

5. The political challenge of austerity politics

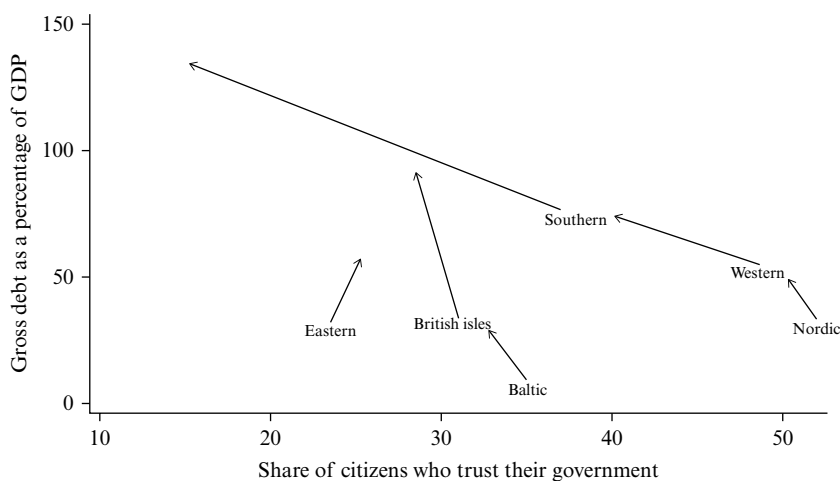
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INTRODUCTION

In the countries most affected by the Great Recession, public finances had developed structural weaknesses well before the crisis hit. The fiscal situation in countries such as Greece, Italy, and Portugal, and the austerity policies that have followed in its wake, have had dramatic consequences. To a clearly higher degree than countries with stronger public finances, these countries have seen rising unemployment, increasing poverty, and deteriorating public services. Moreover, economic and social challenges were already more prominent in these countries before the crisis. Recent developments, accordingly, have widened the prosperity gap in Europe.

The political consequences of this development are far-reaching. To restore market confidence and to comply with fiscal regulations like the Stability and Growth Pact, many countries have implemented large programmes of fiscal consolidation. Austerity, however, often meets with public resistance, so most of these countries have also experienced a reduction in political stability (Armingeon et al. 2016). Trust in mainstream parties has declined, and newly established parties with a populist agenda have enjoyed tremendous electoral success. In the words of the Irish political scientist Peter Mair (2009, 2013), we are witnessing an increasing tension between responsiveness (listening to the people) and responsibility (in this case, complying with fiscal rules and agreements with lenders).

The situation is most alarming in the countries of southern Europe, where we find the greatest fiscal problems and the most dramatic changes in domestic political systems. Figure 5.1 shows average levels of public debt and of trust in the government for six groups of European Union (EU) member states between 2007 and 2015. While debt levels have risen in all of the country groups, and trust in the national government has shrunk in all of them save eastern Europe, the trajectory is clearly most dramatic in southern Europe. A similar picture emerges if we look not at trust in the



Note: Each arrow shows how the average level of trust in the government and the average size of government debt have developed in a group of countries between 2007 and 2015. The six country groups are the Baltic countries (Estonia, Latvia, and Lithuania); the British Isles (Ireland and the United Kingdom); eastern Europe (Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia, and Slovenia); the Nordic countries (Denmark, Finland, and Sweden); southern Europe (Greece, Italy, Portugal, and Spain); and western continental Europe (Austria, Belgium, France, Germany, Luxembourg, and the Netherlands).

Sources: The data are from Eurostat and the Eurobarometer.

Figure 5.1 Change in debt and in trust in the government, 2007–2015

national government but at electoral volatility, the share of the vote going to populist parties, or levels of support for the EU.

In this chapter, I ask how we can improve fiscal performance without putting political stability at risk. By analysing the tension between the need for constraints on fiscal policy, on the one hand, and the political consequences of reduced responsiveness, on the other, I try to shed new light on the prospects for long-term fiscal discipline. My main conclusion is that we need to increase public support for fiscal prudence. If we fail to accomplish that, and instead rely exclusively on fines and external enforcement to achieve fiscal discipline, the chances are that the political system in the worst-affected countries will be weakened for decades to come. The results in this chapter thus contribute both to the political economy literature concerned with fiscal sustainability and the literature on EU issue voting (de Vries 2007). For a long time, attitudes towards the EU played but a minor role in both national and European elections (Reif and Schmitt 1980; Mair 2000). However, due to the orthogonality of the issue

of European integration with respect to the left–right scale, its electoral importance has been compared with that of a sleeping giant (van der Eijk and Franklin 2004; de Vries 2007). More recently, it has been argued that the radical left and the populist right are awakening the giant, by mobilizing on the issue of European integration (Hooghe and Marks 2009). By analysing how the electoral success of Eurosceptic parties is affected by the implementation of fiscal consolidation, I may be able to cast new light on the conditions under which the giant can be awakened.

In the first section, I review the consensus among economists that a lack of fiscal discipline is the primary reason for public indebtedness. I pay particular attention to how this has provided the rationale for the European fiscal frameworks, and I attempt to assess how well it explains fiscal policy during the decade that preceded the crisis. In the second section, I analyse the political consequences of austerity policies. Do voters punish governments which implement fiscal consolidation? And if so, to which parties do the voters go? Is it correct that fiscal austerity leads to an increase in support for populist and Eurosceptic parties? I conclude the chapter by discussing the prospects for fiscal discipline in view of prevailing conditions. In my policy recommendations, I focus on how we can reduce the risk of future debt crises, on how we can mitigate the electoral costs of fiscal consolidation, and most importantly on what we can do to reduce the tension between fiscal responsibility and electoral responsiveness.

FISCAL DISCIPLINE AND THE DEFICIT BIAS

Over the last three decades, the dominant explanation for public indebtedness has been based on the idea that a deficit bias is inherent in political decision making (Debrun et al. 2009). The story goes like this: unless they are restrained in some way, governments have a tendency – especially if they are responsive to the demands of voters – to spend beyond their means. The research literature has identified a number of possible reasons for such a bias.

