DEMOCRACY, DEBT AND DISORDER. TOWARDS THE END OF POLITICAL "GENEROSITY"[1]

Giuseppe Eusepi and Luisa Giuriato
Sapienza University of Rome,
Faculty of Economics,
Department of Public Economics

ABSTRACT

Unquestionably, the existing welfare state, as has evolved in a four-decade span, is destined to collapse unless redistribution enters a new constitutional contract to smooth the intergenerational conflicts that grew out of the presuppositions of Harvey Road. A key insight is that under the spell of intergenerational solidarity, fiscal illusion has perpetrated a violation of the intergenerational equal treatment. The paper, in its initial part, highlights how concentration of expenditures and intertemporal dilution of costs by means of debt creation have provided the ambiance to turn democratic order into intergenerational disorder. It goes on to analyze the evolution of the Italian public debt and the background of the elements that have generated intergenerational disorder. While the data on the Italian public finances during a one-hundred-fifty-year span show that governments have widely resorted to public debt, there are marked differences between public debt policies before and after the 1970s. The paper suggests that intergenerational order has collapsed ever since the Italian governments embraced the presuppositions of Harvey Road.

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What is prudence in the conduct of every private family,
can scarce be folly in that of a great kingdom.

A. Smith, *The Wealth of Nations*, Book IV, Chapter II.

1. INTRODUCTION

Of all faces of the economists' values the three "Es", efficiency, efficacy and equity, rank high among economic analyses while the three "Ds" in the title, representing *democracy*, *debt* and *disorder*, are not considered at all. If we are able to demonstrate that democracy, debt and disorder have as much economic value as the three "Es", that they are interrelated and that in perspective this interrelation has an increasing value, then we shall have justified the writing of this paper.

The three "Es" of the economists are descriptive of three end states where Paretian efficiency, productive efficacy and distributive equity surreptitiously are made coincidental. They are, instead, the result of at least two different technologies: (i) a theory of production, based on perfect competitive markets; (ii) a theory of redistribution – whose foundations are of political or, perhaps, ethical order (Wagner 1958) – aiming at the modification of market results. That said, it is easy to conceive of efficiency and equity as being in conflict. Indeed, the dimension of the conflict largely depends on the political evaluation of market processes[2]. Yet, one cannot help observing that politics is external to market processes, and it is not in a position to be helpful to the making of market democratization. The supremacy of politics over markets in insuring equal results may be explained in terms of an aristocratic vision of politics, as an articulation of the idea of politicians as *"the best men"* or *oi aristoi* in ancient Greece. In this sense, politicians are supposed to be morally superior individuals, more prone to altruism and so capable to solve distribu-

[2] See B. Caplan (2007).

tive market failures. For a view of this sort it is entirely proper to see politics as exogenous[3], thus the order it commands is undemocratic to the core, and so is the welfare it maximizes.

The logical first step in internalizing politics would be to make a shift from economics as an objective science to political economy as an evaluative process of the choosing actors. Through such shifting, institutions would become central to the analysis since the democratic process takes pains to internalize political institutions conceived as bound to rules from their birth.

It is exactly the illegitimacy of decoupling political institutions from constitutional-institutional rules that serves the drive toward the élitist vision of the politician as a benevolent despot. This formed the background of the presuppositions of Harvey Road[4].

Moreover, this paper sets out to demonstrate that under the presuppositions of Harvey Road rotating majorities do not correct most of the inefficiencies that they produce, especially those associated with public debt.

Specifically, Section 2 addresses the impact of the presuppositions of Harvey Road on welfare. Section 3 centers on Paretian optimal redistribution and emphasizes the role of balanced budgets. Section 4 speculates on fiscal illusion as a mode of turning a difficult horizontal (intragenerational) consent into an easier vertical (intergenerational) one. Section 5 identifies in the logic

[3] See W. Kasper and M.E. Streit (1998).

[4] This expression, used by Buchanan and Wagner (1999), is drawn from R. F. Harrod (1951). The presuppositions of Harvey Road can be described as arrogance of the intellectual élite that they know what the best policies are and furthermore that they are able to persuade the politicians to faithfully enact and implement those policies.

of fiscal price or fiscal traceability a way to reduce fiscal illusion. Section 6 focuses on the evolution of the Italian public debt, trying to account for its implication in terms of intergenerational disorder and adopting the primary balances as a proxy of intergenerational disorder. The analysis shows that the reasons behind the rise of public debt before (6.1) and after World War II (6.2) were different, and so was the general state of the public finances. We suggest that prior to the adoption of the presuppositions of Harvey Road public debt did not produce intergenerational disorder, as it financed temporary budgetary imbalances with the expectation of intra-generational repayment. Section 7 offers some concluding remarks.

2. BUCHANAN AND WAGNER: THE PRESUPPOSITIONS OF HARVEY ROAD

The welfare state has come to be known as the glittering emblem of democracy. Yet, what we think of today as the welfare state did not spring out from democracy but to contrast socialism during the Bismarck era and subsequently to adjust market failures under the label of social security (Beveridge). However, the welfare state came into full blown existence in the second part of the 1960s. Promises of large welfare programs in favor of the majority, presumably at the expense of the minority, have been the lubricant to the electoral victory, so the nexus between welfare and democracy rests upon the voting motive and nothing else. The literature on democracy versus autocracies focuses much on the role of elections in shaping policy incentives and the provision of redistribution and public goods. In Acemoglu and Robinson (2005) elections shape the pattern of representation and determine which group of citizens holds the power. This explains why income redistribution may be greater under an interventionist democracy

than under autocracy[5]. Bueno de Mesquita et al. (2003) focus on the role of elections in making politicians accountable; elections imply that the incumbent government needs the support of a large number of citizens to stay in power and thus increases the provision of public goods.

