 2012), p.21.

transport, leisure and personal services), and of course, the banks. These sectors had every interest in blocking the kind of reforms that were necessary for the Southern European economies to function within the single currency. Ironically, if the requirements laid down in the Maastricht Treaty had positive effects on the institutional development of the Southern countries in the run-up to Monetary Union, euro entry itself vitiated or even reversed the progress made by reinforcing a coalition of protected groups whose interests diverged from those of the competitive sector of the economy.

The standard narrative of the euro crisis in the political debate, and even in some academic discussion, has blamed Southern European governments for allowing public spending to grow too quickly, leaving them without any room for maneuver when the economy crashed in 2008.[28] The European Commission and other international organizations have identified the inefficiency and corruption of the public sector as a key source of the Southern European crisis. The most egregious example of such profligacy was allegedly Greece, whose longstanding tradition of politicians using public money to buy electoral support and even enrich themselves led to a 'bloated public sector' and spiraling debt.[29] There is plenty of evidence that the public sector in Southern Europe is traditionally subject to partisan political interference, with clientelistic patterns of recruitment, corrupt allocation of public contracts and weak accountability a characteristic of all the Mediterranean democracies.[30] But there is no evidence that this constitutes a proximate cause of the crisis.

<Figure 2 about here>

A look at the data (Figure 2) shows that the Southern European countries do not have particularly high public spending, nor did they exploit falling bond yields to increase public spending before the crisis. Whatever the true extent of clientelism and corruption in the Greek public sector, Greece's government expenditure as a share of GDP is in fact lower than the Eurozone average, and did not show any significant increases until the crisis began in 2007. Whilst Portugal did increase the size of the state after euro entry, the public sector's share of the economy in Greece and Italy remained broadly stable, with a trend over time rather similar to Germany, whilst Spain's public sector shrank relative to GDP. Before the crisis wrecked the Southern European economies, increasing the relative size of their public sectors as automatic stabilizers kicked in, government spending was on average considerably lower than in the 'virtuous' North.

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[28] See the assessment of this debate in 'Profligacy is not the Problem', *The Economist*, 17 September 2011. http://www.economist.com/node/21529087

[29] For typical news story along these lines see John Sfakianasis, 'The Cost of Protecting Greece's Public Sector', *New York Times*, 12 October 2012. http://www.nytimes.com/2012/10/11/opinion/the-cost-of-protecting-greeces-public-sector.html

[30] Jonathan Hopkin, 'Clientelism, Corruption and Political Cartels: Informal Governance in Southern Europe', in Thomas Christiansen and Christine Neuhold (eds.), *International Handbook on Informal Governance* (Cheltenham: Edward Elgar, 2012), pp.198-215.

Neither is there any evidence that Southern European governments systematically expanded public employment after Monetary Union. According to OECD data, Greece did increase the public sector's share of employment between 2000-2008 (from 19.3 to 20.7 per cent), but Italy and Spain both reduced it.[31] The public sector workforce is not, contrary to many lazily researched newspaper articles, disproportionately large in these countries. Although the Greek public sector has a higher than average share of the labor force for the OECD, Norway, Denmark, France, Finland and the Netherlands all have higher shares. In Italy and Spain, the public sector workforce is smaller than in the United States or Britain.[32] The Southern tradition of clientelism, corruption and inefficiency may well make public sector spending less effective in delivering services and redistributing income than in Northern Europe, but that is not in itself a cause of the crisis.

In fact, the accusations of 'profligacy' are more accurately directed at the private sector of the Southern European economies. Government indebtedness in the Eurozone has a much stronger correlation with government revenues than with government spending, and the Southern sovereign debt problem is very obviously a result of the collapse of the tax take in the wake of the crisis, rather than any reckless increase in spending. As Figure 3 shows, the Southern countries had significantly reduced their budget deficits over the 1990s and 2000s, and the uptick in government borrowing in Greece and Italy after euro entry was the result of falling tax revenues, not increased spending. If public spending is lower than the Eurozone average in Southern Europe, this owes a great deal to systematic and longstanding difficulties in levying sufficient tax revenue to pay for a modern state.

<Figure 3 about here>

Part of the reason tax revenues swiftly fell off after Monetary Union is that temporary tax hikes had been a key tool for meeting the convergence criteria.[33] For example, in Italy Romano Prodi's government established a one-off 'Europe tax' (*contributo straordinario per l'Europa*) in 1996, which would in principle be reimbursed at a later time.[34] The South's history of running high deficits reflected a common difficulty in reconciling the interests of upper and lower income groups, which tended to be resolved by expanding state spending through borrowing rather than dealing with endemic tax evasion. Although some reforms to the tax regime were made prior to euro entry, developments afterward

[31] OECD, Employment in General Government and Public Corporations as a Percentage of the Labor Force, 2000 and 2008. http://www.oecd-ilibrary.org/sites/gov_glance-2011-en/05/01/index.html?contentType=&itemId=/content/chapter/gov_glance-2011-27-en&containerItemId=/content/serial/22214399&accessItemIds=/content/book/gov_glance-2011-en&mimeType=text/html
[32] Data from 2008; ibid.
[33] Spyros Blavoukos and George Pagoulatos, 'Fiscal Adjustment in Southern Europe: the Limits of EMU Conditionality', GreeSE Paper No 12 GreeSE Paper No 12, Hellenic Observatory Papers on Greece and Southeast Europe (London School of Economics, March 2008). http://www.lse.ac.uk/europeanInstitute/research/hellenicObservatory/pdf/GreeSE/GreeSE12.pdf
[34] 'Eurotassa con il bonus', *Corriere della sera*, 31 October 1996. http://archiviostorico.corriere.it/1996/ottobre/31/Eurotassa_con_bonus_co_0_9610316799.shtml

show that these longstanding problems had not been resolved. The reasons for this are partly structural, but also political, with center-right parties in particular adopting a relaxed attitude towards the widespread under-reporting of income by small businesses and the self-employed.