For a number of reasons, governments may have an electoral incentive to run larger deficits than they would have done had they not cared about being re-elected. First, if voters are poorly informed about the nation's fiscal stance, but observe how much they pay in taxes and what they get in return, the incumbent government can gain popularity by cutting taxes and raising spending (inasmuch as voters do not observe the long-term consequences of the deficit). A 'fiscal illusion' of this kind may also arise if voters do not fully understand that the public debt must eventually be

repaid (Rogoff and Sibert 1988). Second, if voters are less concerned about the welfare of future generations than they are about their own, they will reward governments that give higher priority to current consumption and punish those that save for the future (Bowen et al. 1960; Cukierman and Meltzer 1989). Third, similar incentives can arise if voters are short-sighted or put disproportionate weight on their current situation (Buchanan and Wagner 1977).

Other accounts too portray governments as tempted to run deficits. First, while government expenditures are often targeted on concentrated minority interests, it is unclear when or by whom the public debt will be repaid. According to Olson (1982), therefore, concentrated minority interests are more influential than diffuse majority interests, which can cause debts and deficits to be larger than any single actor would prefer (Velasco 2000). Second, if an incumbent government expects to be replaced after the next election, it can use debt strategically to constrain the policy options of its successor. By running a deficit, it can spend additional money on tax cuts or on expenditures of its preferred type, while forcing its successor to repay the debt instead of implementing reforms of its own (Persson and Svensson 1989; Alesina and Tabellini 1990). Third, fiscal policy may suffer from a time-inconsistency problem (Kydland and Prescott 1977), meaning that the optimal fiscal policy from the perspective of the government changes over time, in a predictable manner. In the short run, the incumbent government has the ability to increase output by increasing aggregate demand more than expected. For example, a not previously announced tax cut would increase economic activity, until wage levels have adapted to the increased demand. However, because rational agents realize that governments have an incentive to 'surprise' the labour market, they expect this to happen, and adjust their wage expectations accordingly. This possibility would then simply result in larger deficits without any output benefits. Fourth and finally, the deficit bias may be aggravated in monetary unions or other situations where the costs of fiscal laxity spill over to entities outside the fiscal jurisdiction in question (Eichengreen and Wyplosz 1998; Faini 2006; Basso and Costain 2016).

The idea, then, is that unconstrained democratic governments – operating under no other limits than those imposed by their national electorate – are characterized by a lack of fiscal discipline. This idea has provided the rationale for the Stability and Growth Pact, as well as for the domestic fiscal frameworks of the member states (Morris et al. 2006). The policy recommendations concern three areas: fiscal transparency, fiscal rules, and fiscal councils.

Fiscal transparency means that budgets are presented in a way that makes it easy for citizens to assess the nation's financial position, as well as

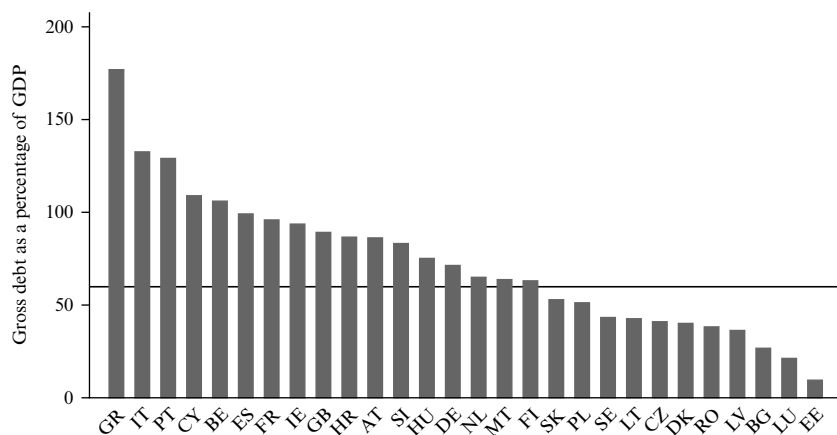
the economic and social implications of government activities (Kopits and Craig 1998). By reducing the information advantage that policy-makers have over voters, this approach makes it less attractive for the incumbent government to increase current public consumption by issuing debt (Alt and Lassen 2006). Fiscal transparency can also prevent governments from using creative accounting in order to comply with fiscal rules (Milesi-Ferretti 2004).

Fiscal rules are constraints on fiscal policy, expressed as numerical ceilings or targets for budgetary aggregates. Their main objective is to limit deficit bias (Debrun et al. 2008). The best-known fiscal framework is the Stability and Growth Pact, which requires deficits to be kept within 3 per cent of gross domestic product (GDP), and gross government debt within 60 per cent of GDP.

Fiscal councils are independent institutions with a mandate to monitor the government's fiscal policy. They are seen today as a complement to fiscal rules, rather than as a substitute. It has been suggested that decisions affecting the budgetary balance be delegated to such institutions, or even that the setting of specific tax rates be assigned to experts (Blinder 1997). However, all existing councils of this kind are merely advisory, and their most common tasks are forecasting, assessing fiscal policy, and evaluating fiscal sustainability (Calmfors and Wren-Lewis 2011).

Over the last few decades, Europe has seen an increase in fiscal transparency, a greater number of fiscal councils, and the introduction of fiscal rules on both the national and the Union level. Yet, such efforts notwithstanding, public debt has risen in virtually all European countries. Current debt-to-GDP ratios are shown in Figure 5.2. The horizontal line is drawn at 60 per cent of GDP. Debt levels above this line constitute violations of the Stability and Growth Pact, unless they are falling by at least five percentage points per year. The highest debt levels are found in Greece, Italy, and Portugal.

The Stability and Growth Pact, clearly, did not prevent public debt from soaring. Many economists have therefore concluded that Europe still suffers from fiscal indiscipline. Their policy prescriptions for dealing with this range from fine-tuning fiscal rules (Bergman et al. 2016) and strengthening fiscal councils (Calmfors 2015) to delegating decisions on the issuance of debt to an independent supranational authority (Basso and Costain 2016). Can we be so sure, though, that it was a lack of fiscal discipline which made public finances so vulnerable?