Yet, the democracy-welfare nexus would give rise to minor or marginal problems if welfare were to be achieved with the budget in balance. A balanced budget, in fact, is an element of the first importance in guaranteeing the survival of those politicians more prone to act in favor of the public interest. However, as the center of gravity passed from the "old time fiscal religion" to the presuppositions of Harvey Road a new breed of myopic politicians have started prowling the political arena. They perverted the ethical basis of the Smithian ethics by utterly accepting the notion that a balanced budget is a folly or a tragedy for a great kingdom. What Buchanan and Wagner (1999) called "Tragedy, not Triumph".

When the presuppositions of Harvey Road gained ground and brought about the separation of the two sides of the fiscal account, one could have reasonably foreseen that this practice would have set governments on a course from which they would be unwilling to deviate[6]. It was precisely their willingness to decide unconstrained that has produced the notorious pro-

[5] One of the referees has pointed out that in dictatorship redistribution would easily be larger than in democracy. Indeed this is true if we consider a liberal democracy with a balanced budget. It is much less true if a democracy espouses the presuppositions of Harvey Road.

[6] Lerner is worth quoting here "The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall be undertaken with an eye only to the results of these actions on the economy and not on any established doctrine of what is sound or unsound" (Lerner 1943, p. 469).

longed budget deficits that all welfare countries face presently. From the implicit acceptance of the presuppositions of Harvey Road, and it alone, not from democracy *per se*, governments fell into the bad habit of resorting to debt. And when this practice became popular, governments began to feel fully entitled to elaborate their own ethics on budgetary matters.

It has been suggested that through the rotating mechanism, majoritarian systems are able to correct, at least within limits, the distortions that democracies generate[7]. It is our contention that distortions created by governments acting under the spur of the Harvey Road gospel cannot be corrected via the succession of majorities. Rotating majorities have largely gone along and developed side by side with debt in every part of the world during the second half of the twentieth century and the twenty-first as well. Resorting to debt is the least costly alternative par excellence whichever the incumbent majority is. Without a public debt entwined with fiscal illusion, democratic governments would have quite possibly been unable to discriminate against future generations and reach an agreement on how much to redistribute within the present generation. There is a close connection between the problem of how much to redistribute through the political market for adjusting market distribution and the creation of public debt. This connection turns what should be a genuine horizontal or intragenerational relationship into a vertical or intergenerational relationship. The verticalization of redistribution has the effect of loosening budget constraints and fiscal illusion forms the background against which governments' public debt has increasingly grown. While in horizontal relationships redistributive expenditures would show themselves for what they are (an alternative to the expenditures on public goods and services) verticalizing redistribution violates the terms of contractual presuppositions. Those of Harvey Road,

[7] J. M. Buchanan and R. Congleton (2003).

were designed to enforce and bring about rights for the present generation only but the presuppositions of Harvey Road also have consequences for future generations. This means that future generations suffer from negative externalities for they were unable to participate in the initial contract. The presuppositions of Harvey Road brought about a relaxation in the law as to the obligation of a promise overthrowing the moral binding well before the political and economic one.

Yet more, the presuppositions of Harvey Road produced moral and financial disorder as they entered democracies and the earthquake that followed is apt to last as long as governments are able to hide the genuine costs of debt. Thus the postwar period proved to be a public indebtedness saturnalia. Little by little, governments, under the camouflage of the rhetoric of welfare, were able to spread the culture of debt default implemented to the point of disorder. Unless or until a fiscal constitution is introduced to give constitutional rank to the balanced budget requirement, governments will go on with the separation between the creation of rights and fiscal duties indefinitely.

3. PARETIAN DISTRIBUTION AND PUBLIC DEBT

Market oriented economists would accept that, through redistributive policies, a certain increase in the welfare of the community could be obtained without any postponement of costs under the condition that the choice on how much to redistribute were taken by a single decision-maker with a single redistributive "project" and under a balanced budget constraint[8].

[8] For a detailed analysis of the relationship between welfare state and welfare see A. Hamlin (2008) in this symposium.

Yet, no democratic welfare state would organize its redistributive policies in this way. In contemporary welfare states, transfers are the result of thousands of transfer programs that conflict not only with one another, but also internally due to the different pressure groups that demand and supply them. Under such conditions, the redistributive results cannot but be random, because each program produces winners and losers within the various income brackets. In this context, only if the government were a single benevolent despot and taxpayers were fully altruist individuals[9], would the emerging result be descriptive of an "optimal Paretian distribution"[10]. However, as we move to a more realistic predicament, we soon realize that, in the face of large groups, a free-rider problem is apt to emerge. But this is not all. Uncertainty arises about how much taxpayers are actually willing to redistribute. Certainly the very existence of public debt as a mode of welfare financing can be thought of as a threat to the Paretian optimal redistribution, which is undermined *ex imis fundamentis*.

To be defined as Paretian, a distributive policy should be the result of consensual processes free of intergenerational externalities. In other words, the Paretian logic is uncomfortable about the pressure of any redistributive political action aiming at the alteration of a balanced budget. This implies that none of the contracting parties suffers losses from redistribution and that a certain amount of transfers take place on a voluntary basis without any authoritative norms of decision established by the government. However, government intervention is coercive in nature, thus we are met by the question: What is the government mission when redistribution is thought of as a regime for adjusting market processes? It is manifest that there would be a modest one, or perhaps, none. The precondition to assign the

[9] As in Barro (1979).

[10] H. M. Hochman and J. D. Rodgers (1969).

government a mission is that of having a nihilistic attitude toward Paretian redistribution or a mitigated one compared to the understanding of redistribution in Western countries, especially after World War II in the U.K. and the USA and at the end of the 1960s in Italy. With the advent of democracy government came to be regarded as an intermediary facilitating exchanges and not as an authoritative élite. This does not mean, however, that every claim or expectation that citizens urge be satisfied comes from citizens themselves, some come from pressure groups. But once dictatorship is abandoned, democratic government does not automatically become a genuine intermediary in the exchanges among individuals owing to its role of intermediary of the various interests of pressure groups asking for and offering redistributive levels that overlap or come in conflict. What this comes to is a confusing intermediary role of the government, which is inappropriate in such a setting, for the redistributive game is likely to produce externalities by definition, redistribution running counter optimal Paretian redistribution.

