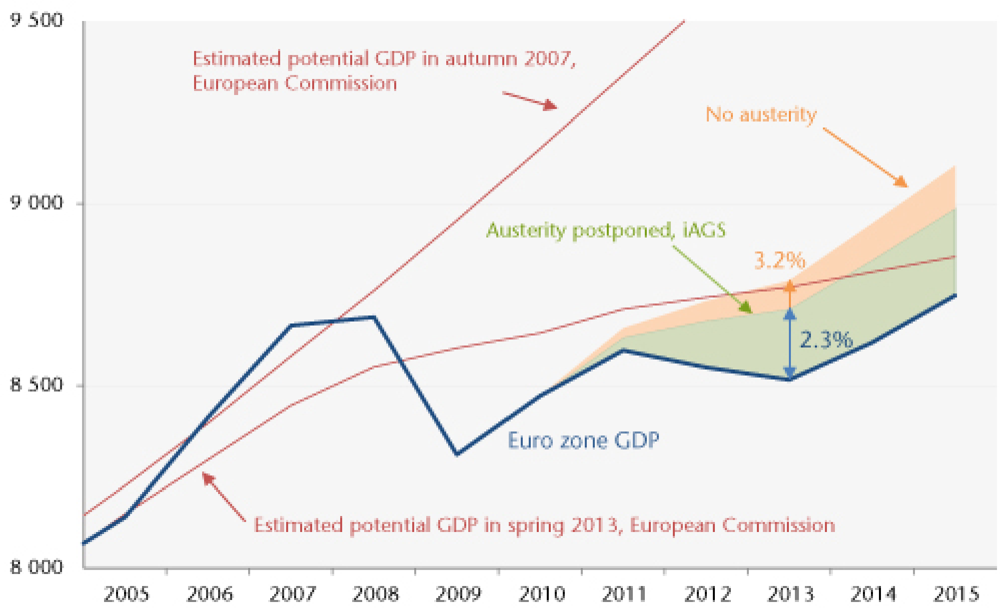
From austerity to stagnation

By Xavier Timbeau

Since 2010, the European Commission has published the Annual Growth Survey to stimulate discussion on the occasion of the European semester, during which the governments and parliaments of the Member States, the Commission, and civil society discuss and develop the economic strategies of the various European countries. We considered it important to participate in this debate by publishing simultaneously with the Commission an independent Annual Growth Survey (iAGS), in collaboration with the IMK, a German institute, and the ECLM, a Danish institute. In the 2014 iAGS, for instance, we estimate the cost of the austerity measures enacted since 2011. This austerity policy, which was implemented while the fiscal multipliers were very high and on a scale unprecedented since the Second World War, was followed simultaneously by most euro zone countries. This resulted in lopping 3.2% off euro zone GDP for 2013. An alternative strategy, resulting after 20 years in the same GDP-to-debt ratios (*i.e.* 60% in most countries), would have been possible by not seeking to reduce public deficits in the short term when the multipliers are high. In order to lower the fiscal multipliers again, it’s necessary to reduce unemployment, build up agents’ balance sheets and get out of the liquidity trap. A more limited but ongoing adjustment strategy, just as fiscally rigorous but more suited to the economic situation, would have led to 2.3 additional points of GDP in 2013, which would have been much better than under the brutal austerity we find ourselves in today. This means there would not have been a recession in 2012 or 2013 for the euro zone as a whole (see the figure below: GDP in million euros).

Impact of austerity on economic activity, 2011-2015



Source: iAGS 2014, Eurostat and European Commission.

