

# Croatia under the Excessive Deficit Procedure: which measures should be implemented?

By [Sandrine Levasseur](#)

How to put public finances on a good track when (almost) all measures regarding spending cuts and tax increases have been already exhausted? Croatia's government has been seeking to solve this tricky problem since mid-November when [an excessive deficit procedure \(EDP\) was launched](#) against the country. Let us explain what an EDP means: the public deficit of Croatia currently exceeds 3% of GDP; the breach is neither exceptional nor temporary; consequently, the government of Croatia has to curb its public deficit in a lasting way.

On 28 January 2014, the EU Council will propose (1) the time limits within which Croatia must reduce its deficit below 3% of GDP and (2) the average annual amounts of deficit reduction during the period. Yet, (3) the EU council will invite *formally* the government of Croatia to propose concrete measures towards reducing the deficit-to-GDP ratio below 3%.

The problem facing the government of Croatia is not straightforward since the proposed measures should not further depress the economy. Currently, only modest signs of recovery are in sight in Croatia, and its unemployment rate stands at a high level (16.5%). The country is among the poorest EU members: its GDP per capita is 62% of that of the EU-28.

**Briefing Paper n° 6** aims at proposing a list of measures that an EU country under EDP such as Croatia could envisage. For each measure, we present the main arguments "in favor of" it and "against" it in general terms. Then, we discuss the

relevance of every measure for Croatia. Note that our list of measures is suitable for both advanced and less advanced EU countries. More generally, our list could be used for any country facing public finance problems and looking for solutions.

Three measures (out of seven) seem to us particularly relevant in the case of Croatia:

- the use of service concession contracts;
- the privatization of some state-owned enterprises;
- the improvement of tax collection and compliance.

The first two measures are related to the need to restructure state-owned enterprises that are inefficient due to poor management. In particular, state-owned enterprises which are neither natural monopolies nor of strategic importance (*i.e.* in the tourism and agriculture sectors) should be privatized. Privatization of other state-owned enterprises should be envisaged more carefully, but not excluded. Croatia is the first country to join the EU with such a high share of state-owned enterprises (25%), and the slow pace of privatization has hindered growth. More privatizations will result in (long-run) gains even if causing (short-run) pains, in particular layoffs among the workforce. Service concession contracts are another way of restructuring the state-owned sectors. The impact on public finances is different, though. Services concession contracts provide a regular source of revenues for the government (through receipts of concession fees) and/or of savings (through lower payments of government subsidies). By contrast, immediate and potentially large amounts of cash can be obtained from the proceeds of privatization.

Recommending a restructuring of state-owned enterprises in Croatia is not a novelty. The [International Monetary Fund](#), the [World Bank](#) and the European Commission have repeatedly stated that the pace of privatization or service concessions should

be accelerated to raise the efficiency of the economy. Currently, the government of Croatia is actively engaged in accelerating such a process, in particular for service concessions. A few recent concessions include [Zagreb's airport](#) and [Rijeka's port](#), while [motorways](#) and [Brijuni's island](#) have also been proposed to bidders.

Croatia's citizens do not always support the restructuring process. To obtain greater public acceptance of privatization and service concessions, communication should be improved and intensified. In particular, the budgetary authorities should explain *what* they are doing, *why* they are doing it, and what the long-run benefits of their actions will be. Otherwise, the restructuring of state-owned enterprises will be perceived as a gift to the private sector. Last but not least, the process of privatization and service concessions should be more controlled to prevent misguided choices, abuse or conflicts of interest. That also means fighting corruption.

The improvement of tax collection is the third measure that we advocate to curb Croatia's public deficit. According to the [Institute of Public Finance](#), the cumulated uncollected tax revenues in Croatia would amount to HRK 40bn, which represents more than twice the projected public deficit for 2014 (HRK 19.3bn). Should the government be capable of collecting at least a portion, it would give a little breathing room to the public finances. In Croatia, increasing the tax collection means several interrelated things: fighting the grey economy (since unreported incomes are untaxed incomes) and prosecuting tax fraud (otherwise, rules and procedures are useless). Again, tighter control means fighting corruption.

By contrast, other measures such as wage cuts in the public sector or low corporate tax rates do not appear suitable to put the public finances of Croatia on track.

Further details can be found at <http://www.ofce.sciences-po.fr/pdf/briefings/2014/briefing6>

# America's fiscal headache

By Christine Rifflart

Before next December 13<sup>th</sup>, 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.

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# Shut down: America in the spotlight

By Christine Rifflart

A State that asks a third of its civil servants to stay home because it can't pay them is in a critical situation. When it's the United States, it's the whole world that worries.

The absence of an agreement on the 2014 budget, which was to take lawful effect as of Tuesday, 1 October 2013, shows the standoff in Congress between Democrats and Republicans. This kind of contention over the budget is not new: no budget has been passed since 2011, and the federal government has worked up to now through "continuing resolutions" that are used to release the funds needed for the government to function and operate, on a provisional basis. Today's blockage is on a different scale, and parts of the administration have had to close their doors due to lack of funds. This exceptional situation is not unprecedented: 17 shutdowns have occurred since 1976, the last two under the Clinton administration, lasting, respectively, one week (from 13 to 18 November 1995) and three weeks (from 15 December 1995 to 6 January 1996).

According to the Office of Management and Budget, of a total of 2.1 million federal government employees, more than 800,000 have been prohibited from working, while others have come to work with no guarantee that they will be paid. For example, those being told not to work include 97% of NASA employees, 93% of the Environmental Protection Agency, 87% of the Department of Commerce, 90% of the IRS, etc. Each of these received [a letter from the President](#) expressing his bitterness. In practice, this also means that some social



services are no longer assured, some government call centres are closed, and the national monuments and 368 national parks are no longer open to the public. Applications for subsidized loans, housing grants, and loan guarantees are no longer being taken, and some government services are closed:



U.S. Department of Commerce

Bureau of Economic Analysis

Due to the lapse in government funding,  
[www.bea.gov](http://www.bea.gov) will be unavailable until further  
notice. This includes access to all data and the e-  
File system.