In Italy, the Berlusconi government exploited the easing of fiscal pressures after euro entry to reward its many supporters in those sectors. With interest rates on Italian public debt dropping sharply, there was some limited scope to cut taxes, as Berlusconi had promised in his high profile 'contract with the Italians', signed on live TV during the 2001 election campaign. The promise to introduce just two tax rates (23% and 33%) did not come to fruition, but the Berlusconi government did completely abolish inheritance tax in 2001, and tax evasion increased particularly after 2003, breaking a downward trend established under the Prodi governments of the late 1990s.[35] As a result, Italy's primary surplus declined steadily after 2000, although the falling cost of debt service allowed the headline deficit figure to remain within the European Commission's 3 per cent limit. Strikingly, the brief return to office of Romano Prodi's center-left coalition in 2006-7 sparked a dramatic increase in tax receipts as business owners and self-employed professionals reported higher incomes in anticipation of a tougher approach by the revenue services. The highly politicized nature of tax collection was revealed in a high-profile spat between the Finance Minister Vincenzo Visco and head of the tax police (*Guardia di Finanza*), Generale Roberto Speciale, who won election to parliament for Berlusconi's center-right after being fired by Visco.[36] On Visco's last day in office in 2008, the Italian revenue service (*Agenzia delle entrate*) published all that year's tax returns online, an exercise in transparency that lasted less than 24 hours.[37]

The problem of tax evasion is related to industrial structure: Southern Europe has the highest proportion of businesses with less than ten workers in the Eurozone, many of which are family concerns operating in the sheltered sector of the economy (shops, bars, restaurants, transport services, pharmacies, self-employed artisans and tradespeople).[38] Monitoring tax compliance for large numbers of small units is more difficult than in economies with more large companies, and small businesses are concentrated in the sectors more prone to operating outside the formal economy (such as construction and tourism). This diffusion of tax evasion opportunities across broad sectors of the population creates a solid political constituency against a more rigorous and progressive tax collection regime, both through the electoral weight of the numerous small business owners and the self-employed, and through the lobbying of well-organized trade associations.

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[35] Alessandro Santoro, 'Sull'evasione parlano i dati', *LaVoce* 25 May 2010. http://archivio.lavoce.info/articoli/pagina1001732.html

[36] 'Chiuso il caso Visco-Speciale. Archiviazione per il viceministro', *La Repubblica*, 11 March 2008.

[37] 'Il reddito degli italiani su internet poi arriva lo stop del garante', *Corriere della sera*, 1 May 2008.

[38] See data from Eurostat, 'Nearly 40% of persons employed by non-financial enterprises in the EU28 worked for SMEs in 2011', Eurostat News Release 175/2013, November 2013. http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/4-25112013-AP/EN/4-25112013-AP-EN.PDF. Also, Matt Yglesias, 'Southern Europe's Small Business Problem', Slate, 6 July 2012. http://www.slate.com/articles/business/small_business/2012/07/the_small_business_problem_why_greece_italy_and_spain_have_too_many_small_firms_.html

This anti-tax coalition is oriented towards the center-right and reflects both social and cultural traditions and deliberate political strategies deployed by the conservative, and mostly authoritarian political elites that governed across Southern Europe in the post-war period. In Italy this involved the hegemonic Christian Democrats acting to develop and preserve an urban petty bourgeoisie, which could act as a reliable support base as the numbers of rural smallholders declined.[39] Formal and informal fiscal incentives and a protective system of regulation (for example, restrictions of the size of retail spaces or the number of pharmacies owned by the same company) nurtured a growing social class of self-employed and owners of small family businesses. In Spain, the Franco dictatorship's protectionist policies also encouraged the development of small businesses.[40] This industrial culture of small, family-based firms mixed with large, historically state-owned enterprises is common across Southern Europe, and is closely linked to the reluctance of center-right parties in Southern Europe to embrace market reforms that would expose small firms to greater competition and promote economies of scale.

The transition to the new currency proved lucrative to many small businesses in the Southern European service sector, including the retail sector, which in some cases was able to exploit citizens' confusion over the conversion to the euro to trigger dramatic rises in some product markets with limited competition.[41] Southern European inflation rates ran ahead of earnings growth, and the gains for small retail concerns and other small businesses operating in sheltered and heavily regulated markets had significant redistributive consequences, enhancing rents for key supporters of center-right parties whilst reducing purchasing power for salaried workers, who tended to vote for the center-left. By enhancing price competition in the industrial sector, but maintaining much of the protectionism enjoyed by small-scale service sector actors, euro membership shifted the balance of power within the Southern European political economy away from salaried employees and in favor of small business owners and the self-employed.

One area where the euro bubble produced some spectacular gains was in construction and real estate. Spain's housing boom saw prices peak in 2008 at almost twice their 2000 level in real terms, while even in Italy, which did not enjoy significant economic growth in the 2000s, house prices were up 50 per cent at their peak.[42] High levels of home ownership in Southern Europe meant that the resulting wealth effect was spread across broad sectors of the population, which in Spain had a dramatic effect on consumer confidence and in Italy mitigated the effects of slow economic growth. Politically, the housing boom empowered the real estate and construction industries and deepened their (often corrupt) connections to political representatives, particularly local councilors who had control over planning and zoning decisions, and political nominees in regional banks (the *Cajas* in Spain and the *Fondazioni Bancarie* in Italy).[43]

[39] Carlo Trigilia, *Grandi partiti e piccole imprese* (Bologna: Il Mulino, 1986).
[40] Leonardo Caruana, Carlos Larrinaga and Juan Manuel Matés, 'La pequeña y mediana empresa en la edad de oro de la economía española: Estado de la cuestión', *Investigaciones de Historia Económica*, 7(2): 322-33 (2011).
[41] 'Intervista a Marcello di Cecco', *Venerdi' della Repubblica*, 25 August 2011.
[42] Dan Andrews, 'Real House Prices in OECD Countries', OECD Economics Department Working Papers, No.831. Paris: OECD.
[43] See Fernández-Villaverde *et al*, 'Political Credit Cycles', p.15-6.