There is not the slightest question but that government resorts to debt because of its failure to reach an agreement on how to redistribute within the present generation of the polity. Only under the unreasonable assumption that conflicts among generations disappear or sharply reduce and an intragenerational agreement is reached, could a government be considered as a genuine intermediary. Obviously, the double knots of debt and disagreement propel an orchestrated consent within the present generation. This is based on the postponement of a share of the cost to future citizens-taxpayers of whom the incumbent government cannot be, even conceptually, representative or intermediary[11].

[11] See R. E. Wagner (2004).

4. AWAKENING FROM THE DOGMATIC SLUMBER

The instrumental role that resorting to debt played even long before the advent of democracies and the fiscal state is widely acknowledged. In peace time, expenditures were financed by dipping into the king's estates, while in war times there was a conspicuous readiness to resort to debt. The fiscal state, did not, alas, change things much. For example England depended on debt to wage the wars against Napoleon, which offered Ricardo so much food for thought.

With the advent of democracies, governments were not at the forefront of efforts to decrease debt. Instead, the indissoluble hendiadys debt-government was even more reinforced and debt continued to be used to finance wars and, although indirectly, to guarantee order.

The Classicists' distinction between ordinary and extraordinary financing sought to differentiate tax financing from debt financing, specifically that in peacetime the expenditures on law and order were to be financed through taxation. This principle of sound finance was eroded under the presuppositions of Harvey Road which replaced the *laissez-faire* doctrine. It is in a context of interventionist democracy of the sort that the government's prominence spread out dramatically, because of its changed role. Its mission shifted from that of guarantor of the players who choose their moves to that of guarantor of the results of the game. Hence, the government turned out to be playing the role of a public insurance that guarantees that the results of the game are *good* for all the players (no losers). Had the presuppositions of Harvey Road not opened the way, first of all ethically and then politically, to deficit and debt, coercive spending justified with positive freedom would

have stayed within limits[12] not far from those that prudence sets for individuals who are bound to respect the imperative that debts have to be paid back.

One could appropriately say that the presuppositions of Harvey Road subverted the government's logic by adherence to holistic rather than democratic principles. Whether a budget should be balanced or not depends not a little on this. Viewing a balanced budget as an irrelevant dogma[13] leads to the aberrant conclusion that the debt (at least domestic debt) is a problem only for private individuals, never for the government, thus a debt is said to be public because we owe it to ourselves. This axiom wholly ignores that bonds' subscribers, who have to be paid back are perhaps a small fraction of the whole taxpayers. Hence, "we", does not coincide with "ourselves". "We", in fact, refers to the subscribers only, while "ourselves" to all taxpayers who have to serve and pay back the debt pro-quota. Under the mien of democracy, governments can easily be taking the strides toward a quasi absolute power. With taxation increased, future taxpayers are obliged to pay for a debt which they would have not been required to pay if the debt had never been created[14].

An extensive literature has developed around the idea that public debt is entirely different from private individuals' debt. The idea is that the government can perform in such a way as to disappoint the promisees and roll over repayment commitments indefinitely. This right not to pay debts is controversial both in theory and in practice. Saying that the government as a pure intermediary is never indebted is not the same as saying that

[12] See. A. de Jasay (1991 and 1996).

[13] The concept of functional finance marks the bright line between private and public budget. This is the first presupposition of the presuppositions of Harvey Road.

[14] See J. M. Buchanan (1958).

the principals for whom it acts are not so. The effect of this relaxation in the principles of sound finance has led to the conclusion that in democracy public debt is not a problem for the government. Certainly it is a problem for the taxpayers. It is also a problem for bonds subscribers in the event of default[15]. Under the presuppositions of Harvey Road, democracy and debt share the same DNA.

Our aim here is not that of traveling again through the debate on whether public debt exists or not and for whom it is a problem. One could easily extend to the case of public debt the logic that drove the Spanish Vice-Roy of Milan in the 1600s to proclaim by law that there did not exist such a thing as the plague, despite the thousand of dead moldering in the streets. Sadly, at least for three decades, the economists following the presuppositions of Harvey Road did much the same thing. They vested the government with the mission of guaranteeing welfare in an alternative setting to the market at least until 1958 when Buchanan, seeking a ground in the Italian school of public finance, awakened his peers from their "dogmatic slumber", to use Kant's expression. More or less implicit in the arguments of Harvey Road pundits was the difference between public and private ethics, between public and private debt, between rules to be applied to public budgets and those to be applied to private ones capsizing, thus, the Smithian perspective in the epigraph. Limiting markets instead of the Leviathan seems to be the ethical basis of the presuppositions of Harvey Road. The presuppositions of Harvey Road, then, have somehow broken the equality between the contracting parties in fiscal matters and have spurred governments to separate the eligibility to benefits via public expenditures from the related covering obligations. Ever since, economists have conceived the entitlement to receive fiscal rights now as divorced from fiscal obligations. They introduced also the rever-

[15] See G. Brennan and G. Eusepi (2002).

sal of the synchronic-symmetric relationship fiscal rights-fiscal obligations into a diachronic-asymmetric relationship. In keeping with this attitude, the Harvey Road pundits have caused one of the most devastating effects on public budgets, namely, the strategic doctrine of postponing the burden. This clearly implies a distinction that is not only logical, but also chronological. The diachronic breach between fiscal rights and fiscal obligations opened up a chasm, not just a crevice, whose filling entails a violation of the intergenerational fiscal treatment.

