Political Tensions in Euro-Varieties of Capitalism

The Crisis of the Democratic State in Europe

By Aidan Regan
Max Weber Fellow, European University Institute (EUI)

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Abstract

The European response to the financial cum fiscal crisis in the Eurozone is leading to a democratic crisis of the state. It has exposed a tension between the national and the supranational in a multi-level polity whilst opening up new political cleavages between the core and periphery of Europe. This dilemma has become particularly acute for program countries that are either directly or indirectly in receipt of non-market financial funding from the Troika. In the absence of exchange rate adjustments, Ireland and Southern European countries must pursue an internal devaluation that shifts the entire burden of adjustment on to fiscal and labour market policy. National governments, regardless of political partisanship, are required to comply with external EMU mandates and liberalise their welfare state, cut public spending and impose market conforming structural reforms. The core argument of this paper is that imposing a one size-fits-all neoliberal solution to diverse economic problems across different varieties of capitalism is the real source of the Eurozone crisis. Using a cross-country comparative analysis of Greece, Ireland, Italy, Portugal and Spain I conclude that this is an outcome of inbuilt institutional and macroeconomic asymmetries in the EMU. But it is leading to unprecedented electoral volatility and a legitimation crisis of the democratic state in Southern Europe.

Introduction

The European response to a financial cum sovereign debt crisis in a currency union without a centralised fiscal treasury or political government is an experiment in crisis management. It has exposed a tension between the national and the supranational in a multi-level polity. No level of this multi-level governance system has the policy instruments to solve the crisis. Monetary policy remains supranational (i.e. European) across seventeen national governments with diverse fiscal, welfare state and labour market regimes. These countries have conflicting interests on who should bear the burden of adjustment. For the sake of argument we can identify this as a tension between creditor and debtor countries, or between the core and periphery of Europe. Much of the economic literature argues that if countries engage in an internal devaluation, impose structural reforms and implement technocratic fiscal policies, the crisis will be resolved (see Buti & Carnot 2012). This might be true but ignores the fact that this is fundamentally a political crisis. Europe lacks the strategic capacity to coordinate a response that distributes the burden of adjustment evenly across debtor and creditor nations.

The member-states of EMU currently have limited policy discretion to pursue an autonomous response to the crisis. In the absence of exchange rate or interest rate adjustment the entire burden of adjustment must fall on domestic prices and wages. In effect, membership of the EMU means that national governments only have one policy instrument at their disposal: internal devaluation and
structural reforms of the labour market. From a political perspective, national governments must comply with the external mandates of EMU membership by reducing their budget deficit to 3 percent of GDP. The negative impact this has on employment is legitimated by the economic argument that cost competitiveness and export-led recovery is the only way to generate the conditions for economic growth. To achieve this, national governments are being encouraged to impose market conforming structural reforms to enhance product and labour market competition. It is this assumption that a convergence in neoliberal market policies will lead to institutional convergence in economic outcomes - across diverse democratic states in the Eurozone - that I challenge in this paper.

To do this I draw upon the core tenets of the varieties of capitalism (VoC) theory in the study of comparative political economy\(^1\). I illustrate that the domestic organisation of distinct political economies in the north and south of Europe interacted with transnational European institutions to produce divergent economic and employment growth patterns. The source of the economic crisis was the attempt to join together different varieties of capitalism into a single currency whilst failing to account for the asymmetric effects this would produce. Northern European countries are built around the institutions of a small open export-driven model of economic growth. Southern European countries, on the other hand, are institutionally conducive to an economy based around domestic-demand in the non-tradable sectors of the economy. My contribution to comparative political economy is to illustrate how these models are systematically related in the Eurozone and to analyse the EMU as an emergent political and institutional regime in itself. I push the VoC argument to its logical conclusion and argue that if countries operate according to their own distinct political and institutional logic, then it is questionable whether some member-states should remain in the Eurozone. Europe needs a variegated response to the crisis that provides the flexibility for member-states to carve out an autonomous economic and employment growth strategy at the national level. If this is not forthcoming then it is perfectly rational for some member-states to consider leaving the Euro.

The core argument of the paper, therefore, is that the EMU works from the assumption of market convergence rather than institutional diversity. It fits the micro-theoretical assumptions of neoclassical economics and the monetarist theory of optimal currency areas. In this regard, orthodox ideas are dominating the policy response of EMU. But the democratic crisis is a direct outcome of the complexity of decision-making in a multi-level polity. The remainder of the paper is structured as follows; first I outline a VoC theoretical framework that incorporates the emergent EMU regime as a political economy in itself. Second, using this framework I trace the origins of the Eurozone crisis to capital inflows and current account imbalances. Third, I detail the adjustment in Ireland and Southern Europe. Fourth, I analyse the political and policy consequences for both the Eurozone and its member-states. Finally, I argue that the one-size-fits-all neoliberal adjustment is leading to a legitimacy and fiscal crisis of the democratic state in Europe.