The political implications of the construction boom demonstrated that rather than eliminating the traditional practices of clientelism and corruption, the restrictions placed on public spending growth by EMU simply displaced the corruption to new areas. Opportunities to hire partisan supporters to public positions were reduced (except to some extent in Greece), but political parties shifted their attention to the corrupt allocation of planning decisions and building permits and the manipulation of public contracts in growing areas such as healthcare and care for the elderly to generate financial resources and political support. In Italy major scandals relating to planning permissions affected the center-left leadership of the Milan province, whilst corruption in the healthcare sector incriminated the center-left leadership in Abruzzo and the center-right in Lazio. In Spain various scandals relating to construction and planning decisions affected major regions such as Valencia and Madrid in particular. Unlike in the case of traditional clientelism and patronage, these new forms of corruption involved a sharing of rents between party politicians in the public sector and private sector companies.

New forms of corruption and rent seeking also appeared through the privatization process and the increasing resort to private provision of public services. Privatized utilities in Southern Europe were sufficiently weakly regulated as to allow energy prices to soar,[44] bringing vast profits to favored investors. The four Southern European countries had the highest natural gas prices after Sweden and Denmark, whilst Italy, Spain and Portugal were all in the top seven EU countries for electricity prices.[45] Regulatory inadequacies reduced disposable income for consumers whilst generating outsized profits for private or semi-private energy companies that in many cases became major players in the financial system. Similarly, privatization opened up opportunities for major private sector investors to take on profitable activities which were often natural monopolies or protected by state guarantees, for example the Benetton group's acquisition of the Italian Motorway network on terms some analysts consider excessively generous.[46]

In sum, euro membership proved profitable to a broad set of well connected and politically mobilized interests that could resist reforms or manipulate the new situation to their benefit. Contrary to the dominant narrative, unionized workers and public sector employees – the classic labor movement 'insiders' – were not the big winners of Southern Europe's participation in EMU. Instead, groups associated with conservative political forces, such as government-regulated industries in the sheltered sector of the economy and more broadly, the small business and self-employed sector, were particularly well placed to ride the boom. When boom turned to bust, policy was refracted through this same power structure.

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[44] For the Spanish case, see Jacint Jordana, 'Multiple Crises or Multiple Adjustments? Dismantling Public Policies in Spain', paper presented at Conference of Europeanists, Amsterdam, 25--27 June, 2013.

[45] Eurostat, 2012. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Electricity_and _natural_gas_price_statistics

[46] Giorgio Ragazzi, 'Un limite ai profitti in autostrada', *Lavoce.info*, 19 July 2006. http://archivio.lavoce.info/articoli/-infrastruttre_trasporti/pagina2287.html

V. The Crisis: Guess Who Pays?

In much the same way as the EU response to the crisis in the South has been macroeconomically pro-cyclical, the ramifications of austerity have also tended to reinforce the social and political inequalities that emerged in the euro era. Although there has been a mix of center-left and center-right political forces in power across Southern Europe in the period since the crisis began, the overriding imperative of deficit reduction through fiscal tightening, and the absence of available monetary levers at the national level, have meant that policy has been little affected by the electoral process. However, EU interventions, by focusing on short-term deficit reduction and shoring up the financial system, have penalized vulnerable groups which gained little from the bubble dynamics of the early euro era, and the social stress resulting from austerity is generating serious threats to the medium term political stability of the region.

The choice for austerity, almost by definition, has regressive distributive consequences. Bailing out investors on the one hand whilst holding down government spending on the other will, all else equal, favor the wealthy at the expense of middle and lower income groups. In Southern Europe, these expectations are borne out by the emerging data on the effects of austerity policies: between 2008-2011, the Eurostat poverty rate grew from 18.3 to 20.7 per cent in Italy, from 18.5 to 22.9 per cent in Greece, and leapt from 15.9 to 21 per cent in Spain.[47] Even more dramatic is the increase in unemployment (2008-2012), from 6.7 to 10.7 per cent in Italy, 8.5 to 15.9 per cent in Portugal, 7.7 to 24.3 per cent in Greece, and 11.3 to 25 per cent in Spain.[48] Not surprisingly this has driven down wages, one of the stated objectives of the fiscal adjustment demanded by the Troika: real wages dropped 20 per cent in Greece, 10 per cent in Portugal, 6 per cent in Spain and 2.5 per cent in Italy between 2010 and 2012.[49] At the same time, EU help has been directed at shoring up the value of government bonds issued by Greece and Portugal, or directly aiding insolvent banks in the case of Spain.

