

Austerity and Adjustment from the Great Recession to the Pandemic—and Beyond

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# Austerity and Adjustment from the Great Recession to the Pandemic—and Beyond

*Klaus Armingeon and Stefano Sacchi*

## Introduction

In the period between 2010 and 2015, almost all democratic countries pursued austerity in an attempt to reduce public deficits. Then countries exited austerity, although following different paths. The onset of the COVID-19 pandemic brought about a hike in public spending to cope with its social and economic consequences that did, however, plant the seeds of future economic adjustments. On September 10, 2021, finance ministers of eight European Union (EU) Member States—among them the Netherlands—signed a letter calling for a renewed effort to “reduce excessive debt” among EU member states (EUObserver 2021). In particular in the Eurozone, the constraints of a monetary union without a fiscal union may force political leaders to think about another round of austerity after the pandemic, at the same time monetary policy will have become less accommodating. The basic rationale for such austerity may be to avoid the possibility that high levels of public debt in some Member States will pave the road to increasing spreads, thereby increasing the likelihood of a need for bailouts.

Fiscal policy in the Great Recession and its aftermath may offer some lessons for fiscal policy in the aftermath of the pandemic. Since fiscal policy sets the framework for social policy spending, insights from the period between 2010 and 2019 may be helpful to understand policymakers’ options once governments exit from expansion and are once again forced to embark on the reduction of excessive debt.

In this chapter we study the political strategies and options of governments during austerity periods using a new dataset on austerity during the 2010s for 30 democratic nations. We complement that quantitative analysis with a case study of Italy, showing the processes and causal relationships leading to the

decisions to enter and to exit austerity. We ask where and when democratic politics mattered in designing and implementing austerity, from the Great Recession to the COVID-19 pandemic. Our main finding is that austerity policy—defined as cutting the deficit—was mostly driven by economic forces and institutions. Then we focus on the process of exiting austerity. Contrary to our findings regarding entry into austerity, we show that exit from austerity cannot be sufficiently explained by changed economic fundamentals. Rather, the longer governments pursue austerity, the more likely they are to exit it, even if the economic fundamentals do not support it.

### Theory and Hypotheses

Austerity can be understood as an economic requirement under specific economic conditions that cannot be disregarded by political actors. This widely shared belief can be traced back to John Locke and others (see Blyth 2013, chs. 4–6). If a national government continuously spends more than it receives, this will result in economic problems such as inflation and rising public debt that must be serviced with ever-increasing interest payments. In addition, expansive policies reduce the credibility of national governments in international financial markets, thereby increasing the risk premiums on interest rates of government bonds. Therefore, in order to sustain the system, the function of government is to ensure that fiscal policy is not crisis-prone. The greater the economic problems, the greater the necessity of fiscal consolidation. This is a standard argument that underlies the debates that took place in the world of politics during the “Great Recession,” such as in the European Council, by policy advisors such as the International Monetary Fund (IMF 2010a), or in scientific debates (Wagschal and Wenzelburger 2008; Schäfer and Streeck 2013, 1).

This is a biased perspective, however. It ignores the possibility that public spending may boost economic growth and thereby lead to increased tax revenues, which may cover even more than the previous spending. It also ignores the fact that austerity may shrink the economy and increase unemployment because of decreased demand. As a consequence, tax revenues decrease and result in increasing public debts and deficits. All this makes clear that austerity is just a policy idea—and, some hold, it is a very bad idea (Blyth 2013). Hence there is no such thing as an “Iron Fist” that necessarily forces governments onto a path of austerity once spending exceeds revenues. Rather, the pressure to pursue

austerity is the outcome of the perceptions and evaluations of economic and political actors. If, for example, an international rating agency concludes that a given level of debts and deficits is unsustainable for a country, this country may run into problems with borrowing on international financial markets (Barta and Johnston 2018, 2021). The reason is that banks receive the signals of the rating agencies and start to lose trust that the government will be able to pay back its debts. By implication, interest rates may then spiral upward, making debt service by that government increasingly difficult.

The economic ideas of powerful actors have far-reaching consequences for democratic politics on the level of the nation state. For example, between 2010 and 2015 the Greek government had to pursue tough austerity policies. However, Greek citizens were not convinced of the appropriateness of this strategy and did not mandate their government to accept austerity requests by international and supranational organizations such as the IMF and the EU backed by German or Dutch governments. At the same time, the German citizens—based on their views on fiscal policy—did not mandate their government to be generous to Greece. Greek austerity was not compatible with Greek democracy, while an expansive policy was not compatible with German democracy. But in the end, the most powerful actors acted on their ideas and realized their goals.

At the beginning of the Great Recession, governments initially reacted with a short-term Keynesian policy by expanding domestic demand. However, by 2010 they started to exit this strategy and increasingly opted for austerity. They were pressured to do this by international financial markets following the advice by rating agencies and by international and supranational actors such as the IMF and the EU. The perspective of the IMF, EU, and international markets was based on the notion that austerity was the only game in town (Armingeon and Baccaro 2012). The worse the fiscal situation of countries was, the more this notion applied. Hence under strong market and political pressure, such as in the Great Recession, governments had little choice in designing fiscal policies: they were forced onto a path of austerity, otherwise international financial markets or international institutions would have sanctioned them. One of the major factors that preempt political decisions in fiscal policy are the rules of the Economic and Monetary Union (EMU) to impose prudent fiscal policy on all EU members, and on the Eurozone members in particular (Heins and de la Porte 2015). Even if governments doubt the beneficial effects of austerity on economic growth under severe external constraints, during the Great Recession they felt forced

to implement austerity. For these reasons, we assume that in a severe fiscal crisis the size of austerity is initially determined by the levels of economic and fiscal problems.

