In the Red
Barta, Zsofia

Published by University of Michigan Press

Barta, Zsofia.
In the Red: The Politics of Public Debt Accumulation in Developed Countries.

For additional information about this book
https://muse.jhu.edu/book/64081

For content related to this chapter
https://muse.jhu.edu/related_content?type=book&id=2278750
The main contention of this book is that countries that amass alarming amounts of debt over the course of many years do so because their existing fiscal policies are too difficult to renegotiate and because major societal groups are not economically hard-pressed enough to compromise. When changes in economic, financial, demographic, or social conditions render existing fiscal policies unsustainable, these countries are unable to sufficiently trim their spending or increase their revenues to stop borrowing in time. The polarization-exposure thesis predicts that once public debt starts to significantly grow in a country, it takes much longer to successfully enact and carry out fiscal reform to stabilize public finances if economic openness is moderate and existing fiscal policies polarize preferences due to their targeted structure than if existing policies are encompassing and the economy is very open. The argument behind this prediction is that reforms are thwarted until a large enough social coalition coalesces in support of (or at least in acquiescence to) a specific combination of reforms. The emergence of such a social coalition implies a certain degree of compromise over the distribution of fiscal pain across society, the conditions for which evolve across time as the benefits of resisting fiscal pain are progressively outweighed by the costs of living with economic problems caused by fiscal imbalances. The costs of waiting for stabilization outweigh the benefits of wrangling over different combinations of spending cuts and...
tax increases much earlier in countries where existing fiscal arrangements do not allow for significantly unequal distributions of fiscal pain and where the pressures from economic problems are more acutely felt by large parts of society. Conversely, the tipping point arrives much later—and a supportive coalition arises with longer delay—where existing policies keep the stakes of choosing between different stabilization measures high and where large parts of society are immune to the economic problems that potentially accompany debt accumulation.

This chapter develops the polarization-exposure theory in detail. The next section explains why sustained large-scale debt accumulation is best conceptualized as an adjustment problem and develops a society-centered model of fiscal adjustment that draws on diverse strands of the literature on the political economy of adjustment and spells out its empirical implications. The third section explains the relationship of the polarization-exposure theory to possible alternative explanations for sustained debt accumulation: primarily to the rationalist fiscal governance literature, but also to institutionalist and ideational branches of the literature on the political economy of adjustment. The last section derives a plan for testing the relative explanatory capacities of each theoretical approach.

The Polarization-Exposure Thesis

When it comes to explaining sustained heavy debt accumulation, it is less important why borrowing originally started than why it is allowed to continue dangerously long. The reasons why countries start to borrow have been thoroughly explored. Often, these reasons arise from outside the realm of politics (Streeck 2013). Large enduring gaps in the budget are often opened by economic shocks, such as the one experienced by many developed economies in the late 1970s when their economies permanently settled on lower growth paths and their unemployment stabilized at much higher levels, boosting expenditure at a time when revenues were flagging. Fiscal imbalances are also often compounded by disturbances in financial markets, such as the large jump in the world interest rates in the early 1980s, which saddled many countries with a substantially increased interest cost on their outstanding debt. Social and demographic shifts have also generated increasing budgetary pressures in developed countries. At other times, the origin of deficits is purely political as policy makers take on new spending commitments and institute tax cuts without making offsetting changes in other parts of the budget out of electoral motivations. What-
ever the original reason for borrowing, though, once a major structural gap opens up in the budget, closing it requires active adjustment to the structure of spending and/or taxation. It often necessitates explicit legislative change, as the better part of spending and taxes is locked in by laws, but even in the case of discretionary spending and revenues, the government has to break with expectations based on past budgetary patterns. The question is why some countries delay making the necessary changes so long that they amass alarming amounts of debt, while others adjust relatively fast.

Obviously, major fiscal adjustments are politically exceedingly challenging. Cuts in transfers, scaling back government contracts, shrinking public employment, curtailing public services, and increasing taxes inflict unambiguous tangible losses on large sections of society. Very often, such losses are particularly painful because private actors had made fundamental economic choices based on past policies, which are difficult to change when policies are adjusted. The order of magnitude of losses to be imposed is often also very significant. A few empirical examples help to appreciate the scale of the necessary change. In Belgium, the (cyclically adjusted) deficit stood at 16 percent of the GDP in 1981, the year before the country embarked on a long period of austerity. Plugging such a hole required increasing taxation by a third or cutting non-interest expenditure by a fourth. The deficit was larger than the entire public employment bill, three times larger than public investment, and barely under the total spending on social transfers. It amounted to as much as the entire direct tax revenue and more than all the indirect taxes. Ireland faced a deficit of 11 percent of the GDP in 1986, the year before it adopted its second major adjustment package, amounting to a fourth of its total revenue and its primary expenditure. Italy was in the same shoes when it embraced austerity in the early 1990s. Greece ran deficits well above 10 percent of the GDP throughout the 1980s, but since its tax revenue and primary spending barely exceeded 30 percent of the GDP, closing the gap would have required a one-third increase in taxes or a one-third cut in spending. Japan ran a deficit of only 6 percent on average in the fifteen years before the global financial and economic crisis hit, but correcting this imbalance would have still required adjustments exceeding what it spent on public employment or public investment.

While imposing considerable fiscal pain on the electorate is bound to give policy makers pause before embarking on major adjustments, they should also be wary of hesitating too long. Since fiscal problems endogenously escalate in the absence of budgetary correction, delay only increases the size of the inevitable future adjustment and intensifies the fiscal pain
that will have to be imposed at a later point in time. As borrowing continues, the growing debt stock generates an ever-larger interest rate burden, boosting expenses and compounding existing budgetary imbalances, while also progressively limiting the fiscal space available for addressing newly emerging collective needs and demands. Simultaneously, sustained borrowing generates financial and fiscal risks and corollary economic effects—most typically high inflation, high interest rates, and problems with international competitiveness—which might impinge on the welfare of the electorate. Therefore, policy makers with reasonable chances of staying in the political race for government in the medium-term future have an incentive to carry out adjustment as promptly as they can.

The capacity of policy makers to adjust existing policies, however, depends on their ability to secure the support of a large enough social coalition. This is partly because policy makers will be unwilling to commit political suicide by going against the wishes of their constituencies. Just as importantly, though, they need to have the necessary clout to put changes into place. They not only need the electoral mandate that can be translated into the necessary governmental and legislative power to enact legislative changes but also have to have sufficient societal backing to enable them to avoid or withstand possible pressure from strikes, demonstrations, riots, intense lobbying, or threats of capital flight when putting the reforms to work. As Gourevitch (1986, 20) writes:

Ultimately, policy choices are made by politicians, by individuals who occupy institutional positions; power comes from the formal authority of those institutions. But somehow political leaders have to get into those institutional positions and hold on to them. And whatever they decide, their policies, to take effect, require compliance or even enthusiasm from countless individuals who work or invest or buy. When politicians make choices, therefore, their choices are constrained by the need to mobilize or retain support. Politicians have to construct agreement from among officeholders, civil servants, party and interest group leaders, and economic actors in society.