The EU's policy response has therefore piled the burden of Eurozone adjustment not only on the Southern European countries themselves, but it has also defined in large part how that burden would be distributed internally. By bailing out states and financial institutions and intervening to shore up bond markets, the European institutions offered massive assistance to the holders of Southern European financial assets, and the majority of the benefits went to wealthy interests in the Southern European countries themselves, as well as the Northern European banks that were exposed to Southern debt. At the same time, the policy demands made by the Troika in exchange for financial assistance have

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[47] Eurostat, At-risk-of-poverty rate anchored at a fixed moment in time (2005) (percentage of the population whose equivalised disposable income is below the 'at-risk-of-poverty threshold' calculated in the standard way for the base year, currently 2005, and then adjusted for inflation).
http://epp.eurostat.ec.europa.eu/portal/page/portal/income_social_inclusion_living_conditions/data/main_tables

[48] Eurostat, Unemployment rate – LFS adjusted series.
http://epp.eurostat.ec.europa.eu/portal/page/portal/employment_unemployment_lfs/data/main_tables

[49] Klaus Busch, Christophe Hermann, Karl Hinrichs and Thorsten Schulten, 'Euro Crisis, Austerity Policy and the European Social Model', International Policy Analysis, Friedrich Ebert Stiftung, February 2013, Figure 4, p.14. http://library.fes.de/pdf-files/id/ipa/09656.pdf

penalized especially wage earners, public employees and welfare recipients. This approach is in turn driven by the preference for austerity of the German government, the result of Germany's own particular trajectory of stagnation and then recovery since reunification (see chapter 6).

The various memoranda outlining necessary measures as conditions for bailouts paint a picture of the type of economy EU leaders wish to emerge in Southern Europe. Despite the relatively low share of state spending as a share of GDP and the restricted scope of the welfare state in Southern Europe, EU conditionality seeks to pare back welfare provision, focusing particularly on the retrenchment of the most developed dimension of social spending in the region: pensions. There are good reasons for adjusting pensions arrangements in Southern Europe, in particular given the unfavorable demographics of the Southern societies, but the focus on the 'sustainability' of the pensions system fails to consider the role retirees' incomes have in supporting the younger generations, who are less well served by welfare arrangements.[50] Cutting pensions, often presented as a way of securing inter-generational equity, in fact exposes citizens of all ages to increased economic risk,[51] particularly since the European leadership has placed far less emphasis on the expansion of welfare provision for the young, and the deficit reduction requirement makes any increase in spending impossible.

A second major plank of the EU reform drive is to dismantle collective bargaining arrangements.[52] Despite the success of centralized wage deals in curbing labor costs in Germany and other Northern European countries, European policymakers insist that decentralization of bargaining to the firm or individual level is the right approach for Southern Europe. This dovetails with a longstanding policy priority of the political right in the Southern countries, with the abolition of reinstatement rights in Italy (the famous Article 18 of the Labor Code) and the reduction of high dismissal compensation in Spain having been attempted several times before the crisis. Thus the Monti government in Italy made labor market reform a priority, and passed a law which, albeit in a rather ambiguous fashion, sought to increase flexibility in dismissals.[53] In Spain the Rajoy government, freed by its large majority of the need to negotiate with other parties, imposed an apparently more severe reform which aimed to facilitate a shift towards company level bargaining at the expense of national and regional agreements[54]. The common pattern across Southern Europe has been to undermine collective agreements in

[50] Julia Lynch, *Age in the Welfare State* (New York: Cambridge University Press, 2006).
[51] Pensions were the main income in 26 per cent of Spanish households in 2012. Crisis, Spain: Families Supported by Pensioners Tripled', *Ansa.Med* 20 May 2013.
http://www.ansamed.info/ansamed/en/news/nations/spain/2013/05/20/Crisis-Spain-families-supported-pensioners-tripled_8735227.html
[52] See Busch *et al*, 'Euro Crisis, Austerity Policy and the European Social Model', pp.10-13.
[53] Maria Teresa Carinci, 'The Italian Labour Market Reform Under the Monti Government (Law No.92/2012), *European Law Journal* 3(4): 305-16 (2012).
[54] Ken Dubin, 'Redefining Insiders: Labour Market and Pension Reform in Spain', paper presented at 20th Conference of Europeanists, Amsterdam, 25-27 June 2013.

favor of a more decentralized, market-driven set of arrangements, under explicit pressure from the European institutions.[55]

The choice for internal devaluation and fiscal austerity as the main response to Southern Europe's crisis has marked political and social consequences for the debtor countries. It imposes quite clearly a more liberal set of economic and welfare institutions, and uses the financial vulnerability of the Southern countries as a battering ram to force through reforms which have long been urged upon them, but which have met sustained resistance in the past. These reforms favor financial and business interests in the South, at the expense of middle and lower income groups. The so-called 'insiders' often blamed for the crisis – stably employed and unionized industrial and public sector workers – have been handed the bill for the crisis, provoked almost entirely by circumstances outside their control, and from which they did not noticeably benefit. Whilst European structural reform demands have included product market, as well as labor market, reform, the latter has clearly been the priority, whilst rent-seeking SMEs in the sheltered economy have largely been let off the hook. The final section assesses the political reactions to these policies in Southern European societies.

VI. The Political Response: Populism vs Technocracy

Southern Europe's experience of the crisis amounts to a major social and political experiment. No member state has faced such a sustained economic downturn in the history of the European integration process, and the only comparable case of prolonged economic contraction on the continent is the unpromising case of the 1930s, which put a brutal end to the first democratic experiences of Germany and Spain. Adding to the mix is the relative youth of the democratic regimes established in the 1970s in Greece, Portugal and Spain, and the turbulent history of democracy in Italy, which experienced a sustained wave of political violence from the late 1960s until the mid-1980s. The choice for austerity constitutes a 'crucial case' to test Barry Eichengreen's thesis that internal devaluation is incompatible with democratic rule.[56]

The political consequences of the crisis so far suggest Eichengreen is right. Since the crisis began, all the parties of government in Southern Europe have been defeated and non-traditional political movements have gained new electoral opportunities. If we take the Lehman Brothers bankruptcy as the start point of the crisis, there have been seven elections in the four Southern European countries, of which five have resulted in changes of government (and one was a repeat election held in Greece under a caretaker administration). Table 1 shows that incumbents have not only tended to lose power, but have also suffered major (and at times spectacular) declines in electoral support, and that

[55] The Euro Plus Pact was quite open about its preferences in this regard; see European Council, 'The Euro Plus Pact: Stronger Economic Policy Coordination for Competitiveness and Convergence', Conclusions of the European Council of 24-5 March 2011, Annex 1, EUCO 10/1/11 REV1. Brussels: European Council. Cited in Busch *et al*, 'Euro Crisis'.