We sincerely regret this inconvenience.

Additional information can be found at [link to PDF](#).

Updates regarding government operating status and resumption of normal operations  
can be found at [www.usa.gov](http://www.usa.gov).

Vital services and programs for which funding is not linked to the vote on the annual budget (so-called mandatory spending), which account for over 60% of pre-interest expenditure and represent 12.7% of GDP, have nevertheless been spared. Some social security programs (Medicare, Medicaid), the postal service, national security, and military operations have thus been protected from shutdown, at least in so far as they are not affected by restrictions on staff whose salaries are covered in the 2014 budget.

Another political and fiscal crisis is looming: the US government could go into default from October 17 if the authorized debt ceiling is not raised. The uncertainty

surrounding this situation is fraying nerves on the financial markets, and the frozen political climate in Congress does not seem to herald an honourable end to what the media are calling a “game of chicken” [\[1\]](#). In 1995, however, Clinton emerged victorious from this crisis with the Republicans, and was re-elected in 1996, despite the Republican majority in Congress.

The economy could be seriously affected while awaiting an end to this crisis. If the salaries and benefits of federal civil servants are not paid, the loss in earnings would come to an average of 1500 dollars per week for each family affected. Given the total of 2.1 million federal employees, this would represent 0.08% of quarterly GDP. In three weeks, this would amount to a loss of 0.25% of GDP for the economy in the 4<sup>th</sup> quarter. Congress could, however, approve retroactive payment of the salaries, which is what generally took place during previous shutdowns.

But this still does not take account of the more important issue of the disorganization of the economy. Considering that on an annual basis half of the federal government’s discretionary spending (*i.e.* 37% of federal spending, or 7.6% of GDP) [\[2\]](#) is affected by the shutdown, since it is financed out of the 2014 budget, this loss in expenditure represents 0.15 GDP point per week. Given the disorganization represented by the government closures (and using a fiscal multiplier of 1.5), the impact on growth could then come to at least 0.22 GDP point per week. If the crisis lasts 3 weeks, then the impact on 4<sup>th</sup> quarter GDP would be at least 0.7 GDP point – which would mean a recession for the US economy by the end of the year!

Other estimates do exist. The Office of Management and Budget evaluated the [cost of the 1995 shutdowns](#) (from 13 to 18 November 1995 and then from 15 December to 6 January 1996) at 1.4 billion in 1995 dollars (*i.e.* 0.5 % of quarterly GDP). Based on the 1995 shutdowns, [Goldman Sachs](#) evaluates the

current weekly cost to the US economy at 8 billion dollars, equivalent to an impact of 0.2% of 4<sup>th</sup> quarter GDP. Moody's Analytic Inc. estimates that the shutdown will have an impact of 0.35% of quarterly GDP per week.

If the budget crisis lasts only a few days, its repercussions on the French economy will be minimal, *i.e.* a reduction in US growth of 1 percentage point would cut French growth by 0.17%. But if the crisis lasts several weeks and overlaps with a crisis over the ceiling on the government debt, which is quickly approaching, then the consequences could be very different. The two crises the (blocked budget and the failure to pay the public debt) would combine and fuel one another, as is emphasized by this [New York Times post](#). It is difficult to imagine the panic this could cause on the financial markets, as interest rates soar and the dollar collapses. This would be a very different story indeed....

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[\[1\]](#) In game theory, a game of chicken is a game of influence between two players in which neither must yield. When for example two cars are racing towards a head-on collision, the "chicken" is the driver who veers off course in order to avoid dying.

[\[2\]](#) A major part of spending by the Department of Defence is approved on a multiyear basis and is not subject to being blocked due to the shutdown. Over half of DoD spending is composed of this discretionary expenditure. Furthermore, mandatory outlays are not financed out of credits subject to the vote on the Budget.

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# Austerity in Europe: a change of course?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. In these recommendations, the Commission calls for postponing the date for achieving the public deficit goals of four euro zone countries (Spain, France, Netherlands and Portugal), leaving them more time to hit the 3% target. Italy is no longer in the excessive deficit procedure. Only Belgium is called on to intensify its efforts. Should this new roadmap be interpreted as a shift towards an easing of austerity policy in Europe? Can we expect a return to growth in the Old Continent?

These are not trivial matters. [An OFCE Note \(no. 29, 18 July 2013\)](#) attempts to answer this by simulating three scenarios for fiscal policy using the [iAGS model](#). It appears from this study that postponing the public deficit targets in the four euro zone countries does not reflect a real change of course for Europe's fiscal policy. The worst-case scenario, in which Spain and Portugal would have been subject to the same recipes as Greece, was, it is true, avoided. The Commission is implicitly agreeing to allow the automatic stabilizers to work when conditions deteriorate. However, for many countries, the recommendations with respect to budgetary efforts still go beyond what is required by the Treaties (an annual reduction in the structural deficit of 0.5 percent of GDP), with as a consequence an increase of 0.3 point in the unemployment rate in the euro zone between 2012 and 2017.

We believe, however, that a third way is possible. This would involve adopting a "fiscally serious" position in 2014 that does not call into question the sustainability of the public debt. The strategy would be to maintain a constant tax burden

and to allow public spending to keep pace with potential growth. This amounts to maintaining a neutral fiscal stimulus between 2014 and 2017. In this scenario, the public deficit of the euro zone would improve by 2.4 GDP points between 2012 and 2017 and the trajectory in the public debt would be reversed starting in 2014. By 2030, the public deficit would be in surplus (0.7%) and debt would be close to 60% of GDP. Above all, this scenario would lower the unemployment rate significantly by 2017. The European countries could perhaps learn from the wisdom of Jean de La Fontaine's fable of the tortoise and the hare: *"Rien ne sert de courir, il faut partir à point"*, i.e. Slow and steady wins the race.