In other words, fiscal adjustment can only succeed if a substantial share of society supports it. Technically, there are many possible ways to close a budgetary gap, but in practice, there has to be at least one combination of tax increases and/or spending cuts large enough to close the budgetary gap that a substantial part of society is willing to accept. An adjustment package...
does not have to be backed by all sections of society to be viable, but it does have to command the support of a large enough share of society so that it can succeed even in the face of potential resistance. Exploring the conditions under which the necessary societal support for adjustment emerges is key to understanding why some countries fail to address their fiscal imbalances for extended periods of time whereas others adjust swiftly.

### Understanding the (Delayed) Emergence of Societal Support for Fiscal Adjustment

Finding a package of spending cuts and tax increases acceptable to a large enough share of society is much easier in some countries than in others because of differences in the policy status quo and in the economic context across different countries. Differences in the way existing fiscal policies raise and allocate government revenue in different countries generate differential levels of conflict within each society about how the necessary fiscal sacrifices should be distributed across various socioeconomic groups. In countries where existing policies lend themselves to reforms with very unequal distributions of fiscal pain across groups in society, finding an adjustment package that musters the support of a large section of society is more difficult than in countries where different tax increases and spending cuts affect large swaths of society fairly evenly. At the same time, differences in the economic structure—specifically, differences in exposure to international economic competition—create differential incentives for various social groups in different polities to seek compromise in the choice of reforms and acquiesce in adjustments that hurt them for the sake of restoring fiscal balance.

Wherever incentives for compromise are weak and the conflict about the distribution of fiscal sacrifices is strong, it is initially impossible to find a combination of spending cuts and tax increases that can muster the support of a large enough coalition of different social groups. Adjustment attempts founder on the resistance of the group(s) that have most to lose from it. However, as time passes, the balance of these countervailing forces of conflict and compromise might change across time as pressures for compromise increase with the escalation of the debt problem—if the worsening of the debt problem inflicts economic losses on parts of society—allowing a critical mass of social support to emerge. Consequently, analyzing a country’s economic profile and existing fiscal policy structure allows us to predict whether its policy makers will be able to address fiscal imbalances swiftly, or their hands will be tied in the face of
growing debt for lengthy periods of time before the political conditions for successful stabilization arise.

These predictions rest on a seminal game theoretical model by Alesina and Drazen (1991), which investigates the ways in which societal actors weigh the costs and benefits of supporting or opposing any given fiscal adjustment package. According to the war of attrition model of delayed stabilization, any group in society prefers swift stabilization to a delayed one—to avoid the escalation of the problem explained above—but each group also has an interest in minimizing its own share of fiscal sacrifices and, therefore, in resisting adjustment packages that assign a large share of the fiscal pain to them. Resisting fiscal pain is a gamble, because if other groups similarly refuse to pick up the bill of stabilization, the problem grows and future adjustment only becomes more painful, while in the meantime the economic side effects of the fiscal problem worsen. Obviously, the model assumes that no group has definitive information about how resolutely other actors can resist fiscal sacrifices. If it were clear at the start that a specific group has no chance of avoiding fiscal pain, it would make sense to acquiesce in fiscal sacrifices right away to avoid the harm that delay causes. Resistance to fiscal pain is rational as long as a group can reasonably expect that another, more favorable adjustment package will be put into place—one that assigns most of the fiscal sacrifices to other groups—before the negative economic side effects of the escalating fiscal problem become unbearable.

As time goes by and adjustment keeps being blocked by socioeconomic groups that believe they can do better, the fiscal and economic situation endogenously deteriorates as the fiscal imbalance is compounded by the accumulating interest burden. As a consequence, the passage of time might eventually tilt the balance of incentives for some groups: the longer they have to wait for fiscal stabilization and the more the economic side effects worsen, the less confidence a group can have that it will be able to wait for other groups to acquiesce in bearing the larger share of the burden of fiscal stabilization before the economic harm they suffer outweighs the benefit of securing a more favorable stabilization package. In other words, the passage of time changes the calculus, not only because of the objective deterioration of the situation but also because it transmits information about other groups’ resolution to resist fiscal pain. As a consequence, some socioeconomic groups might start to prefer paying the price of adjustment to putting up with the fiscal and economic problems any longer in the hope that other groups will give in first.

How fast the tilting of the balance of incentives for conflict and compro-
mise happens depends on two factors. One is the difference between favorable and unfavorable adjustment packages (Alesina and Drazen refer to this factor as “polarization”) because when the difference is large, the benefit of waiting for a better package is considerable. The second factor is the “utility loss” suffered by different groups from having to put up with the economic side effects of fiscal problems while reform is delayed. Groups that are less sensitive to the negative side effects of debt can afford to resist fiscal pain longer. At the extreme, groups that are fully immune to the economic effects of fiscal problems never need to relax their intransigence.

Thus, the war of attrition model teaches us that if it is possible to distribute fiscal pain unevenly across different groups in society, it is initially rational for all groups to take a hard line in resisting any package that assigns more than a minimum share of fiscal sacrifices to them. However, for groups that are sensitive to the economic side effects of fiscal problems, the trade-off between the possibility of escaping fiscal pain and suffering the side effects changes as time goes by. Therefore, some groups initially bent on resisting fiscal pain become amenable to acquiescing in it with the passage of time. Translating these abstract conclusions into concrete predictions about how fast the necessary political conditions for fiscal stabilization emerge in different countries requires three steps. The first is clarifying how unevenly the pain of fiscal stabilization can be distributed across society. The second is exploring the sensitivity of different social groups to the economic side effects of fiscal problems. The third is identifying the relevant groups in society, whose interests govern the politics of debt accumulation, and providing predictions about how their coalitions will evolve.

**Step 1: Fiscal Polarization**

How unevenly the pain of fiscal stabilization can be spread across society depends on the structure of existing spending and taxes. In principle, the budgetary gap can be closed by an array of completely new taxes, but in practice, fiscal reform is likely to be anchored by existing policies: stabilization packages raise existing taxes and cut spending. Although all countries spend on broadly similar programs and assign broadly similar types of taxes, the incidence of spending programs and taxation varies widely across countries. Vast differences have been documented in the way different welfare arrangements, tax systems, subsidies, public employment, and public investment serve the interests of different classes, income categories, generations, insider and outsider groups, sectors, and regions in different countries. In countries where existing expenditures and taxes are
closely targeted to serve the interests of specific sections of society, it is possible to successfully close the fiscal gap through spending cuts and tax increases that allocate losses to a few groups and shield others. In these countries, the existing fiscal structure strongly polarizes the preferences of different groups about different stabilization packages. Therefore, conflict about the specific content of stabilizing measures will be strong even when there is general consensus about the need to stop the accumulation of debt. In countries where major spending programs benefit large majorities of society fairly uniformly and taxes are broad based, any spending cuts and tax increases large enough to plug the hole in the budget are likely to affect the majority of society relatively evenly. In these countries, the existing fiscal policies are not polarizing because the scope for conflict over different stabilization packages is limited.