**H1: At the beginning of a severe crisis, austerity is determined by economic and fiscal fundamentals.**

In theory, in the medium to long run austerity may lead to more growth, less unemployment, and reduced debts and deficits (Alesina, Favero, and Giavazzi 2019). In the short run however, it may be contractionary and lead to less growth and more unemployment. Already in 2010, the IMF argued that austerity typically leads to reduced economic growth for about two years after the policy has been implemented (IMF 2010b, 93–124). In 2016 IMF economists argued that “(f)aced with a choice between living with the higher debt—allowing the debt ratio to decline organically through growth—or deliberately running budgetary surpluses to reduce the debt, governments with ample fiscal space will do better by living with the debt. . . . Austerity policies not only generate substantial welfare costs due to supply-side channels, they also hurt demand—and thus worsen employment and unemployment” (Ostry, Loungani, and Furceri 2016, 40).

Austerity inflicts pain on the citizenry: welfare expenditures writ large are reduced, while unemployment increases. Hence the economic benefits of austerity are at best uncertain. The longer a government sticks to tough austerity while the policy does not quickly ameliorate the economic and fiscal situation, the higher the likelihood that the administration will find that it is riding a dead horse; then this learning should motivate political elites to dismount the beast. At least over time, and lacking economic success, it will get harder and harder for the governing coalitions to craft consensus for further reducing the deficit, and it will be increasingly difficult to defend arguments against such policy.

In addition to learning effects and policy disappointment, politicians must fear that they will be punished by citizens. While there is some (limited) empirical support for the notion that citizens recognize and support austerity policies (Alesina, Favero, and Giavazzi 2019; Arias and Stasavage 2019, Bechtel, Hainmueller, and Margalit 2017, 2014; Bansak, Bechtel, and Margalit 2021), evidence is accumulating that long-term austerity measures are risky from an electoral perspective (see, e.g., Bojar et al. 2022; Bremer and Bürgisser 2023a, 2023b). According to the literature on economic voting and welfare state retrenchment, we would expect that austerity damages

the reelection prospects of governments, particularly if austerity is at the center stage of the electoral campaign (Hübscher and Sattler 2017; Giger and Nelson 2011). This applies in particular to the post-2010 crisis period (Talving 2017). During periods of fiscal consolidation, the tensions between the assumed long-term benefits of the policy and the short-term electoral risks increase (Fernandez-Albertos and Kuo 2020; Hübscher, Sattler, and Wagner 2021; Jacques and Haffert 2021). Therefore, rational governmental parties should shy away from fiscal consolidation the longer it lasts, unless the beneficial effects for growth and employment have kicked in.

Relatedly, the less citizens support austerity, the less governments may feel legitimized to cut deficits and therewith public spending. If citizens are strongly convinced of the beneficial effects or the unavoidability of austerity, this creates quite different room for maneuver by the national governments as compared to a situation when a large share of the citizenry is convinced that austerity is a bad thing. Hence decisions to enter or quit austerity may also reflect the opinions of the citizens on spending and saving policies. Arguably, at the beginning of a phase of austerity policy, many citizens may agree on fiscal reforms. However, the longer the policy lasts and the less the beneficial effects of the policy are visible, the more citizens may lose trust in the policy.

Finally, and closely related to potential electoral punishment and receding public support for austerity, governing parties may fear the rise of challenger parties, which are in almost all cases at the extreme left or right of the political spectrum. These challenger parties may even gain sufficient votes to enter government. They criticize the precedence of international decision-making and fiscal criteria over the national welfare state and its underlying democratic politics (on the left), or they point to the loss of national sovereignty (on the right). Famous examples are the “Lega” in Italy or “SYRIZA” in Greece. Under these conditions, and depending on national configurations of political power outside and within parliament, mainstream governing parties come under considerable pressure when pursuing austerity.

To summarize, political disappointment combined with policy learning, potential electoral punishment, and the growing weight of challenger parties in national politics provide strong incentives for governments to relax their austerity policies, even as external pressures from international markets and organizations continue.

**H2: The longer governments pursue austerity, the less ambitious their plans for fiscal consolidation become.**

While we argue that learning, potential punishment, low or declining public support for austerity, and the rise of challenger parties are the causes of waning government willingness to give in to external pressures for austerity, it is of course difficult to model statistically these interrelated causes and their outcomes. In the statistical analysis we will present some direct effects, but this is insufficient for a systematic quantitative test. For these reasons, in a qualitative case study on Italy, we will illustrate the size and interaction of these causes of declining governmental willingness to pursue austerity policies—something that can be called “austerity fatigue.”

There may be additional competing or complementary hypotheses about entering and exiting austerity based on such variables as the ideology of political parties, an electoral calendar that puts competing elites under pressure, or the options in decision-making of minimal winning versus broad coalitions in government. We will enter these variables into our statistical models.

## Cases, Data, and Methods

### Data and Dependent Variable

When the Great Recession started in 2007 in the United States, initially most governments in democratic capitalist nations embarked on temporary counter-cyclical policies. By around 2010, these strategies were replaced by tough austerity. We focus on this period of comprehensive austerity and its aftermath until the start of the pandemic in 2020. In the spring of 2020, governments and international institutions concluded that only expansionary policies would be able to combat the economic consequences of the COVID-19 pandemic crisis. Therefore, they buried the idea of austerity—at least for the time being.

Austerity is defined as cutting public deficits. Synonymously, we speak of fiscal consolidation. In our statistical analysis we focus on planned consolidations, namely what governments intend to do compared to the status quo. These data are provided by the IMF. They are based on information given by governments about budget decisions and their fiscal implications. Based on adopted public policies with fiscal implications, the IMF calculates the future public deficits of a member country. The IMF starts from information of national administrations on budgetary and macroeconomic data. It