5. FISCAL TRACEABILITY VS. FISCAL ILLUSION

What has been said up to now shows that intergenerational disorder is the result of a redistributive policy that is incompatible with that achievable under balanced budget provisions and that the welfare state democracies do their best to make the redistributive level bearable for the taxpayers of the present generation under the camouflage of deficit financing. The survival of this system, or as one would say nowadays the sustainability of the system, involves intergenerational disorder, which increases from one generation to the next (or from one year to the next). Such mechanism is vital to the solution of *intragenerational* conflicts among successive generations. Debt and disorder, not solidarity, become, thus, the common denominator that interconnects the generations of the welfare state. It is worthwhile to notice that even under the strictest hypothesis of a single redistributive program able to foresee, at least in principle, who the losers and the winners will be, the emerging results would not necessarily be rational. The requirements of a balanced budget are fundamental to make an evaluation in terms of genuine opportunity costs on whether the proceeds of taxation are to be appropriated for the provision of public goods and services or for redistributive programs. The inevitable

friction incident to the redistribution programs to be financed among pressure groups produces fiscal illusion and erases the fiscal traceability of each redistributive program and, *a fortiori*, of the redistributive level as a whole, which emerges only *ex post*, that is, only when the redistributive game is over.

The lack of fiscal traceability, as the fiscal price that each individual pays for each unit of expenditure in each program, provides the ambiance for setting the decision-makers in a position of high uncertainty. While under uncertainty investors who are risk-averse would choose short-term projects, they have to do so in a setting where redistribution is implemented through debt financing. So the introduction of what for lack of a better expression we shall call *anti golden rule* is much urged to attain and maintain the system's political stability. This measure would not only prevent any one from perceiving redistributive transfers as an alternative to public goods, it would help to see them as a part of the safety net protecting individuals from cradle-to-grave. No one would have any interest in contrasting a welfare state conceived as a safety net to protect people against the risk of poverty, sickness, illiteracy and a poor, and perhaps long, old age.

6. DEBT AND DISORDER IN ITALY

In this and the following two sections we shall focus on the evolution of the Italian public debt, trying to account for its implication in terms of intergenerational disorder. We examine not only the level and change in the debt/GDP ratio, but also some proxy of the employment of public debt as a means to transfer the expenditure financing burden to future generations. In the following we adopt the primary balances as a proxy of intergenerational disorder. Persistent primary deficits cause the rise of public debt as the alternative, i.e. the continuous monetization of the deficit, would

cause inflation. However, persistent deficits denote also a public incapacity or unwillingness to raise sufficient revenues and save to pay for the expenditures of the current generations and to repay the stock of debt.

The high public debt ratio to GDP, which has characterized the majority of Western countries during the last decades of the twentieth century, is not an exceptional event in the history of the Italian public finances of the last 150 years. We will begin by reviewing Italy's public debt history. However, the reasons behind the rise of public debt before and after World War II are different, so is the general state of the public finances. In particular, the history of the Italian public finances indicates that the high public debt has not always been associated with persistent primary deficits. We suggest that in some cases public debt was not causing intergenerational disorder, as it financed temporary budgetary imbalances with the expectation of intra-generational repayment.

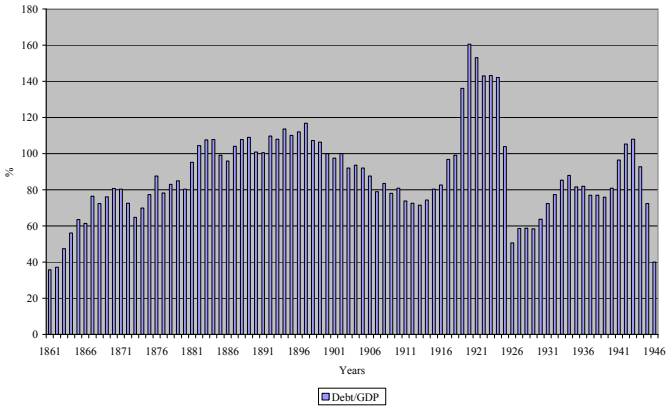
6.1. ITALIAN PUBLIC DEFICITS AND DEBT FROM 1861 TO 1945

High public[16] debt has accompanied Italy's history since the country's unification in 1861, when the newly born unitary State did not repudiate the debts of the kingdoms and duchies it substituted. The initial debt ratio was then 35.8 per cent of GDP, not very far from the level the Italian Republic inherited after World War II (40 per cent of GDP in 1946). Public debt further accumulated in the 1880s and 1890s, as a consequence of

[16] Data on the debt/GDP ratio from 1861 to 1946 are drawn from the time series reconstructed in V. Zamagni (1998) and they are referred to the State sector. Data on the debt/GDP ratio from 1946 to 1979 are reconstructed in R. Artoni and S. Biancini (2003). Data from 1980 to 2007 are drawn from the Bank of Italy, Statistical Bulletin and Supplement (various issues).

the interest payments, of the increased military expenditures, of the support to the industrialization wave and of infrastructure building programs[17], and later on in the war periods and during the Great Depression. As shown in Graph 1, for fifty-four years, the public debt never decreased under the 80 per cent of GDP and it stayed above 100 per cent of GDP for 26 years (1882-84, 1887-1900, 1902, 1919-25 and 1942-43). Thus, the twenty-five years following World War II (1946-71), when the public debt ratio constantly remained under 50 per cent, represent the real exception to a general secular trend of high public indebtedness.

Graph 1 – The evolution of the debt/GDP ratio in Italy from 1861 to 1946



Source: Zamagni (1998)

[17] Italy was a later-comer country in the industrialization process and the insufficiency of capital accumulation and of pro-growth factors were heavily remedied by the State's intervention: the public expenditures rose from 11 per cent of GDP to 14 per cent of GDP in the industrialization period 1880-1887, with the highest increases in the defence chapter. A. Pedone (1969) observes that the extensive direct and indirect public support to the industrial system rooted the widespread belief that the State had to guarantee high profits to the big industry. Besides, transport infrastructure expenditures directly impinged on debt accumulation: the railway building was financed by the emissions of dedicated bonds in 1879, 1882 and 1885.

Although marked by high public debt, the 1861-1946 period should not be associated with intergenerational disorder. First, the tendency towards the accumulation of high debt was frequently interrupted by the attempts to consolidate the public finances[18]: the rigorous fiscal policy of the Right wing government which reduced the debt ratio from 80.8 to 64.8 per cent in three years (1870-73); the financial consolidation (1897-1908) operated by the Left wing governments of the Giolitti time which gained from the positive macroeconomic environment and culminated in the Rent Conversion (1906)[19]; the tight fiscal policy of the Fascist government which, combined with the cancellation of the external war debt and with the high rise of income and prices, reduced the debt ratio from 160 per cent (1920) to 51 per cent (1926) in six years. The other two episodes of debt reduction (1935-39 and 1944-47) can be associated primarily with inflation.

