

Polychroniou, C. J.

**Research Report**

## The Mediterranean conundrum: The link between the state and the macroeconomy, and the disastrous effects of the European policy of austerity

Public Policy Brief, No. 124

**Provided in Cooperation with:**

Levy Economics Institute of Bard College

*Suggested Citation:* Polychroniou, C. J. (2012) : The Mediterranean conundrum: The link between the state and the macroeconomy, and the disastrous effects of the European policy of austerity, Public Policy Brief, No. 124, ISBN 978-1-936192-21-2, Levy Economics Institute of Bard College, Annandale-on-Hudson, NY

This Version is available at:

<https://hdl.handle.net/10419/121990>

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Levy Economics Institute of Bard College

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# ***Public Policy Brief***

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No. 124, 2012

## **THE MEDITERRANEAN CONUNDRUM: THE LINK BETWEEN THE STATE AND THE MACROECONOMY, AND THE DISASTROUS EFFECTS OF THE EUROPEAN POLICY OF AUSTERITY**

C. J. POLYCHRONIOU

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Editor: Barbara Ross  
Text Editor: Michael Stephens

The Public Policy Brief Series is a publication of the Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000.

For information about the Levy Institute, call 845-758-7700 or 202-887-8464 (in Washington, D.C.), e-mail [info@levy.org](mailto:info@levy.org), or visit [www.levyinstitute.org](http://www.levyinstitute.org).

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ISSN 1063 5297  
ISBN 978-1-936192-21-2

## Preface

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Conventional wisdom has calcified around the belief that the countries in the eurozone periphery are in trouble primarily because of their governments' allegedly profligate ways. For most of these nations, however, the facts suggest otherwise. Apart from the case of Greece, the outbreak of the eurozone crisis largely *preceded* dramatic increases in public debt ratios, and as has been emphasized in previous Levy Institute publications, the roots of the crisis lie far more in the flawed design of the European Monetary Union and the imbalances it has generated.

But as Research Associate and Policy Fellow C. J. Polychroniou demonstrates in this policy brief, domestic political developments should not be written out of the recent history of the eurozone's stumbles toward crisis and possible dissolution. However, the part in this tale played by southern European political regimes is quite the opposite of that which is commonly claimed or implied in the press. Instead of out-of-control, overly generous progressive agendas, the countries at the core of the crisis in southern Europe—Polychroniou singles out Greece, Spain, and Portugal—have seen their macroeconomic environments shaped by the dominance of regressive political regimes and an embrace of neoliberal policies; an embrace, says Polychroniou, that helped contribute to the unenviable position their economies find themselves in today.

Although the immediate problems facing southern Europe are certainly economic, Polychroniou insists that they can be better understood in the context of the trajectory of their political regimes. This brief thus traces some of the political roots of the economic crisis. The author chronicles the manner in which the governments of Greece, Spain, and Portugal pushed a regressive agenda over the past two to three decades, producing a macroeconomic climate that led to growing poverty and inequality, and that failed to lay the groundwork for sustainable growth. He outlines the main features of this neoliberal agenda, including privatization of public assets, lagging investments in education, reductions in social services, underdeveloped retraining programs, and intentionally meager revenue collection, and notes

that, on the whole, public expenditures in these countries have been far less generous than the European Union (EU) average.

Social democratic parties in Greece, Spain, and Portugal followed a markedly different trajectory than the ones taken by their northern European counterparts. After breaking out of long traditions of authoritarian rule, the emerging democracies of these southern European nations have pursued agendas that were, by northern standards, quite regressive. Polychroniou argues that meaningful distinctions between socialist and conservative parties began to break down in southern Europe in the late 1980s, with the socialists emerging as tacit supporters of neoliberalism. Social democracy of the northern European variety never really took root in the south. Moreover, whether socialist or conservative parties have controlled the government, the political cultures of Greece, Spain, and Portugal have been marred by clientelism, patronage, and corruption.

The brief concludes with an outline of the reform measures needed to steer a smoother course in the eurozone. Polychroniou insists that the periphery faces a growth problem rather than primarily a debt problem, and that austerity is destroying the foundations for growth. Strict adherence to this austere orthodoxy is contributing to the growth of antidemocratic subcultures and could lead to the rise of authoritarian political movements. To lay the foundations for growth and stability, what's needed is the issuance of some type of eurobond and the development of more powerful federal institutions for the EU, including a central bank able to act as lender of last resort and a parliament with the authority to transfer surplus revenue—although a fine balance between this federal authority and the rights of member-states would need to be maintained.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*  
May 2012

## Introduction

The crisis in the eurozone periphery represents the biggest challenge faced by the European Union (EU) since its creation. It is a crisis that surfaced when the 2008 global financial crisis exposed the flawed design of the euro system by triggering Greece's sovereign debt crisis. But what may be more threatening than the financial crisis itself is how it has undermined the entire foundation of the European economic and monetary union, dangerously increasing the gap between northern and southern European economies, opening a political opportunity for extremists, and posing a serious threat to a global recovery.