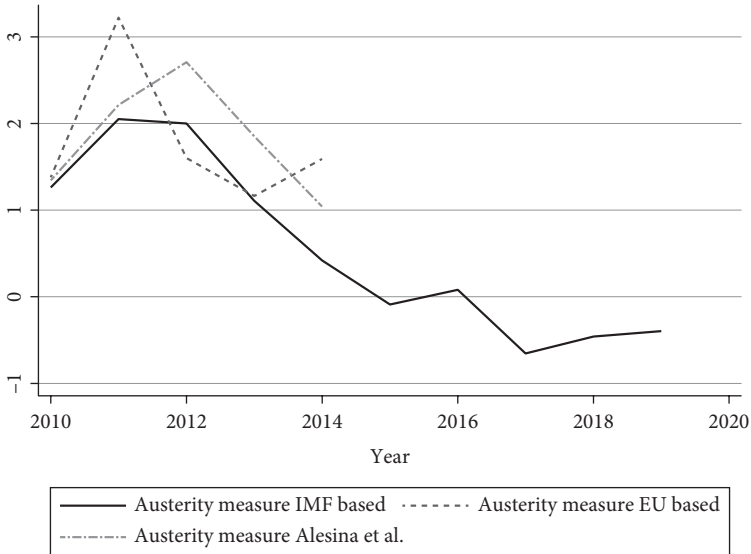
adjusts for its own macroeconomic and fiscal assumptions.<sup>1</sup> It goes without saying that there may be deviations from these projected deficits if economic growth, revenues, or expenditures do not correspond to projections due to unforeseeable economic changes such as an international crisis, or unforeseeable changes in expenditures due to events like a natural catastrophe or unexpected migration influx. However, these data on planned deficits are not mere window dressing for the general public and international markets. They reflect adopted policy measures and credible commitments of tax and spending policies.

We use 19 editions of the IMF *Fiscal Monitor* and their underlying electronic databases. The first *Fiscal Monitor* was published in the fall of 2010; the latest *Monitor* we use is from October 2019. There are two editions of the *Fiscal Monitor* in every year, one in spring and one in fall. Each of these publications lists the historical data on deficits and the planned deficit, calculated according to the methodology described above. We calculate the intended change of structural primary deficits (“cyclically adjusted primary balance”), or primary deficits that are already adjusted for cyclical influences. Primary balances are balances net of interest payments. Structural balances are adjusted for the business cycle. Hence, our measure indicates discretionary governmental decisions on budgets net of interest payments. Arguably, this is exactly what governments can and do decide about.

For each *Fiscal Monitor*, our measure of austerity is the difference between planned cyclically adjusted primary balances in the year after the publication of the *Fiscal Monitor* and the actual cyclically adjusted primary balance in the year before the publication of the *Monitor*. A positive value means that the government strives for a smaller deficit in the coming year as compared to the previous year, hence it is engaging in austerity. A negative value indicates expansionary policy, that is, the government plans a deficit in the coming year that is larger than the deficit in the previous year. This operationalization is superior to outcome measures such as actual changes in deficits, which reflect many more economic and societal changes rather than just political decisions on revenues and spending. Likewise, it is more precise than vague statements about fiscal planning that are not transposed into policy decisions. Finally, some austerity plans cover various years. By using

<sup>1</sup> See for example <https://www.imf.org/en/Publications/FM/Issues/2019/09/12/fiscal-monitor-october-2019> and the respective section on methodology.





**Figure 2.1** Austerity measures. Sources: IMF (various years) *Fiscal Monitor*; Alesina/Favero/Giavazzi 2019; Guthmann 2021.

annual data, we cover all austerity programs that are in effect for a given year. We have data for 30 countries of the democratic OECD and EU countries (excluding Bulgaria, Cyprus, Croatia, Estonia, Luxembourg, and Malta, for which long-term series of cyclically adjusted primary balances are not available).<sup>2</sup> Since we use the information from 19 editions of the *Fiscal Monitor*, we have 19 observations of fiscal policy for each country.

We checked our data against other datasets that are based on “narratives” of spending plans. These are the time series produced by Alesina and colleagues (Alesina, Favero, and Giavazzi 2019) and by Guthmann (2021, 40). Figure 2.1 depicts the average austerity in 30 countries based on our measure as compared to the figures by Alesina et al. and Guthmann for their respective samples. The obvious advantage of our dataset is that it ranges to the fall of 2019, while the time series by Alesina et al. and Guthmann stop in 2014. We believe that the similarities among the three time series are substantial, giving us confidence in our measurement.

<sup>2</sup> For Latvia, data are available only for *Fiscal Monitor* April 2013 and later.

## Independent and Control Variables

### Economic Variables

We measure *fiscal pressures* by the interest rates (10-year interest rates on government bonds), the level of sovereign debt, and the current account, with the expectation that countries that have a negative current account are under much greater pressure to adjust. Likewise, we used economic openness (imports and exports as % of GDP) as an indicator of the extent to which a country is integrated in (and vulnerable to) world markets.

Another set of variables indicates the *economic costs of internal devaluation*. Following Stefanie Walter (2016; Walter et al. 2020) we assume that these costs correspond to the pains of implemented austerity. Prominent among them is depressed economic growth and rising unemployment.<sup>3</sup> If the previous level of growth is high, and the increase of unemployment is low, governments should be less hesitant to pursue fiscal consolidation. In contrast, if a country was already suffering from low growth and rising unemployment, austerity policies would intensify these problems. Therefore, governments may shy away from introducing further fiscal consolidation.

Also, austerity can be avoided—at least in the short run—if a country pursues *external devaluation*.<sup>4</sup> Countries can only externally devalue if they are not in a currency union; that is (as in our sample), if they are not members of the Eurozone. Being in the Eurozone shifts all efforts onto internal devaluation, since external devaluation is not feasible—unless governments accept the costs and risks of leaving the EMU. Hence, other things being equal, we expect a generally higher level of austerity within the group of Eurozone members.

### Political Variables

Moving to political variables, we test whether, once in government, *left parties* are most hesitant to translate external pressure for internal devaluation into austerity programs, or whether these are instead the parties that are most likely to implement far-reaching fiscal consolidation, following a

<sup>3</sup> Since change in real GDP and change in level of unemployment are strongly correlated, we only enter GDP growth in our models.

<sup>4</sup> There are of course also risks and costs of external devaluation, for example, if the public and private debt of a country is denominated to a large extent in a foreign currency (see Walter 2016).

“Nixon goes to China” logic. We also consider the strength of center parties in government (mostly Christian-Democratic). Thus, we consider the strength of left and center parties with respect to that of right (conservative, liberal) parties. We measure the strength of parties as reflected in their share in cabinet posts.