Besides, except for the World War years, the high public debt of the 1861-1946 period was generally associated with actual deficits but with primary surpluses, which indicated the willingness to keep the ordinary finance in balance[20]. Graph 2 shows that only

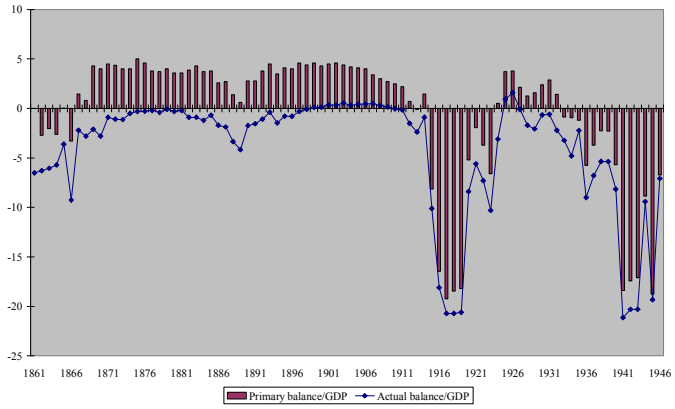
[18] Tight fiscal policies generally followed widely recognised emergency crises which called for reform: the confidence crisis of 1866 on the international markets and the subsequent "corso forzoso" of the domestic currency (the interruption of the currency conversion), which was suffered as a humiliation; the financial and bank crisis in 1893 and the 1919-21 exchange rate crisis.

[19] The Rent Conversion was the transformation of the medium-term bonds to a perpetual rent at 3.5 per cent. This operation adjusted the return on the Italian public bonds to the lower domestic and international interest rates.

[20] Data concerning the public finances are drawn from V. Zamagni (1998); F. A. Repaci (1962); G. Toniolo and P. Ganugi (1992) and from P. Ercolani (1969). A comprehensive account of the period is provided in A. Pedone (1969) and a partial reconstruction of the time series is provided in R. Artoni and S. Biancini (2003).

during the war and the immediate after-war years, one can find high primary deficits, while the whole period is marked by small positive balances. The actual budget deficits of the period were, thus, mainly caused by the interest payments, which absorbed 38.5 per cent of the total expenditures in 1885 (4.45 per cent of GDP), 18.4 per cent of it (2.2 per cent of GDP) in 1913, right before the First World War, 20-24 per cent in the late 1920s, and 16.5 per cent in 1939: a relevant effect on rent formation and income distribution was thus performed.

Graph 2 – Primary and current budget balances in Italy from 1861 to 1946



Sources. Data from 1862 to 1885 are elaborations on Zamagni (1992), Repaci (1962) and Ercolani (1969). Data from 1885 to 1946 are drawn from Ragioneria Generale dello Stato (1969) and from Artoni and Biancini (2003). Data refer to the Government's budget.

The driving forces behind debt accumulation are thus not closely associated with primary deficit, but rather with the variations in the nominal and real growth rate, as shown in Artoni and Biancini's (2003) decomposition of the change in the debt/GDP ratio. Only in the years 1915-1919 and in the years 1942-43, was the high primary deficit the main determinant of the increase in the debt ratio. For the rest of the period, the role of the primary deficit was enhanced or contrasted

by the role played by other variables. In some years, the good budgetary performance contributed together with the exchange and inflation crises in 1920-25 to the debt reduction. In other instances, the role of the budgetary performance was completely offset by the changes in income and prices. In the years 1885-97, the debt increase from 99 to 117 per cent of GDP was to be associated with the nominal income reduction, as the average debt cost was constant at about 4 per cent and the primary balance improved to 4.6 per cent of GDP[21]. In the subsequent period (1898-1911) debt reduction was caused by both real income and price increase. Conversely, the primary surplus reduced and turned into a deficit while the average debt cost stayed constant until 1906 and then oscillated between 3.8 and 3.6 per cent[22].

Although the general picture is complicated by the war episodes, the fiscal stance until World War II seems to confirm our judgment regarding the absence of intergenerational disorder in the Italian public finances. The myth of the zero budget balance was shared at different degrees by both left and right wing governments. Beside its ideological component, it was rooted also in the external constraint imposed by the need to collect financing abroad (in France first and then in Germany): from 1861 to the end of the century, the external debt ranged from 1/4 to 1/3 of the total (Zamagni, 1998), while the debt issued to finance the first World War was almost entirely external (UK and US). Fiscal consolidation episodes were thus the result of automatic stabilization but also of deliberate discretionary policy, which tended to profit by positive economic conditions. The

[21] In a similar way, the debt increase from 1926 to 1934 can be mainly associated with the nominal income reduction, while the average debt cost stayed oscillated around 5 per cent (6 per cent in 1929 and 1934) and the primary balance was positive.

[22] The debt reduction in the years 1935-38 can be similarly explained by the dominance of the increase in nominal income over the worsened primary balances.

Giolitti governments took advantage of the good domestic and international situation and of the 1898 to 1907 rapid income increase to obtain modest, but positive budget balances[23]; in the growth years 1922-26, the Fascist Finance minister De Stefani closed the war deficit by cutting the real expenditures by 54 per cent. During economic downturns, the concern for the budget balance favored pro-cyclical policies: in the years 1932-34, during the great depression, the public expenditure was reduced and public investments were cut to less than the 1928-29 level. The idea of deficit and debt accumulation was simply culturally unacceptable at the time.

6.2. THE POST-WAR EVOLUTION OF PUBLIC FINANCES

We do not indulge in revisiting the history of post-war Italian public finances for they are analyzed in several other extensive surveys[24]. Rather, we will try to single out some aspects that corroborate our interpretation of intergenerational disorder.

