

Family benefits: family business?

By [Hélène Périvier](#)

[Bertrand Fragonard has submitted his report to the Prime Minister](#); it aims, first, to enhance the redistributive nature of family policy and, second, to rebalance the accounts of the family branch, which have recently been running a deficit, by 2016. A realignment of family benefits towards low-income families is proposed as the first objective. As for the second, the two options proposed are adjusting benefits based on means, or taxing them. How can 2 billion euros be found in today's lean times?

With the cow already thin, is it really the time to put it on a diet?

The cutbacks in spending on family policy are part of a broader economic austerity policy aimed at rebalancing the public accounts. The government deficit is of course a serious issue, which cannot simply be swept under the rug. It is bound up with the durability and sustainability of our welfare state, and as concerns the topic being discussed here more specifically, with the future of family policy. But the magnitude and timing of the fight against deficits are central to its effectiveness. The OFCE's forecasting work shows that the massive reductions in public spending being made by France will undercut growth. The lack of growth will in turn slow deficit reduction, which will thus not live up to expectations. Ultimately, you can't have your cake and eat it too, in particular if the economy isn't producing the ingredients.

If we continue down this path of trimming family policy, then how should we proceed? Who should bear the cost? Should we cut

spending or increase revenues?

Staying the course?

A number of principles guide public action. They constitute a compass that helps to stay the course that we have set and to develop the tools needed to do this. With regard to family policy, the first principle concerns horizontal equity: this requires that a household should not see its standard of living fall with the arrival of a child. In other words, based on this principle, all households finance support that benefits only households with dependent children. This constitutes redistribution from households without children to those with children, whether the household is rich or poor. This sharing of the cost of children is justified by the idea that a healthy birth rate benefits everyone. Family allowances are emblematic of this principle.

The second principle concerns vertical equity: every household should participate in the financing of family policy in a progressive manner based on its income, and low-income households with dependent children should receive special assistance, such as the family income supplement [*le complément familial*], a means-tested assistance for families with three or more children.

Nothing of course prevents us from changing tack by changing the relationship between these two principles. Indeed, family policy does need to be reformed: it should take into account the changes undergone by French society in recent decades (which policy now does only partially): increased numbers of women in the workforce, the rise in divorce and unmarried partnerships (today most children are born to couples who are neither married nor civil partners), new family configurations, concern for the equality of children with respect to collective care and socialization, territorial inequalities, etc. ([Périvier and de Singly, 2013](#)). These considerations on family policy need to be integrated into an

overall vision of the tax-benefit system for families –otherwise public policy risks becoming incoherent. The mission statement behind the Fragonard report highlights above all rebalancing the family branch accounts by 2016, “with a significant shift from 2014”.

Don't lose your bearings!

While staying the course on family policy, some leeway is possible. To draw on the contributions of all households, the taxation of the couple could be reviewed. Under the current system, married couples or civil partners have two tax shares; this leads to tax reductions that increase in line with the difference in the income of the two partners (the extreme case being that of Mr. Breadwinner and Mrs. Housewife, the arrangement that this type of taxation was designed to encourage). This is what is called the conjugal quotient [\[1\]](#). This “benefit” is not capped [\[2\]](#), unlike the benefit related to the presence of a child (the famous family quotient, whose ceiling was recently reduced to 2000 euros). Capping the conjugal quotient would not call into question the principle of horizontal equity, as many childless couples benefit from it, couples who, for the most part, had dependent children in the past and have benefited from a generous family policy. Doing this would spread the effort to rebalance the family branch accounts over a wide range of households, including those who do not have or no longer have dependent children [\[3\]](#). The complete elimination of the conjugal quotient (*i.e.* the individualisation of taxes) would provide additional tax revenue of 5.5 billion euros ([HCF, 2011](#)). This tax “benefit” could initially simply be capped: the yield would be greater or smaller, depending on the ceiling adopted [\[4\]](#). The distribution of the gain for couples related to the marital quotient is concentrated among the highest income deciles ([Architecture des aides aux familles, HCF, 2011](#)). Another possible tax revenue concerns the extra half-share granted for having raised a child alone for at least 5 years. Now capped

at 897 euros, this benefit could be eliminated, as it does not meet any of the principles set out above and it is doomed to disappear.