It is often argued that the state of euro zone public finances left no choice. In particular, market pressure was so great that certain countries, like Greece for example, were concerned that they would lose access to private financing of their public debt. The amounts involved and the state of the primary deficit are advanced to justify this brutal strategy and convince both the markets and the European partners. However, the sovereign debt crisis, and hence market pressure, ended when the European Central Bank announced that no country would leave the euro and set up an instrument, Outright Monetary Transactions, which makes it possible under certain conditions to buy back public debt securities of euro zone countries and therefore to intervene to counter the distrust of the markets (see an analysis here). From that point on, what matters is the sustainability of the public debt in the medium term rather than demonstrating that in an emergency the populace can be compelled to accept just any old policy. Sustainability does however require an adjustment policy that is ongoing (because the deficits are high) and moderate (because fiscal policy has a major impact on activity). By choosing the difficult path of austerity, we paid a high price for the institutional incoherence of the euro zone, which was exposed by the crisis. In the 2014 iAGS, we point out costs due to austerity that go beyond the loss of activity. On the one hand, inequality is increasing, and “anchored poverty”, *i.e.* as measured from the median incomes of 2008, is increasing dramatically in most countries affected by the recession. The high level of unemployment is leading to wage deflation in some countries (Spain, Portugal and Greece). This wage deflation will result in gains in cost competitiveness but, in return, will lead the countries’ partners to also take the path of wage deflation or fiscal devaluation. Ultimately, the adjustment of effective exchange rates either will not take place or will occur at such a slow pace that the effects of deflation will wind up dominant, especially as the appreciation of the euro will ruin the hopes of boosting competitiveness relative to the rest of the world. The main effect of wage deflation will be a greater real burden (*i.e.* relative to income) of private and public debt. This will mean a return to centre stage of massive public and private defaults, as well as the risk of the euro zone’s collapse. It is possible nevertheless to escape the trap of deflation. Possible methods are explored and calculated in the 2014 iAGS. By reducing sovereign spreads, the countries in crisis can be given significant maneuvering room. The levers for this include the continuation of the ECB’s efforts, but also a credible commitment by the Member states to stabilizing their public finances. Public investment has been cut by more than 2 points of potential GDP since 2007. Re-investing in the future is a necessity, especially as infrastructure that is not maintained and is allowed to collapse will be extremely expensive to rebuild. But it is also a way to stimulate activity without compromising fiscal discipline, since the latter must be assessed by trends not in the gross debt but in the net debt. Finally, the minimum wage should be used as an instrument of coordination. Our simulations show that there is a way to curb deflationary trends and reduce current account imbalances if surplus countries would increase their minimum wage faster in real terms than their productivity while deficit countries would increase their minimum wage slower than their productivity. Such a rule, which would respect both national practices in wage bargaining as well as productivity levels and the specific features of labour markets, would lead to gradually reducing macroeconomic imbalances in the euro zone.

America's fiscal headache

By Christine Rifflart

Before next December 13th, the Budget Conference Committee must present the results of the discussions begun following the shutdown and debt crisis in October 2013. The objective of the negotiations is to enable Congress to approve the 2014 Budget, for which the fiscal year began on October 1 [1], and find an alternative to the automatic cuts in federal spending that are to take effect on 1 January 2014. An agreement does not seem out of reach. Even if sharp opposition between Republicans and Democrats remains, reason should prevail and the risk of a new budget crisis seems excluded. At worst a new Continuing Resolution [2] will be passed that allows institutions to continue to function and the arbitrary nature of automatic budget cuts in structural expenditure to guide government policy. At best, the negotiations will lead to reasoned cuts in expenditure, and even to increases in some revenues that will then curb the violence of the adjustment, a violence that is amplified by the ending of the exceptional measures to support income and activity that were enacted at the heart of the crisis.

There is little room for negotiation. In fiscal year 2013, the deficit for the entire public sector reached 7% of GDP (after 12.8% in fiscal year 2009), and the federal deficit came to 4.1% of GDP (after 9.8%). The federal debt currently comes to 72.7% of GDP, and is rising. Moreover, growth remains weak: 2.2% at an annual average since the 2010 recovery, with 1.8% expected in 2013, which in particular is insufficient to revitalize the job market. How then is it possible to come up with a budget policy to support growth in a context of fiscal austerity and deficit reduction while complying with the commitments previously made by Congress[3], in particular the Budget Control Act of 2011? Following the crisis concerning the federal debt ceiling in July 2011, on 2 August 2011 President Obama signed the Budget Control Act of 2011, which conditioned any increase in the federal debt ceiling on a massive reduction in government spending over 10 years. In addition to the introduction of caps on discretionary spending [4], 1200 billion dollars in automatic cuts (sequestrations) in expenditures were planned for the period 2013 to 2021 based on a principle of parity between defense and non-defense budgets. A number of social programs (pension insurance, Medicaid, income guarantees, etc.) were exempted, while cuts to the Medicare program for the elderly were limited to 2%. In total, the cuts will apply to a little less than half of federal spending and will represent 109 billion per year in savings on the deficit, *i.e.* 0.6% of GDP.

For the 2014 fiscal year, according to the CBO the combination of these two measures (capped discretionary spending and automatic cuts in unprotected budgets) as well as the renewal of the amount of credits from 2013 to 2014 (*i.e.* a constant nominal budget) will lead to cuts in discretionary spending of 20 billion dollars that will have to be borne entirely by the Pentagon. On this basis, if the cuts are maintained, discretionary spending in the defense and non-defense budgets will have declined by 17% and 17.8%, respectively, in real terms between 2010 and 2014.

But in addition to these brutal cuts, other programs, in particular those primarily intended for low-income households, will experience a reduction in their budget in 2014 because of the expiration of the exceptional measures they previously enjoyed. Thus, the program to extend unemployment benefits created on 30 June 2008 for unemployed people who had exhausted their rights (Emergency Unemployment Compensation) ends on 1 January 2014. In the absence of other plans, this will hit 4 million people.