Given the variety of ways in which different spending and tax arrangements are combined in different countries, it is easier to point out differences in the incidence of spending and taxation in concrete cases than to derive general criteria along which the targeted or encompassing nature of fiscal programs can be diagnosed. Take differences in pensions in the United States and Denmark, for example. In the United States, costs and benefits of the pension system accrue very differently to different groups. On the one hand, Social Security creates divisions between entitlement holders and employers whose labor costs are increased by contributions. On the other hand, tax expenditures on private retirement savings generate further conflicts of interests along income lines, since those with higher incomes can save more for retirement and are therefore entitled to higher tax exemptions. Given high levels of income inequality, this generates very unequal access to tax-financed pension benefits. In contrast, universal pensions financed from general tax revenue spread the benefits and costs of pensions relatively evenly across society in Denmark. Entitlements are available to anyone over the age of 65 and relatively low levels of income inequality dampen the redistributive effect of universalism, whereas the combination of progressive income taxes and regressive consumption taxes takes off the edge of redistributive conflict on the financing side. As a result, in Denmark, pensions are unlikely to stir up severe contention at a time when fiscal stabilization is necessary. In the United States, on the other hand, the pension architecture polarizes preferences about savings to be made on public pension expenditures and about revenue increases. Examples of such variation in the (formal and informal) features of spending and revenues can be drawn from all areas of government finances.

While in concrete cases the targeted versus encompassing nature of
certain policy arrangements is quite obvious, deriving hard and fast universal criteria for evaluating the extent to which fiscal policies target benefits and costs to specific sections of society is impracticable. Standard categories of spending and taxation do not capture the entirety of ways in which the incidence of similar policies can differ across countries, especially since similar de jure features of policies can hide considerable de facto differences. Abstract distinctions between collective consumption versus income transfers, between universalism and selectiveness, or between regressive or progressive taxation (etc.) become blurred and of limited use in evaluating the degree to which some programs serve some social groups at the extent of others. The complexity of existing policies further increases—and the usefulness of abstract categories in gauging redistributiveness and targeting decreases—if we take into consideration the way different spending programs are financed and how the redistributive features of spending and taxation interact.

Types of spending that are normally categorized as collective consumption or collective investment expenditure—like public employment or construction projects—can, in some cases, disguise strongly redistributive and targeted forms of spending if in reality such expenditure is mostly aimed at maintaining the livelihood of specific groups in society. Examples of this phenomenon include the long-term dependence of the Japanese countryside on pork-barrel construction projects for income and employment but to some extent also the reliance of the “military-industrial complex” on defense spending in the United States. Classical transfer spending can be explored using the concepts of universalism, means-testing, and selective eligibility to establish the degree to which welfare benefits are available to large sections of society. However, as Moene and Wallerstein (2001) show, the degree to which a welfare system benefits some at the expense of others also depends on the degree to which income is unequally distributed in the polity. As a result, basic flat-rate pensions are more redistributive in the United Kingdom than in Norway. Furthermore, given the different redistributive effect of benefits financed from general tax revenue and labor-cost increasing social contributions, exploring the incidence of the costs and benefits of welfare spending needs to involve as much attention to the funding side of welfare arrangements as to the analysis of benefits. In Denmark, where pensions are funded from general government revenues, the benefits and costs of the system affect roughly the same sections of society, whereas in Belgium, benefits accruing to labor are financed from contributions paid by employers.

On the revenue side, standard categories of regressive, proportional,
and progressive taxation are instructive in terms of the *de jure* incidence of taxes. At the same time, it is important to be aware of the extent to which irregularities alter the actual patterns of burden sharing. The pervasiveness of evasion among certain socioeconomic groups in Greece or the extensive use of specifically targeted tax exemptions in the United States narrow the *de facto* tax base and strongly modify the redistributive character of the tax system by offering selectively available tax relief. At the extreme, even the distinction between corporate and personal income taxes fades away when large parts of the labor force register themselves as companies or as self-employed to minimize their tax burden, as has been a widespread practice in Hungary.

In the absence of universally applicable categories, spending and taxation patterns can only be evaluated on a country-by-country basis. They can be classified as more or less polarizing using a few rules of thumb. Strongly progressive or regressive taxes in the presence of large income inequality, specifically targeted tax exemptions, and selectively available opportunities for evasion polarize preferences about paths to increase revenues in response to fiscal imbalances. In contrast, compressed income distributions dampen the polarizing effects of progressivity and regressivity, while broader tax bases and strictly enforced tax collection limit the possibility of conflicts about targeted *de jure* or *de facto* tax relief. In terms of expenditure, universal access to transfers, services, and opportunities for public employment limits the scope for conflict about the specific ways of retrenchment. In contrast, the more limited and targeted the access to those benefits is, the more polarized preferences will be about cuts in spending. Finally, when a specific program is financed from earmarked revenue sources, preferences will be more polarized the more clearly the beneficiaries and the contributors of the program are separated. Conversely, the more the beneficiaries and contributors overlap, the more muted conflict will be about reforming expenses and benefits of the program. With these general features in mind, welfare programs, patterns of discretionary spending, and taxation can be analyzed to gauge how polarizing the existing fiscal architecture is in a given country.

**Step 2: International Exposure**

Beside fiscal polarization, sensitivity to the negative economic side effects of fiscal problems is the other decisive factor in the war of attrition model that crucially influences the speed with which fiscal imbalances are tackled. How sensitive different groups are to the negative economic side effects of
fiscal problems depends on their position in the economy. Fiscal problems spill over into the real economy to cause inflation and high interest rates and undermine international competitiveness. Those on fixed incomes will be averse to inflation; companies with good investment opportunities will resent high interest rates; while firms and workers in sectors exposed to international competition will suffer from weak profits and falling employment.\textsuperscript{4} Clearly, these negative side effects of fiscal imbalances are modulated by policies in place. Incomes can be indexed. Investments can be enhanced by subsidies in a high-interest environment. Competitiveness can be shielded through trade restrictions and exchange rate policies. Inflation can to some extent be counteracted by restrictive monetary policy. Importantly, however, all of these countervailing policies generate their own problems. Indexation worsens the inflation problem. Restrictive monetary policies and low exchange rates can make debt service more onerous insofar as they boost interest on sovereign debt or increase the value of foreign denominated debt. Trade restrictions trigger retaliation. Subsidies compound existing fiscal imbalances.

In general, in more open economies, larger sections of society suffer significantly from the negative side effects of debt. This is not only because larger parts of the economy are vulnerable to the competitiveness-reducing effects of inflation and high interest rates but also because the scope for countervailing policies to dampen these effects are more limited the more closely a country’s economy is integrated with the global economy, as capital mobility and openness to trade sharply increase their costs and/or reduce their effectiveness. Therefore, in more open economies, the negative side effects of fiscal problems not only affect a greater part of society, but they are also likely more painful. As a consequence, in more open economies, larger sections of society have significant incentives to compromise their fiscal interests for the sake of speedy stabilization. Conversely, in less open economies, different socioeconomic groups can afford to wrangle longer about the distribution of fiscal sacrifices because their sensitivity to the negative economic side effects of fiscal imbalances is more moderate and there is larger room for policies that mitigate the impact of those side effects.

It bears stressing that the degree of economic openness matters for countries’ ability to promptly adjust their fiscal policies to eliminate fiscal imbalances because it influences the proportion of the population that is sensitive to the possible side effects of fiscal problems—such as inflation and high interest rates—and the intensity of the problems they encounter, as more open economies face steeper costs when trying to mitigate
those side effects in the absence of fiscal stabilization. This link between openness and ability to adjust is slightly different from the one usually posited in the political economic literature of adjustment. Since Peter Katzenstein's seminal works (1985, 1987), it has been received wisdom that (small) open economies are particularly good at economic adjustment because of the corporatist institutions of cooperation and compromise they develop to better deal with the vagaries of the international economy. While the argument advanced here is consonant with Katzenstein's insight insofar as it predicts better adjustment capacities at high levels of openness due to societal interests in maintaining economic competitiveness, it diverges from it in implying that the exposure of some groups in society to international economic competition has an impact on a country's ability to stabilize its public finances even at lower levels of openness, independently of the long-term development of institutional structures. In other words, the argument proposed here posits a continuous positive relationship between openness and fiscal adjustment, rather than one that only manifests itself at high levels of exposure over the long term. It also suggests that the interest in maintaining international economic competitiveness need not encompass the entirety of society to influence the speed with which fiscal stabilization takes place. Finally, and most importantly, it assumes that exposure affects adjustment capacity by influencing the incentives for different groups to acquiesce in fiscal pain, rather than through its effect on institutional structures.