[56] Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression 1919-39* (New York: Oxford University Press, 1996); see also 'Is Europe on a Cross of Gold?', *Project Syndicate*, 11 May 2012. http://www.project-syndicate.org/commentary/is-europe-on-a-cross-of-gold-

in some cases all the mainstream parties have been collectively penalized by frustrated voters, leading to surges in support for new or previously marginal political parties. The success of populist and other non-mainstream parties across Europe in the 2014 European elections shows that this development is not confined to the South.

<Table 1 About Here>

The main victims of austerity have been the parties of the center-left that governed in Greece, Portugal and Spain as the crisis hit. The Portuguese and Spanish socialist parties (PS and PSOE), both of which were in government through the pre-crisis years, suffered serious defeats: the PS dropped from 45 per cent of the vote in 2005 to 28.1 per cent in 2011, whilst the PSOE dropped from 43.9 per cent in 2008 to just 28.8 per cent in 2011, in the space of only one legislature. The Greek socialists (PASOK), who returned to power in 2009 with 43.9 per cent of the vote, were reduced to 12.3 per cent just three years and two elections later. Even the Italian center-left Democratic Party (PD), in opposition for most of the 2008-13 parliament, managed to lose 8 per cent of the vote, whilst Berlusconi's People of Freedom party, the incumbent government until a year earlier, lost 16 per cent. In short, the mainstream political parties that have articulated governing coalitions for decades have suffered historic defeats, opening up a political vacuum.

Into this vacuum have rushed two entirely contradictory political forces. On the one hand, the near impossibility for professional politicians of winning election whilst approving swinging austerity measures brought recourse to governments of technocrats in Greece and Italy. The Papademos government of national unity in Greece between 2011-12, and the Monti government in Italy in 2011-13, represented a doomed attempt by the Troika to impose its preferred policies by legislative fiat, bypassing the normal democratic channel of inter-party competition for power. Both men represented the kind of pro-market and pro-business mind-set preferred by the Troika institutions: Papademos an MIT-trained academic economist and central banker, Monti a Bocconi-trained academic economist and former European Commissioner. The brief and unstable tenure of these governments, subject to the maneuverings of political parties concerned at the electoral fall-out from austerity measures, proved technocracy to be little more than an emergency measure to secure short-term objectives.

The failure of both technocratic and partisan governments to end the crisis, and the obvious curtailment of national sovereignty resulting from the various bailout arrangements, opened up a political space for new political forces opposed both to the austerity measures and to the existing political elites. The established parties' shared adherence to the austerity program highlighted the lack of real political competition and exposed the collusive behavior of the main political leaders.[57] In Greece and Italy, the

[57] The consensus around austerity implied a stark example of the politics of the 'cartel party': Mark Blyth and Richard Katz, 'From Catch-All Politics to Cartelization. The Political Economy of the Cartel Party', *West European Politics* 28(1): 33-60 (2005).

experience of technocracy coincided with an acute crisis of popularity for the mainstream parties, and the rapid rise of new political forces which expressed resentment towards the 'political class' and hostility to the austerity program. The collapse of the PASOK vote corresponded to the remarkable rise of the more populist left party Syriza, which opposed the austerity measures and expressed skepticism towards the European institutions, whilst on the extreme-right the neo-Nazi party Golden Dawn leapt from almost nothing to 7 per cent of the vote. The current pro-austerity coalition in parliament, comprising the conservative New Democracy (ND), what is left of PASOK and one further minor party, has less than 50 per cent of the vote and is only able to sustain a government because of the 50 bonus seats allocated to ND as the largest party under Greece's semi-majoritarian electoral law. The parties of this governing coalition won only 31 per cent of the vote in the 2014 European Parliament elections, in which Syriza was the largest party with 27 per cent, and the neo-Nazi Golden Dawn came in third with 9 per cent. The Greek party system, relatively stable until 2009, is increasingly polarized and unable to generate cohesive governments.

In Italy the Monti government ended with the scheduled election held in spring 2013, which the center-left opposition party, the PD was widely tipped to win. Monti himself decided to stand for election at the head of a centrist coalition led by a small Christian Democratic party with strong backing from the employers' federation Confindustria. The result of the election confirmed how unimpressed Italian voters were with the austerity measures pushed through by the technocrats. Monti's coalition won a disappointing 10.5 per cent, and the PD, which had enthusiastically supported Monti's administration, failed to win its expected overall majority, polling 3.5 million fewer votes than in its defeat to Berlusconi in 2008. The big winners of the 2013 election were the Five Stars Movement (M5S), led by comedian Beppe Grillo, standing for the first time in a national election. The M5S won 8.7 million votes to become the largest single party in the Italian parliament (more than the PD, although the center-left coalition collectively emerged as the largest political force). The PD's disappointing performance led to an internal coup as Matteo Renzi, the rising star of the party's more centrist wing, took over first the leadership and then the Prime Minister's office, polling an impressive 40 per cent of the vote in the 2014 European elections.