Note: The figure shows debt-to-GDP ratios according to the Maastricht definition. The horizontal line, drawn at 60 per cent, corresponds to the debt ceiling in the Stability and Growth Pact.

Source: The data are from Eurostat.

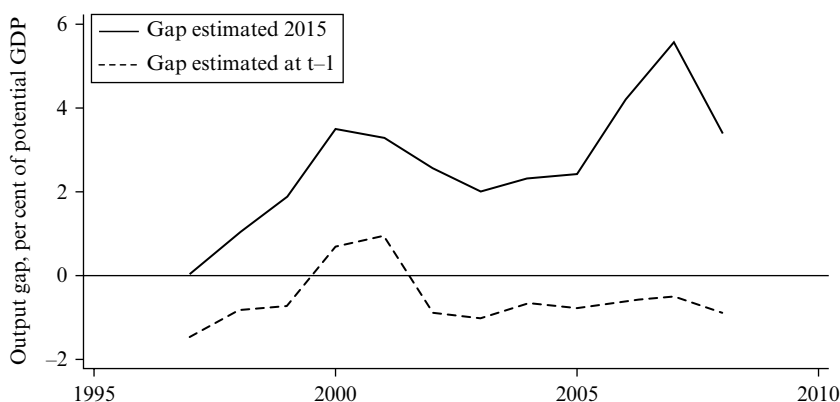
Figure 5.2 Gross public debt in EU member states, 2015

Does Fiscal Indiscipline Explain the Current Problems?

In retrospect, the decade preceding the Great Recession was a golden opportunity to consolidate public finances. Partly thanks to real-estate bubbles, the economy was booming and unemployment rates were below their equilibrium level. Looking back at such beneficial conditions, it is easy to interpret the loose fiscal policies pursued during this period as a lack of fiscal discipline. But can we be so sure fiscal policy would have been different if independent experts had decreed it or a fiscal rule decided it?

Many economists have a naïve notion of what fiscal policy would look like if it had to follow set targets, or if it were conducted by benevolent independent experts. It is not surprising, then, that fiscal problems are blamed so readily on the lack of fiscal discipline in politics. However, when the financial crisis struck the world in 2007, fiscal policy in most European countries fell within the bounds set by the Stability and Growth Pact and accorded with the advice given by the International Monetary Fund (IMF), the European Commission, and other international organizations.¹ There are two reasons why fiscal policy could be too lax despite the comparative concordance among governments, rules, and experts.

The first reason why public finances could be so vulnerable is that the



Note: Both lines show the average output gap for Portugal, Ireland, Italy, Greece, and Spain. The solid line is derived from output gap estimates published in November 2015, while the dashed line shows the forecast made one year before the year concerned.

Source: OECD Economic Outlook.

Figure 5.3 Output gap estimates 1997–2008, PIIGS

Stability and Growth Pact did not require member states to maintain large enough safety margins. While there had been a large number of violations of the pact a few years earlier, there were ‘only’ three countries which breached the pact in 2007 (Calmfors and Wren-Lewis 2011). However, when deficits soared because of the weak labour market, and some countries had to pump money into the financial sector, levels of debt rose quickly. Pre-crisis debt levels in many countries would have needed to be much smaller than the 60 per cent of GDP stipulated in the Stability and Growth Pact for the financial markets not to lose confidence in the solvency of said countries.

The second reason is that the business cycle was systematically misperceived. Figure 5.3 shows the average output gap for Portugal, Ireland, Italy, Greece, and Spain.² The solid line represents the estimates published by the Organisation for Economic Co-operation and Development (OECD) in November 2015. Surely, with such large and positive output gaps, the decade preceding the crisis was a good opportunity to consolidate public finances. However, when we examine how the economy was perceived at the time budgets were passed, a different picture emerges.

The dotted line in Figure 5.3 represents projections made during the autumn before the year concerned. It is intended to approximate the perceptions of policy-makers when they passed their budget bills. As the

figure shows, the governments in these countries were repeatedly told they were in the midst of an economic downturn, with output running below long-run potential. They wrongly believed, therefore, that there was a need to stimulate the economy, and that the budget balance would improve as soon as the economy bounced back.

Moreover, a quick analysis of the advice given by the IMF and the European Commission shows that it was not just politicians who perceived things this way. Consider Ireland, for example. Recent estimates by the IMF indicate that, just before the crisis struck, Ireland was running a structural primary deficit of close to 12 per cent of potential GDP (IMF 2015). It is not surprising, then, that the country's lax fiscal policy has been criticized by both the IMF and the European Commission (IMF 2009; European Commission 2011). At the time these budgets were passed, however, the IMF described Ireland's fiscal position as sound (IMF 2006); and the EU Council concluded that 'the medium-term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact' (Council of the European Union 2007).

So, how important were these misperceptions for the fiscal outcomes? According to my estimates, biased projections weakened annual budget balances in OECD countries by approximately 1 per cent of GDP (Nyman 2016b). It is possible that the decade preceding the Great Recession was a unique period, but there are indications that perceptions of the business cycle were biased throughout the post-war period. For example, the OECD has presented economic analyses in its Economic Outlook since 1967, but only during the last years of the 1980s did they state that the economy was in an upturn.

WHAT HAPPENS TO GOVERNING PARTIES THAT CONSOLIDATE?

Europe has not seen the end of austerity policies. Many countries have already taken dramatic measures to improve their structural budget balance, but it will take both time and additional fiscal adjustment before debt rates return to their pre-crisis levels. As argued above, moreover, public debt can increase rapidly even under fiscally disciplined governments. We can therefore rest assured that similar situations will also arise in future.

But what happens to governments that implement fiscal consolidation? Do they lose votes in subsequent elections? And if so, where do their previous voters go? Do the latter vote for established opposition parties, or do new parties emerge? Is it correct, as suggested in Chapter 3, that

fiscal consolidation has led to an increase in the share of the vote gained by populist parties? Before examining these questions empirically, I will briefly discuss why governments that implement fiscal adjustment may be at an electoral disadvantage.