The Diversity of Capitalist Democracies

The central research finding in comparative political economy over the past twenty years is that what governments do is conditioned by the structure of the political economy. According to Hall and Soskice (2002) the organisation of a country’s political economy includes the structure of corporate governance, industrial relations, finance, social policy, labour market, education and training. The relations within these subsectors and their historical evolution over time produce different varieties of

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\(^1\) This is not only related to Hall and Soskice (2002) but a political-economic research tradition that includes, to name but a few: Esping Anderson (1990), Streeck & Thelen (2005), and Scharpf (2012). The core insight is that cross-national differences in outcomes can be explained by historically embedded institutions and politics.
capitalism. From a political science perspective they condition the type of public policy choices that governments are likely to pursue in times of economic crisis and growth. In the Eurozone one can argue that there are three variants of capitalism. Northern European countries; Germany, Netherlands, Austria and Finland, are often described as coordinated market economies (CMEs). They have centralised unions and employers with the capacity to autonomously coordinate collective bargaining and labour market outcomes. In addition they have embedded democratic state traditions committed to social protection and income security. They have traditionally relied upon export-led economic growth as a mechanism to generate employment. Hence, their macroeconomic structure supports a preference for stable fiscal policies (see Carlin & Soskice 2011).

On the other hand, Southern European countries in the Eurozone; Spain, Italy, Greece, Portugal and Cyprus, are often described as mixed-market or Mediterranean varieties of capitalism (Jackson & Deeg 2006). They have fragmented trade unions and employers with limited capacity to autonomously coordinate collective bargaining and labour market outcomes. They have weak welfare states and a significant amount of social security occurs through family relations. Traditionally they have generated economic growth through domestic demand. This gives priority to wages and consumer spending over profit generation in export markets. Prior to EMU this organisational structure leant itself to an accommodating monetary and fiscal policy, with governments regularly devaluing the currency to offset a loss of competitiveness and the inflationary impact of a rapid increase in domestic prices. Wealth is often held in fixed assets such as property and corporate governance dependent upon close business relations among family-run firms. Ireland can also be characterised as a mixed-market economy but more liberal in orientation. It differs from the north and south of Europe in that it has a business cycle closer to the UK and USA, and a much more flexible labour market.

The core argument of this paper is that the attempt to join together these two different economic growth models into a shared currency within a multi-level polity without a centralised political government is the real source of the Eurozone crisis. As stated in the introduction we can describe the organisation of the political economies in Southern Europe as conducive to a growth model based on wage-led domestic demand. In contrast, the organisation of the political economy in Northern Europe is conducive to a growth model based on profit-oriented export driven demand. Both of these regimes, however, are systematically connected. The EMU is a semi-closed trading area with less than ten percent of trade leaving the Eurozone, and which predominately goes to other countries in the EU (Hancké 2012). The EMU was designed as an unaccommodating currency regime that provided unprecedented autonomy to the European Central Bank (ECB). This primarily benefitted the export driven model of northern Europe. This would not be a problem in a federal state system such as the USA. But it is a problem for a polity such as the EMU with no capacity for fiscal, wage, employment and labour market coordination - to offset the asymmetric impact of an economic shock.

The core problem with empirical research in the VoC tradition was that it failed to analyse the systematic relationship between the divergent macroeconomic growth models in the north and south of Europe within the EMU. The Eurozone is a semi-closed trading economy operating in a global international market without a government. VoC research was predominately focused on the institutional complementarities between sub-sectors of the economy at a national level, and the comparative advantage this provided to multinational firms in the export sectors. This provided important insights into why cross-national variations in public policy outcomes persist, particularly those pertaining to the labour market and employment. The core conclusion, much like Epsing-Anderson (1990) was that domestic institutions are deeply embedded and difficult to change. But it did not allow for a systematic analysis of the non-traded sectors in the domestic economy. This is all the more unusual when one recognises that, with a few exceptions, domestic demand is what drives
most capitalist development. Hence I want to highlight one variable that VoC researchers paid insufficient attention to, and which is crucial for understanding the origins and consequences of the Eurozone crisis: the macroeconomic relationship between different political regions within the EMU. This requires moving beyond methodological nationalism of the VoC framework.

Taking a more international political economy perspective seriously will illustrate the importance of analysing the growing political tension between national democratic-states and a multi-level polity such as the EMU. Institutional analyses in comparative political economy paid insufficient attention to the fiscal capacity of the state in capitalist democracies to manage crises. Politicians are not just responsive to the organisation of the capitalist-class in the export-led sectors of their economy but to the distributional concerns of their domestic electorates. Within Europe, there are not only distinct political economies but democratic welfare-state traditions, constituted by diverse political parties seeking to satisfy various distributional demands from increasingly volatile voters. What makes for a successful electoral strategy, or political party for that matter, in Italy, France, Greece or Ireland is not the same as Germany and the Netherlands. But despite very different democratic state and political party traditions these member-states pooled their national sovereignty into a complex multi-level polity that would restrict their capacity to be responsive to the distributional demands of the electorate (such as using macroeconomic policy to generate full employment). Hence, both the nation-state and European institutions have decreasing strategic capacity to satisfy the input and output requirements of democratic government (Scharpf, 2009). This, however, is less an outcome of a neoliberal conspiracy by elite policymakers but the inbuilt political and institutional constraints of governing the European Union.

It is integrating an empirical analysis on the interactive and potentially negative effect of EMU on capitalist democracies in the north and south of Europe that I contribute to comparative political economy. The question is not just whether the nation-state or EMU can sustain institutions for economic efficiency but whether they can maintain the legitimacy for democratic order.