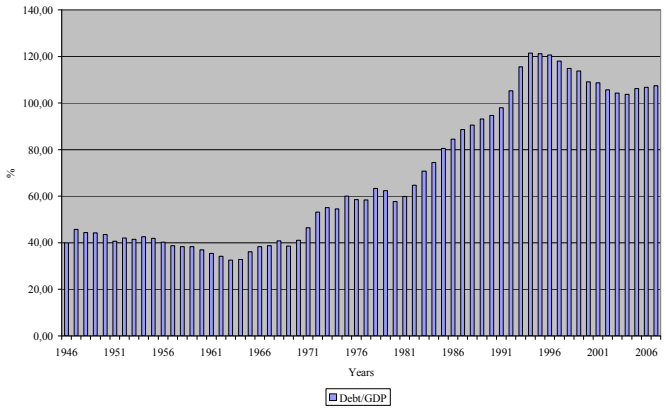
In the first years after-World War II (1948-62), the incumbent centrist governments adopted liberal policies, while keeping fiscal discipline. Public debt, which had been reduced by post-war inflation, was stabilized for two decades thanks to the control of the budget deficit and to the strong economic growth (Graph 3). In this 'Golden Age', a 'public finance

[23] The fiscal consolidation was obtained by the high automatic flexibility of the revenues and by the low rate of increase in the expenditures (Pedone, 1969).

[24] For analyses of the fiscal and budget policies, see Franco (1992); G. Brosio and C. Marchese, (1986); D. P. Giarda (1988a, 1988b, 1989) Commissione Tecnica per la Spesa Pubblica, (1986); R. Artoni and S. Biancini (2003). For a survey of the macroeconomic policies in the after-war period, see A. Graziani (1972).

phase' according to Buti and Sapir (2006), "the three sides of the Musgravian triangle seemed to reinforce one another [and] there appeared to be no trade-off between allocative efficiency, redistribution and stabilization" (Buti and Sapir, 2006, p. 4). In the largest European countries this phase ended at the mid-1970s with the end of the previous high growth rates and opened the way to a 'public choice phase', *à la* Buchanan, marked by increasing public deficits and trade-offs between allocative efficiency and redistribution.

Graph 3 The evolution of the debt/GDP ratio in Italy from 1946 to 2007



Sources. Data from 1946 to 1979 are drawn from Artoni and Biancini's (2003) reconstruction of the time series and are referred to the public sector. From 1980 onwards, data are drawn from the Bank of Italy, Statistical Bulletin - Supplement (various issues) and are referred to the general government.

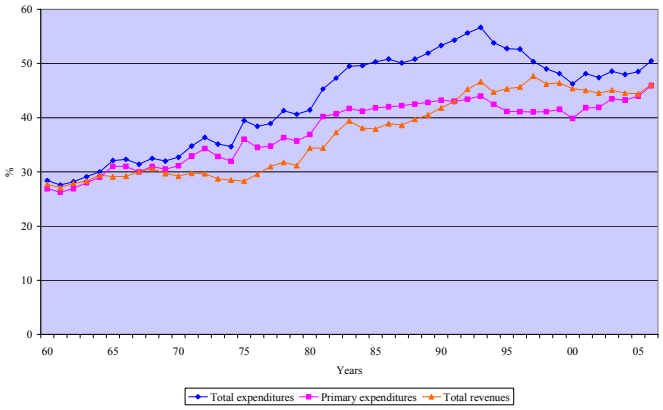
Italy's Golden Age ended earlier than in the other European countries. The composite nature of the 1963 first centrist-leftist government had a huge impact on fiscal policy, which lost its shared guiding principles. The adoption of Keynesian analysis had provided poli-

ticians with a rationale for reliance on borrowing that would now be utilized to win votes[25].

Fiscal policy reflected the compromise between the Liberal view of a limited State intervention and the requests for extended welfare programs and redistributive policies. As a matter of fact, social protection expenditures were increased, as the left-wing parties of the coalition required, while fiscal revenues were not increased, as the centrist component required (Graph 4). On the breaking of the public finance equilibrium, N. Andreatta observed:

> "To those who think that in our country there is still an unsatisfied demand for public goods, the solution is to be found in an expansion of fiscal revenues rather than a reduction in expenditures. The mistake made by the reformers was to ask for a 'socialist' expenditure policy without asking for a 'socialist' revenue policy" (Andreatta, 1973, p.88).

Graph 4. General government revenues and expenditures (as % of GDP): 1960-2006



Source: ISTAT

According to Franco (1992), the expenditure expansion[26] of the decade (1965-75) answered to equity

[25] We would like to thank Philip R. Jones for pointing this out.

needs that other Western countries had already satisfied, such as the extension of compulsory education, the institution of public nursery schools, the extension of public health care to all citizens, the institution of pensions for poor elderly and for disabled people and a larger coverage of unemployment benefits. Political factors and the inefficiency of the decision-making process dominated after the mid 1970s, when there was no further substantial extension in the public services provision. The welfare expenditure was on a number of occasions employed to contrast social conflicts and negative cycles (the number of teachers increased while the number of students decreased, pension norms were not modified although the employment and demographic situations were changing, invalidity and early retirements were improperly used). The relevance of the political factors was so evident that it sometimes seemed to cancel the influence of other structural factors (changes in costs, productivity, population):

> "There is nothing purely economical at the roots of the strong rise of public expenditure […] It is the inevitable consequence of an institutional system and of political conflicts which cannot provide for effective protection against the pressures of interest groups" (Salvati, 1984, p. 126).

As shown in Graph 4, while public expenditure rapidly grew (from 27.6 per cent of GDP in 1961 to 34.8 per cent in 1971), revenues were kept nearly constant as a percentage of GDP (about 30 per cent) until the end of the 1970s. This led to the erosion of the budgetary primary surplus (Graph 5) and to the increased debt financing, despite the favorable negative snowball effect of the period, i.e. the combination of the high growth rates and low interest rates.

