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Italy between the EU and Berlusconi

Effects of external and internal factors on the Italian Public Debt

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Table of Contents

Chapter 1: Introduction

The goal of this paper is to investigate whether the reduction of the Italian public debt between 1994 and 2004 and the increase after 2004 is due to internal or external factors. Given the current debt crisis in Europe, this is a fundamental question since it may demonstrate if Italy, and states in general, are able to handle their fiscal problem by themselves or they need external help.

In this study, high public debt is considered to have mainly negative effects on the economic performance of the country (as suggested by Dornbusch et al., 1998, p.478; Moon 2010 p. 36; Spaventa, 1988, 16; Chowdhruy, 2010), although it may produce some benefits (Moon, 2010, 34). Thus, it must be reduced with different policies that governments can choose (Krugman 2012, Corsetti 2012). Italy, in particular, has a long history of extremely high public debt (Technical Commission for Public Finance, 2007, 1), however, from 1994 to 2008 there is an evident variation, in particular between 1994 and 2004 the debt decreased due to the reduction of primary expenditures.

The International Political Economy literature suggested three main possible theories to explain the variation of public debt regarding internal factors. First, the opportunistic political busyness cycle explains the variation by arguing that politicians manipulate the economy in order to be re-elected (Nordhaus, 1975; Tufte 1978; Alesina, 1988; Rogoff-Sibert 1988). Second, the partisan business political cycle explains variation due to difference goals among parties, with leftist parties tending to adopt more expansionary policies (Hibbs, 1977; Mulas-Granados, 2003; Fowler, 2006). Finally, the last and most viable theory looks at level of fragmentation, polarization and government instability to explain variation. Increasing levels of these variables tend to produce expansionary policies (Alt, Lassen, 2005; Grilli et al., 1991; Roubini et al, 1989; Alesina and Perotti, 1996; Person, Tabellini, 2004).

The alternative to these three internally focused theories is to consider external factors that may have influenced Italian decision makers in reducing the debt between 1994 and 2004 (Whitehead, 2006). The Maastricht Treaty and the European Union may have played this role since Italy has to reduce its debt in order to be able to join it (Efthyvoulou, 2011; Oatley, 1999).

The evidence, in the form of a detailed analysis of parliamentary debates and newspaper articles, will show that Italy was able to reduce the public debt only when pressured from outside and that the external constraints of the European Union, in the form of Maastricht Parameters, greatly impacted the level of Italian debt. Once Italy complied with them and became a member of the European Union, the effect disappeared and the Italian public debt started increasing again. Internal factors do not appear to have played a role. In particular, the qualitative study of parliamentary debates on the budget shows that the level of polarization and the role of veto players caused by it have remained constant and therefore can't be used to explain the variation in public debt.

The study is divided as follow. Chapter Two will outline in more detail the three theories relying on internal factors to explain debt variation and the external constraints explanation. Chapter Three will describe the variation of the public