**The Origins of the Eurozone Crisis**

The Eurozone is composed of seventeen linguistically diverse countries and has a combined population of 317 million people (the USA is 300 million). It has a GDP of €9.4 trillion and accounts for 14.6 percent of global trade (the second largest in the world). But importantly only ten percent of this GDP actually leaves the Eurozone, and predominately goes to other EU countries (Hancké 2012). As argued in the previous section this means that the Eurozone, in effect, is a semi-closed trading economy. A gain in competitiveness for one country, by definition, can only come at the expense of another country. The implication is that trade has become a zero-sum gain among seventeen nation-states sharing the same currency. That is, unless a country can gain market share outside the Euro area it will come at the expense of another EMU partner. This has exposed a horizontal political tension between member-states of the EMU. Germany accounts for over 26.7 percent of Eurozone GDP, and by far the largest exporter from the trading area. Given its economic resources it is a rule maker rather than a rule taker when designing the policies of EMU. From a macroeconomic perspective fiscal reflation in a closed economy will stimulate aggregate demand. But this Keynesian policy assumes that the closed economy is governed by a homogenous nation-state. This is not the case in a polity composed of states with competing economic interests, institutions and economic philosophies.

![Figure 1 about here]

The core problem at the heart of the Eurozone crisis is a structural imbalance between export led economies with current account surpluses (Germany, Netherlands, Austria and Finland) and
countries with current account deficits (Italy, Spain, Greece, Portugal and Ireland) that emerged directly after the establishment of the EMU in 2000 (see figure 1). These divergent trends are usually taken to illustrate the underperformance and loss of competitiveness by the ‘GIPSI’ countries in the Eurozone, and central to the establishment of the EU Commission macroeconomic scorecard in 2011. The indicators in this scorecard are firmly focused on how to improve the balance of payments for deficit countries, through holding down unit labour costs. This, by definition, promotes competition in wages among member-states as a strategy for economic development. Coordinated wage restraint by centralised unions and employers, made possible by domestic institutions, is one of the core factors in explaining the export oriented success of small open economies in Europe. Germany, despite its size, is the perhaps the best example of this. But from the perspective of EMU as a whole, what the ‘beggar thy neighbour’ approach to wage competition fails to appreciate is the negative impact it has on the exporting capacity of other countries sharing the same currency. This is all the more problematic if we accept that within the Eurozone there are two different macroeconomic growth models in northern and southern regions: export-profit and domestic-wage demand. In this context holding down wages in a semi-closed trading area negatively affects all member-states.

What the divergence in current account balances in figure 1 actually illustrates is that from 2000-2008 Ireland and Spain imported more than they exported (De Grauwe & Ji 2012). Capital flew out of countries were exports exceeded imports, such as Germany, to purchase assets located in countries with increased domestic demand (Ireland and Spain); fuelling domestic prices and house price booms (Fitzgerald et al 2012). Since 2000 Germany’s current account surplus (€192.2bn) is identical to the combined current account deficit of Greece, Italy, Portugal and Spain. This export of capital meant that these deficit countries became indebted to surplus countries, with the implication that their economies become heavily reliant on private credit to fuel domestic demand (see figure 2). All of this was made possible by a one-size fits all monetary policy by the ECB and a single interest rate that made cheap credit widely available for peripheral member-states after entry to the EMU. Hence the current account imbalances occurred because the private and public sectors in some member-states took advantage of negative interest rates, the absence of exchange rate restrictions and began borrowing excessively on the European money markets for domestic consumption.

[Figure 2 and 3 about here]

But this is precisely what political leaders who signed up to EMU wanted and got from the single currency (see Moravcsik, 2012). For Germany, it provided an anchor for a stable exchange rate that would benefit its export driven model within Europe. It removed the volatility of exchange rate fluctuations and the ability of its trading partners to devalue their currencies relative to the Deutschmark. It provided an integrated European finance market that was highly profitable for German banks. France, on the other hand, feared the economic might of German reunification, and sought a tool that would generate the conditions for a federal Europe that would decrease rather than increase the power of German money. For Ireland, Italy, Spain, Greece and Portugal the EMU would reduce the cost of borrowing and facilitate capital inflows for national investment. All countries got what they wanted. This is less a case of economic institutional calculation but politics. The critical mistake was that policymakers assumed that a convergence in ECB market interest rates, in addition to strict fiscal policies to be embedded into the Growth and Stability Pact, would provide the conditions for an institutional convergence in business cycles across diverse political economies in the Eurozone. This has proven to be a fundamental mistake.

The assumption of institutional convergence was not present in the negotiations that led to the European Monetary System (EMS) in the late 1970’s. During this period there were competing
perspectives between the ‘monetarists’ and the ‘economists’ (see Mourlon-Druol 2013). The German Chancellor; Helmut Schmidt, refused to accept a shared currency until there was real convergence in fiscal policy regimes. The monetarists, on the other hand, argued that a currency union would itself lead to economic convergence and eventually a political union in Europe. After Maastricht there was a blurring of the two positions. It was assumed that a single interest rate would lead to market convergence but only if the ECB was constructed in the image of the Bundesbank, and complemented with strict fiscal rules to be imposed on member-countries. The deeper analysis and reflective of much economic literature on perfect competition, argued that ‘structural reforms’ in product and labour markets is what will really drive institutional convergence. Countries that implemented supply-side structural reforms would generate the conditions for price and wage flexibility, and therefore develop the capacity to adjust their economies in the aftermath of an asymmetric shock. This is the economic idea that underpins the Troika adjustment programs in Ireland and southern Europe today.