Yet the EU's leaders do not seem fazed by these risks. Apparently convinced that profligacy is at the root of the crisis, Germany and the EU's neoliberal chorus have been rather content to blame the Greeks, and the Mediterraneans in general, for the mess in the European periphery—which helps explain their “kick the can down the road” policy response.<sup>1</sup> The conservative impulse to impose harsh austerity measures on the eurozone's debt-wracked economies (more a form of punishment than an economic policy with well-measured outcomes) has made things even worse—leading the quack doctors to up the dose of the medicine that made the patient ill in the first place. The new German-inspired fiscal compact treaty is the latest indication of how perverted Euroland's economic policymaking mindset has become. No wonder contagion fears in the eurozone have resurfaced, with Spain on the brink of joining Greece and Portugal as a “zombie debtor” of the EU and the International Monetary Fund (IMF).

Still, the crisis in the eurozone periphery may indicate that more specific processes are at work than the badly conceived architecture of the euro system and the imbalances produced by its underlying mechanisms. Upon close inspection, the crisis in southern Europe (and, in all likelihood, in Ireland as well) evinces a strong relationship between political regimes, social policies, and the national macroeconomic environment, but not in the way it is usually portrayed by Brussels bureaucrats and the media. Instead of overly generous regimes, we have governments that aggressively pursued a neoliberal agenda, promoting the privatization of state assets and lagging far behind the rest of Europe in human and social services, investment in education, unemployment benefits, and tax collection. In fact, contrary to popular belief, government policies in countries like Greece, Portugal, and Spain, which form the core of the crisis in southern Europe, have on the whole been regressive rather than progressive.

In all three cases, we have peripheral nations with similar historico-political experiences, facing similar problems of underdevelopment and executing similar types of economic and social policies over the last 30 years. For all three countries, the distinction between socialist and conservative parties broke down around the late 1980s, and the socialists emerged as tacit cheerleaders of the neoliberal experiment, pushing through the corresponding policies and often paying a price at the ballot box as angry voters turned against them. Meanwhile, clientelism, corruption, and patronage came to define the political culture through which the state regimes in Greece, Portugal, and Spain exercise power—practices that are reflected in socialist and conservative parties alike.

Clearly, there are specific domestic factors that led to the buildup of the sovereign debt crisis both within and outside the context of the global financial crisis and the imbalances generated by the flawed design of the euro. That is what this brief intends to highlight, along with the destructive impact of neoliberal policies on these troubled economies. It concludes with an outline of the reform measures needed in EU governance for the crisis to end without major casualties and ruptures.

## Background

When the Dubai debt crisis broke out in November 2009, European markets experienced relatively little turbulence. But Europe's political leaders, as if they saw the handwriting on the wall, began to display sudden concern about the debt levels among some eurozone member-states—debt they were aware of all along but had opted to ignore as long as growth was still on the right path. A month later, the “big fat Greek debt crisis” burst onto the world scene, and the eurozone crisis was under way. However, the position among Europe's policymakers at the time was that this was an isolated incident (whether a fallacy of wishful thinking or merely a political posture because of the dark cloud hanging over the whole of Europe) and largely the result of a corrupt political culture that overspent and “cooked the books” (largely true, but still an incomplete account). Even when Portugal and Ireland prompted concerns about their heavy indebtedness, Europe's leaders believed that Greece was the main problem, and that solving the Greek debt crisis would put an end to all contagion fears and thus get the eurozone out of the woods. Europe's leaders continued to hold on to this preposterous belief as late as last month, and France's then president, Nicolas Sarkozy,

and Italian Prime Minister Mario Monti, two leaders with totally diverse communication styles and temperaments, took to the stage after the Greek debt swap was approved to announce that the eurozone crisis was over, or “nearly over.”

There is plenty of foolishness in the political world, but Europe’s leaders seem to be far ahead in the game. Before the dust had settled on the Greek bond swap, the eurozone crisis resurfaced,<sup>2</sup> with the periphery again drawing the attention of the bond vigilantes. Now it looks like it is Spain’s turn to join the European Financial Stability Facility (although the hope is that it can last until the European Stability Mechanism goes into effect later this year). Spain’s banks are going under, its economy is in deep recession, and borrowing costs for the 10-year bond (at over 6 percent) have again reached unsustainable levels. Italy, the eurozone’s third-largest economy, also faces grim prospects: its economy has weakened considerably (shrinking by 0.2 percent and 0.7 percent in the third and fourth quarters of 2011, respectively, with a contraction of 1.2 percent forecast for 2012) and borrowing costs have moved up sharply (a mid-April three-year bond auction paid an interest rate of 3.89 percent, up from 2.76 percent in March).