In planning fiscal consolidation, all political parties may be influenced by the timing and the competitive landscape of the *next election*. The closer the next election is, the less they may be willing to take the risk of fiscal consolidation that could lead to an electoral backlash. Therefore, we counted the time since the last election (with ‘1’ being the year of the last national election).

Both left-socialist or communist and right-populist parties tend to fight against austerity imposed by external actors such as the IMF or the EU. In addition, at least in Italy, even a center party such as the Five Star Movement acted as a *challenger* party. We used the vote share of these parties as an indicator of the strength of challenger parties. For definition of left-socialist, communist, and right-populist parties, see Armingeon et al. (2021).

Broad coalitions may be less vulnerable to major political conflict. Therefore, they may be in a better position to pursue austerity. In operationalizing the type of government studied, we followed Armingeon et al. (2016, 629), classifying surplus coalitions and minority governments (both depending on broad parliamentary support) as *broad coalitions*. For definitions of types of government see Armingeon et al. (2021).

The Eurobarometer surveys of the European Commission asked for the *public support of austerity measures*. We used the share of respondents that agreed (totally, and tended to agree) with the statement, “Measures to reduce the public deficits and debt in our country are not a priority for now” as an indicator of skepticism about austerity—calculated from the semi-annual Eurobarometer Survey between May 2010 and November 2019 (<https://www.gesis.org/en/eurobarometer-data-service/home>).

Finally, we operationalize our main independent variable in our second hypothesis, *austerity duration*, as follows: We identified the *Fiscal Monitor* which reported the highest level of austerity in the period 2010–2019. If this was a Spring issue of the *Fiscal Monitor*, we coded this year as a duration of 0.5 years; the next year was coded as 1.5 years, and so on. In cases where a maximum of austerity was reported in a Fall issue, duration in this year was coded as 0, in the next year as 1, and so on.

### Further Variables

For a separate analysis of the consequences of austerity, we calculated the average number of *changes of governments* in the years 2010–2019 minus the average number of changes of governments in the years 2000–2009.

For a separate analysis we also needed information on the economic *vulnerability to austerity* of a country. We started from the work of Walter et al. (2020) and combined the level of debts, the size of deficits, the level of unemployment, and the private savings of citizens (as % of GDP) into an additive index to measure economic vulnerabilities. For deficits, debts, and unemployment with considerable volatility over time, we calculated three-year averages (2010–2012 and 2016–2018) to smooth out short-term fluctuations, while for private savings we used data for 2010 and 2018. We calculated the z-scores for all variables and added up these scores. High scores indicate high vulnerability.

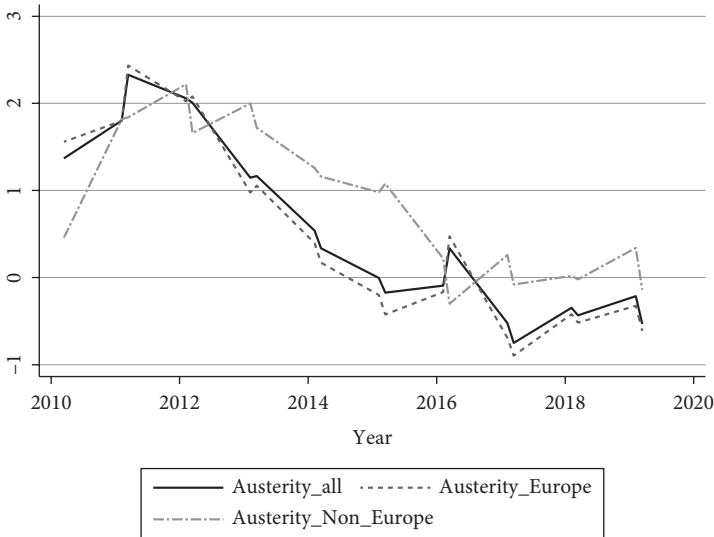
## Econometric Model

We estimated autoregressive distributed lag (ADL) models. In the ADL models, the dependent variable is entered in levels, and it is also entered as a lagged variable on the right-hand side of the equation. Standard errors are robust standard errors. (See De Boef and Keele 2008; Beck and Katz 2011). Data for political and economic variables come from Armingeon et al. (2021) if not otherwise indicated.

## Analyses and Findings

### Quantitative Analysis

Figure 2.2 depicts the average size of austerity between 2010 and 2019 in 30 countries (for a country-by-country graph, see Figure 2.6 at the end of this chapter). It shows the average austerity for all 30 countries under study (blue line) as well as the average austerity in all European countries of the sample (red line) and in all non-European countries (grey-green line). There are two basic findings: (1) Although non-European countries embarked on a slightly more austere path between 2013 and 2016, the general pattern of policy development is very similar in Europe and outside Europe. (2) On average, austerity peaked in 2010–2013, then receded until 2015 and vanished thereafter.



**Figure 2.2** Austerity (planned minus previous cyclically adjusted primary deficits). Source: IMF *Fiscal Monitor* (various years). Note: averages for all countries (30 countries), for all European countries and for all non-European countries. For each year there are two entries (Spring and Fall issue of the *Fiscal Monitor*).

Therefore, we adopted a two-step strategy. We first estimated a model using only economic variables (and EMU membership) for the initial period of the Great Recession, namely 2010–2014 (see Table 2.1). We estimated these models for all countries, and separately for the European countries (All: Models 1 and 3; Europe: Models 2 and 4), as well as with and without interest on government bonds, since there could be a concern about endogeneity: international financial markets could define interest rates on the basis of the perceived future austerity plans of governments. However, substantively, these models—with and without interest rates—produce similar results. If we know the previous size of austerity, the current accounts, the long-term interest rate, and the previous economic growth rates, we can explain a large part of variance in austerity. At the same time, political factors—such as the partisan composition of government, public opinion, or the strength of challenger parties—turn out not to be significantly correlated with austerity policies in the beginning of the period under study (data not reported here). In other words, in the beginning of the major wave of austerity policies, the significant explanatory variables were only economic.