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## France: why such zeal?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. As part of this, the Commission granted France an additional two years to reach the deficit reduction target of 3%. This target is now set for 2015, and to achieve this the European Commission is calling for fiscal impulses of -1.3 GDP points in 2013 and -0.8 point in 2014 (see ["Austerity in Europe: a change of course?"](#)). This would ease the structural effort needed, since the implementation of the previous commitments would have required impulses of -2.1 and -1.3 GDP points for 2013 and 2014, respectively.

Despite this, the French government has chosen not to relax its austerity policy and is keeping in place all the measures announced in the draft Finance Act (PLF) of autumn 2012. The continuing austerity measures go well beyond the Commission's

recommendations: a negative fiscal impulse of -1.8 GDP point, including a 1.4 percentage point increase in the tax burden for the year 2013 alone. Worse, the broad guidelines for the 2014 budget presented by the government to Parliament on 2 July 2013 point to a structural effort of 20 billion euros for 2014, *i.e.* one percentage point of GDP, whereas the Commission required only 0.8 point. The government is thus demanding an additional 0.6 GDP point fiscal cut, which it had already set out in the multi-year spending program in the 2013 Finance Act.

The table below helps to provide an overview of the effort and of its impact on the French economy. It shows the trends in growth, in unemployment and in the government deficit in 2013 and 2014, according to three budget strategies:

1. One using the relaxation recommended by the Commission in May 2013;
2. One based on the budget approved by the government for 2013 and, *a priori*, for 2014;
3. One based on an alternative scenario that takes into account the negative 1.8 GDP point fiscal impulse for 2013 and calculates a fiscal impulse for 2014 that would be sufficient to meet the European Commission's public deficit target of -3.6%.

**The different scenarios for deficit reduction in France**

In %

	Relaxation (1)		Approved budget (2)		Alternative scenario (3)	
	2013	2014	2013	2014	2013	2014
Fiscal impulse	-1.3	-0.8	-1.8	-1.0	-1.8	-0.2
Unemployment rate	10.5	10.6	10.7	11.1	10.7	10.5
Growth	0.2	1.3	-0.2	1.0	-0.2	1.7
Public deficit	-4.3	-3.6	-3.9	-3.1	-3.9	-3.6

Source : Authors' calculations based on the iAGS model.

According to our estimates using the iAGS model [\[1\]](#), the public deficit would be cut to 3.1% of GDP in 2014 in scenario (2), whereas the Commission requires only 3.6%. As a

consequence of this excess of zeal, the cumulative growth for 2013 and 2014 if the approved budget is applied would be 0.7 percentage point lower than growth in the other two scenarios (0.8 point against 1.5 points). The corollary is an increase in unemployment in 2013 and 2014: the unemployment rate, around 9.9% in 2012, would thus rise to 11.1% in 2014, an increase of more than 350,000 unemployed for the period. In contrast, the more relaxed scenario from the European Commission would see a quasi-stabilization of unemployment in 2013, while the alternative scenario would make it possible to reverse the trend in unemployment in 2014.

While the failure of austerity policy in recent years seems to be gradually impinging on the position of the European Commission, the French government is persisting along its same old path. In the face of the social emergency that the country is facing and the paradigm shift that seems to be taking hold in most international institutions, the French government is choosing to stick to its 3% fetish.

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[\[1\]](#) iAGS stands for the Independent Annual Growth Survey. This is a simplified model of the eleven main economies in the euro zone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain). For more detail, see the working document [Model for euro area medium term projections](#).

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## **Pensions: the Moreau report's**



# poor compromise

By [Henri Sterdyniak](#)

Under pressure from the financial markets and Europe's institutions, the government felt obliged to present a new pension reform in 2013. However, reducing the level of pensions should not now be a priority for French economic policy: it is much more urgent to re-establish satisfactory growth, reform the euro zone's macroeconomic strategy, and give a new boost to France's industrial policy as part of an ecological transition. Establishing a committee of senior officials and experts is a common practice that is used these days to depoliticize economic and social choices and distance them from democratic debate. In this respect, [the Moreau report](#), released on 14 June 2013, seems like a bad compromise. Although it does not call into question the public pension system, it weakens it and does not give itself the means to ensure the system's social viability.

## **Do the social security accounts have to be balanced during a depression?**

The deficit in the pension schemes in 2013 was mainly due to the depth of the recession, which has reduced the level of employment by about 5%, causing a loss of about 12 billion euros in funding for the pension schemes. The central objective of Europe's economic policy should be to recover the jobs lost. Unfortunately, the Moreau report proposes continuing the strategy of a race to the bottom that is being implemented in Europe and France: "the pension schemes must contribute to restoring the public accounts and to France's international credibility" (page 82). The report forgets that lower pensions lead to a decline in consumption, and thus in GDP, and to lower tax revenues and social security contributions, especially since all the euro zone countries are doing the same thing.



The report recommends reducing the deficit in the pension system relatively quickly by increasing the taxes paid by retirees. It adopts several well-known proposals uncritically. It would align the rates of pensioners' CSG wealth tax with those of the employed. At one time, unlike employees, pensioners did not pay health insurance contributions. They have been hit by the establishment and then increase in the CSG tax. They already pay an additional contribution of 1% on their supplementary pensions. They are suffering from the retreat of the universal health scheme in favour of top-up health insurance. Increasing their CSG rate from 6.6% to 7.5% – the same as for employees – would bring in 1.8 billion euros. But shouldn't it be necessary in exchange to eliminate the 1% contribution on supplementary pensions and make their top-up health insurance premiums (which are not paid by the companies) deductible?