Spain and Italy are on a steady path toward default. They cannot continue borrowing at unsustainable levels. In fact, as a senior economist at Moody’s Analytics stated recently, “Borrowing costs above 5.7pc will significantly raise the chance of default” (Chan 2012). Borrowing costs are also rising for yet another recession-stricken peripheral country, the Republic of Cyprus, a nation whose economy, according to IMF forecasts, is expected to decline by 1.2 percent in 2012. There is a growing possibility that Cyprus may be forced to seek a bailout from the EU and the IMF. Greece, Portugal, and Ireland, of course, are already receiving bailout assistance and subject to harsh austerity measures. Naturally, their economies are going from bad to worse to disastrous.

It doesn’t take a genius to realize that instead of being over, or “nearly over,” the eurozone crisis is entering a new and far more dangerous phase. In spite of the bond swap, Greece’s sovereign debt-to-GDP ratio remains unsustainable and will actually increase considerably in the years ahead. But why did the crisis erupt in the eurozone periphery? Is it purely because of the euro’s flawed design? Or did the macroeconomic environment produced by the kind of political regimes in the region play a part as well? Here, we have three state regimes with similar historico-political experiences that pursued consistently regressive

policies that lead to growing poverty and sharp inequalities and failed to lay the foundations for sustainable growth. The governments reduced social services and cut education budgets sharply while looting of the state coffers by the domestic economic elites had become the dominant form of southern European entrepreneurial capitalism.

Indeed, the experiences of Greece, Portugal, and Spain reveal a different trajectory than the one taken by northern EU member-states. In the light of the above, a strong case can be made that the specific interplay of domestic political and economic processes in the three southern Mediterranean nations which are currently at the center of the eurozone crisis deserve serious attention when analyzing the crisis facing the Mediterranean club (which includes Italy). On the other hand, the austerity measures these troubled economies have been forced to implement as part of Germany’s hard-core insistence on fiscal discipline ensures a deepening recession and further problems ahead. Their economies need to be put on a growth track while doing away with the regressive policies and practices that their state regimes have adopted in the last three decades or so. But in order for that to happen, the EU must abandon its undemocratic and neoliberal policies. Under the current EU politico-economic configuration, the peripheral countries of the eurozone will continue their economic and social downside—unless they opt to leave the eurozone (though Germany may be the first to do so if political developments move in a direction not to its liking and it begins to feel the cost is too great). So the future of the eurozone depends on simultaneously addressing structural, systemic, and institutional factors both at the national and the regional level—a nearly impossible task even for the most enthused supporters of the EU.

### **Greece, Portugal, and Spain—The Three Pariahs of Social Democracy**

Political and sociocultural explanations are not usually taken into account in discussions about the economy, but they should be. It is also the case that economics rarely enter into the analyses of political developments, and that’s very unfortunate. The problems facing southern European countries today are economic in nature but cannot be understood outside a larger historical and political trajectory, which is another way of saying that the southern Mediterranean crisis also has political roots.

One of the key reasons for the sharp but often misconstrued deviation between southern and northern Europe in the age of the euro has to do with political regimes, the economic setting, and political cultures. Greece, Spain, and Portugal lie well outside the European social democratic trajectory (all three have a long tradition of authoritarian rule), and the policies they have pursued since emerging as parliamentary democracies in the mid-1970s are quite regressive by European standards. Even the application of harsh austerity measures forms part of the continuation of the regressive policies that have been integral to the nature of these regimes. All three countries were drawn quite late into the orbit of capitalist accumulation and democratic legitimation, and none have developed a liberal democratic state. Instead, the pathologies of populism (the propagation of easy solutions for difficult problems), stasis (resisting change so organized interests can maintain their hold on various ill-based privileges), and “amoral familism” shaped the political culture. In addition, there was a strong relationship between political clientelism and the development of media systems, underground economic activities flourished and were accepted as part of the formal economy, and highly ineffective and corrupt public bureaucracies created fiefdoms of power.

Southern Europe also reveals far greater economic inequalities than in the north. Decades of socialist rule failed to supply the necessary retraining programs and vocational education systems that are so prevalent and well funded in northern Europe—in spite of the persistently high rates of unemployment these countries have been facing. The problem of unemployment was seen through the prism of the electoral process, and taking care of the party faithful was always a top priority. National economic strategies occupied little room in the cosmos of southern European politics; instead, personality cults thrived, as in the case of Andreas Papandreou in Greece, Mario Soares in Portugal, and Felipe González in Spain. As for the welfare systems in southern Europe, governments extended meager funding to them, but this was part of a larger policymaking approach: public social expenditures were routinely much lower than the EU average, evading taxes was a national pastime, and state revenue collections for the three pariahs of social democracy always lagged well behind state revenue trends in northern Europe, reflecting the organic nature of political ties between the state, the rich, and big business interests.<sup>3</sup>

Greece, Portugal, and Spain were ruled by socialist parties throughout the 1980s, most of the 1990s, and well into the 2000s