Why Would Voters Punish Governments?

At first sight, it is unclear why we should expect voters to punish governments for austerity policies. After all, governments do not implement fiscal consolidation because they are evil or incompetent, but because they believe it will lead to a more efficient inter-temporal allocation of public resources. Nevertheless, we can imagine two situations where a majority of citizens will oppose fiscal adjustment.

In the first situation, voters reward or punish governments in proportion to how expansive or contractionary their fiscal policy is. Other things being equal, voters will act *as if* they prefer lower taxes and higher spending today, even if it means greater austerity in future. The possible reasons for this are the same as those described earlier. In short, fiscally disciplined governments may be at an electoral disadvantage, because voters suffer from a fiscal illusion (Rogoff and Sibert 1988), because they are short-sighted (Buchanan and Wagner 1977), or because they are willing to exploit future generations (Bowen et al. 1960; Cukierman and Meltzer 1989).

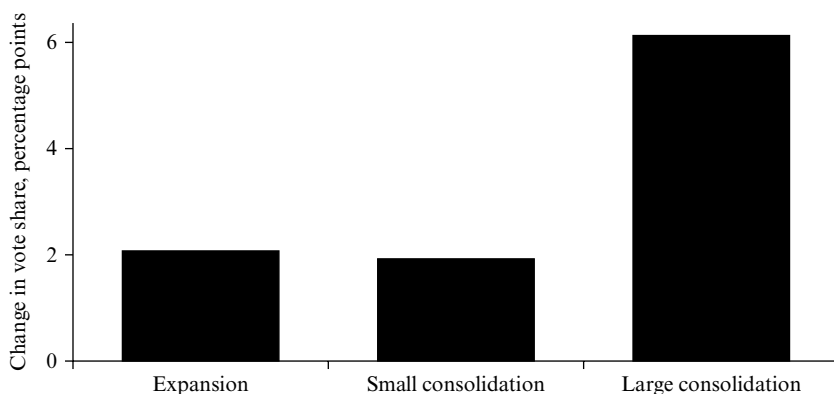
In the second situation, voters react asymmetrically to fiscal expansion and contraction. In other words, they may punish governments for carrying out fiscal consolidation, even if they have nothing against fiscal discipline in general. Borrowing from the ‘new-politics’ approach in welfare-state research (Pierson 1996), according to which retrenchment in the welfare state follows a different political logic than expansion of the same, we can imagine two explanations for such a bias. First, the costs of retrenchment are concentrated, immediate, and well defined, as compared with the future benefits made possible by fiscal consolidation. And it is widely held that concentrated interests have more political influence than diffuse and scattered ones (Olson 1965; Wilson 1973; Lohmann 1998). Second, voters may exhibit a negativity bias, which means they react more strongly to losses and negative risks than to corresponding positive experiences. The literature on retrospective voting (Bloom and Price 1975; Lewis-Beck and Paldam 2000) confirms the existence of this bias, and experiments on the psychological bias known as loss aversion (Kahneman and Tversky 1979, 1984) – that is, people’s tendency to prefer avoiding losses to making equivalent gains – have given it further empirical support.

What Do the Data Say?

To analyse the electoral consequences of fiscal adjustment, I have combined economic data from the OECD with data on vote shares and party characteristics from the ParlGov database (Döring and Manow 2016). My dataset covers 244 national elections between 1972 and 2016. The empirical results presented in this chapter consist of graphs and correlations. See Nyman (2016c) for a more formal analysis of the same questions.³

To define the fiscal policy conducted during each election period, I have used the OECD's measure of cyclically adjusted net lending. This is a measure of the budget balance, adjusted for temporary costs and revenues associated with the business cycle. In this chapter, I will refer to this as the structural budget balance. If the adjustment is correctly estimated, changes in the structural budget balance will reflect discretionary actions. An increase in the structural budget balance, for example, will correspond to spending cuts, to tax hikes, or to a mixture of the two. I define fiscal expansion as an election period during which the structural budget balance diminishes; *small-scale* fiscal consolidation as an election period during which it improves, but by *less* than 5 per cent of GDP; and *large-scale* fiscal consolidation as an election period during which it improves by *more* than 5 per cent of GDP.

Figure 5.4 shows the average decrease in the share of the vote going



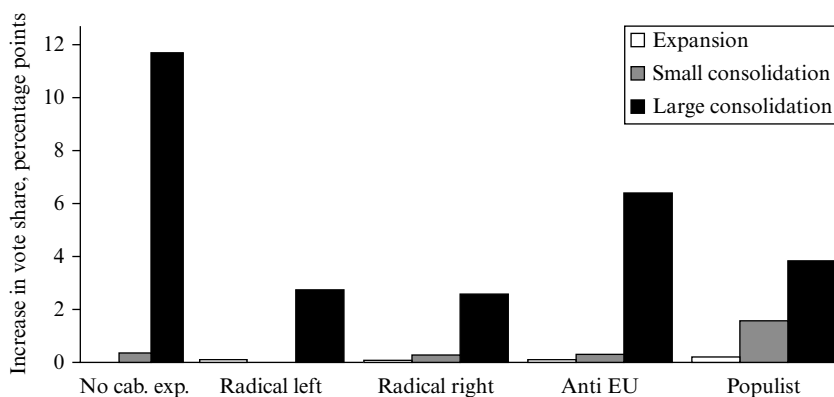
Note: Each bar represents the average vote loss for a party which spent most of the election period in government. From left to right, the election periods are divided into periods of fiscal expansion (a weakened structural budget balance), of small-scale consolidation (the budget balance is improved, but by less than 5 per cent of GDP), and of large-scale consolidation (the budget balance is improved by more than 5 per cent of GDP). The bars contain 269, 253, and 27 observations, respectively.