Pensioners are entitled, like employees, to a 10% allowance for business expenses, but with a much lower ceiling. Even for employees, this allowance is much higher than actual business expenses; it offsets to some extent the possibilities of tax evasion by non-employees. The removal of the allowance would lead to 3.2 billion euros more in tax revenue to the state and a 1.8 billion reduction in certain benefits, linked to the amount of taxable income. Retirees would lose 2% of their purchasing power. But it is hard to see how this 5 billion would make its way into the coffers of the pension programmes.

Taxing pension family benefits (which would yield 0.9 billion) is certainly more justifiable, but again it is unclear how and why the product of this tax would go to the pension funds, especially as family benefits are the responsibility of the CNAF (National family benefits fund).

On the other hand, with regard to increasing contributions the report is very timid in at best proposing an increase of 0.1 percentage point per year for 4 years, *i.e.* ultimately 1.6 billion euros in employee contributions and 1.6 billion in

employer contributions.

Most importantly, the report intends to increase the highest pensions (those who pay the full rate of CSG tax) only at the rate of inflation: 1.2 points for 3 years, thereby hitting them with a reduction of 3.6% in their purchasing power. Pensions subject to the reduced rate of CSG would lose only 1.5%. The lowest pensions would be spared. While this disparity in efforts may seem justified, the reliability of the public pension system would be seriously undermined. How can we be sure that this de-indexation will last only three years, that it will not become a more or less permanent management tool, which would especially hit older pensioners whose standard of living is already low? As the pensions received by a retiree are not all currently centralized, it is difficult to have the indexation of pensions vary in accordance with their level. The solution advocated by the report – to take into account the situation of the pensioner vis-à-vis the CSG – is hard to manage; making someone's pension level depend on their family's tax situation is just not justifiable. Pensions are a social right, a return on the contributions paid in, and not a tool for adjustments. How can we justify a 3.6% decline in the purchasing power of part of the population while GDP per capita is expected to continue to rise? Should the purchasing power of pensioners be cut when it has not benefited from an increase since 1983, even during periods of wage growth? Respect for the implicit social contract that underpins the pension system means that pensioners should make the same efforts as employees, no more, no less.

Furthermore, in times of economic recession the refrain that *efforts need to be equitably distributed* is dangerous. If everyone makes an effort by accepting less revenue and then reducing their expenditure, the inevitable result will be a drop in overall consumption, which, given spare production capacity, will be accompanied by a decline in investment and

thus in GDP.

### **Guaranteeing a fall in pensions**

In the medium term, the report's main concern is to ensure a decline in the relative level of pensions. Indeed, because of the Balladur reform, since 1993 wages recognized in the general pension scheme have been re-valued based on prices, and not on the average wage. The replacement rate (the ratio of the first pension payment to final salary) falls in line with strong increases in the average wage: at one time the pension system's maximum replacement rate was 50%, but this drops to 41.5% if real wages rise by 1.5% per year, but only to 47% if they rise by 0.5% per year. The mechanism introduced will lead to lowering the average level of pensions by 31% if the real wage increases by 1.5% per year, by 12% if it grows by 0.5% per year or by 0% if it stagnates. However, in recent years, wages have been rising by only 0.5% per year. The relative level of pensions might then recover. It is necessary therefore to increase wages to reduce the relative level of pensions.

The committee of experts gathered around Mrs. Moreau have therefore made two alternative proposals:

- – Either the wages used will be re-valued only as: price + (real wages less 1.5%), which means that, regardless of the wage increase, the maximum replacement rate for general pensions would fall to 41.5%. The relative decline in pensions would therefore be definitively consolidated. On the technical side, the increase in wages recorded will become a tool for adjustment, whereas, objectively, it should be used to calculate the average wage over the career; the oldest wages would be sharply devalued. However, the report acknowledges (page 107) that the current level of pensions corresponds to parity in living standards between active employees and pensioners, and that the proposed change would lead

eventually to lowering the standard of living for retirees by 13%. Nevertheless, it considers that “this development is acceptable”. Is this a judgment that should be made by the experts or by the citizens? Moreover, it neglects that this loss would come on top of the impact of the tax reforms and de-indexation that have also been recommended.

- – Or, every year a committee of experts would propose a reduction in the level of the pensions to be paid based on a *demographic factor* that would ensure the system is balanced. In addition to the fact that this would be another blow to democracy (isn't it up to the citizens to arbitrate between pension levels and contribution rates?) and to social democracy (the social partners would merely be *consulted*), and employees would have no guarantee of the future level of their pension, especially given the memory of the precedent set by the appointment of an expert group for the minimum wage (the *SMIC*), which was fiercely opposed to any increase.

### **Lengthening the contributions period**

The Moreau report calls for further lengthening the period of contribution payments required based on the principles of the 2003 Act (extending the contribution period by two years for every three year increase in life expectancy at age 60). The required contribution period would then be 42 years for the 1962 cohort (2024), 43 years for the 1975 cohort (2037), and 44 years for the 1989 cohort (in 2051). As the average age when vesting begins is currently 22 years, this would lead to an average retirement age of 65 in 2037 and 66 in 2051. This announcement is certainly designed to reassure the European Commission and the financial markets, but it leads above all to worrying the younger generations and reinforcing their fear that they will never be able to retire.

Is it really necessary to announce a decision for the next 25 years without knowing what the situation will be in 2037 or

2051 with respect to the labour market, job needs, social desires or environmental constraints? Eventually, like all the developed countries France cannot escape the need to revise its growth model. Is it really necessary to do everything possible to increase production and private sector employment at a time when ecological constraints should be pushing us to decrease material output? Maintaining the possibility of a period of active retirement in good health is a reasonable use of productivity gains. Reform should not go beyond a retirement age of 62 years and a required contribution period of 42 years. So if the “long career” approach is maintained, people who start work at age 18 can retire at 60, and those who start at age 23 will stay on until 65. But working conditions and career development programmes need to be overhauled so that everyone can actually stay in work until those ages. This also implies that young people seeking their first job receive unemployment benefits, and that the youthful years of precarious employment are validated.