(in Portugal, the socialists came to power in the mid-1970s). In Greece, the Panhellenic Socialist Movement (PASOK), founded in 1974 with Andreas Papandreou as its leader, was in power from 1981 to 1989, when its right-wing turn and the eruption of various scandals (some involving Papandreou himself) led to its ouster. However, largely on the strength of its leader’s populist rhetoric and charismatic personality (Papandreou was Greece’s Juan Peron), PASOK made a comeback. It ruled uninterruptedly from 1996 to 2004, when, again beset by scandal and having alienated a large segment of its populist base—having converted from a regressive, kleptocratic political organization into a neoliberal party that practiced systemic political corruption while preaching the virtues of unfettered markets—it lost to the conservative New Democracy party, which rose to power with a mandate to restructure the state and root out corruption.

The conservatives won the parliamentary elections in both 2004 and 2007. While in power, they continued the policies of their predecessors and made extensive use of the corruption nexus. Major scandals surfaced in the second term (including illegal public land swaps with the abbot of an Orthodox monastery). With the economy already in recession, the socialists were voted back into office in 2009, with George Papandreou (Andreas’s eldest son), running on a typical populist platform, telling voters there was “money around” and promising to turn Greece into the Denmark of the South. A few months later, the future Denmark of the South was instead on its way to becoming a banana republic: in May 2010, Papandreou turned Greece over to the IMF and put in place the most radical structural adjustment program in postwar European history.<sup>4</sup>

To be sure, extreme populism, graft, and corruption have been integral to Greece’s modern political culture, thanks to the existence of a paternalistic state where “kickbacks” for the provision of public services are routine. But under the long and ignominious reign of the socialists, the looting of public wealth became an art form and the covering up of corruption a science. PASOK continues to be synonymous with clientelism, corruption, and patronage (even though the conservative New Democracy party was bedeviled by the same problems while in power). Now, thanks to the tragic situation the country finds itself in as a result of the sovereign debt crisis, Greek voters have turned away from the two major parties in droves, and accuse them of being directly responsible for the catastrophe that has befallen the nation.



In discussions of the Greek crisis, much has been made of the growth rates the economy registered between 1997 and 2007. It is true that during this period Greece averaged 4 percent GDP growth; however, this rather impressive economic performance rested upon the twin pillars of heavy state borrowing and EU transfers. Thus, government debt doubled between 2001 and 2009, while EU transfers for 2000–06 amounted to approximately 20 billion euros, equal to roughly 3.3 percent of annual GDP (CIA 2009).

In the decade leading up to the debt crisis, Greece consistently maintained a public debt ratio above 100 percent of GDP. But there is relatively little to be shown for it in terms of investments and sustainable growth patterns. One key variable in the correlation between debt accumulation and the lack of public investment is the huge discrepancy between expenditure and revenue. Data reveal that the Greek government collects on average 7.9 percent of GDP from direct taxes annually, while the EU average is 13.7 percent.<sup>5</sup>

Turning now to Spain, the picture that emerges for the Spanish Socialist Party (PSOE) bears some striking similarities to that of PASOK in Greece. PSOE, with Felipe González at the helm, achieved power in 1982 and ruled until 1996. As in Greece, the socialists monopolized political power for extended periods of time. However, during its 14-year rule PSOE became better known for its neoliberal agenda—which included mass privatization of state companies, deregulation of labor, liberalization of the telecommunications industry and energy sector, business-friendly tax policies, a massive reduction of the government’s role in human and health services, and sharp budget cuts in education—than for its pursuit of progressive politics. González’s neoliberal program in Spain compared favorably with that of Margaret Thatcher’s in Britain. Government debt declined substantially during the 1990s, but the economy experienced a series of recessions and unemployment remained stubbornly at 20 percent as regressive policies became the hallmark of the González regime. As one long-time expert of southern Mediterranean politics argued, the socialists in Spain replaced the authoritarian right as the functionaries of big business, becoming “the New Right” (see Petras 1990).

Just like in Greece, it took Spanish voters a rather long time to absorb the socialists’ right-wing turn and kick them out of office. And just like in Greece, Spain’s socialists became immersed in huge corruption scandals<sup>6</sup> that finally led to their downfall: they lost to the conservative People’s Party in 1996’s general

elections and were trounced in 2000, pulling in less than 35 percent of the vote. PSOE returned to power in 2004 (largely due to the impact of the Madrid train bombings in March), and won again in the 2008 general elections. Under José Luis Rodríguez Zapatero, the party pursued a postmodern political agenda (favoring gay rights and greater participation of women in government) and implemented a reactionary set of social policies (e.g., cutting civil service pay and unemployment benefits, and raising the retirement age). Like his counterpart in Greece, Zapatero failed to deal with the crisis that had fully engulfed Spain by 2010. In May 2011, angry voters punished the socialist party with a historic defeat in local and regional elections, and the conservative People’s Party went on to score a decisive victory in the national elections in November.