This is also the case of the Supplemental Nutrition Assistance Program (SNAP), which had benefited under the American Recovery and Reinvestment Act of 2009 from additional funding that elapsed on 1 November. Yet 47.7 million beneficiaries (15% of the population) received food stamps this year. According to the CBPP, the 7% cut in the program's funds should result in a decrease of 4 million in the number of beneficiaries.

Another example: the housing benefits for the 2.1 million families who cannot find decent housing will also be affected by the termination of the budget extensions introduced in 2009 and the automatic cuts. If the budget is not renewed, from 125,000 to 185,000 of the families receiving benefits at end 2012 will no longer receive aid at end 2014.

According to the information currently available, a minimum agreement on the Budget Conference Committee seems to be emerging. The cuts in the defense budget could be approved [5], while eventual increases in public utility charges would be used to fund budget extensions for some social programs and lighten the impact of the automatic cuts. Last April, President Obama presented his Draft 2014 Budget to Congress. At that time he proposed to remove the procedures for automatic cuts, to reduce the debt in the long term through an extensive fiscal reform, and in the shorter term to defer a portion of the 2014 budget cuts to fiscal years 2015 and 2016 in order to boost growth. The agreement, which is likely to be presented to Congress by 13 December, will undoubtedly not be this ambitious. Faced with Republican (the majority in the House of Representatives) partisans of additional savings, the Democrats (the majority in the Senate) will find it difficult to defend an increase in public spending in 2014 and to adopt a fiscal policy that is less harmful to growth this year than it was in 2013.

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[1] After not having been adopted by Congress, the 2014 budget has been financed since 16 October by a Continuing Resolution (see note 2) on the basis of the 2013 budget amounts. The Resolution is retroactive from the 1st day of the 2014 fiscal year, *i.e.* 1 October 2013, until 15 January 2014.

[2] A Continuing Resolution is a temporary resolution passed by Congress that is used to extend the appropriations made the previous fiscal year to the current fiscal year, while waiting for new measures to be approved.

[3] According to the CBPP, if all the deficit reduction measures adopted since 2010 in the 2011 Budget, the Budget Control Act of 2011 and the American Taxpayer Relief Act of 2012 are taken into account, the cumulative impact on the deficit would be 4000 billion over the period 2014-2023, *i.e.* the equivalent of 24% of 2013 GDP.

[4] Discretionary spending (33% of federal spending) is spending for which the budgets are voted on an annual basis, unlike mandatory spending (61%), which is based on programs covered by prior law. The spending side of the government’s fiscal policy rests mainly on changes in discretionary spending, which are structural expenditure.

[5] Expenditure related to defense had already fallen by 13.1% in real terms between Q3 2010 and Q3 2013.

The sources of an industrial renewal

By Jean-Luc Gaffard

French companies in many sectors have had to deal with a relative increase in unit labour costs, a relative decline in the price of value added, and lower margin rates, meaning that many of them are facing strong competition and are relatively uncompetitive on price due to not having innovated and invested enough in the past. The result over the last decade has been a significant loss of substance in France's industrial network and a worsening foreign trade deficit. The challenge of carrying out an industrial renewal is clearly posed. This is not limited simply to manufacturing but encompasses any activity that is likely to deal with demand on a relatively large scale and is organized on an industrial basis[1].

It is common sense to assume that the solution lies in the renewed capacity of these companies to innovate, to export and quite simply to expand, or in a word, in the ability to regain or acquire the non-price or structural competitiveness that they are currently lacking. The difficulty they face is that their lack of price competitiveness is leading them to seek immediate reductions in cost to the detriment of investment in innovation. Faced with this difficulty, economic policy makers must resolve a real dilemma: either to take measures to compete on taxation, social contributions, or even wages in an effort to restore companies' price competitiveness at the risk of further weakening aggregate demand and ultimately negatively impacting their turnover, or to keep the existing system of taxation at the risk of depriving these companies of the means to invest and innovate.

The consensus of the day naturally denies the existence of such a dilemma. The presumed neutrality of money and the budget, coupled with the flexibility of the markets for goods and labour, is supposed to help the economy back on the path of steady, stable growth. Businesses, now reassured by the restoration of balanced public accounts and freed of excessive regulatory constraint, are again free to invest.