Figure 5.4 Average decrease in vote share for governing parties

to governing parties, according to the fiscal policy conducted during the election period. After periods of both fiscal expansion and of small-scale consolidation, governing parties have on average lost approximately two percentage points. This tendency is sometimes referred to as the cost of ruling (Nannestad and Paldam 2002). Following periods of large-scale fiscal consolidation, however, the loss in vote share has been much greater. On average, governing parties of this category have lost six percentage points in the subsequent election. Moreover, the size of the vote loss tends to grow with the size of the fiscal adjustment (Nyman 2016c). This finding – that the vote loss does not differ between periods of fiscal expansion and of small-scale consolidation, but that governing parties can expect severe electoral punishment after periods of large-scale consolidation – strongly supports the idea that voters react asymmetrically to fiscal expansion and contraction.

But which are the parties that gain votes after periods of fiscal consolidation? If voters switch their support to the main opposition parties, the electoral punishment for fiscal consolidation will only result in an increase in government turnover. The expected vote loss will probably deter the incumbent government from implementing such a policy, and this will affect budget discipline; but at least fiscal consolidation will not influence what kinds of parties are in power (i.e., all will be conventional established ones). However, if voters lose trust in all of the established parties, the effect of severe austerity could be to alter the composition of parliament in a more systematic manner. We will now look at how the total vote share for different categories of political parties changes, depending on the fiscal policy implemented.

Figure 5.5 shows the average change in total vote shares for different categories of parties, grouped according to whether the preceding election period was one of fiscal expansion (light grey bars), of small-scale consolidation (dark grey bars), or of large-scale consolidation (black bars). Because disappointment with the mainstream parties and the political establishment can take various forms, it is important to distinguish between different kinds of non-mainstream parties. For example, because a large part of fiscal consolidations tend to be made up by cuts in social insurance and welfare services, we might expect the opposition towards these policies to result in an ideological shift towards the left. On the other hand, if general anti-establishment sentiments are the primary consequences of austerity policies, we might expect populist and radical parties to rise on both sides of the ideological spectrum. From left to right, the figure shows the results for parties without cabinet experience, for radical-left parties, for radical-right parties, for Eurosceptic parties, and for populist parties. These categories are positively correlated, so



Note: From left to right, the figure shows the average change in percentage of the vote cast for parties without cabinet experience, for radical-left parties, for radical-right parties, for Eurosceptic parties, and for populist parties. Election periods are divided into periods of fiscal expansion (a weakened structural budget balance), of small-scale consolidation (the budget balance is improved, but by less than 5 per cent of GDP), and of large-scale consolidation (the budget balance is improved by more than 5 per cent of GDP). Something not shown in the figure is that parties without cabinet experience have on average experienced a small reduction in their vote share during periods of fiscal expansion (-0.7 percentage points).

Figure 5.5 Change in vote shares for different kinds of parties

it is not unusual to find that the same party belongs to several of these categories.⁴

As shown by the black bars, all of these categories of parties have gained votes following periods of large-scale fiscal consolidation. Parties without previous cabinet experience have experienced the greatest changes. On average, when the structural budget balance has improved by more than 5 per cent of GDP, their share of the vote has increased by almost 12 percentage points. This is a clear sign that fiscal consolidation causes citizens to vote for parties other than those which traditionally compete for government office. In many cases, these parties were not even represented in parliament when they broke through electorally. The ‘Five-Star Movement’ in Italy, for example, was only founded in 2009, by the comedian Beppe Grillo. In its first election, this party received 25.6 per cent of the vote. Much the same happened in the case of the Spanish party Podemos: in the 2015 election, just one year after being established, it got 20.7 per cent of the vote. Similar growth trajectories can be seen in the case of Syriza in Greece, of Jobbik in Hungary, and of ‘Action of Dissatisfied Citizens’ in the Czech Republic.

The second and third sets of bars show that, following periods of fiscal

consolidation, support for radical parties of both left and right tends to rise. Radical parties are here defined as parties which score below 2 or above 8 on a left–right scale from 0 to 10, according to the expert surveys used in the ParlGov database. The symmetrical rise in support for parties of the radical left and right corresponds well with the idea that citizens are mainly voting *against* the mainstream parties. However, there are far-reaching cross-national differences hidden behind these averages. In some countries, it was the radical left which met with electoral success; in others it was the radical right.

The fourth set of bars shows that Eurosceptic parties too gain support after periods of fiscal consolidation. Eurosceptic parties are here defined as all parties positioned below average on a pro-EU scale, which like the ideological scale is based on expert surveys. Seeing how governments often blame the EU for unpopular domestic policies, it is perhaps not surprising that fiscal consolidation increases the vote share for Eurosceptic parties. The correlation between unpopular fiscal policies and support for parties with Eurosceptic views could reflect a reduced legitimacy for EU institutions (Wyplosz 2016), or it may mean that slumbering Eurosceptic attitudes have become salient (van der Eijk and Franklin 2004).

As shown by the last set of bars, the share of the vote cast for populist parties has also increased after election periods marked by fiscal consolidation. On average, such parties have increased their share of the vote by 1.6 percentage points after periods of small-scale consolidation, and by 3.9 percentage points after periods of large-scale consolidation. There is an ongoing discussion about how populism can be defined and measured, but most scholars would agree that populist parties can be found anywhere on the left–right scale. The categorization used here comes from Inglehart and Norris (2016), and includes both left- and right-wing populist parties.

In Chapter 3, Ann-Cathrine Jungar discusses whether people vote for populist parties to protest against the political establishment or because such parties better represent their political preferences. Her conclusion is that populist parties are on the rise because of a congruence between their policies and the preferences of their voters. Moreover, she argues, these parties strengthen the political system, because they provide previously unrepresented voters with a political alternative. However, the fact that support for populist parties grows during times of austerity is hard to explain in terms of ‘enlightened’⁵ preferences against immigration or the EU. The fit is better with a picture of what happens when governments – instead of doing what the electorate demands – do what they believe to be right, or what they are required to do according to the fiscal framework. In the next section, I discuss why populism and other challenges to a

well-functioning democracy can be expected to grow when governments are forced to be unresponsive to the demands of voters.