### **Taking the arduous character of work into account**

The convergence of public, supplementary and private pension programmes likewise involves taking into account how arduous jobs are, by distinguishing between professions that are difficult to exercise after a certain age, meaning some kind of mid-term conversion is necessary, and jobs that are too tough, which can reduce life expectancy and thus should be phased out. For those who still have to do such jobs, periods of heavy work should give rise to possible bonus contribution periods and reductions in the age requirements. Common criteria should be applied in all the pension systems. In offering only one year's bonus for 30 years of hard labor, the Moreau report does not go far enough. This is almost insulting and makes it impossible to open up negotiations on a plan to align the different systems.

### **What is to be done?**

Whereas the [COR report](#) declared only a limited deficit (1% of GDP in 2040), the Moreau report proposes inflicting a triple penalty on future pensioners: de-indexation, a lower guaranteed replacement rate and the automatic extension of the contributions period required. This is no way to reassure the young generations or to highlight the advantages of the old-age pension system.

Pension reform is not a priority for the year 2013. In the short term, concern should be focused not on the financial imbalances in the regimes induced by the crisis but mainly on getting out of the depression. A strategy of a race to the bottom economically and socially, which is what de-indexation would lead to, must be avoided.

In the medium term, in order to convince young people that they will indeed enjoy a satisfying retirement, the goal should be to stabilize the pension / retirement ratio at close to its current level. The State and the unions must agree on target levels for the net replacement rate for normal careers: 85% for the minimum wage level; 75% for below the social security ceiling (3000 euros per month); and 50% for one to two times that ceiling.

To guarantee the pay-as-you-go pension system, the government and the unions must state clearly that a gradual increase in contributions will be required to bring the system into equilibrium, if necessary, once a strategy of extending the length of careers has been implemented at the company level that corresponds to the state of the labour market and actual workforce needs.

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# Competitiveness: danger zone!

By [Céline Antonin](#), [Christophe Blot](#), Sabine Le Bayon and [Catherine Mathieu](#)

The crisis affecting the euro zone is the result of macroeconomic and financial imbalances that developed during the 2000s. The European economies that have provoked doubt about the sustainability of their public finances (Spain, Portugal, Greece and Italy [\[1\]](#)) are those that ran up the highest current account deficits before the crisis and that saw sharp deteriorations in competitiveness between 2000 and 2007. Over that same period Germany gained competitiveness and built up growing surpluses, to such an extent that it has become a model to be emulated across the euro zone, and especially in the countries of southern Europe. Unit labor costs actually fell in Germany starting in 2003, at a time when moderate wage agreements were being agreed between trade unions and employers and the coalition government led by Gerhard Schröder was implementing a comprehensive programme of structural reform. This programme was designed to make the labour market [\[2\]](#) more flexible and reform the financing of social protection but also to restore competitiveness. The concept of competitiveness is nevertheless complex and reflects a number of factors (integration into the international division of production processes, development of a manufacturing network that boosts network effects and innovation, etc.), which also play an important role.

In addition, as is highlighted in a [recent analysis by Eric Heyer](#), Germany's structural reforms were accompanied by a broadly expansionary fiscal policy. Today, the incentive to improve competitiveness, strengthened by the implementation of improved monitoring of macroeconomic imbalances (see [here](#)), is part of a context marked by continued fiscal adjustment and high levels of unemployment. In these conditions, the implementation of structural reforms coupled with a hunt for

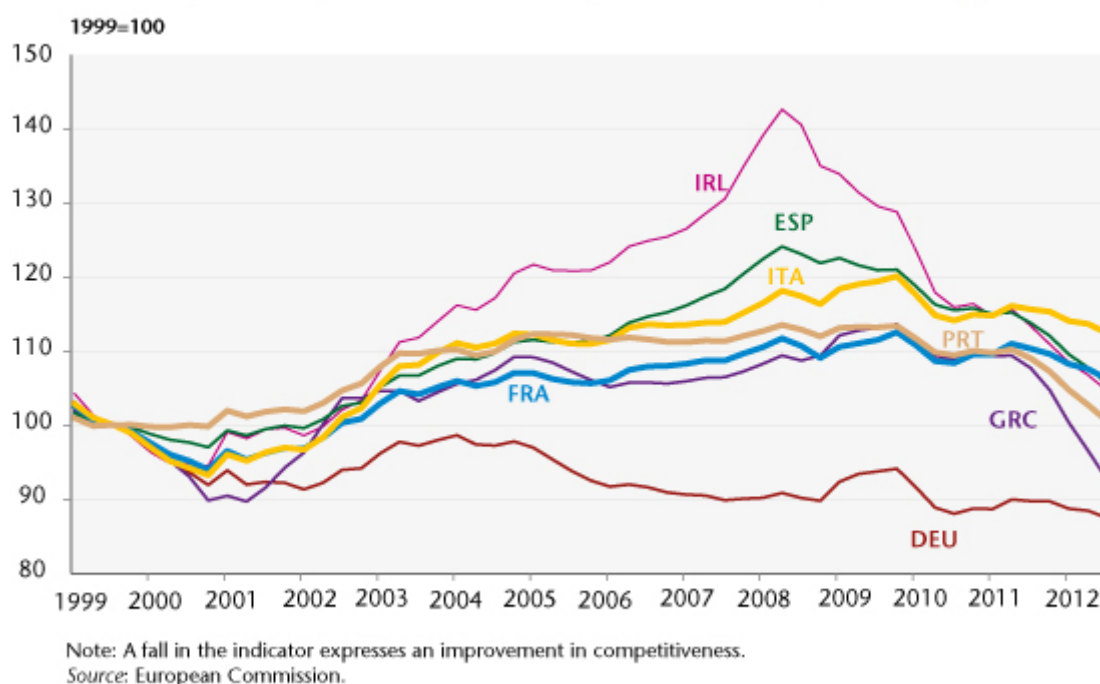
gains in competitiveness could plunge the entire euro zone into a deflationary situation. In fact, Spain and Greece have already been experiencing deflation, and it is threatening other southern Europe countries, as we show in [our latest forecast](#). This is mainly the result of the deep recession hitting these countries. But the process is also being directly fueled by reductions in public sector wages, as well as in the minimum wage (in the case of Greece). Moreover, some countries have cut unemployment benefits (Greece, Spain, Portugal) and simplified redundancy procedures (Italy, Greece, Portugal). Reducing job protection and simplifying dismissal procedures increases the likelihood of being unemployed. In a context of under-employment and sluggish demand, the result is further downward pressure on wages, thereby increasing the deflationary risks. Furthermore, there has also been an emphasis on decentralizing the wage bargaining process so that they are more in tune with business realities. This is leading to a loss of bargaining power on the part of trade unions and employees, which in turn is likely to strengthen downward pressure on real wages.