This consensus embodies a reductive vision of the functioning of market economies. The model of perfect competition, which is the standard in this instance, pictures a world where companies respond simply to price signals sent by the markets for goods and by factors whose operation is immunized against any power exercised by one or another protagonist in these markets. Somehow or other, this is what is meant by the assumption of efficient financial markets whose function is to discipline firms and States. The reality is very different. Markets are naturally and necessarily imperfect. Companies develop strategies on pricing, production and investment that deal with this market environment at the same time that they help to shape it. It is important to recognize this reality before trying to define economic policies suited to it.

The sources of business competitiveness

In an industrial market economy, business growth comes from *innovation*, in other words from companies' ability to develop non-price or structural competitiveness that is more robust and more lasting than just price competitiveness. Technological or organizational innovation aimed at the creation of new products or services or at the exploration of new markets entails however a *detour away from production*. Time is needed to develop a new production capacity before using it and benefiting from it.

Generally, this new capacity has a higher construction cost than the cost of simply replacing existing capacity. Additional costs must be borne before the corresponding additional income can be collected. A loss of competitiveness, in principle temporary, is apparent. This could be reflected in increases in current prices (of old products) if the hike in costs is to be passed on immediately or, more likely, by a reduction in margins. The performance of the production of existing goods or services is thus negatively affected by the decision to innovate [2].

In this context, it is still necessary for the company to remain competitive on prices in the short term in order not to lose significant market share to its competitors. It is in regard to this immediate requirement that the issue of *labour costs* comes up. This is a particular issue in the euro zone where in the absence of possible adjustments via exchange rates, legal and regulatory differences on social and fiscal matters create real distortions in competition – and when, furthermore, the international fragmentation of production (in reality the relocation of segments of production to countries where wages are lower but qualifications identical) is providing businesses that have the ability or opportunity to exploit this an advantage in terms of the costs passed on in product prices, margins and investment volumes.

Maintaining or regaining immediate price competitiveness will not, however, suffice. It is still necessary to encourage companies to innovate. But when investments, including intangible investments, are irreversible and when information on the future configuration of the market is not immediately available, it is difficult for companies to do this. They cannot base their decisions on price signals alone. They must be able to secure their investments by acquiring sufficient knowledge about the future market, that is to say, not only the size of demand, but also about competing and complementary offers. The point is to ensure that competing investments do not exceed a certain threshold and that complementary investments attain a certain threshold. This is possible only thanks to practices that have to be considered monopolistic, which are related to different forms of connections between the companies concerned[3]. This kind of *organizational strategy* foregrounds, not a particular company, but a *network of companies*, a sort of ecosystem that often brings together a local dimension and capacity to project outwards. The characteristic of these networks is to balance competition and cooperation. Practices that can be characterized as market imperfections here become incentives to innovate. They help to define the *boundaries* of the firm best suited to the decision to innovate.

What is true of investment in physical capital is equally important for investment in human capital. This investment has a gestation period that essentially amounts to the learning time. This is an essential element in developing new productive capacities. Its products must be secured. The labour relationships specific to a company and to the networks of firms between companies contribute to this. The *stability* of the employment relationship, which binds the employee to the company, is a decisive factor in the learning and retention of professional experience. The *mobility* of employees between companies is another factor. This mobility enables each company to draw on what an employee has learned in another company developing the same sort of skills. It is also a source of increases in wages, but it becomes possible only if companies are in a situation of monopolistic competition.

The difficulty of innovating even when investments are irreversible and market information is incomplete requires having access to financing in order not only to bridge the gap between the profile of costs and the profile of revenue, but especially to have a lengthy financial commitment, that is to say, stable financial relations or control of the capital. The problem most innovative firms encounter is that the assets created are not easily re-deployable (including intangible assets). This constraint, which justifies developing the organizational means to acquire credible information about the market, requires at the same time being able to enjoy continuing financial support.

Goals and means of an industrial renewal policy

Identifying in this way the stimulants of business growth should guide the policies to be implemented, which are reducible neither to competition policy nor to industrial policy. These policies concern the operation of various markets (goods markets, labour markets, credit markets and financial markets). They make use of a variety of instruments and are situated at different geographical levels.

Industrial policy should set itself the goal of stimulating *cooperation* between companies, including competing firms, and, more broadly, of contributing to the formation of ecosystems involving companies, banks and research institutions. The point here is not at all to designate products or technologies or even territories to promote *a priori*, but instead to help foster market conditions that encourage companies to invest in the ways that seem most promising. The criteria adopted for subsidies or tax relief should meet this objective, which is obviously more complex than that recently put forward of targeting sectors where competition is strong [4]. This should be the specific objective of funding for France's "competitiveness clusters", as well as of other forms of public assistance.