Of course, one could argue that the pattern is the same today all across Europe. The social democrats flirt with progressive economic programs when they are in opposition but embrace the neoliberal agenda once they are in power, privatizing state assets, reducing social benefits, and cutting taxes for the rich and corporations. This can be attributed partly to the overwhelming power of the financial and corporate sectors in an era of declining trade unions and ideological confusion, and partly to the “soft” commitment of social democratic parties to progressive economic change—especially since the collapse of socialism, which lent legitimacy to social democracy’s claim of representing the best of two ideological extremes (i.e., state communism and free-market capitalism). The difference, however, is that social democracy never took root in southern Europe (the social democratic agenda, in turn, was accepted by virtually all conservative parties in northern Europe as late as the 1970s). And for countries with authoritarian legacies and strong reactionary forces—as in Greece, Portugal, and Spain—the socialists were far more likely to use ideology for opportunistic reasons and far quicker to push the neoliberal agenda when things got rough.

In Portugal, the socialists entered southern Europe’s modern political stage a bit earlier by winning the 1975 elections for the constituent assembly—with the charismatic and authoritarian Soares as party head—after the Carnation Revolution of 1974 brought down the Estado Novo (“New State”) corporatist authoritarian regime installed in 1933. After a brief period of political upheaval due to fears of a communist takeover by some radicalized elements within Portugal’s armed forces, the Portuguese Socialist Party (PSP) won the 1976 national assembly elections with slightly more than 35 percent of the vote. However,



in 1979, after failing to manage the deteriorating condition of the economy—which included runaway inflation, high unemployment, declining wages, and widespread poverty—the party lost in the assembly and the coalition government collapsed.

The truth of the matter is that the PSP faced a situation in the years immediately after Portugal's return to parliamentary democracy where reactionary forces retained firm control of the economy while a number of other political parties, both to its left and to its right, had considerable popular support. The 1973–74 oil crisis and the transformations that took place in the years after the collapse of the authoritarian regime that had ruled for 50 years had severe impacts on the country's trade and balance of payments. But by the time it was ousted from office, the socialist party had already shown that its strategy for a way out of the economic crisis rested with neoliberal-inspired policies. In 1977–78, the government pushed forth a one-year IMF economic program in exchange for a line of credit. Not surprisingly, in the 1979 national elections voters turned to the right, and the PSP saw its electoral percentage drop by nearly 10 points over 1975.

Over the next four years, the economy continued to deteriorate and the austerity measures remained in place. Popular discontent with the right-wing government brought Soares and the socialists back to power in 1983. But Soares, seeking yet another IMF-supported economic program, backed even harsher austerity measures—thereby showing the future of southern European socialism. Under Soares, Portugal became the first OECD country to accept the “free market” doctrine known as the Washington Consensus and submit to the shock treatment of IMF austerity. Soares wholeheartedly embraced austerity in order to receive (at current exchange rates) close to \$800 million in international credit (IMF 2012). In 1983, Portugal's foreign debt exceeded \$14.2 billion, which, at nearly 60 percent of GDP, represented one of the biggest debt-to-GDP ratios in the world at that time.

The period 1983–85 represents the high point of southern European socialism. Socialist parties were in power in Greece, Portugal, and Spain, and the authoritarian legacy of the past seemed to belong to a very distant age. However, the rise of socialism in the south did not open up paths to greater democracy or a more progressive economic agenda. As some analysts correctly observed, “for southern Europe as a whole, the years 1983–85 represented a period of maximum socialist conformity around a personalist leadership” (Gillespie and Gallacher 1989,

164). Putting aside the rhetoric of their leaders and the “progressive” manifestos they circulated, southern Europe's socialist parties were highly antidemocratic and run by authoritarian leaders, with Papandreou in Greece probably the most authoritarian of all.<sup>7</sup> By the end of 1985, all three socialist governments in the region had turned to neoliberalism as a means of addressing their pressing economic and social issues.

The fortunes of the PSP rose and fell throughout the rest of the 1980s and the 1990s, since under Portugal's multiparty system the coalitions necessary for governments to be formed often broke down because of tactical differences among the political partners. But it is almost impossible to distinguish between the socialist and social democratic parties, which seem to be competing to see which party can push the neoliberal agenda further and faster when they find themselves in office.<sup>8</sup> The socialists made a strong comeback in 2005, winning the elections for the first time with an absolute majority. They won again in 2009 but did not retain a majority, and in 2011, Prime Minister José Sócrates was forced to resign after the government failed to obtain support for its austerity measures.<sup>9</sup> In the elections that followed, the socialists suffered a historic defeat, once again paying the price for being a wolf in sheep's clothing (see Henriques 2012).