RESPONSIBILITY, RESPONSIVENESS, AND THE QUALITY OF DEMOCRACY

Even if the debt problems were not caused primarily by fiscal indiscipline, there is more or less a consensus among economists that everyone is better off if fiscal policy is not too responsive to the demands of voters. This does not have to be a democratic problem; after all, every contemporary democracy uses non-majoritarian institutions in policy fields where it is important to isolate decision making from fickle mass opinion (Majone 1996). The rationale for constraining fiscal policy is that, if policy-making is encumbered by a deficit bias, then constraining the government's policy options can lead to better fiscal outcomes.

But in addition to its formal institutions, a well-functioning representative democracy involves democratic ideals like enlightenment, legitimacy, and responsibility. If voters' opinions are based on misconceptions or psychological bias, or citizens do not trust their political representatives, or political parties are unable to take responsibility for the greater good, then the democratic process is unlikely to yield desirable outcomes. In the area of fiscal policy, it will probably lead to higher debts and deficits. However, such aspects of democratic decision making scarcely figure at all in the economic literature on fiscal discipline.

In this literature, both voter preferences and party characteristics are usually assumed to be stable. But what happens when the distance between the popular will and the policy which is implemented becomes too large? What does this do to the political system, and to our democratic ideals? Below, I discuss why we should expect enforced fiscal discipline to have implications for how voter preferences are formed, for how legitimate the political system is, and for how responsible the parties in parliament will be. (By enforced, I mean policies which are explicitly required by lenders or by EU fiscal frameworks.)

In an ideal democracy, the behaviour of voters reflect their 'enlightened preferences'. Or in the words of Jane Mansbridge, we want citizens' policy demands and voting choices to reflect 'the preferences that people would have if their information were perfect, including the knowledge they would have in retrospect if they had a chance to live out the consequences of each choice before actually making a decision' (Mansbridge 1983, p. 25). In the realm of fiscal policy, we would like voters to have information about the budget balance and the long-term consequences of government debt.

Survey data have shown, in fact, that well-informed citizens are more likely to support deficit reduction (Althaus 1998).

Is this just wishful thinking, or are there things we can do to make preferences better informed? Beginning with Plato and Aristotle, political philosophers have repeatedly argued that enlightenment emerges from discussion and contention among a diversity of ideas (Barabas 2004). This position is also dominant among less esoteric democratic theorists (Föllesdal and Hix 2006). And while it might be naïve to believe the deficit bias can be eliminated through education, it stands to reason that discussions about the budget balance and fiscal sustainability will make people more aware of the need for fiscal discipline. Unfortunately, when it comes to austerity and other unpopular decisions, governments tend to resort to various strategies of blame avoidance, rather than promoting public debate (Weaver 1986; Pierson 1996). Economists and politicians alike have sought to supply governments with strategies for avoiding blame, so as to reduce the electoral costs for unpopular policies (Vreeland 2003). Indeed, the need to create a scapegoat for the pursuit of restrictive fiscal policies is often cited as one of the main reasons behind the Maastricht Treaty (Rotte and Zimmermann 1998). One aspect of such strategies, however, is often overlooked: they are likely to have repercussions on the opinions and preferences of voters. How can citizens adopt informed opinions if there is no debate? And why should they support fiscal discipline when the government itself cannot argue for its merits?

If fiscal rules are repeatedly used as scapegoats, the effect may be to undermine their legitimacy, as well as that of the government. Ultimately, legitimacy is required if a democracy is to survive (Lipset 1959). Until things get really critical, however, there are more pressing concerns. If governments on the national level are forced to implement policies that lack public support, they may appear powerless or unresponsive to popular demands. Either way, their democratic legitimacy is likely to take a knock.

On the European level, the scapegoat function of the Commission and of other EU institutions raises further concerns about legitimacy. The classic scapegoat for unpopular economic policies is the IMF. Unlike the institutions of the EU, however, the IMF has only a temporary presence in its mission countries. A build-up of resentment against permanent institutions like the European Commission is much more dangerous, because the legitimacy of European integration and of the Union's institutions can be undermined thereby (Wyplosz 2016). Survey data from the Eurobarometer suggest there is cause for concern on this point. For example, in the countries of southern Europe, where the sharpest fiscal consolidation has been carried out, the percentage of the population reporting an inclination to trust the EU fell from around 60 per cent in 2009 to approximately 25 per

cent in 2012 (Guiso et al. 2016). This trend echoes the above-mentioned finding that Eurosceptic parties gain support during periods of austerity.

The last democratic ideal I will discuss here is the need for responsible parties. To begin with, political parties should contribute to public debate, by showing honesty, sharing knowledge, and presenting rational arguments. This will enable voters to bring their opinions into line with their enlightened preferences. Populist parties, by contrast, deliver messages that appeal more to voters' wishes and emotions than to their enlightened preferences. Such parties are also likely to make promises that they cannot keep. To be sure, democracy is ultimately about the rule of the people. As Rousseau noted, however, 'the people cannot be corrupted, but they are often deceived, and it is only then that they seem to wish for what is bad' (Rousseau 1968 [1762]).

Responsible parties must also balance their desire to maximize their vote share against the need to make decisions for the common good. Mair (2009, 2013) describes macroeconomic policy-making as a conflict between responsibility (meaning both policy efficiency and commitment to agreements and accepted procedures) and responsiveness (meaning the degree to which the actions of the government follow the salient preferences of the electorate). According to Katz and Mair (2008), the growing tension between responsibility and responsiveness has led to a bifurcation in many party systems, whereby established parties are joined by a new type of opposition. According to the two authors, the new opposition parties are characterized by a strong populist rhetoric and a tendency towards irresponsible opposition and a politics of outbidding. Their explanation for the emergence of these parties is that the established parties have become more responsible than responsive – in part because of the increased importance of fiscal frameworks, of obligations to international organizations, and of commitments to prior agreements. Or as Wolfgang Streeck (2011) puts it, 'citizens increasingly perceive their governments not as their agents, but as those of other states or of international organizations, such as the IMF or the European Union'. This gap between the voters and their government may explain why support for newly established and populist parties increases after periods of fiscal consolidation (Figure 5.5), as well as why levels of trust in the government have fallen in countries with fiscal problems (Figure 5.1).