Industrial policy has a *regional dimension*, since companies have a tendency to group together to benefit from external effects, in particular learning synergies not only with regard to technological knowledge but also to knowledge of the market. This phenomenon is in line with the willingness of local authorities to assist in the creation of clusters. However, there is no evidence that these local authorities have the information they need or that they can avoid being captured by lobbies. Competition between them can be expensive when it involves tax competition, which can probably improve the situation of some but only at the expense of others, and which negatively affects overall performance. This inevitably raises the issue of the competence, number and size of the local authorities.

Competition policy is not a substitute for industrial policy. It must pursue the same objective, *i.e.* to *distinguish between competition and cooperation*. From this perspective, the role that competition policy should play is to punish imperfections and distortions that are harmful to innovation and validate those that foster it. The handling of cooperation agreements in R&D is indicative of this requirement. It cannot be exclusive. Other types of agreement must be able to escape the common law on competition.

Labour market policy must set itself the goal of strengthening the ways and means of *enhancing skills*. First and foremost, this means creating the conditions for stabilizing the employment relationship, which is a source of learning for employees and of making sure that companies retain the skills acquired. These conditions are undoubtedly covered by the employment contract itself, but they are also inseparable from the constitution of the communities or clusters making up innovative business networks. These networks are “local” labour markets in which labour mobility between firms is potentially beneficial to all the partners with respect to mastering new skills. Moreover, an end needs to be put to incentives that contribute to perpetuating the privileging of low-skilled or unskilled jobs. Finally, legal and regulatory conditions that permit businesses to hold onto jobs in the event of temporary difficulties (*i.e.* the use of short-time working) should be strengthened.

Banking policy should set itself the goal of creating *stable relationships between companies and financial institutions*. So-called relationship banks, which collect information on borrowers, have higher costs than traditional banks, but they also have the advantage of providing resources to businesses facing liquidity problems linked to the characteristics of the innovation cycle. In fact traditional intermediation increases the growth rate of the economy and reduces its long-term volatility, as opposed to market-based funding[5]. It is also important to refocus the financial system on traditional intermediation, especially on business credit, and to return to a form of separation between the two types of activity, so that lending to business avoids the consequences of the inevitable vagaries of market activity[6].

Fiscal policy must set itself a dual objective. The short-term goal is to *reduce labour costs* by reducing the rate of employers' social contributions and increasing the tax on value added. The medium-term objective is to *penalize unproductive activities*, those whose contribution to growth is dubious. From this perspective, it is undoubtedly necessary to tax financial services and to make greater use of taxes on wealth and the transmission of wealth, as is recommended by the International Monetary Fund. Without prejudging the possible ways tax reform could be implemented, there is a two-fold importance to reform: first, to promote the production of industrial-type goods and services that are suited to international trade, and second, to carry out a redistribution of income and wealth in order to increase the potential demand for these goods and services.[7]

Industrial renewal poses a major challenge for the French economy, which is now caught between the German economy and the Spanish economy. It requires a reorientation of all the policies that affect and guide corporate behaviour, going beyond just manufacturing firms – policies that are not reducible to either the search for lower costs or to the promotion of new technologies or to compliance with the rules of free competition.

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[1] On the nature of industrial organization, see Chapter 4 of the work by N. Georgescu-Roegen, 1971, *The Entropy Law and the Economic Process*, Cambridge Mass., Harvard University Press.

[2] See C. M. Christensen, 1997, *The Innovator's Dilemma*, Harvard, Harvard Business School Press.

[3] G. B. Richardson, 1990, *Information and Investment*, Oxford, Clarendon Press. G. B Richardson, 1998, *The Economics of Imperfect Knowledge*, Cheltenham, Edward Elgar.

[4] P. Aghion, M. Dewatripont, L. Du, A. Harrison and P. Legros, 2012), "Industrial Policy and Competition", *NBER Working Paper* 18048.

[5] Bolton P., X. Freixas, L. Gambacorta, and P. E. Mistrulli, 2013, Relationship and Transaction Lending in a Crisis, *BIS Working Paper*, no. 17.

[6] T. Beck, 2013, Finance and Growth: Too Much of a Good Thing, *Vox eu*.

J.-P. Pollin and J.-L. Gaffard, 2013, "Pourquoi faut-il séparer les activités bancaires?" [Why it is necessary to separate banking activities], Note de l'OFCE, n° 36.