It is perhaps also useful to discuss the relationship of the predictions put forward here about the effect of openness on the speed of fiscal stabilization to another key insight of the political economy literature: the finding that more open economies maintain larger government spending—and, in the case of developed Western democracies, much larger welfare state commitments—to buffer the effects of the volatility of the international economy on domestic incomes (Cameron 1978; Rodrik 1996). At first sight, the prediction that countries with more open economies adjust faster might seem to be in contradiction with the heavy welfare commitments of open economies, because the received wisdom is that welfare reform is harder the more extensive the vested interests are in existing welfare provisions (Pierson 1996). However, the thesis advanced here emphasizes exactly that it is not the extensiveness of vested interests that matters for the speed of stabilization but their polarization. As long as interests in existing welfare state arrangements are relatively uniform across large groups in society, fiscal stabilization is politically relatively uncomplicated irrespective of the size of the welfare state. Furthermore, there is no reason to automatically
assume that stabilization can only happen through the retrenchment of the welfare state; the argument proposed here is agnostic about the mix between welfare or other spending cuts and revenue increases in stabilization packages. Therefore, the observation that more open economies tend to have larger welfare states is fully compatible with the prediction that open economies adjust faster due to the larger proportion of society having stronger incentives to compromise their fiscal interests for the sale of swift stabilization and the elimination of the negative economic side effects of debt accumulation.

Step 3: Relevant Groups in Society and the Evolution of Social Coalitions

The argument outlined above suggests that the politics of fiscal stabilization plays out in a two-dimensional political force field shaped, on the one hand, by conflicts of interests generated by existing fiscal policies and, on the other hand, by commonalities of economic interests in a more stable macroeconomic environment conducive to international competitiveness. In this two-dimensional field, the relevant clusters of interests are jointly delineated by stakes in existing fiscal policies and concerns about the negative economic side effects of fiscal problems. Therefore, the societal groups whose incentives drive the politics of fiscal adjustment can be identified at the intersection of those two orthogonal sets of interests: as vested fiscal interest groups, possibly divided according to exposure to the international economy. Differences in existing policies and economic structures draw different maps of conflicts and commonalities of interests from one country to another.

Given the wide variation in fiscal policies across countries explained above, vested fiscal interest groups are different in different countries. It is impossible to identify a priori, theoretical categories: vested interest groups have to be identified country by country on the basis of the existing policy structure. For example, workers likely constitute a uniform vested interested group in countries with universal welfare systems; whereas they can be deeply divided about welfare in countries where tight eligibility conditions and targeted benefits create insiders and outsiders to the system. Similarly, business interests align more closely on tax issues where corporate taxes are undifferentiated than in systems where the tax system grants preferential treatment to some firms over others based on size, sector, or other criteria. The clustering of interests could even be geographical in countries where the incidence of spending and taxation varies strongly along regional lines or between urban and rural areas.
Sensitivity to the economic side effects of persistent borrowing cross-cuts the vested fiscal interest dimension and might delineate commonalities of interest in swift fiscal stabilization across lines of fiscal conflicts. Again, the divisions along this dimension are country-specific, due to differences in economic structure and economic policies that might be directed at mitigating the economic side effects of debt accumulation. The analysis needs to focus on the extent to which fiscal problems spill over into high inflation and high interest rates and the way different groups are affected by these problems. In general, though, it can be expected that groups exposed to international economic competition are most likely to be acuter in more open economies.

Whatever the relevant groups are in any given country, the logic of the war of attrition model suggests that they coalesce into social coalitions in resistance to and in support of stabilization attempts subject to the balance of incentives they face for defending their vested interest and for making sacrifices for the sake of stabilization. Social coalitions initially align along the vested interest dimension as different groups jointly oppose reform to policies they share interest in. Insofar as existing policies reflect the balance of power between different groups in society, uniform resistance to reform by a vested interest group is unlikely to be overcome through pressure from the rest of society. However, wherever significant sections of society are sensitive to the economic side effects of debt accumulation, social coalitions based on the defense of vested interests give way to social coalitions based on shared interest in fiscal stabilization with the passage of time, as groups sensitive to the economic side effects of debt start to prefer to compromise their fiscal interests for the sake of defending economic ones. As parts of vested interest groups relax their intransigence to reform, there is a better chance that still-intransigent groups can be overpowered. As a result, if there is a critical mass of groups open to compromise, they can jointly support an adjustment package that assigns a limited share of the fiscal pain to them and foists the rest of the necessary fiscal sacrifices on others. This process is expected to play out much slower in relatively closed economies with polarizing fiscal structures and faster in open economies with encompassing fiscal arrangements.

To sum up the logic of the argument about how the political conditions for dealing with fiscal problems evolve: countries differ in their adjustment capacities because it takes longer in some than in others to resolve conflicts between different sections of society about how to share the fiscal pain necessary to close the fiscal gap. Where there is greater room for very unequal
distributions of fiscal sacrifices due to the existence of more closely targeted policies, the conflict is stronger. Where the economic side effects are temperate, typically in less open economies, groups are under less pressure to compromise. Therefore, in countries with moderately open economies and closely targeted fiscal policies, it takes longer for a supportive coalition of different groups to coalesce behind a specific adjustment package that policy makers can put into place. In such countries, reform attempts repeatedly fail in the face of resistance of groups that are affected and debt keeps on growing for a long time, before the negative economic effects of persistent borrowing bring about a realignment in coalitions and a politically feasible adjustment plan. Conversely, social support coalesces behind a stabilization package fairly swiftly in countries with encompassing policies and open economies. This theory is able to account both for why borrowing persists in some countries for a long time and how such countries eventually regain control over debt accumulation. It also distils the factors that differentiate countries with severe problems of sustained excessive debt accumulation from those that fare better at adjusting their policies to changing conditions and thus at keeping their debt under control.

Where Does the Polarization-Exposure Theory Fit? Interests, Institutions, and Ideas in the Politics of Debt Accumulation and Fiscal Adjustment

The polarization-exposure theory is rooted in the analysis of material interests that govern the evolution of social coalitions whose resistance or support fundamentally determine policy choices, following a venerable tradition built by scholars like Gourevitch (1986), Rogowski (1990), Frieden (1991a and b, 1996, 2002), Hiscox (1999, 2001) or Ansell (2008). Just like earlier theories in this tradition, the hypotheses provided here are founded on abstract economic theory, specifically, the game theoretical modeling of incentives faced by different socioeconomic groups. At the same time, by incorporating the effect of the existing fiscal policy structures on social coalitions, the predictions of this model also take seriously the historical institutionalist lesson on path dependence and the way in which past policy choices shape politics in the present (Pierson 2000, 2004).