These steps would increase tax revenue and help fund family policy. These options would unquestionably increase the tax burden on households. If we add to the effort requested the constraint to not increase taxation, then the 2 billion euros would have to be found through cuts in spending on family benefits. The room for manoeuvring becomes almost razor thin. Out of concern for vertical fairness, these cuts must be borne by the best-off families with children. But this vertical redistribution is conceived within the limited framework of families with children. Yet vertical equity generally consists of a redistribution from better-off households to poorer households. What is therefore being applied here would be a principle of vertical equity that could be described as "restricted vertical equity".

There is no free lunch...

The family allowance is clearly in the firing line in this narrow framework for family policy that excludes from its scope the taxation of couples in particular. It represents 15% of the family benefits paid, or 12 billion euros. There are two main options: the amount could be adjusted in line with the level of household resources, or the benefits could be taxed. But which? Both options have advantages and disadvantages.

Subjecting the family allowance to conditions would help to target wealthy families while not affecting the others. This targeting would enhance the redistributive character of the system, which would definitely be an advantage. But this requires setting income thresholds above which the amount of benefits received decreases. So families in similar situations would receive different levels of benefits depending on whether their incomes were just below or just above the

threshold. This would undermine the universal commitment to the welfare state. Furthermore, the thresholds could lead to a contraction in the labour supply of women in couples: the “classic” trade-off would be, “if I work more, we will lose benefits” – it is still the activity of women, and always the activity of women, that suffers. To limit these negative effects, the thresholds could be smoothed and variable income ceilings introduced based on the activity of the two partners by raising those applying to couples where both work. What would gradually emerge is a huge white elephant, a Rube Goldberg machine that generates higher management costs with extra work for the CAF service. In addition, the system would be less transparent, because it is more complex, leading to overpayments, fraud, and even more annoying, a lack of take-up (those eligible for a benefit don’t apply). Finally, selective benefits are the breeding ground for debate around a culture of dependency, with the suspicion that “the reason these people don’t work is in order to get benefits”. Note that this risk disappears if the thresholds are set at a high level.

Taxing the family allowance would get around these problems: it is simple, with no extra management costs, as the amount of benefits received would just be added to taxable income. So the progressiveness of the income tax system would apply. More affluent families with children would pay more than those on lower incomes. But targeting would be less accurate than before: many families with children would be affected, and households that were previously not taxable may become so (even if this involved small amounts). Finally, the tax burden would increase, which is politically costly.

By construction, in both cases families that have only one child would not be affected because, under a family policy designed to promote high birth-rates, they do not receive family benefits. And in both cases families without dependent children are not required to contribute.

Don't throw the baby out with the bath water ...

Adjusting the family allowance for income is the track that seems to be preferred by the Fragonard report. The opinion of the High Council for the family (HCF) indicates that this approach has been rejected by the majority of that body's members. Overall, the measures proposed in the report are to reduce the spending on families with dependent children within the limited scope of family policy, namely benefits. The danger looming is that the guidelines proposed lead to paralysis by freezing the different oppositions and exacerbating the conservative visions for family policy. Some will justly view this as a systematic attack on family policy, since the overall budget is cut. Nevertheless, an overhaul of family assistance is needed, but it cannot involve a reduction in spending in this area as the need is so great, especially to ensure progress with regard both to gender equality and equality between children. Any reform must be based on the principles of justice and on an approach to the welfare state that needs to be reviewed and renegotiated. Even though the budget constraints are serious, we cannot reduce the amount allocated to family policy, but nor should we retreat from the in-depth reform that is needed.

[\[1\]](#) Note that mechanisms such as a tax break or incentive to promote employment tend to favour people who are cohabiting over married couples. The interactions between the multiple tax provisions complicate comparisons of the tax treatment of people with different marital statuses.