The euro zone countries are pursuing a non-cooperative strategy that is generating gains in market share mainly at the expense of other European trading partners. Thus since 2008 or 2009 Greece, Spain, Portugal and Ireland have improved their competitiveness relative to the other industrialized countries (see graph). The continuation of this strategy of reducing labor costs could plunge the euro zone into a deflationary spiral, as the countries losing market share seek in turn to regain competitiveness by reducing their own labour costs. Indeed, this non-cooperative strategy, initiated by Germany in the 2000s, has already contributed to the crisis in the euro zone (see the box on p.52 of the [ILO report](#) published in 2012). It is of course futile to hope that the continuation of this strategy will provide a solution to the current crisis. On the contrary, new problems will arise, since deflation [\[3\]](#) will make the process of reducing both public



and private debt more expensive, since debt expressed in real terms will rise as prices fall: this will keep the euro zone in a state of recession.

Figure 1. Competitiveness measured by unit labour costs (total economy)



[1] The Irish case is somewhat distinct, as the current account deficit seen in 2007 was due not to trade, but a shortfall in income.

[2] These reforms are examined in detail in a report by the Conseil d'analyse économique (no. 102). They are summarized in a special study [La quête de la compétitivité ouvre la voie de la déflation](#) ("The quest for competitiveness opens the door to deflation").

[3] For a more comprehensive view of the dynamics of debt-driven deflation, see [here](#).

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# Inequality and Global Imbalances: reconsidering old ideas to address new problems

by [Jean-Luc Gaffard](#) and [Francesco Vona](#)

The main challenge of the Bretton Woods agreements was to reconcile social justice and full employment to be achieved through domestic policies with an international discipline and progress toward trade liberalization (Rodrick 2011). After more than six decades, such division of objectives between international and domestic policies has been questioned by the current economic crisis, characterized by high debt levels, remarkable global imbalances and low global demand. It can hence be useful to reopen an old debate by reconsidering ideas that were discarded in the past, such as the proposal of Keynes to create global demand stabilizers. Our suggestion is that a global stabilizer that prescribes surplus countries to gradually increase their wages can have both a direct positive effect on global demand, without increasing public debts, and an indirect one by favouring a reduction in income disparities.

The structural lack of global demand represents unquestionably the key constraint to exit from the great recession. Worldwide, sluggish demand appears as the resultant of two quite independent factors, a *constraint* and a *political choice*. The choice is of those countries, especially emerging ones plus Germany, that build up their wealth on export-lead growth using a mix of wage moderation and clever firms' industrial strategies. The public debt constraint, instead, impacts upon the possibility to expand demand of the majority

of developed countries. As these countries should enforce restrictive fiscal policies to prevent default, their only chance to expand demand impinges on redistribution in favour of poorer households who consume a larger fraction of their incomes.

The current debate on this matter is misleadingly at best, oscillating between the usual Scylla and Charybdis of more or less state intervention. From a standard Keynesian viewpoint, the bottleneck in global demand is the consequence of neo-liberal policies, which in Europe are worsened by the opposition of Nordic countries against large scale public funded EU programs, possibly financed with EU bonds. From an orthodox viewpoint, which relies upon the belief in a trickle-down mechanism (increase the wealth of the rich eventually benefit all), the crisis represents an opportunity to remove the last barriers to a full liberalization of labor and goods markets. These barriers would prevent EU economies to raise their competitiveness with respect to their new emerging competitors, the BRICS (Brazil- Russia- India-China- South Africa). While Keynesians are overoptimistic in their belief that more public expenditures will succeed in ensuring a fresh start to our feeble economies, orthodox economics neglects by assumption the problem of global demand. In particular, it ignores that a race for competitiveness based on further wage moderation and welfare state cuts would only amplify the global demand constraint.

It is well documented that, in last thirty years, living conditions and real wages of both low and middle skilled workers decreased substantially while profits and, in general, earnings of top 1% earners increased impressively, especially since the 2000s (Piketty and Saez 2006, Eckstein and Nagypál 2004, OECD 2011). The widening in incomes has been especially large in the US and Anglo-Saxon countries where deregulated labour markets allow wage to adjust downward, but also affected European economies in other forms such as

structurally higher unemployment rates and higher profit shares (Krugman 1994). The excessive decrease of the median wage with respect to the average productivity created a fundamental wedge between demand, which is more sensible to wage changes than to changes in profit opportunities, and supply, for which the opposite holds. Globalization plays a key role in increasing inequality between profits and wages as increases in capital mobility were not accompanied in parallel increases in international labour mobility (Stiglitz 2012). Only the joint working of increasing debt (both private and public) and of productivity improvements related to new information & communication technologies prevented the demand deficit to emerge earlier together with the dysfunctional role of excessive inequality (see Stiglitz 2012, Fitoussi and Saraceno 2011, and on the role of technical change Patriarca and Vona 2013). Global imbalances played a key role in maintaining high the level of global demand as long as savings of countries with commercial surpluses (e.g. China) were borrowed to households and governments in countries with commercial deficits (e.g. the US). By mitigating the consequence of on excessive inequality, they keep also under control the political pressure for redistribution. But, as we have seen, they are a source of macroeconomic instability. In fact, the saving glut in export-led economies creates a mass of liquidity in search of investment opportunities that increases the likelihood of asset price bubbles, especially in presence of an inadequate and oversized financial sector (Corden 2011).