In keeping with the interest-focused tradition, the polarization-exposure theory makes no specific predictions about how changes in the balance of incentives for different socioeconomic groups and the evolution of social coalitions feed through political institutions to effect policy
choices and outcomes, or what role ideas and ideology play in influencing this process. This obviously does not imply questioning the importance of institutions and ideas in affecting politics and policy choices. While the polarization-exposure theory puts interests center stage, the mechanism of political and policy change it advances plays out in specific institutional and ideational contexts.

Institutionalist scholars point out that social groups are not political actors that strategize, decide, and take action (Thelen 1999). Therefore, interests, strategies, and the use of power cannot be understood independently of the specific institutional contexts. Varied constellations of political actors and rules of the political game shape how societal conflicts play out in different countries.6 Constructivists add that these factors cannot exercise their effect independently of ideas, as available conceptual models of the economy and society determine what actors consider possible and desirable.7 From this theoretical perspective, institutional and ideational factors are bound to crucially influence the extent to which a country is able to adjust its fiscal policies in order to deal with an escalating debt accumulation problem. Some institutional traits help to overcome the resistance of particularistic interest groups,8 others foster adjustment by encouraging compromise.9 Ideas matter because certain interpretations of a policy problem provide important focal points around which compromise can arise (Blyth 2002; Culpepper 2008). At the same time, the institutional and ideational context of politics and policy-making is not static. Institutions of coercion and compromise emerge and break down, and new ideas can generate the glue for new compromises.10 Indeed, it has been one of the central questions of more recent institutional scholarship: why and how institutions, which generate such strong and stable incentives and constraints for extended periods of time change and give way to new institutions, incentives and constraints (e.g., Streeck and Thelen 2005).

Consequently, institutions and ideas are indispensable components of a comprehensive narrative analyzing the way different countries deal with their fiscal imbalances. Understanding how societal interests govern political and policy developments requires attention to the landscape of political actors that represent different social groups and further their interests; to the institutional power they employ in doing so; to the institutional structures that tolerate conflict or foster compromise among them; and to the economic and social ideologies that inform their actions. At the same time, there is no reason to assume that these institutional and ideational frameworks are immutable fixtures of the environment. In fact, analyzing the shifting incentives shaping different groups’ approach towards different
stabilization packages with the passage of time can be useful in understanding the stability and change of those institutional and ideological frameworks. Observing the congruence or tension between shifting policy preferences of various societal groups and the institutions and ideas through which they are pursued can provide the key to explaining institutional and ideational change.

Thus, the polarization-exposure theory calls for a pragmatic approach to institutions and ideas that expects that societal preferences—which can shift with the shifting of incentives as time passes—always eventually feed through institutional and ideational structures to affect policy outcomes, even if this requires adjustments in institutions and ideas. This approach assumes that interest-representing organizations—parties, unions, employers organization, lobbies, etc.—need to keep their strategies in sync with the preferences of their supporter base, both when resistance to fiscal pain is preferable and when fiscal sacrifice becomes more attractive, on pain of losing support to alternative (old or new) interest-representing organizations. The pattern of interest-representing organizations, the constellation of the supporter bases they serve and their strategies for conflict and compromise with each other jointly embody social coalitions formed in support of or in resistance to different ways of fiscal stabilization. When the underlying preferences of societal groups shift from resistance to acquiescence, organizations either adapt their strategies and their alliances to the new constellation of societal preferences or they are sidelined or replaced by new organizations with new strategies and alliances. This transformation might also lead to changes in ideologies and policy paradigms as political entrepreneurs justify new political strategies and/or rationalize new coalitional affinities and conflicts.

The polarization-exposure theory also privileges the structural power of different social groups over their institutional power in the longer term. For example, workers’ ability to disrupt production through industrial action or business’ ability to withhold investment is assumed to be more significant in the longer term than co-decision rights granted by corporatist systems, whereas the electoral power of populous social groups is expected to have traction even in unbalanced electoral systems. Consequently, the functioning of institutional and ideational frameworks fostering domination or compromise is expected to be subject to the balance of structural power and the alignment or conflicts of interests. Even time-honored traditions of negotiation and compromise are unlikely to prompt political actors to accept major fiscal losses on behalf of their constituencies if their supporters are opposed to fiscal pain and wield significant structural power.
At the same time, when the priorities of major groups are aligned, systems of coordination might arise to facilitate the actual negotiation procedures needed to hammer out a compromise.\textsuperscript{11} In a similar vein, state actors’ room for autonomous action is expected to be contingent on social support for (or at least acquiescence in) a general direction of reform.

Therefore, the approach applied in this book implies tracing the impact of the evolving policy preferences of powerful societal groups—and the attendant stability and realignment of social coalitions—when narrating and explaining the actions and interactions of political actors within concrete institutional and ideational frameworks in different countries. The strategic choices of institutional actors—e.g., parties, unions, government coalitions, etc.—concerning fiscal reform are explained with reference to the preferences of their constituencies, with special emphasis on how these preferences evolve with the passage of time under pressure from the escalation of the fiscal and economic problems. Those strategic choices are used, in turn, to explain how policy evolves across time.

\textbf{How Does the Polarization-Exposure Theory Differ? Competing Explanations for the Problem of Debt Accumulation}

Beyond satisfying a realist predilection for exploring the unobservable societal foundations of politics and policy making, focusing attention on the evolution of the preferences of social groups toward different fiscal stabilization packages (and on the factors that govern the evolution of those preferences) also fills a significant gap in the literature on fiscal problems and fiscal adjustment. Arguably, the lack of specific modeling of differences in the commonalities and conflicts of societal interests toward fiscal policy has been a key factor in hamstringing efforts to comprehensively explain why some countries get stuck on a trajectory of debt accumulation dangerously long, whereas others keep debt growth under control. Theories of fiscal problems and explanations of fiscal adjustment alike tend to attribute a fixed set of general incentives to political actors (governments, parties, unions, employers’ organizations, etc.) across countries and investigate the ways in which those general incentives exert their effect in country-specific institutional (and, in some cases, ideational) circumstances. While this approach has led to important conclusions about how institutional and ideational conditions influence annual budgetary decision-making to lead to borrowing or balanced budgets year-by-year and how they influence the success of fiscal stabilization, these findings do not add up to a comprehen-
sive understanding of why (and how long) borrowing is allowed to persist and when fiscal stabilization becomes possible.

The increasing prevalence of fiscal problems in prosperous developed countries since the 1970s fostered the development of a robust rationalist literature exploring the forces that lead governments to spend beyond their means. The early strand of this literature hypothesized that policy makers run deficits on purpose to enhance their electoral chances by pleasing the electorate with higher spending, lower taxes, and better economic performance in the short term and keeping them in the dark about the long-term costs of overspending. Empirical studies have found some indication of electorally motivated deficits, but overall, the evidence is far from conclusive. In terms of accounting for the phenomenon sustained and excessive debt accumulation, the key weakness of this approach is its exclusive focus on the electoral benefits of borrowing. Once debt accumulation starts to generate problems for the economy, the electoral benefits of borrowing are likely to evaporate. Attention to the possible economic side effects of debt accumulation, and especially to the ways in which they might affect large parts of the electorate, is necessary to understand the full set of incentives policy makers face and to predict whether further borrowing is likely to be electorally profitable or costly. The polarization-exposure theory presented in this book implies that deficits can only be electorally beneficial as long as large parts of the electorate are immune to the negative economic side effects of deficits, which is more likely in relatively closed economies.