The M5S and Syriza represent dramatic upheavals in their respective party systems. Whilst the stability of European electoral politics has declined over the past two decades and new parties have been more and more successful in many countries, the speed with which these parties have grown, conquering more than a quarter of the vote in the space of less than five years, is almost unheard of in recent electoral history. Both parties have latched onto popular resentment over the way in which the crisis is being managed and in diverse ways have challenged the pro-Euro mainstream consensus. The M5S has played an ambiguous game on austerity and the euro, but has talked openly about debt restructuring and promised a referendum on the euro in its 2013 election campaign.[58] Syriza on the other hand has remained committed to the euro, but opposed to the austerity

[58] Beppe Grillo, *Lettera agli italiani*. 6 February 2013.
http://www.beppegrillo.it/2013/02/lettera_agli_italiani.html

measures imposed by the Troika.[59] Both parties express popular frustration at the lack of open political debate and competition between the established party elites. The rise of Matteo Renzi, whilst helping revive one of the mainstream parties, is also a sign of political change. Not only has he introduce a very new, 'Americanized' style of leadership to Italy, he has also begun to challenge the austerian approach of the European Union to managing the crisis.

In Spain and Portugal, party system change has been less dramatic, but the mainstream parties are still shedding support. In the Spanish case, the most destabilizing development is at the territorial level, with the Catalan nationalist movement's shift towards a pro-independence strategy. Catalonia represents a fifth of Spanish GDP and is its fourth richest region in per capita terms. Catalan independence is vehemently opposed by the main Spanish political parties, and there is at present no constitutional mechanism for secession to take place. However recent surveys suggest that the referendum on independence promised by the Catalan governing parties could possibly deliver a majority for leaving Spain.[60] At the same time, the most successful new party in recent elections, the UPyD led by former Basque Socialist Rosa Díez, uses a strong anti-regionalist discourse, suggesting a radicalization of the sensitive territorial debate in Spain. The 2014 European elections saw the emergence of an entirely new left party, Podemos, led by a Madrid university professor and talk-show host, which was formed only three months before the poll but managed to win 8 per cent of the vote. Alongside the impressive 10 per cent won by Spain's historic left party Izquierda Unida, this amounts to a major signal of popular impatience with the performance of the two largest parties, the PP and PSOE, who between them lost the support of almost a third of the Spanish electorate since the 2009 European vote.

These developments pose a very obvious threat to the EU leadership's strategy for dealing with the Southern European crisis. The failure of technocracy to provide a sustainable route to imposing internal devaluation leaves the electoral route as the only one available. Yet Southern European voters are increasingly reluctant to vote for the reliably pro-European parties that have dominated their party systems ever since the 1980s, and the socialist parties, the key to integrating the working class into a neoliberal economic framework, have suffered the most serious declines in support. By forcing established national political elites to implement painful austerity measures which have led to further economic collapse, the EU leadership is running the risk of destroying the political forces that have articulated support for European integration and liberalizing reforms in Southern Europe.[61] Moreover, the austerity measures have undermined

[59] Baptiste Dericquebourg, 'Where Syriza Stands', *Le Monde Diplomatique*, 7 July 2013. http://mondediplo.com/2013/07/07syriza

[60] 'Hipotético referendum sobre la independencia de Cataluña', *El País Metroscopia Blog*, 21 November 2012. http://blogs.elpais.com/metroscopia/2012/11/hipotetico-referendum-sobre-la-independencia-de-catalunya.html

[61] See the data on declining public confidence in democratic institutions in Sonia Alonso, 'The Growing Ideological and Economic Breach Between Northern and Southern EU Countries is Pushing Europe Towards a Perfect Storm', *LSE EUROPP Blog*, 22 July 2013. http://blogs.lse.ac.uk/europpblog/2013/07/22/the-growing-economic-and-ideological-breach-between-northern-and-southern-eu-countries-is-pushing-europe-towards-a-perfect-storm/

support for the European Union in the South, with only 33 per cent of Greeks and 46 per cent of Spaniards having a favorable view of the EU in 2013.[62]

The depth of the crisis is placing the democratic institutions at the member state level, and the relations between the member states and the European Union, under unprecedented strain. Although there have been a wide variety of grassroots protests against austerity, particularly in Greece and Spain, popular frustration has so far been largely articulated through formal democratic channels. One safety valve is the opportunity of migration, which enables many younger, and particularly better educated, Southern Europeans to exercise an 'exit' option rather than remain and seek to force change through 'voice'.[63] This, of course, exacerbates existing demographic imbalances in Southern Europe, subtracting the most productive citizens and increasing the relative size of the dependent population. But with unemployment hitting 2/3 of Greeks under 25, opportunities for migration may prove the best defense against political instability and even democratic collapse.

VII. Conclusion

The debt crisis in Southern Europe is first and foremost a particular regional manifestation of the broader global economic crisis that began with the unwinding of an over-leveraged global financial system in 2007, and has been magnified and intensified by the institutional failings of European Monetary Union. Yet the response to the crisis has focused on the perceived policy errors and historical institutional weaknesses of the Southern Europe states themselves, with a contractionary fiscal policy prescribed as the main remedy. This response has not only decimated the Southern European economies by adding a deliberate squeeze in demand to an exogenous demand shock, it has eaten away at the principal mechanisms for channeling popular participation through democratic institutions: the political parties.

This constitutes a major natural experiment with very high stakes. There is no historical precedent for adjustment on this scale in a democratic context, and the current approach is counting on Southern European citizens maintaining an unwavering commitment to the euro to justify years of sacrifice with no end in sight. Even in the best case scenario, living standards are unlikely to recover in the short term, casting doubt over the sustainability of popular acceptance of the single currency and its institutions. But worse, the current policy mix appears doomed to failure. Italy, carrying a public debt of over 130 per cent and with negative average growth since euro entry in 1999, will be unable to sustainably service its debt burden, even with ECB help, unless growth returns. Yet the austerian policies imposed from Brussels and Frankfurt make such growth highly improbable, even in the unlikely scenario of Italy implementing all the recommended structural reforms. In sum, countries such as Italy are being invited to stagnate for the indefinite future, whilst implementing unpopular policies imposed upon them by largely

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[62] 'The New Sick Man of Europe: The European Union', cit.