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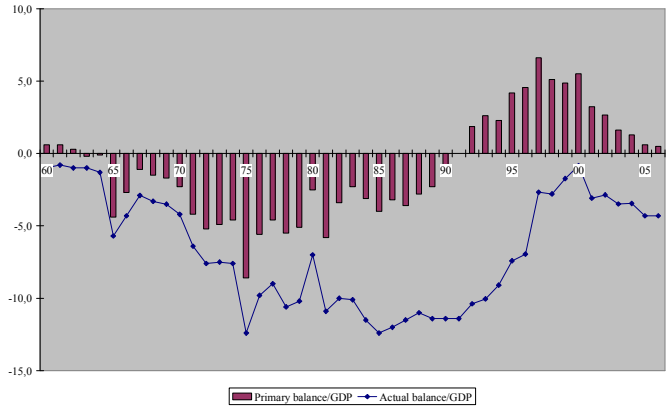
[26] For the analysis of the expenditure expansion, see. B. Dente (1992); B. Quintieri (1990) D. P. Giarda (1988b). For a survey of the revenue dynamics, see V. Ceriani, F. Frasca and D. Monacelli (1992).

Graph 5. General government actual and primary balances (as % of GDP): 1960-2006



Source: Data from 1960 to 1979 are drawn Morcaldo (1992);from 1980 onwards data are drawn from Bank of Italy, Annual Reports and Statistical Bulletins – Supplements (various issues)

Revenues increased, quite unexpectedly, in the 1980s as a result of a comprehensive tax reform which, however, had not been directed primarily to revenue raising[27]. This was not sufficient to close the gap with expenditures, an objective that would have helped maintain the political and social consensus:

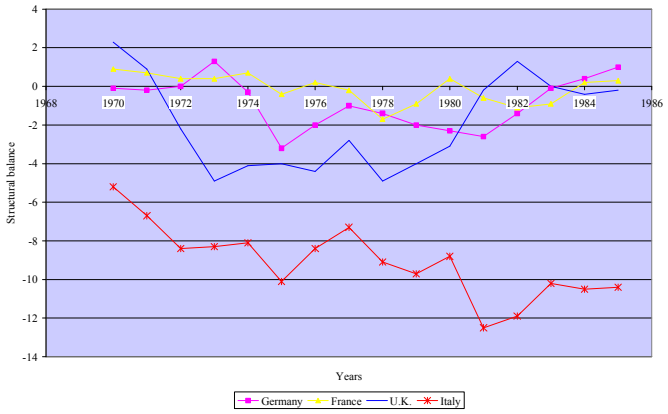
> "The attempts of particular interest groups to obtain increasing monetary transfers and grants, by means of an increasingly rapid legislative production, could be easily satisfied, as seemingly nobody paid for them. […..] Deficit financing acted as the flywheel of general satisfaction" (Reviglio, 1977, p. 110).

Intergenerational disorder showed up in the accumulation of actual budget deficits and especially in the absence of primary positive balances for nearly thirty years. Although the 1970s saw the presence of general government deficits in many developed coun-

[27] On the delay of the tax reform, see A. Pedone (1992).

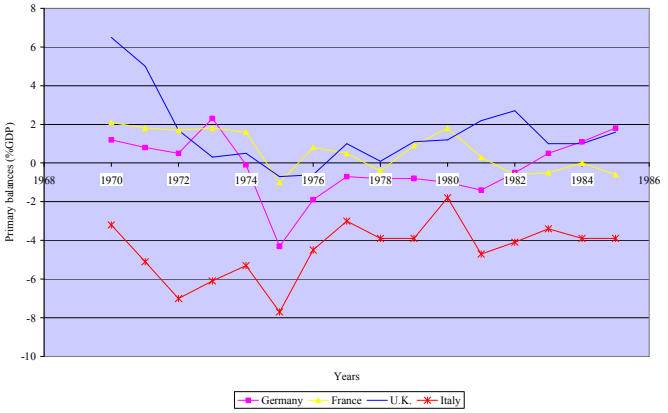
tries, none of them registered a series of high and uninterrupted structural deficits (Graph 6) and of continuously negative primary balances as Italy (Graph 7). As a consequence, Italian public debt rose almost uninterruptedly, reaching 121 per cent of GDP in 1994 (Graph 3).

Graph 6. Structural budget balances (as % of GDP): 1970-1985



Source: OECD Statistics

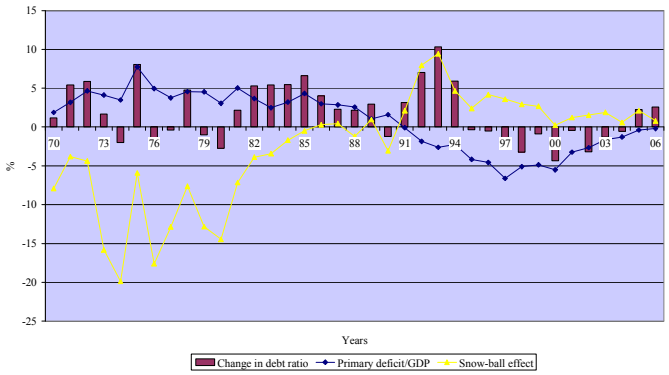
Graph 7. Primary budget balances (as % of GDP): 1970-1985



Source: OECD Statistics

Until 1990-91, when it regained its balance, the primary deficit was the driving factor of the debt accumulation, prevailing over the snow-ball effect (Graph 8). A negative snowball effect persisted until the mid-1980s, when it turned positive. Disinflationary policies in the first part of the 1980s had raised, in fact, interest rates above GDP growth rates: in the absence of a parallel restrictive fiscal policy, this added to debt accumulation. Therefore, not only the initial push on the expenditure side, but also the subsequent combination of monetary discipline and fiscal indiscipline were responsible for the debt dramatic increase (Bosi, Golinelli and Stagni, 1989).