[7] Keen M., 2013, Tax Policy in (and for) Hard Times, Vox eu http://www.voxeu.org/article/tax-policy-hard-times#.Um7TETxwZzA.gmail

IMF, 2013: Fiscal Monitor, Taxing Times, World Economic and Financial Surveys http://www.imf.org/external/pubs/ft/fm/2013/02/fmindex.htm

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When the OECD persists in its mistakes…

By Henri Sterdyniak

The OECD has published an economic policy note, "Choosing fiscal consolidation compatible with growth and equity" [1]). There are two reasons why we find this note interesting. The OECD considers it important, as it is promoting it insistently; its chief economist has, for instance, come to present it to France's Commissariat à la Stratégie et à la Prospective [Commission for Strategy and Forecasts]. The subject is compelling: can we really have a fiscal austerity policy that drives growth and reduces inequality? Recent experience suggests otherwise. The euro zone has been experiencing zero growth since it embarked on a path of austerity. An in-depth study by the IMF [2] argued that, "fiscal consolidations have had redistributive effects and increased inequality, by reducing the share of wages and by increasing long-term unemployment". So is there some miracle austerity policy that avoids these two problems?

1) What goals for fiscal policy?

According to the authors of the OECD study, the goal of fiscal policy should be to bring the public debt down by 2060 to a "prudent" level, defined for simplicity's sake, we are told, as 60% of GDP. All the OECD countries must work towards this objective and immediately make the necessary adjustments.

But a target of 60% is totally arbitrary. Why not 50% or 80%? Furthermore, this goal is set in terms of gross debt (as defined by the OECD) and not debt under Maastricht. But the difference is far from meaningless (at end 2012, for France, 110% of GDP instead of 91%).

The OECD makes no effort to understand why a large majority of the organization's members (20 out of 31, including all the large countries) have a public debt that is well over 60% of GDP (Table 1). Do we really think that all these countries are poorly managed? This high level of public debt is associated with very low interest rates, which in real terms are well below the growth potential. In 2012, for example, the United States took on debt, on average, of 1.8%, Japan 0.8%, Germany 1.5%, and France 2.5%. This level of debt cannot be considered to generate imbalances or be held responsible for excessively high interest rates that could undermine investment. On the contrary, the existing debt seems necessary for the macroeconomic equilibrium.

We can offer three non-exclusive explanations for the increase in public debts. Assume that, following the financialization of the economy, firms are demanding higher rates of profit, but at the same time they are investing less in the developed countries, preferring to distribute dividends or invest in emerging markets. Suppose that globalization is increasing income inequality [3] in favour of the rich, who save more, at the expense of the working classes who consume virtually all of their income. Suppose that, in many countries, aging populations are increasing their savings rate. In all three cases a demand deficit arises, which must be compensated by private or public debt. Yet since the crisis of 2007-2008 private agents have been deleveraging. It was therefore necessary to increase the public debt to prop up demand, as interest rates were already at the lowest possible level. In other words, it is not really possible to reduce public debt without tackling the reason why it's growing, namely the deformation of the sharing of value in favour of capital, the increase in income inequality and unbridled financialization.

Table 1. State of the public finances in 2012 (% of GDP)

	Gross public debt	Structural primary balance	Output gap*	Loss in potential GDP due to the crisis	Effort required**
Austria	85	1.1	-1.6	-3.0	0.2
Belgium	104	0.3	-0.8	-4.5	1.6
Canada	85	-2.5	-0.4	-6.1	2.7
Finland	63	-1.8	-1.4	-9.7	3.8
France	110	-1.3	-2.4	-3.6	4.7
Germany	89	1.4	0.1	-1.6	0.0
Greece	166	3.2	-11.7	-17.6	8.2
Ireland	123	-1.8	-7.9	-9.6	5.8
Iceland	132	2.6	-4.2	-9.0	3.6
Italy	140	4.4	-4.5	-6.8	0.7
Japan	219	-8.1	-0.8	-3.1	18.3
Netherlands	83	-1.4	-1.5	-7.6	2.8
Portugal	139	-0.6	-6.7	-10.4	7.5
Spain	91	-1.8	-7.7	-9.1	5.3
United Kingdom	104	-5.1	-2.1	-10.4	9.2
United States	106	-5.4	-3.0	-5.7	7.7
Euro zone	104	0.6	-2.0	-4.9	2.6
OECD	109	-3.2	-2.3	-4.6	6.0

* According to the OECD; ** short-term effort required to eventually stabilize the debt at 60% of GDP.

According to the OECD, gross public debt on the order of 100% of GDP, as at present, poses problems in terms of fragile public finances and a risk of financial instability. The economy could in fact be caught in a trap: households (given income inequality, aging or their justified mistrust of the financial markets) implicitly want to hold 100% of GDP in public debt (the only risk-free financial asset), interest rates are already near zero, and the financial markets are wary of a country whose debt exceeds 60% of GDP. We cannot escape this trap by reducing public deficits, as this reduces economic activity without lowering interest rates; what is needed is to reduce private savings and carry out a Japanese-style financial policy: the central bank guarantees the public debt, this debt is held by households, and the rate of compensation is low and controlled.

We only regret that the OECD has not made a serious analysis of the cause of the swelling public deficits.