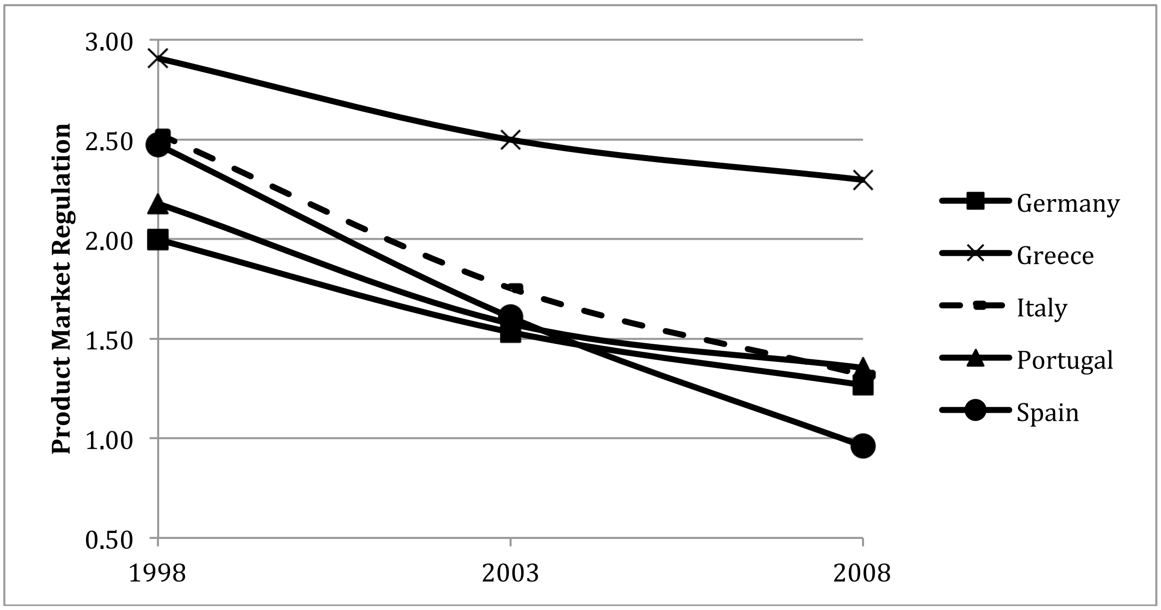
[63] Albert Hirschman, *Exit, Voice and Loyalty. Responses to Decline in Firms, Organizations and States* (Cambridge, MA: Harvard University Press, 1970).

unelected supranational institutions. Not surprisingly, as soon as a credible politician with popular support has emerged, such as is the case of Matteo Renzi in Italy, his first move has been to question the constraints of the Fiscal Compact.

Europe is engaged in a major gamble, and the elections held since the crisis began have brought major transformations to what were relatively settled patterns of citizen representation and party competition in Southern Europe. The lack of concern for the electoral process reflects an approach to the political economy in which democratic accountability takes second place to the nebulous notions of investor confidence and credible policy commitments. Bypassing the democratic process is presented as a necessary part of the cure for Southern Europe's economic malaise, so that the verdict of the market and the policies of the experts can take center stage in the policy process, overriding citizen demands for social protection.

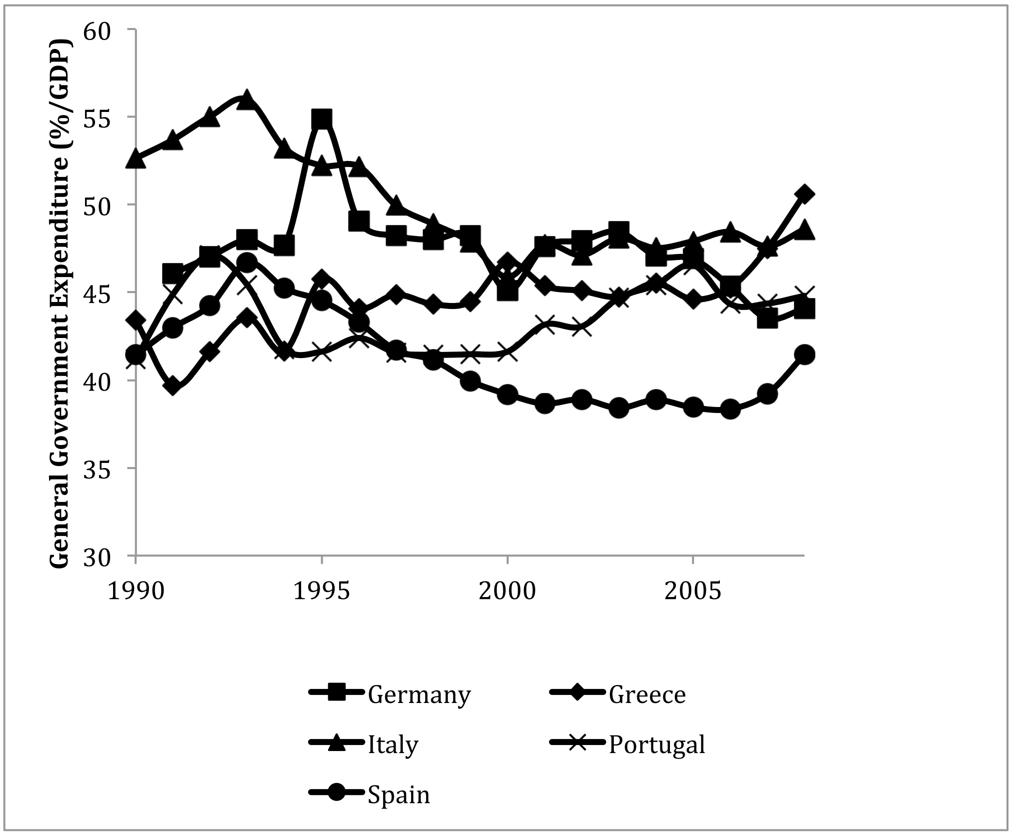
The success of this strategy rides on whether the European Union's leaders have correctly assessed the Southern European electorates' patience and endurance. Needless to say, the collapse of political authority that could result from prolonging the squeeze on the Southern European economies threatens the euro project itself. Greece, Italy, Spain and Portugal constitute a third of Eurozone GDP, and their departure would mean the end of the euro as it has been imagined up to now. Such an outcome remains unlikely, and current Eurozone policy assumes that Southern Europeans will do 'whatever it takes' to stay in the euro, as their remarkable resilience in the face of a catastrophic and abrupt drop in living standards suggest. But the evidence of a sharp decline in pro-European sentiment, and the tenuous grip on government power of pro-European political forces across the four countries, cautions that this assumption will be tested to the limit in the coming years. In the absence of a compelling economic rationale for a single currency covering the whole European Union, the euro has always been an essentially political project. Yet, the current crisis is not only undermining the euro, but also the European Union more broadly, encouraging the emergence or strengthening of anti-EU forces and weakening the commitment to the EU not only in the struggling periphery, but also in the bailout-fatigued core. The European project of 'ever closer union', in which each step towards integration begets further reforms, may have run into the buffers. The founders of monetary union may come to regret pinning the future of Europe to a now discredited economic dogma.