**Table 2.1** Baseline Models (2010–2014)

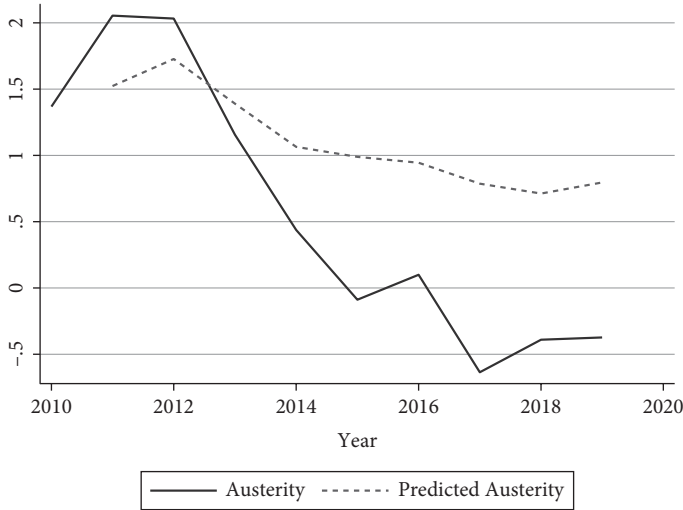
|   | (1)                | (2)                 | (3)                | (4)                 |
|---|--------------------|---------------------|--------------------|---------------------|
|   | Austerity<br>All   | Austerity<br>Europe | Austerity<br>All   | Austerity<br>Europe |
| Austerity, lag1                                   | 0.30***<br>(3.73)  | 0.32***<br>(3.86)   | 0.30***<br>(3.73)  | 0.32***<br>(3.86)   |
| Current accounts, lag1                            | -0.10**<br>(-3.19) | -0.11***<br>(-3.33) | -0.10**<br>(-3.19) | -0.11***<br>(-3.33) |
| Long-term interest, lag1                          | 0.09*<br>(2.32)    |                     | 0.09*<br>(2.32)    |                     |
| Debt, lag1  | 0.00<br>(0.32)     | 0.00<br>(0.29)      | 0.00<br>(0.32)     | 0.00<br>(0.29)      |
| Openness, lag1                                    | -0.00<br>(-0.65)   | -0.00<br>(-0.01)    | -0.00<br>(-0.65)   | -0.00<br>(-0.01)    |
| Real growth, lag1                                 | 0.16**<br>(3.09)   | 0.11*<br>(2.06)     | 0.16**<br>(3.09)   | 0.11*<br>(2.06)     |
| Economic and Monetary Union<br>(EMU) member state | 0.49*<br>(2.01)    | 0.48<br>(1.88)      | 0.49*<br>(2.01)    | 0.48<br>(1.88)      |
| Constant  | 0.30<br>(0.56)     | 0.46<br>(0.67)      | 0.30<br>(0.56)     | 0.46<br>(0.67)      |
| Observations                                      | 115                | 95                  | 115                | 95                  |
| R <sup>2</sup>                                    | .49                | .49                 | .49                | .49                 |

*t* statistics in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

Thus, in a next step we predicted the size of austerity for the period 2010–2019 based on the coefficients of this economic model. If the economic variables were equally important for size and development of austerity in the latter period (2015–2019) as in the initial period (2010–2014), predicted and actual austerity should, on average, develop in sync. Figure 2.3, however, shows that this is not the case.

Based on the economic fundamentals and their impact on austerity decisions in the initial years of the Great Recession, austerity should have receded much less since 2013, and therefore should have stayed on a much higher level than it actually has. In the theoretical section we have argued that governments have a hard time sustaining austerity in the long run, either



**Figure 2.3** Actual and predicted austerity 2010–2019 based on estimations for 2010–2014. (Model 1; ADL, all, including interest.)

because they learn that it does not work as well as expected in the short run, and/or because they fear that it might become electorally risky. By implication the validity of our argument on duration of austerity rests critically on the absence of a correlation between austerity and economic success and/or electoral success. This indeed seems to be the case, as Figures 2.4 and 2.5 indicate.

If austerity were economically successful, the more governments cut back deficits, the more economic vulnerability should have been reduced by the year 2018 as compared to 2010. This is true for Ireland, but for all the other countries there is a zero correlation between austerity and improvement of their economic position.

Similarly, based on Alesina et al. (2019), we would expect austerity to be beneficial not only for the economy but also for the current government’s reelection prospects. However, those governments that were particularly diligent in austerity were not systematically more likely to remain in office, as shown in Figure 2.5

The vertical axis of the graph in Figure 2.5 is the difference in number of changes of governments in two different periods: 2010–2019 and 2000–2009. This indicates whether governmental volatility was higher or lower in 2010–2019 as compared to 2000–2009. If austerity were to increase the chances of reelections, this indicator should be lower for high-austerity countries. This however is not the case.

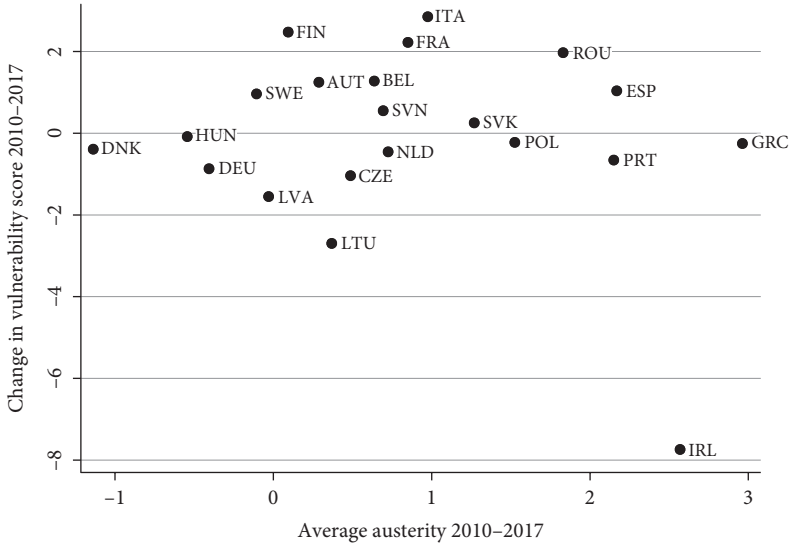


Figure 2.4 Austerity and the reduction of economic vulnerability.