Graph 8. Composition of the change in the public debt/GDP ratio (SFA excluded): 1970-2006



Source: Elaborations on Bank of Italy, Statistical Bulletin and Supplement (various years)

The positive snow-ball effect, which still lasts since the 1990s, made the 1993-1997 stabilization process[28] all the more burdensome, as it was entrusted only

[28] Fiscal consolidation was made unavoidable by the financial crisis of 1992 and by the perspective of joining the EMU.

to the primary surpluses, the first ones after more than twenty years. The EMU fiscal rules have contributed a great deal to sustaining this fiscal consolidation, which nevertheless lost its momentum after 2000, as demonstrated by the 2000 primary surplus of 5.5 per cent of GDP, reduced to 0.2 per cent six years later, before a substantial and stable debt retrenchment could be obtained. The tendency towards intergenerational disorder proves thus to be deeply rooted in fiscal policy and to be hard to be opposed by rules, unless these are given a really constitutional status.

The effects of budget imbalances on intergenerational disorder and the potential tensions implied by the current policy regime are clearly described also by the intergenerational accounts, i.e. the present value of net taxes that individuals of different age cohorts are expected to pay over their remaining lifetimes. When the sum of the net taxes of all living generations is not sufficient to cover the present value of future government consumption and service the currently existing government debt, the difference is apt to be paid by future generations. An intergenerational fiscal imbalance shows up in the average generational account of future generations being significantly higher (or lower) than that of the generation born in the base year (the new-born generation). Studies for Italy[29] assess the intergenerational disorder produced by the fiscal policies of the 1970s and 1980s. In the baseline scenario of Cardarelli and Sartor (2000), which includes the effects on the budget of the two pension reforms and of the fiscal consolidation of the 1990s, the generation born in 1998 receives on average 11,100 euros of net transfers, while the future generations will have to pay 39,000 euros: the difference of 50,100 euros implies that future generations will have to pay 30 per cent more in taxes than the cur-

[29] D. Franco et al. (1994), D. Franco and N. Sartor (2000), European Commission (2000), R. Cardarelli and N. Sartor (2000).

rent new-born generation[30]. Postponing fiscal consolidation, i.e. the creation of primary surpluses and the reduction in the stock of public debt, will allow the generations born in the mean time to benefit from the status quo and will impose an even higher burden on future generations.

Finally, the vulnerability of a high-debt country such as Italy is apt to increase because of the dramatic consequences of aging on the unfunded social security system. Nonetheless, Italy's problems do not derive from the financial side thanks to the pension reforms of the 90s that are expected to cut future retirement benefits significantly[31]. The EU projections on the financial sustainability of European social security systems (European Commission, 2006) forecast a slight change in pension expenditure from 14.2% of GDP in 2004 to 14.6% in 2005, which is nothing compared to the 7.1% increase of Spain or the 6.7% increase of Hungary. The total age-related public expenditure will also increase by only 1.7% from 2004 to 2050, which is much less than the 6.3% increase of Belgium or the 8.5% increase of Spain. However, the social security systems are also shaped by political constraints, which are going to play a powerful role in the future, as the old-age dependency ratio will almost double in fifty years (from 27.9% in 2000 to 64.5% in 2050). Galasso (2006, 6) argues, "the aging society augments the political relevance of the elderly voters—those close to retirement. As the identity of the pivotal voter changes—and the median voter becomes older— the political support for social security increases". The dominance of the political push could thus offset the current financial projections and lead to

[30] The closing of the fiscal gap could also be spread on all generations and would require a 4.96 per cent increase in the taxes or a 5.14 per cent decrease in the expenditures for all generations.

[31] These reforms provide a long transition period which protects those who voted them and prevents them from being affected by the new provisions.

substantial increases in pension spending, whose financing will probably cause new intergenerational redistribution[32].

7. CONCLUSIONS

Whether the redistribution through the political market is a problem depends not a little on the influence of the presuppositions of Harvey Road. Seeking a grounding in public choice theory, we have endeavored to provide a critique of the presuppositions of Harvey Road and an evaluation of their effects on the financing of the welfare system and the related public indebtedness. From the standpoint of Harvey Road scholars and their followers, the amount of redistribution is directly determined by the kind of safety net offered by the government. This, however, raises obvious problems for constitutional political economists. To this end, special emphasis has been given to Pareto optimal redistribution, which provides a conceptual framework for truly designing balanced budgets. In particular, we have endeavored to focus our analysis on the strength of this framework to prevent government from behaving in such a way as to create fiscal illusion.

Our intent has been to offer a new perspective by relating distributional changes that occur within a generation to distributional changes that occur between generations. Our data show that the solution to the redistributive problem via a verticalization of a genuine

[32] There are powerful arguments for thinking that intergenerational conflicts are likely to become sharper. One of these is provided by recent discussions on the implementation of two provisions already approved in the 90s: the postponement of the retirement age at 60, starting from January 2008 and the revision of the replacement ratios. These provisions were strongly opposed by both trade unions and senior workers. In particular, the weakening of the first provision is anticipated to imply an expenditure increase by 10 billion euros for the next ten years.

horizontal relationship turns what is an intragenerational conflict into an intergenerational one. During the past thirty or forty years, governments have lived in a setting of debt-disorder thanks to the political "generosity". The last part of the paper has closely followed the evolution of the Italian public debt to see whether there was any evidence to support the intergenerational disorder issue.

A fiscal constitution - based on a traceable fiscal system such as that based on a general proportional taxation, combined with a negative income tax exempting minimal incomes - would provide an alternative setting to the present financing system.

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AUTHORS' CONTACT INFORMATION

Professor Giuseppe Eusepi
Sapienza University of Rome,
Faculty of Economics,
Department of Public Economics,
Via del Castro Laurenziano, 9,
00161 Rome, Italy.
Phone: ++ 06-49766955
E-mail: Giuseppe.Eusepi@uniroma1.it

Dr. Luisa Giuriato
Sapienza University of Rome,
Faculty of Economics,
Department of Public Economics,
Via del Castro Laurenziano, 9,
00161 Rome, Italy.
Phone: ++ 06-49766985
E-mail: luisa.giuriato@uniroma1.it