In sum, the development of southern European socialism had little in common with the social democratic tradition of northern Europe. It was under socialist rule that Greece, Portugal, and Spain witnessed the rise of neo-authoritarian leaders, the emergence of a paternalistic political culture, and the systemic shift to neoliberal economic policies (see Kurth and Petras 1993). As for social policy, the “clientelistic-particularistic” approach remains a unique characteristic of the southern European welfare state (see Magone 2003). And contrary to what one might expect from so-called “socialist” parties, government intervention to address unemployment and poverty was rather limited in size and scope compared to what was happening in the rest of Europe. Vicente Navarro (2011), writing on the debt crises in Spain, Greece, Portugal, and Ireland, observed that

in Spain, as late as 2009, the level of poverty (60% of median income) declined only 4 points after implementation of state interventions (public social transfers): from 24% before to 20% after transfers. The EU-15 average decreased from 25% to 16%. Sweden's poverty rate fell from 27% to 13%. The decline in poverty rate resulting from public social transfers in

Spain is the lowest in the EU-15. Another indicator of the limited redistributive impact of state interventions is that the Gini coefficients in all four countries are higher than the EU-15 average (29.2). Spain's Gini coefficient is 31.3, the same as Ireland's; Greece's is 34.3; and Portugal's is the highest at 36.8.

As already indicated, the decline in state revenues was another strong characteristic of state regimes in southern Europe. This was neither accidental nor due to administrative incompetence. It was the way the regimes served the interests of the domestic elite—that is, through massive tax cuts and looking the other way on tax obligations, which in countries like Greece reached astonishing levels. The impact on public debt was disastrous:

The decline of revenues to the states (the consequence of tax cuts) forced the states to borrow from the banks, where the rich deposited the money saved due to reduced taxes. The indebtedness of the states and the need to borrow were clearly related to the reduction of taxes. When the economy came to a stop as the [housing] bubble burst, the structural public deficit became apparent. Public deficits as [a] percentage of GNP increased substantially . . . from 2007 to 2009 as a consequence. Spain went from a surplus of 1.9% of GNP in 2005 to a public deficit of 11.1% in 2009. Greece went from a deficit of 6.4% in 2007 to 15.4% in 2009, with Ireland moving from 0% to 14% in the same period. In all of [these countries, including Portugal], rapid growth of the public deficit was based on the extremely regressive nature of state revenues. With most taxes based on labor income and consumption, when employment declined, unemployment grew, and consumption declined, the public deficit escalated dramatically (Navarro 2011).

### **Reforms, Austerity Measures, and Growth**

The Mediterranean conundrum is about reforms and growth gone awry. It is about weak economies being unable to make a successful transition in a single-currency economic environment. As latecomers to globalizing capitalism and liberal-democratic politics, nations with long authoritarian legacies squandered one historical opportunity after another to institutionalize a pro-

gressive economic and social agenda, despite popular mandates to that end. They opted instead to keep the masses at bay by locking voters into a long-term relationship based, not on the delivery of public goods and a just socioeconomic order, but on promises of targeted resource redistribution to the party faithful—while they catered to institutional interests and the needs of the domestic economic elites.

The three pariahs of social democracy—Greece, Portugal, and Spain—had structural economic problems long before their entry into the eurozone. They failed to address them, not only in terms of shaping their domestic economies along the lines of the social democratic model, but also by embracing neoliberal policies in order to accommodate the interests of the dominant economic elites. Those structural problems became deeper during the process of European integration, as industry and agriculture shifted from the periphery to the core. Once in the eurozone, southern European economies saw their competitiveness decline, and increasingly relied on borrowing as a means of sustaining an artificial “bubble” economy. Moreover, the heavy-handed, inefficient bureaucracies of the socialist regimes had developed an antigrowth mentality that served as a disincentive to serious investors. In this manner, the state regimes of the south ended up possessing the worst aspects of both capitalism and bureaucratic socialism.

The austerity measures the governments of Greece, Portugal, and Spain have imposed on their citizens are not only brutal but also intensely unjust. They primarily target the working populations, civil servants, retirees, and the most vulnerable members of society while leaving the rich and powerful unscathed. Greece and Portugal not only surrendered themselves to the dictates of the EU and the IMF but also went much further than they had to, waging open class warfare against the average citizen so they would not be compelled to challenge the interests and the privileges of the powerful. In Greece, where new austerity measures have been imposed almost on a monthly basis for the past two years, this form of class warfare is historically unprecedented (see Antonopoulos and Papadimitriou 2012). But, as we pointed out above, socialist regimes in southern Europe have always had a knack for imposing neoliberal policies in hopes of resolving capitalism's problems.

As such, the debt crisis in the eurozone periphery is as much political as it is economic, and the problems facing countries like Greece, Portugal, and Spain are related as much to the macroeconomic environment created by their domestic regimes

as to the flawed architecture of the euro system and Germany's aggressive export policies. The regressive policies these countries adopted during the previous two to three decades produced macroeconomic environments that were extremely weak, lacking a foundation for sustainable growth and job creation, and loaded with all kinds of social contradictions. Allowing the affluent classes to engage in widespread tax evasion increased the levels of inequality and poverty in southern Europe more than in the rest of the continent, and clearly put extra pressure on borrowing needs.