[\[2\]](#) It is, implicitly, but for extremely high levels of income, reaching the upper end of the income tax brackets with or without the marital quotient (this implicit cap limits the advantage to 12,500 euros).

[\[3\]](#) On condition that these additional tax revenues are paid

to the family branch.

[\[4\]](#) For a ceiling of 2,590 euros, the extra tax revenue from capping the conjugal quotient would be about 1.4 billion euros ([HCF, 2013](#)).

In memoriam. Raymond Boudon

By Michel Forsé

Raymond Boudon, Professor Emeritus at the University of Paris Sorbonne, died at the age of 79 on Wednesday, 10 April 2013. It is difficult to summarize so much fruitful work. He was of course the leader of the school of thought known as methodological individualism, which holds that the collective is always the result of rational individual actions. He devoted much of his effort to setting out the foundations for this and attached great importance to the thought of Max Weber. At the beginning of his career, his personal contacts with the American Paul Lazarsfeld led him to develop a formalized and rigorous approach to social facts, in contrast to the structuralism which was so much in vogue at the time and which he disliked. For Boudon, as the title of one of his latest books (2011) suggests, sociology was a science in the strict sense of the term. In a similar vein, he also tried to show in numerous articles and books all the havoc that ideological and cultural relativism could inflict.

A very prolific author, arguably making him one of the major sociologists of the twentieth century, he was also an editor. At the PUF publishing house he was until recently head of the “Sociologies” collection, which featured both translations of

classic works and publications by young authors. For many years he also directed *Année Sociologique*, the journal founded by Emile Durkheim.

As a member of the Académie des Sciences Morales et Politiques, he played an active role promoting research projects. He was also a member of many prestigious foreign academies, such as the British Academy and the American Academy of Arts and Sciences.

Raymond Boudon graduated from the prestigious Ecole Normale Supérieure with a degree in philosophy and taught throughout his career – many of his works are marked by a strong pedagogical approach. He wanted to make the great authors known, often in a new light, and to bring to life key concepts of sociology, for example, through the *Dictionnaire critique de la sociologie* and *Traité de sociologie*, which he directed. He was of course also a researcher, in the field of methods and theories as well as in empirical analysis. At the CNRS, he founded and for many years headed up the Study Group on Sociological Methods and Analysis.

Exacting in his scientific approach to social facts, unperturbed by not following the latest fashion, and with an impressive *oeuvre* translated into many languages, Raymond Boudon was, nevertheless, very simple and approachable, as all those who knew him can attest. Beyond the scholar whose work will remain, first and foremost we have lost a militant humanist.

Cyprus: Aphrodite to the rescue?

By [Céline Antonin](#) and [Sandrine Levasseur](#)

For two weeks Cyprus sent tremors through the European Union. If the banking crisis that the island is going through has attracted much attention, it is essentially for two reasons. First, because the dithering over the rescue plan led to a crisis of confidence in deposit insurance, and second, because it was the first time that the European Union had allowed a bank to fail without coming to its aid. While the method of resolving the Cyprus crisis seems to represent an institutional advance [\[1\]](#), insofar as investors have been forced to face up to their responsibilities and citizens no longer have to pay for the mistakes of the banks, the impact of the purge of the island's real economy will nevertheless be massive. With its heavy dependence on the banking and financial sector, Cyprus is likely to face a severe recession and will have to reinvent a growth model in the years to come. In this respect, the exploitation of natural gas resources seems an interesting prospect that should not be ruled out in the medium / long term.