The problem, however, and central to comparative capitalist framework in this paper, is that the assumption of convergence not only ignores the empirical cross-national variation in the underlying organisation of political economies, but assumes these differences can be easily overcome by committed governments with the ‘correct’ techno-economic policies. Central to the prescribed austerity and structural adjustment programs since 2009 is the assumption that if governments liberalise their welfare state, de-centralise collective bargaining and flexibilise the labour market they will eventually generate the conditions to compete with the German model of capitalism in international export markets. It is certainly true that Germany introduced deeply contested structural reforms in the post-EMU era (usually captured under the ‘Hartz reforms’) which created significant political and distributional turmoil for both SPD and CDU led coalitions. In this regard, Germany has the legitimacy to prescribe structural reforms as a panacea to the economic and employment crisis in Southern Europe (Regan, 2013). But it would be a mistake to assume that these reforms underpin the competitive resilience of the German economy. This can be traced to the embedded corporatist institutions that provide economic actors with the resources to negotiate political compromises and solve complex economic problems (Culpepper 2012). Germany had the strategic capacity to carve out an autonomous response and develop an export-led strategy that complemented the monetary constraints of EMU. Ireland and Southern Europe do not.

Hence, whilst the divergent current account imbalances certainly indicate the different long term growth potential of southern and northern European economies, and therefore their capacity to pay off debt and achieve lower interest rates on government bonds; they also reflect two different growth models that are systematically connected in EMU. Deficit countries (in the private and public sector) borrowed cheap money from surplus countries to feed domestic-demand. This may or may not have crowded out the export sectors. But given that the Eurozone is a semi-closed trading economy, it would have been systematically impossible for all countries to behave like Germany. Each participant benefitted from the exchange. Furthermore, this is precisely what the designers of EMU had intended. But they did not get their anticipated convergence in the organisation of national political economies.

The Impact of the Eurozone Crisis

[Figure 4 and 5 about here]

The outcome of joining these different varieties of capitalism together was that post-EMU some countries experienced a financial orgy, fuelling divergent and uncoordinated business cycles (see figure 3). Investors were throwing their money at risky investments leading to asset price bubbles and subsequently private sector debt. The Euro currency as an isolated variable did not cause this but it
made some member-states extremely vulnerable to financial markets and a sudden stop in capital inflows. This is precisely what happened to Ireland and Southern Europe from 2008-2012 (Lane 2013). In fact, the extent of capital inflow is the single most important variable for analysing which countries got into trouble in the aftermath of the financial crisis (Wolff 2012). In the Eurozone, member-states borrowed excessively for either private spending (Ireland and Spain) or public spending (Greece). The outcome of these credit bubbles was strong economic and employment growth in the domestic economy. This provided national governments with unprecedented resources to satisfy the political and legitimate distributional demands of their electorate.

Hence, the real impact of EMU was an explosion in cross-border capital flows, cheap credit and an inevitable rise in private and public debt across Ireland and Southern Europe (see figure 4). None of these countries had the policy tools to control the awesome power of cheap money. But from a VoC perspective it was perfectly rational for these countries to take advantage of the absence of exchange rate restrictions. Their domestic economic and political institutions are more conducive to facilitating domestic-demand than export-led growth. The problem was not economic growth based on domestic demand in-itself but the composition of investment. In Ireland, Spain, Portugal and Greece credit was predominately invested in the commercial and housing mortgage markets, leading to an asset-price boom. This, in turn, created the perverse effect of higher inflation rates in countries such as Ireland when compared to the pre-EMU period. During this period the ECB was targeting the average Harmonised Consumer Price Index (HCPI) across member-states experiencing diverse business cycles. The problem with this measure is that it does not consider asset-price inflation. Hence, European policymakers completely missed the impact of house price inflation on national competitiveness - measured in unit labour costs – across Ireland and Southern Europe (see figure 5).

The divergence in competitiveness shown in figure 5 reflects an increase in the overall share of the non-tradable sectors (construction, tourism and public administration) in the economy. Divergent wage setting institutions, associated with different varieties of capitalism, certainly contributed to this but it was generally caused by the inflow of capital imports from surplus countries (Germany). When these capital flows went into reverse during the international financial crisis the deficit countries got into economic difficulty. Hence, it is not competitiveness per se that is the underlying problem of current account imbalances in the north and south of Europe but the accumulation of debt. On the one hand this can be explained by the fiscal recklessness of political parties in governments (Greece) but it was primarily the result of reckless behaviour by private market actors in private finance markets. This was made possible by an integrated and liberalised European money market that began with the abolition of capital controls in the 1980’s, followed by the harmonisation of financial regulations in the 1990s and culminated in the single currency: EMU.