It is more than clear that the continuation of fiscal consolidation through austerity orthodoxy will throw Europe's peripheral economies over the cliff, leading to all sorts of undesirable social outcomes and causing political instability that may give rise to new authoritarian regimes, possibly even supported by a populist law-and-order citizenry. To be sure, in addition to causing immense pain, the economic policies pursued by the current EU leadership are producing a growing trend of antidemocratic subcultures throughout the Union.

In Greece, the austerity measures have been devastating. GDP has contracted by 18 percent since 2008–09 and unemployment has climbed above 20 percent.<sup>10</sup> Wages have been cut by 25 percent, and there have also been big cuts in pensions and unemployment benefits. Yet the internal devaluation hasn't led to any increase in competitiveness, for the simple fact that the productive base of the Greek economy is virtually nonexistent and needs a big boost. The current level of public debt is unsustainable and there are no growth prospects on the horizon. Greece remains a potential candidate for a forceful exit from the eurozone.<sup>11</sup>

Austerity is also destroying Portugal's economy. The Bank of Portugal projects a 3.4 percent decline in economic activity for 2012, following a decline of 1.6 percent last year. Wages have fallen by 7 percent, the unemployment rate has reached a new high (15 percent), the deficit has gone up, and all indications are that more austerity measures are in store—which means that Portugal may soon turn into another Greece (Richard 2012). This is truly a tragedy, because deficit and debt ratios in Portugal have been much lower than in Greece, and the country in general did not experience the boom-and-bust scenario of Greece and Spain (see Anand, Gupta and Dash 2012). However, Portugal does have a very large external deficit (Rossi 2012).

The latest cause of concern in the eurozone is Spain. The cheap loans made by the European Central Bank (ECB) have run

their course, and markets are again getting edgy about economic developments in the periphery. Spain's banks are on the brink of collapse, primarily because of the bursting of the housing bubble, and its economy is entering another recession. At 24 percent, its unemployment rate is the highest in the EU. As bank lending to the private sector contracts and the austerity measures sink the economy deeper into recession, unemployment will rise even further, markets will panic, fear will set in, and yields on Spanish bonds will spike. The new government, headed by Mariano Rajoy of the conservative People's Party, has announced a gut-wrenching 27 billion euro austerity program, operating under the firm conviction that such measures will provide the foundation for future growth. (If Rajoy manages to completely sink Spain's economy, he may, like José Manuel Barroso, who sought to enforce similar measures in Portugal in 2002–04, become president of the European Commission.) In the meantime, Standard & Poor's has downgraded Spain's credit rating by two notches (from A to BBB+), forecasting, under one possible scenario, a 4 percent GDP decline in real terms for 2012 (S&P 2012).

Spain may very well end up seeking assistance from the EU and the IMF. It is highly unlikely that it can solve its fiscal and economic problems on its own. Neither can Greece or Portugal. Yet these countries are being forced to adopt measures that will cause their economic and social condition to deteriorate, and convert them once and for all into economic colonies of northern Europe. This is one of the terrible contradictions of belonging to a monetary union that lacks fiscal and political integration. The current development of the European economy as a whole is producing what the late dependency theorist Andre Gunder Frank called a "metropolis-satellite" structure. The consequence of this sort of development is the permanent economic retardation of the "satellites" (e.g., Greece, Portugal, Spain, and Italy) and the continuing growth of the "metropolis" (Germany and its neighbors). This is an outcome that would not, in the case of the eurozone, be politically sustainable for long; in fact, France's new socialist president, François Hollande, has already stated that he won't sign the fiscal treaty EU leaders approved in December 2011 unless a growth clause is included. In any case, the EU's current system remains flawed and even dangerous, and could very well lead to dramatic developments for the entire regional economy unless its governance is restructured and its political leaders abandon the current economic orthodoxy.

## EU Governance Restructuring

The EU's strategic response to the eurozone crisis has been mostly confined to calls for fiscal discipline and greater fiscal coordination. Yet the truth of the matter is that, leaving Greece aside, Europe doesn't have a debt problem but rather a growth problem, the result of a stubborn commitment to anti-inflationary thinking and an attachment to outdated and dangerous economic dogmas (such as the idea that deficit reduction stimulates growth). Fiscal austerity in the midst of a severe recession has proven to be a catastrophic recipe everywhere it has been tried. Even the UK's economy is suffering a double-dip recession because of the conservative government's ideological commitment to fiscal consolidation.