Leaving ethical considerations aside, the concern for rising inequality in western economies would have been irrelevant for overall growth provided the lower demand there was compensated by a growing demand in emerging and export-led countries, such as China. Unfortunately, the compensation did not and is not expected to take place soon for at least two reasons.

First, oligarchies in emerging economies (especially China)

found it convenient to sustain global demand indirectly, rather than through wage increases proportional to productivity, by investing large current-account surpluses in the US financial market and so financing US consumers. The indirect empirical support for this argument is that inequality increased in China too since the market friendly reform started. Especially inequality in factor shares, i.e. between profits and wages, increased substantially since the 1995 with the labour share falling by between 7.2% and 12.5% depending on the accounting definitions used (Bai and Qian 2010).

Secondly, a historical comparison of catching-up episodes can help shed light on the origin of the global demand glut. Between the second half of the 19<sup>th</sup> century and the beginning of the 20<sup>th</sup> century, the economic catching-up of both Germany and the US with the UK was soon followed by convergence in living standards and wages (Williamson 1998). Nowadays, the economic catching-up of China is much slower in terms of convergence of wages and living conditions. By way of example, China's GDP per capita increased from 5.7% to 17.2% of US GDP per capita from 1995 to 2010 (source: World Penn Tables), while the hourly labour compensation cost is also increasing but reached only 4.2% of the US labour compensation cost in 2008 (source: Bureau of Labor Statistics Data). This gap between GDP per capita and unit labour cost in China clearly shows that the catching-up in terms of workers' living conditions is far slower than the economic catching-up.

The reasons for this slow wage convergence deserve further investigations and have probably to do with factors affecting institutional changes that support redistribution from profits to wages, including culture and tax progressivity (Piketty and Qian 2009), in the catching up country. Certainly, the size of Chinese population relative to the world population did not help in fastening these institutional changes. By simple assumptions of standard bargaining theory, bargaining power

depends on the outside option that, for workers, is limited by existence of a large 'reserve army' willing to work for extremely low wages. One can then argue that the larger the reserve army, the longer it takes to reduce the downward pressure on the workers' wages in the advanced part of the economy. De facto, the wage convergence has been much faster in previous catching-up episodes since the labour constraint becomes stringent sooner due to the smaller size of the population, allowing workers to fight for better conditions and higher wages. In a nutshell, an excessively large reserve army in the countryside prevents both wages to increase and democratic reforms to take off in China, thus creating a wedge between the timing of economic growth and the one of political reforms, required to rebalance demand and supply.

Not only the slow wage convergence of catching-up country causes persistent global imbalances between demand and supply, it is also the essential reason of the obstacles faced to reduce inequality in western countries. First, implementing redistributive policies and increases in real wages are likely to further reduce competitiveness and to bring about a substantial investment outflows. Second, the treat of delocalizing production abroad can have forced workers to accept lower wages; an effect that is difficult to correlate empirically with observable proxies of globalization such as trade or investment outflows.. While empirical analyses looking at the last 30 years of the 20<sup>st</sup> century concur that globalization was not the main driver of inequality increases, recent evidence shows that: (i) Outsourcing had a negative impact of on middle and low skill wages and employment levels in developed countries, especially in the last decade (Firpo, Fortin and Lemieux 2011); (ii) The effect of trade on inequality can be underestimated due to production fragmentation (Krugman 2008).

Global imbalances are also likely to create political obstacles to policies aimed at reducing inequality. An overs-

sized financial sector contributed to increase earnings of the top 1% of the population and so their lobbying power. This allowed these super-rich to heavily influence political decisions making their rents higher, especially through a massive reduction of tax progressivity (Fitoussi and Saraceno 2012) and other opaque channels (e.g. fiscal loopholes, Stiglitz 2012). Now, this lobby of super-rich makes it exceedingly difficult to limit the power of finance and restore fairer tax rates for financial rents and top incomes.

How to avoid the stalemate generated by global imbalances and global pressure for wage moderation? Are there in the system as it is endogenous forces that will eventually reduce global imbalances and inequality?

The first option is to wait for reforms in China. Politicians in western countries can hope in a speeding up of this process that will lead to a parallel increase in real wages and hence global demand. This will be the ideal market solution, but it is unlikely to occur in the short- and medium-run. A second possibility will consist in a large scale devaluation of western economies' currencies: Dollar, Euro and Yen. However, such a policy is likely to create a devaluation spiral, also increasing investment uncertainty. Moral suasion is unlikely to convince Chinese politicians to not devalue the Yuan as their assets in dollars and euro will depreciate substantially. A third protectionist solution is not convincing at all as it is likely to trigger a retaliation spiral paving the way for global wars. Indirect and global political interactions are an issue at stake here: nationalistic political parties and the associated protectionist policies are more likely to become popular if the timing of Chinese reforms is too slow and so the adjustment process too painful in the medium-run. A fourth solution is to resort to an old idea of John Maynard Keynes on 'global automatic stabilizers'. In the post-WWII context, Keynes proposed an international institution, the so-called

International Clearing Union' (ICU), to reabsorb both commercial surpluses and deficit, seen as equally worrisome (see also the article in Italian of A. Bramucci 2012). In particular, persistent commercial surpluses were seen as a potential source of long-term shortages of global demand. The main idea was to coordinate thorough the ICU both re-evaluations and demand expansions for the countries in surplus, and de-evaluation and control of capital movements for countries in deficit. Such an institution would go in the right direction to help reabsorbing global imbalances, but lack enforcement power to ensure that the necessary adjustments are effectively put in place.