This evidence leads us to consider alternative explanations. Is the pure economic model simply mis-specified, since political variables—such as governments’ ideological composition, type of government, or closeness of next general election—are not included, which may have been consequential

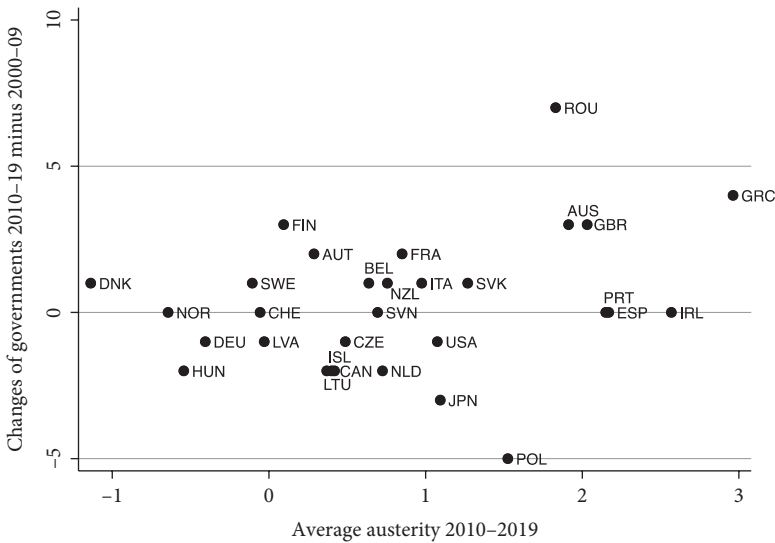


Figure 2.5 Austerity and changes of governments.



in a second phase of austerity? Table 2.2 summarizes the estimation results of five models. Model 1 is the baseline economic model. Over the whole period of 2010–2019, only the “current accounts” variable has a significant coefficient.

This does not change if additional political variables are entered pertaining to the size of the coalition, the share of left and center parties in government (base category: right parties), the time elapsed since the last election, the vote share of challenger parties, or the annual growth rate of challenger parties (measured as the average change in their vote share over the last four years, which usually includes at least one election). This conclusion is not altered if we interact interest rates with left governments, as suggested by Raess (2021).<sup>5</sup>

However, substantial improvements in the model can be observed if variables on public opinion and duration of austerity policies (Models 3 and 4) are included. If the share of citizens with a skeptical stance on austerity (“reducing debt and deficits is not a priority”) is integrated, this variable is significantly and negatively correlated with austerity. At the same time, economic variables and Eurozone membership gain significance, indicating that previous models may have been mis-specified. By the same token, inclusion of duration of austerity clearly supports our main “political” hypothesis of austerity fatigue: the longer governments pursue austerity, the less pronounced their efforts in cutting deficits become. Interestingly there is no significant interaction effect of duration with challenger parties or critical stances on austerity.

The main problem with Models 3 and 4 is their focus on EU member states, as Eurobarometer data on austerity skeptics are only available for these countries. Therefore, we re-run the models excluding public opinion variables (Model 5). These estimations corroborate our previous central finding: Over the course of austerity policy, governments increasingly deviate from the goal of reducing the public deficit. Comparing Models 2 and 5—which differ only with regard to the duration variable—it is clear that the duration of austerity increases the explained variance considerably.

The highly significant result of our variable “duration” is also surprising given that we estimate it in a very conservative way. We expect the variable

<sup>5</sup> Data not reported here. Raess (2021) argues that in the Great Recession financial markets were suspicious about the willingness of Social Democratic parties to pursue austerity, which in turn led such parties to implement austerity policy in order to build reputation.

Table 2.2 Austerity 2010–2019

|  | Model 1           | Model 2          | Model 3             | Model 4             | Model 5             |
|--|-------------------|------------------|---------------------|---------------------|---------------------|
| Austerity <sup>(a)</sup>                                 | 0.27<br>(1.45)    | 0.22<br>(1.23)   | 0.32***<br>(4.63)   | 0.30***<br>(4.72)   | 0.14<br>(0.81)      |
| Current accounts <sup>(a)</sup>                          | -0.10*<br>(-2.09) | -0.10<br>(-1.90) | -0.10***<br>(-3.49) | -0.11***<br>(-3.84) | -0.13*<br>(-2.57)   |
| Long-term interest <sup>(a)</sup>                        | 0.06<br>(1.11)    | 0.10*<br>(1.99)  | 0.13**<br>(2.75)    | 0.05<br>(1.25)      | -0.02<br>(-0.48)    |
| Debt <sup>(a)</sup>                                      | -0.00<br>(-0.50)  | -0.00<br>(-0.33) | -0.01**<br>(-2.64)  | -0.01<br>(-1.93)    | -0.00<br>(-0.51)    |
| Openness <sup>(a)</sup>                                  | -0.00<br>(-0.28)  | 0.00<br>(0.14)   | -0.00<br>(-0.49)    | -0.00<br>(-0.40)    | 0.00<br>(0.22)      |
| Real growth <sup>(a)</sup>                               | -0.03<br>(-0.46)  | -0.05<br>(-0.72) | 0.04<br>(1.21)      | 0.04<br>(1.13)      | -0.04<br>(-0.63)    |
| Member Eurozone  | 0.21<br>(0.82)    | 0.32<br>(1.43)   | 0.64**<br>(3.02)    | 0.75**<br>(3.28)    | 0.66**<br>(2.76)    |
| Broad coalition <sup>(a)</sup>                           |                   | 0.30<br>(1.65)   | 0.18<br>(1.31)      | 0.22<br>(1.63)      | 0.33<br>(1.80)      |
| Left govt. <sup>(a)</sup>                                |                   | -0.00<br>(-0.10) | -0.00<br>(-1.25)    | -0.00<br>(-0.78)    | 0.00<br>(0.36)      |
| Center govt. <sup>(a)</sup>                              |                   | 0.00<br>(0.57)   | -0.00<br>(-0.74)    | -0.00<br>(-1.07)    | -0.00<br>(-0.03)    |
| Time since last election, yrs.                           |                   | -0.03<br>(-0.53) | -0.03<br>(-0.67)    | -0.03<br>(-0.75)    | -0.02<br>(-0.45)    |
| Challenger parties <sup>(a)</sup>                        |                   | -0.02<br>(-1.58) | -0.02*<br>(-2.01)   | -0.02**<br>(-2.66)  | -0.03*<br>(-2.35)   |
| Growth of challenger parties, past 4 yrs. <sup>(a)</sup> |                   | 0.03<br>(0.49)   | 0.06<br>(1.55)      | 0.08<br>(1.92)      | 0.06<br>(1.16)      |
| No Priority <sup>(a)</sup>                               |                   |                  | -3.17**<br>(-3.29)  | -2.38*<br>(-2.39)   |                     |
| Duration austerity, yrs.                                 |                   |                  |                     | -0.13***<br>(-4.07) | -0.24***<br>(-4.23) |
| Constant   | 0.45<br>(0.94)    | 0.42<br>(1.01)   | 2.55**<br>(3.18)    | 2.58***<br>(3.39)   | 1.43**<br>(3.10)    |
| Observations   | 259               | 259              | 192                 | 192                 | 259                 |
| R <sup>2</sup>   | .33               | .35              | .59                 | .61                 | .43                 |