The political fallout of what happened when these credit bubbles burst is now part of European history. In Ireland and Southern Europe the level of private and public debt accumulated was quickly made visible to citizens and markets. Increased tax revenues made possible by a period of full employment and high growth collapsed, when domestic demand contracted. Governments stepped in to guarantee the bad debt of their banks. Fiscal deficits increased and debt-GDP ratios soared. In the absence of a lender of last resort international investors panicked. Bond yields rapidly diverged and the fragility of the Eurozone was exposed (see figure 6). Greece, Ireland and Portugal were capitulated out of international finance markets and had to resort to an ECB-IMF-EU (Troika) loan to avoid a sovereign default. In return for this ‘bailout’ these member-states were required to implement an aggressive internal devaluation: public sector austerity and structural reforms, in the
assumption that wage competitiveness was the fundamental problem. The sovereign crisis soon spread to Spain and Italy in 2011. Whilst not directly priced out of the international bond markets, they required emergency funding from the ECB to keep their banking system and economies liquid. In return for this they too must impose structural reforms and cuts in public expenditure.

The Internal Devaluation Solution

There are four important observations to be made about the austerity and structural reform agenda as a response to the financial cum sovereign debt crisis in Europe. First, it was not supranational institutions such as the European parliament or commission that managed to impose fiscal consolidation across the Eurozone but the European Council. The new executive powers that have emerged from the EU Council in the aftermath of the crisis have created a mode of governance that mirrors an executive federalism with no formal-legislative legitimation (Jürgen Habermas 2012). The outcome is a market conforming technocratic regime that gives priority to fiscal stability as the primary solution to the economic imbalances at the heart of the Eurozone. In particular, and reflective of the intergovernmental mode of decision-making that has emerged, Germany has succeeded in getting all member-states to pursue individual and national austerity policies, and to institutionalise this into a new Eurozone ‘fiscal compact’. This has given the EU council unprecedented procedures and capabilities to both monitor and sanction member-states for violating the rules of austerity.

Second, the problem with institutionalising strict fiscal rules in the middle of a recession is less the assumption that coordinated austerity is a solution to a European financial-banking crisis but its social impact on employment (figure 7). In the Eurozone unemployment has crept above 12 percent. But this masks the deeper asymmetric implications of the unemployment crisis in Ireland and Southern Europe. The unemployment rate is 27 percent in Greece, 26 percent in Spain, 17 percent in Portugal and almost 15 percent in Ireland. More worrying, however is the distribution of this crisis within countries. The cross-national youth unemployment rate in Spain, Italy, Portugal and Greece varies between 42 and 56 percent respectively. Most of this is the outcome of a contraction in domestic demand not industrial output. To overcome the unemployment crisis the GIPSI countries are being encouraged to adopt labour market supply-side reforms, as a complement to fiscal retrenchment, as a strategy to generate growth. But most research on the effectiveness of these reforms in comparative political economy is negligible (see Armingeon & Baccaro 2013, Avdagic & Salardi 2013). Empirically, it is widely accepted that structural reforms only work as a long-term strategy in a period of strong economic growth, and when complemented by social security policies that ensure high levels of income replacement. This was accepted and embedded into the policy discourse of the EU Commission on Labour and Social Affairs from 2002, who attempted to promote the ‘flexicurity’ regimes of Nordic economies. Since the crisis, however, the policy response to labour market problems has been dominated by ECOFIN.

Third, the central focus on fiscal stability and structural reforms that has emerged from the EU Council is not only flawed economically and socially but completely ignores the central problem facing democratic states in Europe; how to re-gain control over financial markets. The frustrated attempts to regulate the global financial system and its parametric expression in the EMU are being blockaded by the political fragmentation among nation-states. This is particularly the case

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It is difficult to get precise data on the influence of Germany in conditioning economic policy in the aftermath of the Eurozone crisis. For more detail on decision-making in the European Council see James Cross (2013).
for liberal oriented economies such as Ireland and the UK who jealously guard their prerogatives to defend domestic financial sectors and are therefore reluctant to build new supranational capacities for political action. The fiscal pact ultimately sets the seal on the intergovernmental mode of national regulation which makes it possible for national governments to narrowly promote the specific interests of their variety of capitalism - blocking off a supranational response.

Finally, and most importantly for this paper, the German inspired fiscal-stability agenda promotes a one size fits all solution that does not take into account the need for differential adjustment programs in the north and south of Europe. It rules out flexible interventions that are tailored to the specific economic growth models, political institutions and economic cultures in each member-state. The underlying cognitive argument used to validate the strategy is the notion of Ricardian equivalence or ‘expansionary fiscal contraction’\(^3\). It is assumed that a shrinking public sector will lead to increased competitiveness in the private sector, which in turn will kick start an economic recovery based on export led growth. The subsequent improvement in the current account, it is argued, will send a signal to international financial markets that the government has the capacity to pay down its long-term borrowings. The problem with all of this, of course, is that it is based on minimal empirical data (see Blanchflower). It is based on the same logical argument that was used to create the EMU in the first place; namely that a one-size-fits-all market conforming policy can solve diverse political problems.

From a VoC perspective, the divergence in outcomes and the failure to resolve the crisis by shifting the burden of adjustment on to deficit countries is unsurprising. There is not a complementary institutional fit between the national fiscal and labour market policies of each member state and the EMU. Monetary policy remains Europeanised yet the institutions to transmit this to the real economy remain national; with the implication that the various ECB monetary easing programs since 2011 are not having the assumed expansionary effect on the real economy. Banking, much like fiscal, wage, social and labour market policies operate at the national not European level. Hence the assumption that an institutional complementarity between all these sub-spheres of the economy can be achieved through the implementation of stricter rules is not possible if one accepts that there are different varieties of capitalism in Europe. But it does draw our attention to the complexity of decision-making among heterogeneous democratic states in a multi-level polity during hard economic times.