Combining a global rule for wage adjustment with WTO sanctions can represent a more clever and reliable way to revive global demand. The first part of the proposal would consist in linking real wage growth not only to productivity growth, as proposed by A. Watt (2011), but also to commercial surplus. Conditioned to the country's level of development (so the prescribed adjustments should take into account of initial level of GDP per capita and obviously adjusted for PPPs), countries experiencing medium-term growths both in productivity and in the commercial surplus have to increase real wages. Otherwise, other countries could raise tariffs on the products exported by the country that does not follow the rule. The effective capacity to implement of the rule can be reinforced by giving to Unions, either global or local, and NGOs the power to control for specific situations where the rule is not respected, i.e. special export-oriented zone in China where labour standards are particularly low. In the case of commercial deficits, the country could be asked to follow (real) wage moderation and to put under control public deficit. In such a context, these restrictive policies would have limited harmful effects on growth for the increase in external demand that follows the wage increase in the export-oriented countries. The proposal would have also positive effect in reducing the overall level of functional inequality



worldwide, restoring a more balanced distribution between wages and profits.

Overall, the coordination of global demand and supply would be restored using a simple automatic stabilizer that will neutralize the protectionist treat and, at the same time, will relax the constraints that prevent inequality-reducing policies to be approved in western countries.

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# In the Netherlands, change is for now!

By [Christophe Blot](#)

While France has just reaffirmed that it will meet its commitment to reduce its budget deficit to below 3% by 2014

(see [Eric Heyer](#)), the Netherlands has announced that it is abandoning this goal on the grounds that additional austerity measures could jeopardize growth. The country plunged into recession in 2012 (-1%), and GDP will fall again in 2013 (see [the analysis of the CPB](#), the Netherlands Bureau for Economic Policy Analysis). In these circumstances, the social situation has deteriorated rapidly, with a 2 percentage point rise in unemployment in five quarters. In the first quarter of 2013, 7.8% of the workforce was out of work. Beyond the implications for the Netherlands itself, could this rejection of austerity (finally) signal a shift in Europe's strategy of fiscal consolidation?

Up to now, the coalition government elected in September 2012 and led by the Liberal Mark Rutte had followed the general strategy of consolidation, with expectations of rapidly bringing the deficit below 3%. However, the austerity measures already being implemented together with an adjustment in the housing market and the general decline in activity throughout the euro zone led the Netherlands into a new recession in 2012 and put off the prospects of meeting the budget target in 2013. In view of the European Commission's projections for growth and for the budget deficit in 2013, it does however seem that the Dutch government would have been able to achieve a deficit of 3% in 2014, but like France, at the cost of taking additional measures.

The budget deficit is expected by the Commission to come to 3.6% in 2013. The CPB expects an even slightly lower deficit (3.3%), using growth forecasts similar to those of the Commission. In these conditions, the fiscal effort required to reach the 3% target in 2014 would amount to between 3.5 and 7 billion euros. In comparison, for France this would require the approval of additional austerity measures for 2014 amounting to 1.4 GDP points, *i.e.* just under 30 billion euros (see [France: holding to the required course](#)).

However, under pressure from the social partners, the Dutch

government ultimately abandoned the plan announced on March 1 that provided for savings of 4.3 billion euros, which mainly consisted of a wage freeze in the public sector, a freeze in the income tax scale and the stabilization of public spending in real terms. Putting austerity on hold like this should give a small boost to the economy without calling into question fiscal sustainability, as the improved prospects for growth should reduce the cyclical component of the budget deficit.

While the 3% target will of course not be met, it is not at all clear that the markets will make much out of this infringement of the rules. In fact, the difference in interest rates vis-à-vis the German rate has stabilized since it was announced that the plan had been abandoned, whereas the difference had tended to increase in the previous weeks (see figure).



While this decision should not upset the economic and financial stability of the Netherlands or the euro zone, it does nevertheless send a strong anti-austerity signal from a country that had hitherto favored fiscal consolidation. It is therefore one more voice that is challenging the effectiveness of this strategy and emphasizing the economic and social risks associated with it ([see here](#) for an overview of the case against austerity and the 2013 [iAGS report](#) for more specific points concerning an alternative strategy for Europe). It is also a decision that should give France inspiration. Credibility is not necessarily gained by sacrificing one objective (growth and employment) for another (the budget deficit). It is still necessary to await the response of the European Commission in that the Netherlands, like most countries in the euro zone, is subject to an excessive deficit procedure. If the decision of the Netherlands is not challenged, then this will represent a significant shift in European macroeconomic strategy.

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# What kind of pension reform for 2013?

In a speech on 28 March, Francois Hollande raised the 20 billion euro deficit forecast for 2020 in order to announce a further extension of the pension contributions period, while refusing to end the indexation of low state pensions and pensions in the statutory pension system. Francois Hollande and the French government also pledged to re-balance the public finances by 2017. As they no longer wish to increase the tax burden in a period of weak or even non-existent growth, this means cutting public spending by at least 70 billion euros, or about 7%. As pensions account for a quarter of public expenditure, they cannot be spared the austerity axe. There is a major risk that the goal of re-balancing the public finances will result in lowering the level of pension payments. When negotiating the supplemental pension arrangements in March 2013, the MEDEF managed to obtain pension increases of 1 percentage point below the inflation rate for 3 years, meaning a 3% loss in purchasing power. In a [recently published note](#) (*Notes de l'OFCE*, no. 26 dated 24 April 2013), Henri Sterdyniak explains that there are other possible approaches to reform.