Fiscal coordination, the EU's main task for stabilization, makes a mockery of the notion of an Economic and Monetary Union. The crisis in the periphery can be solved only through the EU's introduction of institutions and mechanisms that bear the distinct mark of a federal state: a powerful parliament with the authority to transfer surplus revenue for budget stabilization, a central bank that can act as a lender of last resort, the issuing of some type of eurobond, and a balanced relationship between federal authority and state (national) rights. This is the direction the EU must take if it intends, not merely to survive, but to fulfill the aspiration of a continent to become a global actor, and to reclaim the values of sustainable economic progress and social justice that have been trampled by Brussels' neoliberal agenda.

There have been a number of "modest proposals" so far, all of which address the need for change in the current economic approach. The issuance of a eurobond may not be far away, but that in itself will not be enough to eliminate imbalances or provide stabilization. In fact, it is rather surprising that so many growth-oriented analysts look to eurobonds as the way out of the crisis. Without further changes in the EU's governing architecture, eurobonds will do nothing more than make investors happy and increase the risks for Germany. As such, Germany's resistance to a eurobond is not absurd. What *is* absurd about the German posture is the government's insistence that all that's needed for a return to normalcy is fiscal discipline and heavy doses of austerity. For a nation that prides itself on not forgetting its own history, Germany seems to have a very short memory when it comes to the relationship of satellite states to the metropolis: in times of severe economic crisis, political turmoil, or war, the satellites often break free.

## Notes

1. For a critical account of the German approach to the eurozone crisis and the way in which the flawed design of the euro system contributed to imbalances, see Papadimitriou and Wray (2011); see also Pérez-Caldentey and Vernengo (2012).
2. The eurozone crisis isn't back: it never left. It merely went into a brief hibernation, as the world watched Europe's leaders try out various fixes for the wrong crisis. No matter how much cheap money the ECB provides or how high the EC "firewall" rises, Europe's economic sickness cannot be cured without massive government intervention to get the regional economy rolling again, or without correcting the flaws in the eurozone's design. Current economic policies, and the new German-inspired fiscal compact treaty, will eventually turn Europe into an economic wasteland, force some countries to exit the euro (a better alternative than remaining captive to chronic stagnation), possibly split the eurozone into Teutonic and Latin unions—or even lead to its complete demise.
3. This is not necessarily to suggest that there is a southern European model, especially since there are some important distinctions between north and south in nations like Spain and Italy. But there are common features of underdevelopment and clear similarities in political and social structures that cannot be ignored, as they point the way in which political regimes and the prevailing political culture help shape the macroeconomic environment.
4. The austerity measures introduced included steep pay cuts, sharp increases in value-added taxes, pension reductions, slashes in social programs, increases in the maximum number of people companies could legally lay off each month, extreme pension reforms, privatization of state assets, and tax breaks for the banks and the rich. The Papandreou government accepted the terms of the first EU/IMF rescue package (worth 110 billion euros) without a fight, despite a usurious interest rate of 5 percent. It also went out of its way to convince the public that austerity was a "patriotic duty," and promised that the crisis would be over by mid-2011.

What happened, of course, is what every economist had predicted from the start: the economy took a sharp turn for the worse (GDP shrank by 4.5 percent in 2010 and 6 percent in 2011), unemployment reached catastrophic levels (it currently exceeds 20 percent), and the public debt increased. Moreover, the Papandreou government did nothing

- to combat corruption, reduce state expenditures, collect some 42 billion euros in back taxes owed by businesses and the wealthy, or even undermine the power of vested interests. Not even the military junta that ruled the country with an iron fist from 1967 to 1973 would have dared implement the open class warfare that PASOK did under Papandreou.
5. See Meghir, Vayanos, and Vettas (2010), 11. For a critical overview of Greece's political economy and the role its political culture has played in its economic collapse, see Polychroniou (2011).
  6. Corruption in Greece and Spain applies to all major political parties and continues to this day. In 2009, over 700 public officials in Spain were facing criminal investigation for corruption, with most cases linked to the explosion in housing prices. In Greece, on the other hand, public officials rarely, if ever, face trial for corruption.
  7. Indicative of how antidemocratic the southern socialist parties were, party leaders prepared the lists of candidates for parliament; but in Greece, it was Papandreou himself who was in charge of the list; see Gillespie and Gallacher 1989, 177.
  8. Portugal has a number of parties that call themselves social democratic, but names are deceiving. Aside from the Socialist Party, there is the Social Democratic Party, which belongs to the ideological camp of the European right; this is the party of EU President José Manuel Durão Barroso, who served as its leader from 1999 to 2004. Then there is the Democratic and Social Centre Party – People's Party, whose membership is largely Catholic and conservative.
  9. See Leao and Papacio-Vera (2011) for an analysis of the problems facing the Portuguese economy.
  10. For an extensive report on unemployment in Greece, see Antonopoulos, Papadimitriou, and Toay (2011).
  11. For an assessment of the impact of austerity in Greece and throughout Euroland, see Papadimitriou and Wray (2012).

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