**The Political Consequences for the Eurozone**

Political leaders at the national level in creditor and debtor countries are operating in a complex institutional matrix that offers competing incentives and constraints on their behaviour. They have to respond to the popular preferences of domestic electorates to ensure re-election and simultaneously respond to the interests of other political leaders at the EU level, to ensure their membership of a ‘government of governments’ (Scharpf 2012). In the aftermath of the Eurozone crisis this has become an asymmetric tension. Those countries with the most economic resources are in a significantly stronger bargaining position to get other member-states to comply with their interests.

Presently the EU lacks all the pre-requisites of input legitimacy that characterises a nation-state. There are no European wide political parties\(^4\), no European wide capacity to generate revenue and no directly elected President or a European government capable of acting in the common interest. Political cleavages and the public sphere remain an entirely national affair. Furthermore, the capacity to coordinate a European wide solution to the Eurozone debt crisis is restricted by the multiple veto points built into sharing sovereignty in a multi-level polity. Policymaking and power relations are

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\(^3\) Discussion with ECB official monitoring the Irish adjustment

\(^4\) With the ironic exception of the Irish based ‘Libertás’ who are a right-wing conservative libertarian party.
diffused across a wide variety of actors and institutions. It is for all these reasons that Fritz Scharpf has long argued that the EU is best characterised as a negative process of market-making that is structurally biased toward the promotion of neoliberal markets (see Scharpf 2002, Höpner & Schäfer 2008). Even if social democrats wanted to turn the EU into a federal system capable of satisfying the most basic social contract implicit in national welfare states they would be incapable of doing so because of institutional asymmetries. The outcome for Scharpf (2012) is a variant of Hayekian technocracy.

Supranational European institutions such as the European parliament, and to a certain extent the European Commission, have been side-lined during the crisis. They have been replaced by intergovernmental Eurozone summits between heads-of-state as the main forum for political decision-making. The Commission subsequently monitors and implements the outcomes; particularly the financial and economic affairs commissioner. In a context of crisis management, where creditor countries in Northern Europe are being requested to distribute scarce resources to deficit countries in the South, this shift to national bargaining should not be surprising. But it draws our attention to the asymmetrical influence of powerful nation-states, as opposed to European political actors, in designing the structural adjustment programs in Ireland and Southern Europe. Hence, contrary to the assumptions of pro-Europeans from Jürgen Habermas to Ulrich Beck, the crisis is not leading to more European integration but a return to the nation-state, with national governments defending the interests and comparative advantage of their national economies. The outcome is a German-EMU.

[Figure 8 about here]

**The Political Consequences for Ireland and Southern Europe**

In Ireland and Southern Europe there has been unprecedented electoral volatility at the national level under the Troika adjustment programs (see figure 8)\(^5\). The general trend is that incumbent governments, regardless of partisanship, who implement economic policies that are imposed upon them by external actors, are being severely punished at the ballot box. In Ireland, in 2011, the main party of the centre-right coalition; Fianna Fail, went from 77 seats in parliament to 20. This is unprecedented in Irish politics (see Marsh 2012). Their coalition partner; the Green party lost all their seats at both the national and the local level. The current centre-right coalition; Fine Gael and Labour, won the election on the basis that they would re-negotiate the Troika adjustment program. This never materialised. The Labour party are suffering the most in electoral terms. They received 33 seats in parliament in 2011, their biggest electoral victory in history. In the current polls they are set to lose 18 of these seats. In a recent by-election they received less than 5 percent of the vote.

The Greek centre-left party; Panhellenic Socialist Movement (PASOK), won 43 percent of the national vote in 2009. In 2010 they entered the Troika adjustment program and began to implement the conditional austerity measures. In 2011 the Prime Minister; George Papandreou resigned after a series of violent protests and the government collapsed. In the subsequent 2012 election PASOK suffered a historic defeat and barely secured 13 percent of the vote (see Dinas and Rori 2013). The newly emerged leftist party; Coalition of the Radical Left - Unitary Social Front (SYRIZA), under their new charismatic leader; Alexis Tsipras took 27 percent of the popular vote. A government was formed by the centre-right; New Democracy, who whilst losing 10 percent of the vote secured enough seats to form a minority government. A neo-Nazi party; Golden Dawn, took 7 percent of the national vote or 18 seats in parliament. According to current polls (2013) they would

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\(^5\) I am still collating this data
win over 11 percent of the vote if new elections were held, giving them the balance of power in parliament (Alco 2013). The post-dictatorship political party system comprised of the centre-left and centre-right is collapsing.

In 2005, the Portuguese Socialist Party (PS) won 45 percent of the vote which was reduced to 35 percent in 2009. In 2012 after entering the Troika adjustment they suffered their largest ever defeat taking 28 percent of the vote. In six years they lost over 30 seats. The current centre-right liberal party; the Social Democrats, increased their popular vote from 28 percent to 38 percent. But according to current polls they would be voted out of office if a new election is held, with a variety of emergent parties set to change the parliamentary landscape. The trend is identical to other EMU program countries; sitting governments regardless of political partisanship are being voted out of office with new parties and social movements emerging that are likely to reconfigure the political landscape.