2) Reduce the structural primary deficits

The OECD recommends that all countries embark on extensive programmes to reduce their structural primary deficits. To do this, we must first assess these structural primary deficits. However, the OECD estimates are based on a very specific hypothesis, namely that most of the production lost due to the crisis can never be made up. That is to say, for the OECD as a whole, 4.6 points of potential GDP have been lost forever out of the 6.9 point gap in 2012 between GDP and the pre-crisis trend. Also, the OECD believes that the structural primary balance of many countries was negative in 2012 whereas it would have been positive if the loss of production could have been made up. For France, the OECD estimates the structural primary balance at -1.3% of GDP, while the balance would be 0.5% if the loss due to the crisis could be made up. Only the United States and Japan would retain a structural primary deficit under the “catch-up hypothesis”.

Assume that long-term rates remain below the growth rate of the economy and that it is not necessary to reduce the public debt ratios. Then a structural primary balance at equilibrium would be sufficient to stabilize the public debt. Only two countries would need to make fiscal efforts: Japan (for 6.7 GDP points) and the US (for 2 points). The other countries would primarily be concerned with re-establishing a satisfactory level of production.

However, the OECD assumes that the countries will suffer forever from the shock induced by the crisis, that it is imperative to reduce the debts to 60% of GDP, that long-term rates will be higher (by about 2 points) than the economy’s growth rate in the very near future, and that public health spending will continue to rise. This leads it to conclude that most countries should immediately engage in a highly restrictive policy, representing 4.7 GDP points for France, 7.7 points for the United States, 9.2 points for the United Kingdom, etc.

The problem is that the OECD study assumes that these restrictive policies will not have any impact on the level of economic activity, or at least that the impact will be temporary, so that it can be neglected in a structural study of the long term. This is based on a notion that, though widespread, is wrong: that the economy has a long-term equilibrium that would not be affected by short or medium-term shocks. But this makes no sense. Real economies can go off in a different direction and experience periods of prolonged and cumulative depression. Is it possible to imagine a long-term Greek economy that is unaffected by the country's current situation? The shock induced by the strategy advocated by the OECD would mean a lengthy period of stagnation in Europe , Japan and the United States; the depressive effect would not be offset by lower interest rates, which have already hit bottom; a fiscal cutback of 6% of the OECD's GDP would result in a fall in GDP of 7.2% [4]; and the decrease in activity would be so great that debt ratios would rise in the short term (see the explanatory box below). To believe that the economy would eventually return to its long-term trajectory is just wishful thinking. The OECD provides no assessment of the impact of such a policy produced with a macroeconomic model.

We can only wonder that the OECD continues to advocate austerity policies that were shown in the years 2012-2013 to have adverse effects on growth and a negligible impact on the level of public debt, instead of advocating a policy stimulus that, while its content is of course debatable, would be more promising for the Western economies.

3) Choosing the right instruments

The bulk of the OECD study, however, is devoted to researching the policy instruments that would be most effective for achieving fiscal consolidation.

Based on previous work, the OECD assigns to each instrument an impact on growth, equity and the trade balance (Table 2). The organization has happily discovered that in some cases public expenditure can be helpful for growth as well as equity: such is the case of spending on education, health, family benefits and public investment. These should therefore be protected to the fullest. However, the OECD does not go so far as to imagine that they could be strengthened in some countries where they are particularly low today. In other cases, the OECD remains faithful to its free market doctrine: for example, it considers that spending on pensions is detrimental to long-term growth (since reducing it would encourage seniors to remain in employment, thereby increasing output) and is not favourable to equity. One could argue the opposite: that reducing public spending on pensions would hit the poorest workers, who would then live in poverty during their retirement; the better-off would save in the financial markets, which would strengthen these and thus fuel financial instability. Similarly, for the OECD unemployment and disability benefits hurt employment, and thus growth. Moreover, subsidies would be detrimental to long-term growth, as they undermine the competitive balance, and thus efficiency, but the OECD puts all subsidies in the same bag: the research tax credit, the PPE employment bonus, and the common agricultural policy, whereas a more detailed analysis is needed. Moreover, orthodox economic theory itself recognizes the legitimacy of public action when the market fails. The OECD has a negative view of social contributions, whereas it is legitimate for public PAYG systems to be funded in this way. The organization believes that income tax hurts long-term growth by discouraging people from working: but this is not what we find in Scandinavia.

Finally, the ranking produced (Table 2) is only partly satisfactory. The OECD warns against lowering certain public spending (health, education, investment, family) and occasionally advocates higher taxes on capital, corporation tax and income tax, and environmental taxes. But at the same time it advocates cutting back on pensions and unemployment insurance and reducing subsidies.