*t* statistics in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

(a): Variable lagged for one year

to have a monotonic and linear effect. With each additional time unit of “duration” the extent of austerity is expected to decrease by the same amount. If for example in one country, austerity were to vanish already one year after its peak while in another country it remains at a high level and is reduced only after some years, the chances for significant results to emerge would be very low. In fact, scatterplots of estimated austerity (based on our general model) for periods immediately after austerity’s peak and after about three years (the median category of austerity) do not signal any extreme distributions.

At this point, however, the explanatory power of statistical models built on linearity and, at best, two interactions becomes problematic. How do economic constraints and political factors such as the rise of challenger parties, the change in public opinion, the discourse in the political systems between all major actors, and the duration of austerity policies interact? Such complex causal networks require qualitative case studies capable of tracing processes of political conflict and compromise as well as policy processes. It is to such a study of a critical case—Italy—that we now turn.

### Italy: The Interaction of Economic Constraints and Politics

Although it was never subject to explicit conditionality by the EU or the IMF, Italy went through austerity in the early 2010s. In the following years, governments tended to scale back their austerity efforts. Forceful budgetary consolidation was pursued through welfare (in particular pension) cuts, foregone social investments (in health care, education, and social safety nets), and rising taxes. Later governments increasingly shed further consolidation as support for austerity decreased over time. Populist parties capitalized on such sentiment, putting forward a platform aimed at reversing welfare cuts and actually promoting new welfare programs, which was partly realized by the populist government in 2018–2019. Our case study makes it plausible—in addition to the model estimations that reduce societal complexity to simple models (see Hall 2003)—that at least in Italy, the causal factors behind the duration effect of austerity are learning and policy disappointment among the political elite, the fear of increasing electoral punishment, and the frustration of citizens with lack of policy success. These developments supported the rise of populist parties: the Five Star Movement being neither left nor right, and the right-populist Lega. In addition, also on the right end of the

spectrum of the party system, “Brothers of Italy” substantially gained votes in recent elections, becoming the most voted party in 2022 general elections.

While Italy recorded an almost continuous increase of public debts, from 50% of GDP in the 1960s to about 150% at the beginning of the pandemic, it has nonetheless managed to keep a primary budget surplus for most of the time since the early 1990s. This used to be acknowledged by international rating agencies and their very positive scores (Lenzi 2018). It was with the Eurozone crisis of 2011 that fears mounted about the sustainability of Italian public debt, due to its high level. In addition, the then-conservative government under Berlusconi failed to introduce unpopular reforms, first and foremost pension reform (Sacchi 2015). Italy was on the verge of default in late fall 2011 when, under the aegis of the European Union, the Berlusconi government was replaced by a technocratic government led by the economist and former EU Commissioner Mario Monti. Under the pressure of economic fundamentals (and implicit conditionality by European institutions), this liberal and technocratic government introduced fiscal consolidation worth 3% of GDP (1.3% of GDP in expenditure cuts, 1.7% of GDP in new taxes). Austerity in Italy peaked in 2011 and 2012 and greatly overshot values predicted by our economic model based on all 30 countries. After 2012, however, austerity efforts abated almost continuously, and since 2015 Italy has exited austerity, although the economic fundamentals (and in particular the level of debt) should have caused much stronger and longer austerity policies.

Arguably the policy did not work as expected, and this may be linked also to credit rating agencies not buying into the hope that austerity would in the short run lead to economic expansion. Rather, notwithstanding tough austerity, between summer 2011 and spring 2013, the Italian public debt was downgraded by Moody’s, Fitch, and Standard and Poor’s (Lenzi 2018). Likewise, citizens became frustrated and, while still worrying over debt, they were increasingly disillusioned by the real economy’s dismal performance. Support for the Monti government plunged from 78.6% in November 2011 to 43.9% in December 2012 (Atlante Politico 2012).