Toward the end of the 1980s, the hypothesis of intentional borrowing increasingly gave way to a different reasoning within the rationalist fiscal governance school: one that focuses on the collective action problems involved in joint budgetary decision-making, which cause policy makers to persistently fall back on borrowing despite knowing better. In this approach, unintentional deficits are a “residual source” of financing when decision makers cannot reconcile their spending and tax preferences so that the budget balances. Common resource pool models contend that individual decision makers do not fully internalize the social costs of additional spending benefiting their constituencies, so they keep lavishing more on their voters while taxes lag behind, whereas a veto-actor version of this approach focuses on governments’ inability to limit spending and raise taxes if different governmental actors veto spending cuts and tax increases that hurt their constituencies (Roubini and Sachs 1989).

While the ultimate driver of borrowing in this approach is the interests of different electoral constituencies—and in this sense, the logic of the theory is similar to the polarization-exposure thesis presented here—
constellation of these interests is never substantively explored or used to explain the severity of the collective action problems. Instead, the focus is on the governmental sphere and on the way institutions give representation to or suppress the multitude of interests in the decision-making arena. The collective-action problem is expected to be more severe (and, thus, borrowing to be more persistent) in settings where the decision-making process incorporates a greater number of divergent political preferences, such as in proportional electoral systems with multiparty governments. However, the problems should be mitigated by the adoption of institutional mechanisms that enforce coordination. Although there have been attempts to use intragovernmental ideological differences as a proxy for the substantive divergence of policy preferences among parties within governments, these are few and far between, and they are hampered by the fact that some of the most important conflicts of fiscal interests are sometimes housed within parties rather than between them.

Empirical evidence supports the expectation that appropriate coordination mechanisms significantly improve the chances of balancing the budget. It is therefore unsurprising that fiscal targets, deficit ceilings, penalties, commitment to a specific path of corrective action, surveillance, and transparency became part of the design of the fiscal oversight system that was meant to protect the European Economic and Monetary Union from the excessive borrowing tendencies of some of its members. In practice, however, the European experiment showed that successful coordinating institutions cannot be implanted into political contexts that do not endogenously generate them. Especially in countries with track records of persistent borrowing in the past, fiscal limits were routinely circumvented and transparency was undermined by creative accounting, while commitments to targets were regularly broken. The manifest failure of the European fiscal system to correct the fiscal paths of some of the most delinquent European countries suggests that the lack of a well-functioning coordinating mechanism might be a symptom of a deeper underlying cause of the permanent deficit problem, which imposed institutions cannot resolve. The question then becomes why some countries are unable to adopt the institutional mechanisms that would protect them from persistent borrowing.

The importance of why some countries adopt better coordinating mechanisms than others has not been lost on scholars in the fiscal governance approach. In attempting to account for differences in budgetary institutions across countries, Mark Hallerberg and his colleagues emphasize that institutional constraints on budgetary decision-making are adopted and operate essentially by consent of the very policy makers whose
discretion needs to be constrained (Hallerberg et al. 2009). This implies that it is not so much the adoption of the appropriate budgetary coordination mechanism that allows a country to limit borrowing, but the willingness of policy makers to constrain their own ability to pursue the fiscal interests of their voters at the price of perpetuating debt accumulation. Coordinating budgetary institutions become an intervening variable, while the ultimate explanation lies in what policy makers prioritize: fiscal balance or the particular fiscal interest of their constituencies. While Hallerberg et al. seek to account for the presence or absence of consent to constraining institutions within the government-centered framework—citing volatility in ideological polarization within governments and the fiscal conservativism of the electorate—their results do not allow for drawing definitive conclusions on this matter.21

The difficulty of the rationalist fiscal governance school with explaining how policy makers prioritize between the fiscal interests of their constituencies and controlling debt accumulation draws attention to the limitations of focusing attention strictly within the confines of the governmental sphere and of treating fiscal policy as the outcome of a yearly budgetary exercise. Better understanding policy makers’ priorities requires moving the investigation beyond the governmental arena to explicitly model the constellation of the interests of the different constituencies. This, in turn, involves accounting for the costs of debt accumulation for different constituencies as well as the benefits arising from the protection of a constituency’s fiscal interests. While the fiscal governance approach emphasizes the political benefits of defending vested fiscal interests, it is practically blind to the costs22 because it focuses on discrete yearly budgetary decisions without taking into consideration the cumulative effects of persistent borrowing and, thus, the growing negative economic side effects that accompany the accumulation of debt. The polarization-exposure approach offered in this book implies that policy makers are more likely to prioritize the promotion of the fiscal interests of their constituencies (and, thus, refuse to abide by fiscal institutions that constrain their ability to do so) when extant fiscal policies create intense conflicts of fiscal interests and when moderate international exposure limits the sensitivity of different constituencies to the economic side effects of debt accumulation.

Moving beyond the strict governmental-parliamentary sphere also allows for incorporating political actors that exert their influence outside of the electoral channel into the explanation of fiscal trajectories.23 The importance of such encompassing analysis of the polity in modeling policy choice is demonstrated by the literature on the political economy of policy
adjustment, which calls attention to the role of unions, employers’ con-
federations, or other organized interest groups in the politics of policy reform. This literature has provided invaluable insights into the ways prosperous developed economies adapted their policies to challenges from globalization, deindustrialization, technological shifts, population aging, and the like since the late 1970s.24 Since these challenges significantly contributed to the fiscal problems of developed countries (Pierson 2001; Streeck 2014), the adjustment literature is highly relevant when it comes to exploring the differential experiences of different countries in dealing with debt.

However, the adjustment literature does not provide a ready-made explanation for why some countries accumulate debt dangerously long, while others assert control over their fiscal imbalances relatively swiftly. Scholars in this tradition have never focused directly on the issues of persistent borrowing and debt accumulation. Although they investigate instances of fiscal stabilization as components of broader macroeconomic reform, they are more interested in the conditions under which adjustment becomes possible and the substantive content of reform than in the speed with which countries take control over their fiscal imbalances, which—given the cumulative nature of the fiscal problem—crucially influences the severity of the resulting debt situation. Studies of macroeconomic reform highlight how institutions facilitate compromise among various political actors about spending and taxes, and emphasize the role that ideas play in providing shared understandings of the origins of the macroeconomic problems among those actors.25 At the same time, they also demonstrate that neither institutional structures, nor ideas are fixed features of the political environment by documenting how ad hoc social pacts can form around new ideas to enable reform even in countries that lack time-honored corporatist and consociational institutions.26 The question then becomes how the institutional and ideational preconditions for compromise arise and how long this takes in different countries, but these issues remain outside of the purview of studies of macroeconomic adjustment. The polarization-exposure thesis implies that it takes longer for the institutional and ideational preconditions of compromise to arise in countries where the obstacles to fiscal compromise—rooted in conflicts generated by the extant policy structure—are more severe and where resolving macroeconomic problems are less urgent due to the limited exposure of large parts of society to international economic competition.