To sum up, there is a risk that fiscal discipline will damage our democratic ideals if it deviates so much from the popular will that it must be externally enforced. For example, if a government uses the Commission or the Stability and Growth Pact as a scapegoat for its policies, instead of defending said policies in public, the effect may be to damage the legitimacy of European institutions and to undermine the formation of

enlightened preferences among citizens. On the other hand, if established parties are not responsive enough to voters' demands, we may see them get replaced by less responsible parties.

HOW TO INCREASE FISCAL DISCIPLINE WITHOUT PUTTING POLITICAL STABILITY AT RISK

The simultaneous rise of public debt and of political dissatisfaction, as manifested in growing support for populist parties, in reduced trust in national governments, and in higher rates of electoral volatility, is one of the most worrying trends in Europe. Over the last decade, in the member states of the EU, the debt-to-GDP ratio has increased by 25 percentage points on average. Forcing debts back to their pre-crisis levels is an important challenge that requires fiscal discipline. Meanwhile, alarming developments in the domestic politics of many countries raises questions about how unresponsive governments can be before the political cost becomes too large.

While each of these developments is of great concern on its own, finding a solution becomes difficult indeed when they appear simultaneously. If austerity policies have contributed to political dissatisfaction, additional fiscal consolidation will probably make things even worse. And how can fiscal discipline be enforced if citizens elect parties that oppose fiscal rules and previous agreements with lenders? This dilemma is confirmed by the empirical findings in this chapter. When fiscal adjustment is implemented, voters desert established parties in favour of Eurosceptic parties without previous government experience. To a great extent, moreover, these parties can be characterized as populist parties. While it is not possible to test directly whether such parties are also less concerned about fiscal discipline, their other traits clearly indicate that they probably are. Besides, dramatic change in the party composition of a nation's parliament can be problematic in itself.

The situation is most alarming in the countries of southern Europe. Here we find the worst fiscal problems, as well as the greatest political instability. In Spain and Italy, the two dominant parties have together lost 33 and 25 per cent of the vote respectively to newly established parties. In Greece, the ruling party PASOK was virtually eliminated when it went from 44 per cent in 2009 to 5 per cent in 2015. The new ruling party, Syriza, received 36 per cent of the vote in the 2015 elections. Now, in late 2016, after continued cooperation with the European Central Bank (ECB), the IMF, and the European Commission, the latter party is down to 20 per cent in the opinion polls. The conflict between responsibility and responsiveness could not be more obvious.

While the fiscal problems in these countries have already had dramatic consequences, and further widened the social and economic gap between European regions, I believe we have reached the end of the road in what can be accomplished through fiscal rules and institutions that aim directly at enforcing fiscal discipline.⁶ Unless we can increase public support for fiscal discipline, we will find it very difficult to achieve fiscal sustainability in any way which is also politically sustainable. This approach stands in sharp contrast to recent reforms in European fiscal frameworks, where the focus has been on strengthening the enforcement of rules (by increasing the number of situations where the Commission and the Ecofin Council can impose fines), as well as on changing voting rules (so that a qualified majority is no longer needed for new steps in the excessive-deficit procedure).

There are two reasons why ‘forcing’ fiscal discipline on incumbent governments cannot solve these problems. First, the fiscal problems were not primarily caused by fiscal indiscipline. During the decade before the Great Recession, most countries conducted a fiscal policy in line with recommendations from the European Commission and other monitoring bodies. The problem during those years was that analysts mistakenly perceived economic output to be below its capacity, which caused fiscal policy as well as advice from independent experts to be overly expansive. This, together with the fact that the Stability and Growth Pact did not require large enough safety margins to cope with the expenditures directly related to the Great Recession, is a better explanation than fiscal indiscipline for the gloomy situation of public finances in Europe.

Second, even if established parties can agree on a trajectory for fiscal policy over the medium term, there will always be other parties that do not abide by such an agreement. If there is a wide gap between public opinion and the policies which are implemented, dissatisfied citizens may vote for unestablished parties which promise an end to austerity policies, even at the cost of breaking with the fiscal framework or with agreements with the EU. Indeed, this is exactly what has happened in countries such as Hungary, Greece, Spain, and Italy, where Jobbik, Syriza, Podemos, and the Five-Star Movement have come out of nowhere and gained 20–35 per cent of the vote.

I have divided my policy recommendations into three parts, structured after what they are meant to achieve. The recommendations in the first part concern how we can minimize the risk of sovereign debt crises in the future. The second part is focused on lowering the electoral costs of fiscal consolidation, while the third set of recommendations are meant to reduce the tension between responsibility and responsiveness.

Let me begin with the first set of recommendations. In order to reduce

the risk of future debt crises, we must acknowledge that public debt can rise rapidly, even without a lack of fiscal discipline. It used to be costly wars that put unexpected pressure on public finances: at the end of World War II, for example, many countries had a government debt of 100 to 200 per cent of GDP. During this last recession, by contrast, the causes lay in a combination of bank bailouts, expenditures directly related to the weakening labour market, and systematic misperceptions of the business cycle (Nyman 2016b). Moreover, public debt tends to rise during economic downturns, when both the economic and the political costs of fiscal consolidation are large. Governments should therefore try to establish safety margins during upturns in the business cycle, so that they are not forced to implement austerity policies in the midst of economic downturns.

I have two suggestions for how to secure such safety margins. The Stability and Growth Pact requires gross debts to be smaller than 60 per cent of GDP. This ceiling should be combined with a more ambitious *target* at which countries should try to aim, in order to create a large enough safety margin when the next crisis hits. The operationalization of this target should be decided by the individual member states. Moreover, fiscal policy has been made increasingly dependent on structural indicators – that is, estimates of what the economy would look like if it were operating at full potential. If the calculation of such indicators is biased, a similar bias will inflect fiscal policy. This is an argument for using backward-looking criteria when evaluating compliance with fiscal policy rules. If fiscal policy has been too expansive over a given period, compliance with backward-looking criteria will require the government to compensate for past errors.