Figure 1:
Product Market Regulatory Reform in Germany and Southern Europe



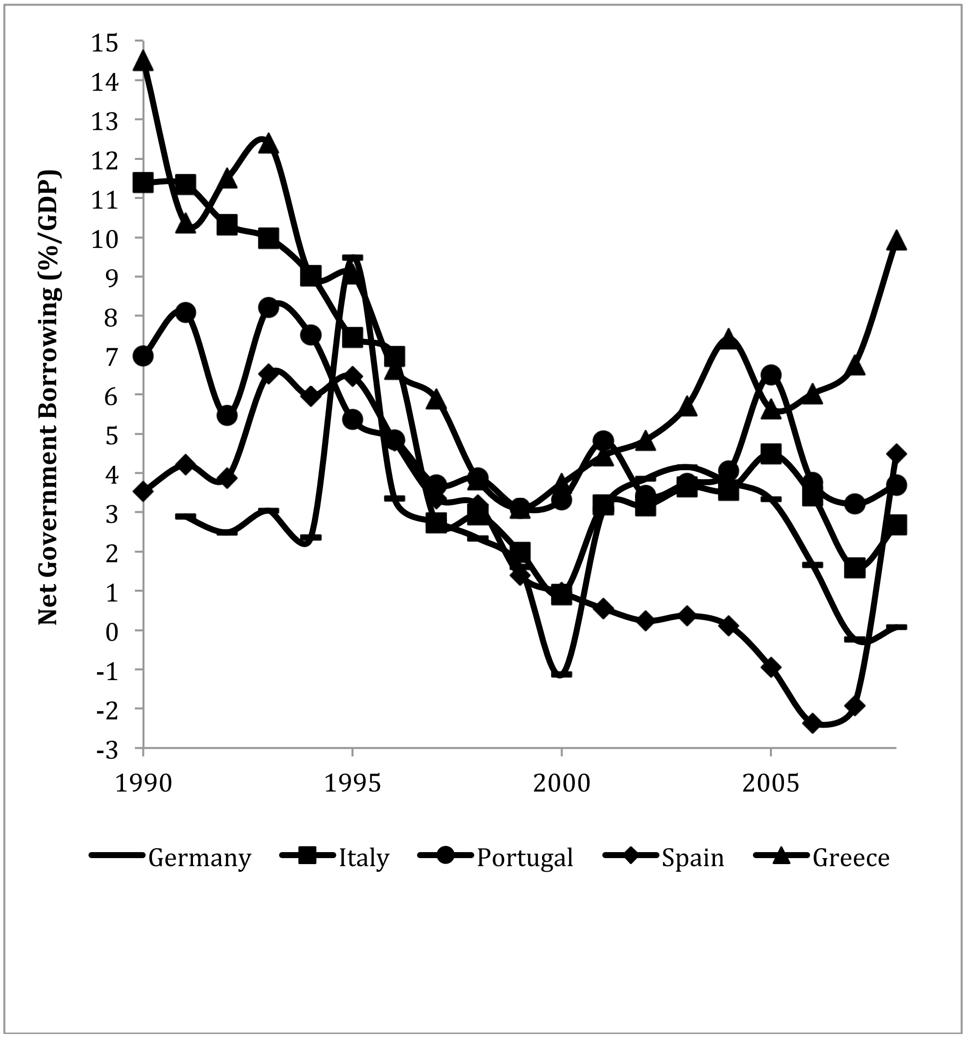
Source: OECD, Product Market Regulation (PMR) Indicator (higher values = more regulated product markets)
http://www.oecd.org/eco/reform/indicatorsofproductmarketregulationpmr.htm

Figure 2:
Government Expenditure in Germany and Southern Europe
1990-2008 (% GDP)



Source: IMF World Economic Outlook

Figure 3:
Government Borrowing in Germany and Southern Europe
1990-2008 (% GDP)



Source: IMF World Economic Outlook

Table 1
Electoral Change and Government Turnover in Southern Europe 2008-13

Election	Government turnover	Change in incumbent vote share	New entrants vote share
Portugal 2009	No	-8.4%	0
Greece 2009	Yes	-8.4%	0
Portugal 2011	Yes	-8.5%	0
Spain 2011	Yes	-15.1%	1.8%
Greece May 2012	No	-30.7%	13.1%
Greece June 2012	Yes	-0.9%	0
Italy 2013	Yes	-8%	25.5%

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