In summary, the polarization-exposure thesis helps to fill in the gaps in our understanding of long-term heavy debt accumulation and answers questions about persistent borrowing and fiscal adjustment that existing
theories—in the rationalist fiscal governance school of thought or in the adjustment literature—cannot. It does so by approaching debt accumulation from a novel angle. It expands the analysis beyond the strict governmental sphere of yearly budgetary decisions to explicitly explore the evolution of societal preferences toward adjustment under the changing pressures of aversion to fiscal pain and the economic pressures created by debt accumulation. In doing so, it also looks beyond the institutional and ideational circumstances to better explain how the conditions for compromise arise in time and to explain how long it takes in different countries.

Methodological Considerations

The rest of this book gauges the empirical relevance of the polarization-exposure thesis through a set of qualitative case studies that explore the history of debt accumulation in Belgium, Greece, Ireland, Italy, and Japan. It employs process tracing as well as within-case and cross-case comparisons. A qualitative approach is arguably more suited to investigating the fit of the polarization-exposure explanation than a quantitative one for two reasons. The lesser of those two reasons is the difficulty involved in standardizing fiscal polarization, one of the two key explanatory variables of the model. (This issue has been explained in depth above.) The more significant reason is that quantitative measures taken at specific points in time are unable to capture the diachronic dimension of the mechanism that is hypothesized to drive the politics of debt accumulation. Process tracing allows for exploring how well the diachronic mechanism of realigning social coalitions posited here explains the twists and turns of the politics of debt accumulation in the real world, and for comparing the explanatory capacity of the model to alternative hypotheses at each important critical juncture (Pierson 2004). At the same time, cross-case comparisons allow for probing the capacity of the two explanatory variables (fiscal polarization and international exposure) to explain the length of time it takes from diagnosing debt accumulation as a serious problem to putting successful reform packages into place. Because the two independent variables interact, several pairwise comparisons are necessary to sample different combinations of fiscal polarization and international exposure.

The universe of cases from which the sample was drawn consists of distinct instances of debt accumulation in OECD member countries between 1970 and 2007. Instances of debt growth prior to 1970 are not considered here, due to problems with the availability of consistent cross-country debt
data from before 1970. However, the years between 1970 and 2007 provide a fairly exhaustive collection of all the periods of debt accumulation between the Second World War and the global financial and economic crisis, because in the decades of high economic growth prior to 1970, most countries were dramatically decreasing the debt-to-GDP ratios they inherited from the war. The only exception is Ireland, which accumulated debt between the mid-1940s and the late-1950s, but by the 1970s, debt was on the decline in that country, too (Reinhart and Rogoff 2010). The debt spurts since 2007 are not included in the universe of cases because there is insufficient perspective at the time of writing to definitively evaluate how successful countries are in handling the debt issues triggered by the global financial and economic crisis. Table 1.2 in chapter 1 provides an overview of the cases of debt accumulation between 1970 and 2007, including details on the duration and severity of debt growth.

In an effort to sidestep theoretical controversies about admissible levels of debt and acceptable delays in tackling growing indebtedness—explored in detail in chapter 1—the book samples as its case studies instances of debt accumulation from cases where there can be little doubt that the problem warranted policy response. Belgium, Canada, Greece, Ireland, Italy, and Japan—with the largest scope and longest duration of debt accumulation—constitute such cases. Other countries had significantly more benign experiences with debt prior to 2007, and therefore, there is much greater ambiguity about whether and when debt accumulation should have been stopped. Of these six countries, the rest of the book explores five—Belgium, Greece, Ireland, Italy, and Japan—in detail in a series of within-case and cross-country comparisons, selected and matched along criteria described below. (Canada is briefly discussed in the conclusion to evaluate the degree to which this sixth case of large-scale debt accumulation is consistent with the predictions of the thesis advanced here.)

Despite similarities in the severity of their debt problems, the five chosen countries display significantly different track records in dealing with their fiscal issues. Japan and Greece have never been able to effectively address their fiscal problems. Greece accumulated debt at a very fast rate throughout the 1980s, and although the debt-to-GDP ratio roughly stabilized around 100 percent by the mid-1990s due to a number of favorable exogenous factors, high levels of debt and the failure to deal with fiscal imbalances made Greece vulnerable to adverse changes in the global economy and financial markets, which led to a debt crisis and default in the 2010s. Japan’s debt accumulation started at a slow rate in the 1970s, but it has intensified considerably since the early 1990s and remained practi-
cally unaddressed in the past four decades, apart from a brief interlude of tightening around the turn of the millennium. Although Japan has avoided major debt crises, it is the most indebted country in the world with gross debt amounting to two-and-a-half times its GDP in 2015. Italy exemplifies a case where fiscal stabilization was long delayed but eventually succeeded. Italy accumulated debt between the mid-1970s and the mid-1990s without adopting any significant stabilizing measures, but it was eventually able to reverse debt accumulation and reduce the debt-to-GDP ratio through resolute consolidation by the second half of the 1990s, although it relapsed in the 2000s. At its peak, the debt amounted to 117 percent of the GDP. Belgium and Ireland addressed their fiscal issues relatively early on. Both launched drastic austerity programs in 1982 to arrest the debt spurt that started in the late 1970s. When these programs fell short of fully bringing borrowing under control, the two countries’ paths diverged. Ireland reinforced its earlier measures with a new stabilization package in 1987, setting debt on a steep downward path. Belgium, on the other hand, failed to redouble its efforts and saw its debt snowball further until favorable changes in financial market conditions allowed it to reduce its debt-to-GDP ratio from the mid-1990s.

In terms of fiscal polarization, the five countries are distributed along a continuum. Ireland represents the least polarized fiscal structure, particularly around the time when it was facing fiscal challenges in the 1980s. It had tax and spending policies that distributed benefits and burdens in fairly undifferentiated fashion among the bulk of society. In the other five countries, policies created distinct large clusters of vested fiscal interests. In Belgium, a fully contribution-based social security system polarized interests between business and labor. In Italy, similar conflicts about a conservative welfare state were compounded by the dependence of the population of the South on transfers, public employment, and construction contracts and by the ability of small firms to escape fiscal burden-sharing through evasion. In Greece, vested interests were polarized by bloated public employment, a conservative pension system, and immense tax evasion. In Japan, conflicts about an unsustainable pension system added to the polarization of interests between urban and rural populations due to distortions of the tax system as well as regionally targeted subsidies and construction contracts.

In terms of international exposure, the five countries range from extremely open to mostly closed (see figure 2.1). Ireland and Belgium represent the most open economies. In both countries, the sensitivity of large sections of society to the negative side effects of debt accumulation was particularly high at the time of acute fiscal challenges, as both countries
were members of the fixed exchange rate system of the European Monetary System (EMS), which implied that inflationary problems accompanying fiscal imbalances inflicted particularly significant harm on firms and workers in the exporting or import-competing sectors. While Italy and Greece have had roughly similar proportions of trade within their national incomes, exporting and import-competing sectors were arguably more sensitive to the negative economic side effects of debt in Italy due to the country’s membership in the EMS. At the same time, accession to the euro—and the delegation of monetary policy to the supranational level—has significantly weakened the link between fiscal problems and competitiveness for Italian producer groups since 1999. Finally, Japan’s economy has been mostly insulated from international economic competition, with imports and exports amounting to less than a quarter of the GDP.