The second set of policy recommendations is meant to make it less costly for governments to implement fiscal consolidation. One such strategy would be to reduce the salience of this issue, by making the adjustment automatic instead of discretionary. If nominal expenditures do not automatically increase in line with rising wages or prices, the budget balance will improve without discretionary actions, since tax revenues tend to rise as wages increase. However, such a solution will cause economic growth to reduce levels of public spending automatically (Nyman 2016a). To counteract this political bias, a reduced level of indexation should be combined with other measures, such as a floor for tax revenues or a medium-term target for the tax ratio.

When implementing unpopular policies, governments can also use scapegoating tactics – that is, they can blame their policies on someone else. Or they can try to reduce the salience of the issue. However, it is probably a wise long-term strategy to avoid such tactics – partly because they damage the legitimacy of the scapegoat, and partly because they make voters less informed about why fiscal discipline can actually be a good thing.

In a situation as extreme as the one in which we now find ourselves, it is hard to see how certain countries will be able to repay their debt without dramatic consequences for their political system. One solution to this problem could be some form of collective debt restructuring, whereby the creditor countries agree to write off a portion of the debt (Wyplosz 2016). In practice, this has already happened in the Greek case. Naturally, however, this is a politically contested topic, with many more aspects than I can cover here.

My third set of policy recommendations concern the most important challenge – but also the most difficult one – which is how to increase public support for fiscal discipline. In the end, the only way to enhance fiscal responsibility without reducing policy responsiveness is by increasing the salience of the country's fiscal position, by changing voters' preferences, and by making citizens better informed. The idea is to move the expressed wishes of citizens closer to their enlightened preferences.

Perhaps it is not surprising that the European Union has failed in this regard. According to public-choice theory, international organizations are created in part because they benefit incumbent national governments (Vaubel 1986). For example, international agreements can enable national policy-makers to implement unpopular domestic policies without taking the blame for them. Instead of having to argue that such policies are beneficial in the long run, policy-makers can use the international agreement as a scapegoat. And while fiscal rules can be introduced (formally speaking) on the national level, the creation of the Economic and Monetary Union (EMU) opened a window of opportunity, allowing the political elite to introduce fiscal frameworks that would have been difficult to implement in the national political arena (EEAG 2003; Baimbridge and Whyman 2005).

However, using an external agent as a scapegoat is dangerous, especially when it is a permanent institution like the EU (Wyplosz 2016). As argued above, the legitimacy of the scapegoated institution can be damaged, and the quality of citizens' preferences as well. If the institution lacks legitimacy, it may also be less effective as a scapegoat. Furthermore, if the country in question receives bailout loans from the ECB or from other member states, the domestic fiscal policy pursued can get entangled in conflicts of interest between member states. As such, it may contribute to a deterioration in relations between countries.

It may be a bit naïve to believe that fiscal sustainability will be achieved if only public discourse is guided by rational arguments. But even should it prove impossible to increase sincere public support for fiscal discipline, we should at least strive to increase the legitimacy of the fiscal frameworks and institutions. This will probably require that they be created on the national level and exposed to national debate. There is also evidence to

indicate that national fiscal frameworks are more effective than their supranational counterparts. For example, Bergman et al. (2016) find that national fiscal rules increase fiscal discipline; by contrast, they find no such effect on the part of the Stability and Growth Pact. It bears noting that the Fiscal Compact requires member states to introduce balanced-budget rules on the national level. If they do not comply, they can be brought before the Court of Justice of the European Union, and ultimately fined. However, forcing countries to implement certain rules is not likely to solve the problem of legitimacy.

This leads to my last two policy recommendations. First, to the extent possible, fiscal frameworks and fiscal councils should be designed in such a way that they increase public support for fiscal discipline. They can do this by enhancing fiscal transparency, increasing the salience of the country's fiscal position, and contributing to the public debate on fiscal policy (whether by participating actively or by providing a point of reference to which prevailing policies can be compared). Other discipline-enhancing methods, like a resort to scapegoating or a strict enforcement of rules, should be used with care. Second, national fiscal rules and fiscal councils have often been introduced in response to a public debt crisis. In the wake of a fiscal crisis, the public is more aware of the negative consequences of fiscal indiscipline and can be expected to be more positive towards institutions of this kind. Governments ought, therefore, to use the opportunity created by the current crisis to create or modify national fiscal frameworks.

Until we find ways to increase public support for fiscal discipline, we will be caught in a difficult dilemma. If we make fiscal policy more responsive to popular wishes, the chances are that debt levels will continue to increase and that more countries will suffer dramatic sovereign debt crises. And if we make policy-making less responsive, trust in established parties will likely keep falling and populist parties will continue to rise. Since the countries with the worst fiscal problems to a large extent also have the most vulnerable political systems, an increasing tension between responsiveness and responsibility is likely to widen the prosperity gap in Europe.

NOTES

1. Greece stands out as a clear exception and an obvious example of fiscal indiscipline.
2. The output gap is the most common measure of the business cycle. It measures the estimated difference between actual and potential output, usually expressed as a percentage of potential GDP. The output gap is negative during bad times and positive during good times.
3. Previous research has found that fiscal adjustment does not affect the likelihood that a government will be re-elected (Alesina et al. 1998, 2012; Brender 2003; Brender and

Drazen 2008); nor does it influence a government's expected vote share (Peltzman 1992; Lowry et al. 1998; Drazen and Eslava 2010). I argue (Nyman 2016c) that these studies underestimate the effects, because of two identification problems.

4. For four of these categories of parties, the change in vote share is positive during periods of fiscal expansion as well, although it is very close to zero. This means their vote shares have increased over time. It is only the vote share for parties without cabinet experience that has decreased on average during periods of fiscal expansion (-0.7 percentage points, not shown in the figure).
5. That is, informed, deliberate, and considered. See the words of Jane Mansbridge, quoted below.
6. By this I mean rules and institutions that affect policy, but not the information available to policy-makers or the public support for fiscal discipline.

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