This fits into findings from opinion polls showing a declining trend in support for austerity in Italy. The share of respondents in Eurobarometer data who believe that reducing deficit and debt is *not* a priority shows an upward yet modest trend over the years; the share of those who believe that reducing debt and deficit cannot be delayed has gone down more emphatically over the years, from 90% to 75% (calculated from Eurobarometer surveys, see above). At the same time, at the end of the austerity period in 2016, half of respondents believed that EU austerity policies were a hindrance to Member

States' growth, while a third supported them as the only way public finances can be kept under control (IPSOS 2017). In summer 2017, austerity was believed to have brought more disadvantages than advantages by 65% of respondents, and more advantages by only 10% (SWG 2017a); by the same token, 72% of respondents believed the EU should ease up on rigorous fiscal policies and favor growth-oriented investments, while 12% supported fiscal rigor (SWG 2017b). Arguably, the increasing austerity skepticism of the governments with Social Democratic orientations (under Enrico Letta, Matteo Renzi, and Paolo Gentiloni between 2013 and 2018), the fear of electoral punishment and public opinion turning against austerity made fiscal consolidation increasingly difficult in political terms, although economic fundamentals would have justified a tougher policy of welfare retrenchment and tax increases. By 2018 the Social Democrats, who had pursued a very mild austerity, were ousted by the populist Five Star Movement and Lega, for which austerity was a clear no-go—at least in their rhetoric.

The rise of these populist challenger parties help qualify our argument and reconcile it with findings by Bansak et al. (2021), who find that austerity was supported as a general policy response to the financial crisis (as shown by Eurobarometer data above). The same authors highlight the importance of the austerity package actually put in place, finding that support for austerity is greatly reduced if it involves social and education policy cuts, and pension cuts in particular, which is exactly what was done in the Italian case.

Some policy examples may illustrate this process of austerity fatigue. The 2012 pension reform of the liberal technocratic Monti government created a rift in the political community. People about to retire discovered that they had to wait up to six more years. Elderly workers who had accepted farewell packages from their companies on the assumption that this would be a walkway to retirement were left on their own, becoming unemployed at over 55 or even 60 years of age in a depressed labor market. While the Social Democratic Renzi and Gentiloni governments from 2014 to 2018 adopted a piecemeal approach and tackled some of the outstanding issues, the basic structure of the reform—which had attracted praise from the EU and international organizations such as the OECD—was maintained. By the same token, a wide-ranging labor market reform was introduced in 2015, which was meant to increase employment opportunities for the outsiders by de-segmenting the labor market and substantially expanding unemployment benefits (Sacchi 2018). However, its policy narrative made it a highly contentious reform, and it was generally perceived as reducing rather than increasing workers' rights (Galanti and Sacchi 2019). At the same time, a



Semi-annual data from Fiscal Monitor, various issues

**Figure 2.6** Austerity by country. Sources: IMF (various years) *Fiscal Monitor*.

minimum income scheme was introduced for the first time in Italian history in 2018, but it was criticized as being too little and too late. This all paved the way to the center-right-populist coalition government of Lega and the Five Star Movement. This coalition, led by Giuseppe Conte, immediately took a confrontational stance with the EU, blatantly questioning the validity of the deficit rule and introducing two costly expansionary social policy measures in early 2019. First was a temporary reversal of the 2012 pension reform, allowing early retirement with no adverse impact on the amount of the pension benefit (a measure that had featured prominently in Lega's electoral campaign). Second, the minimum income scheme introduced in 2018 was replaced by a much larger one (pompously called citizenship income), still means-tested and subject to an activation requirement, which had been the electoral flagship issue of the Five Star Movement. These two measures marked the end of austerity in citizens' perceptions and was the ultimate vindication of austerity fatigue—even before expansionary budgetary responses to the COVID-19 pandemic introduced by a different coalition government (still led by Mr. Conte and including the Five Star Movement) with the Social Democrats replacing Lega as a junior partner.

## Conclusion

What explains austerity since the beginning of the Great Recession? In examining its evolution during the Great Recession and beyond, we have shown that austerity was initially strongly correlated with economic and fiscal fundamentals. However, the explanatory power of the economic model diminishes as austerity policies continue over time. Controlling for economic variables, we have argued that governments became increasingly unwilling to pursue an austerity strategy. The main reasons for this could be learning effects, that the policy is not as successful as planned in terms of economic or fiscal variables, or that governments become concerned about the electoral costs of austerity the longer it is in place—and, by implication, the rise of challenger parties. While we have strong evidence of the explanatory power of an economic model at the outset of austerity policies and of increasing austerity fatigue with the duration of spending cuts, the causal pathways—which arguably differ across countries—could not be clearly identified in the quantitative study. However, our case study of Italy illustrates how, in that country,

challenger parties, electoral concerns, and both public and elite dissatisfaction with austerity policies dovetailed to bring about increasing austerity fatigue.

What are the lessons for post-pandemic fiscal policy and related welfare state policies in Europe? We expect that after the health shock and the temporary fiscal and monetary expansionary policy, international financial markets will factor in the level of sovereign debt when setting the interest rates of sovereign bonds. This is all the more likely as the consequences of the Ukrainian war may offset the expected economic growth stemming from recovery from the pandemic. Since some countries, in particular in Southern Europe, may be in a bad position in this regard after the pandemic—something that was already the main rationale of the Next Generation EU initiative (Armingeon et al. 2022)—their governments may be forced to cut back deficits. True, it is likely that EU institutions will not prescribe that those countries come off their expansionary policies cold turkey this time, particularly if the consequences of the Ukraine war should be serious. The Growth and Stability Pact was temporarily suspended by the European Commission in March 2020. This suspension is set to expire by the end of 2023 but might be further extended. Speaking to the European Parliament in March 2022, EU Commission executive vice president Dombrovskis recognized that “debt reduction strategies should be sustainable, credible and growth-friendly. This implies *gradual* fiscal adjustment” (Dombrovskis 2022, our italics). Yet, debt reduction should eventually be, while high-debt countries may also be forced to cut their deficits more abruptly if growth turns sluggish and international markets start questioning debt sustainability. That may trigger another round of support from the EU institutions, which would likely be made conditional on “structural reforms.” Since welfare state expenditures are the bulk of public expenditures, high-debt governments in the Eurozone may have little option but to again shrink the welfare state, as they do not have the option of external devaluation of their own currency. It seems therefore not unlikely that in a few years we will come full circle again: introducing austerity first and exiting austerity afterward because it is unsuccessful or electorally unsustainable.

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