Given this pattern of variation and similarities, the rest of the book evaluates the explanatory power of fiscal polarization and international exposure through a series of within-country analyses and pairwise comparisons that help to control for alternative explanations. Italy serves as the base case through which the mechanism of political change underlying fiscal adjustment is explored. The country represents a middling case both in terms of fiscal polarization and international exposure. It is a case that lends itself particularly well to within-case comparisons because Ita-

Fig. 2.1. Exports plus imports as a percentage of GDP in Belgium, Canada, Denmark, Ireland, Greece, Italy, and Japan from 1970 to 2007. Source: Ameco.
ly’s fiscal, political, and economic history is characterized by many sharp changes (impressive instances of fiscal stabilization after long periods of debt growth, momentous changes in political institutions, and the transformation of the economic environment after euro accession) that help to explore the explanatory capacity of alternative factors. The comparison of Belgium and Ireland allows for gauging the effects of fiscal polarization. It approximates a “most similar” case study design that controls for international exposure as well as alternative institutional and ideational explanatory variables. Besides having similarly open economies, the two countries also have important institutional features in common and display similar ideational developments over the period concerned. Where they differ, theory would predict that Belgium should have better institutional adjustment capacities. In light of these similarities and the institutional advantages on Belgium’s side, Ireland’s superior performance in regaining control over its debt problem can be confidently attributed to differences in fiscal polarization. The juxtaposition of the Greek and Japanese cases, on the other hand, approximates a “most different” case study design. The two countries differ significantly on a whole range of economic and social factors and on political institutions and they have been dominated by very different economic and political ideologies. Nevertheless, both countries displayed similarly ruinous inability to address their debt problems. (Table 2.1 summarizes the main parameters of each case study.)

The concluding chapter adds brief sketches of two further cases. As mentioned above, it briefly discusses Canada’s experiences with debt to provide the missing case for a full overview of the most serious instances of debt accumulation. Canada displays many similarities with the Belgian and Italian cases. Its track record in dealing with its debt problems parallels Italy’s almost exactly: it accumulated large stocks of debt throughout the 1980s and the early 1990s but managed to effectively reverse debt growth in the mid-1990s, after the debt-to-GDP ratio had reached 100 percent. Its fiscal structure was similarly polarized at the time of its greatest fiscal troubles as Belgium’s, with conflicts about the welfare system interacting with issues of interregional redistribution in a federal system. Canada is somewhat more open to trade than Italy, and its exposure to international economic competition increased in the 1990s upon the free-trade agreement with the United States and subsequently, the adoption of the North Atlantic Free Trade Agreement (see figure 2.1). The conclusion also briefly explores a more benign case of debt accumulation. The Danish case complements the Irish one, providing further evidence for the role of low fiscal polarization in swift and resolute stabilization—in two instances of
intense debt spurts in the early 1980s and 1990s—even when the government’s welfare commitments are significantly more extensive and exposure to international competitiveness is less extreme than in the Irish case.

The exploration of fiscal trajectories of different countries in this book does not rely solely on the investigation of fiscal figures but blends numerical analysis with qualitative accounts of policy choice. This is because the variable of interest—the length of time it takes from diagnosing debt accumulation as a serious problem to putting successful reform packages into place—cannot be fully captured through observing the ascents and descents of the debt-to-GDP ratio. On the one hand, it is reasonable to assume that fiscal problems are diagnosed with some lag as the size and persistence of fiscal imbalances become clearer to policy makers. On the other hand, debt accumulation is not a function of fiscal policy alone: it also crucially depends on economic performance. Major revenue and spending items automatically change with changes in national income and unemployment, influencing yearly borrowing in unanticipated directions, while the proportion of outstanding debt to GDP depends on economic growth. Therefore, the evolution of the debt-to-GDP ratio is an imperfect indicator of fiscal policy and the number of years spent on an upward debt trajectory inadequately measures the delay in policy adjustment. For these

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Dependent variable</th>
<th>Case study design</th>
<th>Location in book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>moderate-low</td>
<td>delayed stabilization, then relapse</td>
<td>cross-temporal variations explored</td>
</tr>
<tr>
<td>Ireland</td>
<td>high</td>
<td>swift response, problem fully tackled</td>
<td>most-similar institutions and ideas</td>
</tr>
<tr>
<td>Belgium</td>
<td>high</td>
<td>swift response, problem only partially tackled</td>
<td></td>
</tr>
<tr>
<td>Greece</td>
<td>low</td>
<td>no effective response</td>
<td>most-different institutions and ideas</td>
</tr>
<tr>
<td>Japan</td>
<td>low</td>
<td>no effective response</td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>moderate-low</td>
<td>swift stabilization</td>
<td>short comparison with Ireland and Italy</td>
</tr>
<tr>
<td>Canada</td>
<td>moderate-low</td>
<td>delayed stabilization</td>
<td></td>
</tr>
</tbody>
</table>
reasons, the narratives in this book analyze different countries’ fiscal trajectories by jointly investigating fiscal figures; the policy discourse; and the presence or absence, success or failure of concrete policy measures. The policy discourse is explored to gauge the extent to which fiscal imbalances that seem significant in retrospect were interpreted as problematic at the time and to establish when tackling deficits became a professed policy objective. Policy measures—planned and actual reforms—are identified with the help of existing expert analyses of fiscal policy in the given country to determine policy intentions and their level of success.\textsuperscript{34} Fiscal figures are used to ascertain the effect of such measures on the evolution of deficits and the debt-to-GDP ratio.

Qualitative analysis is also privileged in exploring the two explanatory variables of the model. This is emphatically true for fiscal polarization. Due to difficulties with standardization noted above, numerical examination of the size and proportion of different spending and revenue items in itself cannot adequately describe the incidence of the benefits and costs of different governmental programs. Therefore, the case studies rely on expert accounts of policy to better understand patterns of redistribution arising from taxes and expenditures than what is immediately obvious from numerical analysis. Exposure to international economic competition lends itself better to numerical assessment: the proportion of exports and imports within GDP provides a good primary indicator. Although this proportion changes somewhat across time—and therefore a single figure cannot precisely describe exposure over several decades—the basic patterns of trade are stable enough to consistently characterize a country as more or less open to international trade. At the same time, complementary qualitative investigation of the monetary environment and trade-related policy choices allows for better understanding the conditions under which different parts of society face international economic competition.

The methodological design of the rest of the book entails the detailed investigation of debt accumulation in five countries over extended periods of time. The analysis involves process tracing in each country as well as comparisons within and across countries. It entails exploring developments on three different levels: policy, politics, and the socioeconomic environment. Such analysis is bound to rely mostly on secondary sources. As Lustick (1996) warned, such an empirical strategy needs to be executed with care because there is a risk that selection bias among sources used might lead to a distorted interpretation of history. Therefore, special care needs to be taken to compare and contrast several sources in discovering each component in this complicated process. At the same time, the multi-level
nature of the analysis automatically helps such triangulation, because it necessarily draws on sources from very different fields and integrates various types of data (e.g., economic and fiscal figures; electoral data; sociological studies; political analysis; works in economics, public finance, and public administration; etc.). This provides a possibility for cross-checking whether information drawn from disparate sources about developments in the three disparate spheres of analysis are compatible with each other.

The next three chapters execute this empirical strategy and tell the story of debt in Italy, Belgium, Ireland, Japan, and Greece. The sixth chapter pulls together the lessons from all of these studies to provide a full set of comparisons; to complement them with short sketches of the Danish and Canadian cases; and to return to the theoretical considerations discussed at length in this chapter.