The OECD seeks to take into account the heterogeneity of national preferences. But it does so in a curious way. It considers that countries where income inequality is high (the United States and United Kingdom) should be more concerned with equity, but that the opposite holds for egalitarian countries (Sweden, Netherlands). But the opposite position could easily be supported. Countries that have highly egalitarian systems want to keep them and continue to take account of equity in any reforms they undertake.

Ultimately, suppose that, like France, all the countries had set up an efficient system for the control of their public finances (the RGPP then the MAP). At equilibrium, all expenses and revenues have the same marginal utility. If there is a need to save money, this should involve a reduction in costs and an increase in revenue in the same proportions. Dispensing with this strategy would require a detailed analysis of the utility of the spending and the cost of the revenue, an analysis that the OECD is incapable of providing. The fact that the OECD considers that spending on disability is generally detrimental to growth does not give it the right to advocate a strong reduction in disability spending in Finland, without taking into account the specific features of the Finnish system

Table 2. Short-term (ST) and long-term (LT) impact of fiscal consolidation instruments on growth, equity and the trade balance, according to the OECD

	Growth		Equity		Trade balance	Ranking*
	ST	LT	ST	LT		
Spending (down)						
Education	--	--	-	--	+	17
Health	--	-	-	-	++	15
Other spending	--	+	-		+	9
Pensions		++			++	2
Disability	-	+	--	-	++	11
Unemployment	-	+	-		++	4
Family	-	-	--	--	+	16
Subsidies	-	++	+	+	+	1
Investment	--	--			++	13
Revenue (up)						
Income tax	-	--	+	+	+	5
Social contributions	-	--	-	-		14
Corporation tax	-	--	+	+	++	6
Ecological tax	-	+	-		+	7
Consumer tax	-	-	-		+	12
Property tax	-				+	8
Other property tax	-		++	+	+	3
Sale of goods	-	+	-	-	+	10

* The higher the figure, the less the instrument should be used in fiscal consolidation.

All things considered, the recommendations for France (Table 3) are of little use, whether this is a matter of greatly reducing the level of pensions and unemployment benefits (under the pretext that France is more generous than the average of the OECD countries!) or of reducing subsidies (but why?) or of reducing public consumption (because France needs an army, given its specific role in the world).

Table 3. Fiscal adjustments recommended for France by the OECD (% of GDP)

	Short term	Long term
Pensions	-0.6	-2.2
Subsidies	-0.7	-0.7
Unemployment benefits	-0.7	-0.4
Ecological tax	+0.7	
Corporation tax	+0.5	
Other public consumption	-1.2	-1.1
Total adjustment	4.7	4.7

Overall, the OECD does not provide any simulation of the impact of the recommended measures on growth or equity. It is of course possible to do worse, but this still winds up in a project that would lead to a sharp decline in growth in the short to medium term and a decrease in spending on social welfare. Even though it claims to take account of the trade balance, it does not argue that countries running a surplus should pursue a stimulus policy in order to offset the depressive impact of the restrictive policies of countries running a deficit.

But the OECD also holds that there are of course miracle structural reforms that would improve the public deficit without any cost to growth or equity, such as reducing public spending without affecting the level of household services by means of efficiency gains in education, health, etc.

What a pity that the OECD is lacking in ambition, and that it does not present a really consistent programme for all the member countries with an objective of growth and full employment (to reduce the unemployment caused by the financial crisis) and of reducing trade imbalances, especially a programme with social objectives (reducing inequality, universal health insurance, and a satisfactory level of social welfare)!

Box: Austerity policy and the public debt

Consider an area where GDP is 100, the public debt is 100, the tax burden is 0.5 and the multiplier is 1.5. Reducing public spending by 1 lowers GDP by 1.5 and public revenue by 0.75; the public balance improves by only 0.25. The debt / GDP ratio rises from 100% to 99.75 / 98.5 = 101.25%. It takes 6 years for it to fall below 100%.

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[1] Boris Cournède, Antoine Goujard, Alvario Pina and Alain de Serres, *OECD Economic Policy Papers*, July 2013. A more detailed version can be found in: Boris Cournède, Antoine Goujard and Alvario Pina, "How to achieve growth-and-equity fiscal consolidation ?", *OECD Economics Department Working Paper*, 2013.

[2] Laurence Ball, Davide Furceri, Daniel Leigh, and Prakash Loungani, "The Distributional Effects of FiscalConsolidation", IMF WP/13/151, June 2013.

[3] See: OECD, 2012, *Toujours plus d'inégalité* [More and more inequality], March.

[4] Using the multiplier of 1.2 from the OECD Note, 2009, "The Effectiveness and the Scope of Fiscal Stimulus", March.