In Spain and Italy similar processes can be observed. A snap general election in 2011 was called in Spain after the perceived failure of the government to cope with the economic crisis. The ruling Spanish Socialist Workers’ Party (PSOE) led by former Deputy Prime Minister; Alfredo Pérez Rubalcaba, suffered their worst election since Spain’s transition to Democracy in 1977 (see Kennedy 2012). They went from 43.9 to 28 percent of the national vote. The centre-right Peoples Party under Mariano Rajoy swept to power taking 44 percent of the popular vote. But he is now confronted with increased national separatist movements across Spain. This return to regional politics, particularly in Catalonia, is primarily driven by nationalist discourses that are in contradiction with pro-European integration (Wiley & Martinez 2010).

It is in Italy, however, were there has been most political volatility. In 2013 the electorate rejected the technocrat Mario Monti and his Civic Movement. They received 10 percent of the vote which is less than what was gained by the pre-existing centrist parties that he gathered to form his civic movement. While the Social Democratic Party; ‘Partitio Democratico’ (PD) led by Pier Luigi Bersani, emerged as the largest party, taking 29.5 per cent of the vote, it was 8 per cent less than what they had achieved in the 2005 elections. The clear winner of the Italian elections was Beppe Grillo and the Cinque Stelle Movimento (Five Star Movement). They emerged out of nowhere to take 25 per cent of the vote, recording the largest ever vote share for a party entering their first election (Regan 2013). Berlusconi’s centre-right ‘Popollo Della Libertá’ (PDL) emerged as the second largest party, taking 29 per cent of the vote. Some have lauded this as a political comeback, but this hides the fact that it was the biggest ever defeat for a sitting party in Italian elections, losing 16 per cent of their vote. This is much like what happened to the Christian Democrats in the late 1980s. The outcome of the election was that Italy found itself in the hands of the Eurosceptic Beppe Grillo, who does not play by the rules of representative democracy, heralding an unprecedented crisis for the Italian polity.

National governments across the Eurozone have opted for the responsible position of internalising the adjustment pressures associated with EMU membership and prioritised the interest of creditors over their citizens (Mair 2013). The problem with this, however, is that responsible governments are now implementing irresponsible economics. National governments have not been able to adopt a variegated response that is tailored to the specific needs of their domestic economies. This could be justified if fiscal consolidation and structural reforms solved the diverse economic problems facing these countries. The IMF (2013), among a whole host of other commentators, has since concluded that this is not the case. The outcome is growing popular support for anti-austerity political movements on both the far-left and the far-right. In this situation both the input and output legitimacy of the democratic state in Europe is being called into question⁶.

⁶ This is not to say that large scale protests and dissatisfaction with the state and political parties are a problem for democracy. On the contrary, they may be more necessary than elections.
The Fiscal Crisis of the Democratic State

The response to the Eurozone crisis draws our attention to the declining fiscal capacity of the democratic state to shape distributional outcomes in capitalist democracies (Schafer and Streeck 2013). The institutional design of the EMU and the emergent economic governance regime underpinning it has added an additional constraint to this long-standing problem. It leads to four empirical observations that are particularly important for understanding the relationship between the debt crises and how to govern different varieties of capitalism in the EMU.

First, there is a growing gap in EMU countries between public revenue and public expenditure, with the implication that governments have to increasingly borrow money on international markets to service the state. In the aftermath of the Eurozone crisis governments stepped in to guarantee the debt of private markets. The outcome was a sovereign debt crisis. Rather than the state ‘taxing’ market activities to pay for the crisis they now ‘borrow’ it from the same markets (Streeck & Mertens 2013). Most economic analyses have focused on the impact of this increase in public debt on the long term growth potential of an economy (Reinhardt and Rogoff 2010). What has not been analysed in sufficient detail is the impact of public debt on the ability of political parties in government to use discretionary fiscal spending to pay for the social investments we traditionally associate with the welfare state. The crisis of the democratic welfare state is precisely at this nexus between the irreconcilable tension between decreasing revenue and rising social expenditure.

Second, with less revenue and increased dependence on financial markets for expenditure, national governments have prioritised the interest of corporate creditors in negotiating fiscal adjustment. In the aftermath of the Eurozone crisis the public finances in Ireland, Greece, Spain, Portugal and Italy were thrown off course by a sudden increase in the interest rate charged by finance markets for sovereign bonds. A marginal increase in the rate of international borrowing alters the composition of domestic budgets. It means that a significant amount of expenditure must go on re-financing interest payments alone. The outcome is that national governments, regardless of political partisanship, are increasingly unable to use taxpayer’s money to invest in social projects that benefit citizens. They must satisfy the interests of a new growing constituency; private creditors and investors (Streeck and Mertens 2013). But if one accepts that different varieties of capitalism exist in Europe the outcome is even bleaker for countries running a current account deficit. Cuts in social spending and an increase in the cost of borrowing decreases the capacity for Southern European governments to build the institutional infrastructure, research, training, social and educational opportunities that are necessary to compete with the social and coordinated market economies of Northern Europe.

Third, contrary to the technocratic assumptions underpinning the EMU it is not democratic pressure from citizens that is restricting the composition of budgetary adjustments but tax competition. The problem is a declining capacity by the fiscal state to raise revenue. For example, in the aftermath of the crisis successive Irish governments have adopted a strategy in Brussels to accept and promote fiscal discipline as a solution to macroeconomic imbalances. The international diplomatic strategy of aligning Ireland with auster e Northern Europeans is designed to protect their low corporate tax regime. They have opposed all attempts at a coordinated transaction tax on financial trading in the EMU, which reduces the capacity of the EMU to collectively raise revenue within its jurisdiction to solve the crisis. The Irish policy to resist a European financial transaction tax was designed by the Clearing House Trading Company; a financial lobby group with a permanent

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7 The irony, of course, particularly in Ireland, is that these markets were saved only months previously by state guarantees of bondholders in domestic banks.
committee in the Prime Minister’s Office (Financial Times 2012). The Portuguese government have done likewise. In the midst of unprecedented cuts to social spending, governments are cutting corporate tax rates to incentivise inward investment. The interests of this new growing constituency for market conforming governments; international creditors and the holders of financial assets, have significantly more influence on public policy than citizens.

Fourth, the priority accorded to repaying interest on debt places long-term restrictions on the ability of competing political parties to offer alternative choices to the electorate. This is directly observable in the GIIPS countries in the aftermath of the crisis. Political parties change yet policy remains the same. In a context whereby citizens cannot influence government decisions then all claims to input legitimacy have been suspended (Scharpf 2012). The most minimal requirement of representative liberal democracy is that citizens can have a meaningful input to shape collective policy choices (usually through elections or democratic corporatism). If this is empirically non-observable then it is fair to say that the democratic state is in crisis. This dilemma could be overcome, however, with claims to output legitimacy. That is, citizens in a democratic republic might accept the absence of input legitimacy in the interest of ‘investor confidence’ if the Euro-technocratic economic policies being implement (cuts in public expenditure, de-centralised collective bargaining, and structural reforms of the labour market) led to effective outcomes such as economic and employment growth. But this is not the case. For all the GIIPS countries in the troika adjustment program (directly or indirectly) the debt-GDP ratio has increased, economic growth has contracted, unemployment is rising whilst budgetary deficits have only marginally been reduced.

Finally, if joining together different varieties of capitalism is a central factor in explaining the crisis, and the one-size-fits-all response of EMU is exacerbating this, it begs the question whether leaving the Eurozone is an optimal strategy for some member-states. Or to be more precise: would exiting the Euro currency a) halt the legitimation crisis facing the democratic state and b) provide the capacity to carve out a more flexible response at national level? At present this is an open question. It is simply not possible to calculate the risks and conditions of what would happen if this were to occur. But if one pushes the argument in this paper to its logical conclusion; namely that there are different varieties of capitalism in the Eurozone then it is hard to justify why a country should keep a currency that requires an adjustment that exacerbates rather than solves their debt crisis. But this argument assumes that the EMU-currency in-itself is the problem whereas in actual fact it is the political constraints of governing a multi-level polity with national competing interests that is the real source of the crisis. If Europe could develop the institutional and fiscal capacities that would provide the necessary flexibility for national varieties of capitalism to co-exist, and develop long-term autonomous growth strategies with the same currency, then exiting the EMU would not be necessary. But at present the empirical conditions for this transfer of sovereignty to Europe are non-existent.

Conclusion

This paper has argued that the attempt to join together different varieties of capitalism into a multi-level polity with a single currency without a government is the real source of the Eurozone crisis. The European response prescribes a one-size-fits-all approach of fiscal austerity and structural reforms that has exacerbated the divergence between core and peripheral regions of the EMU. The asymmetric implication of the adjustment is a crisis of the democratic state in Ireland and Southern Europe. At national-level political parties change but policy remains the same. Creditors are prioritised over citizens. It is this empirical analysis on the emergent political economic tensions of the EMU as a

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8 In this regard Ireland is no different to Germany in defending the domestic interests of its national model of capitalism
multi-level polity *in-itself* that distinguishes my contribution from the VoC literature in comparative political economy. The paper concluded by arguing that the crisis can only be resolved by adopting a *variegated* response that is tailored to the specific institutional and political needs of each member-state. Whether this requires some countries to leave the Eurozone is an open empirical question.
Figure 1: Current Account as a Percent of GDP

Figure 2: Net International Investment as % of GDP

Source: EU Commission (2012)
Figure 3: Private Credit Flow as a % of GDP

![Chart showing private credit flow as a percentage of GDP from 2000 to 2010 for Germany, Netherlands, Ireland, and Spain.](image1)

Source: EU Commission (2012)

Figure 4: Private Debt as a Percent of GDP

![Chart showing private debt as a percentage of GDP from 2000 to 2010 for Germany, Netherlands, Ireland, and Spain.](image2)

Source: EU Commission (2012)
Figure 5: Public Debt as a % of GDP

Source: EU Commission (2012)

Figure 6: Harmonised Competitiveness Indicators
Figure 7: Unemployment as a % of Labour Force

Source: EU Commission (2012)
References


Regan, Aidan (2013) Italy’s political and institutional crisis means that Beppe Grillo and Silvio Berlusconi will benefit the most if the country once again goes to the polls. *European Politics and Policy at LSE.*