To grasp what is at stake in Cyprus today, let us briefly recall the facts. On 25 June 2012, Cyprus requested financial assistance from the EU and the IMF, essentially in order to bail out its two main banks (Laiki Bank and Bank of Cyprus), whose losses are estimated at 4.5 billion euros due to their high exposure to Greece. Cypriot banks were hit both by the depreciation of the Greek assets they held on their balance sheets and by the partial write-down of Greek debt under the second bail-out plan (PSI Plan of March 2012 [\[2\]](#)). Cyprus estimated that it needed 17 billion euros in total over four years to prop up its economy and its banks, about one year of the island's GDP (17.9 billion euros in 2012). But its backers

were not ready to give it this much: the national debt, which had already reached 71.1% of GDP in 2011, would become unsustainable. The IMF and the euro zone thus came to an agreement on a smaller loan, with a maximum amount of 10 billion euros (9 billion financed by the euro zone and 1 billion by the IMF) to recapitalize the Cypriot banks and finance the island's budget for three years. Cyprus was in turn ordered to find the remaining 7 billion through various reforms: privatizations, an increase in corporate tax from 10 to 12.5%, and a windfall tax on bank deposits.

Initially [\[3\]](#), Nicosia decided to introduce a one-off tax of 6.75% on deposits of between 20,000 and 100,000 euros and 9.9% on those above 100,000 euros, and a withholding tax on interest on these deposits. Given the magnitude of the resulting protest, the government revised its approach, and the taxation of deposits gave way to a bankruptcy and restructuring. The solution adopted concerned the country's two main banks, Laiki Bank and Bank of Cyprus. Laiki was closed and split into two: first, a "good bank" that will take over the insured deposits (less than 100,000 euros) and the loans from the ECB to Laiki [\[4\]](#), but which will also take over its assets and ultimately be absorbed by Bank of Cyprus; and second, a "bad bank" that will accommodate the stocks, bonds, unsecured deposits (above 100,000 euros), and which will be used to pay off Laiki's debts [\[4\]](#), according to the order of priority associated with bank liquidations (depositors being paid first). In addition to absorbing the "good bank" hived off of Laiki, Bank of Cyprus will freeze its unsecured deposits, some of which will be converted into shares to be used in its recapitalization. To prevent a flight of deposits, temporary [\[5\]](#) capital controls were put in place.

This plan introduces a paradigm shift in the method of resolving banking crises in the European Union. At the beginning of the euro zone crisis, in particular in the emblematic case of Ireland, the European Union considered that

creditors had to be spared in the event of losses, under the logic of “too big to fail”, and it called on the European taxpayer. But in 2012, even before the declaration of Jeroen Dijsselbloem, Europe’s doctrine had already begun to bend [6]. Hence, on 6 June 2012, the European Commission proposed a Directive on the reorganization and resolution of failing credit institutions, which provided for calling on shareholders and bondholders to contribute. [7] However, the rules on creditors are to apply only from 2018, after approval of the text by the Council and the European Parliament. This type of approach is now being tested experimentally in the Cyprus crisis.

Heavy consequences for the real economy

The situation of the country before 2008

In the period preceding the global economic crisis, the Cypriot economy was thriving, and indeed in 2007 even in danger of overheating. Over the period 2000-2006, its GDP grew on average by 3.6% per year, with growth of 5.1% in 2007. The unemployment rate was low (4.2% in 2007), with even some labour shortage as a result of the emigration of Cypriot nationals to other EU countries. The influx of foreign workers into Cyprus helped to hold down wages. Consumer spending and, to an even greater extent, business investment, which were largely financed through credit, were particularly dynamic starting in 2004, with growth rates that in 2007 reached, respectively, 10.2% and 13.4%. Inflation was moderate, and in this generally positive context, Cyprus qualified to adopt the euro on 1 January 2008.

In this pre-crisis period, the Cypriot economy – a small, very open economy – relied in the main on two sectors: tourism and financial services.

The two key sectors of the Cypriot economy

Revenue from tourism (Table 1) has provided a relatively

stable financial windfall for the Cypriot economy. This (non-cyclical) flow brings in approximately 2 billion euros annually. [8] As a share of GDP, however, the weight of tourism has decreased by half since 2000, to a level of less than 11% in 2012. Likewise, the share of tourism in the export of services fell sharply during the last decade: in 2012, it accounted for 27% (against 45% in 2000). Over the last 15 years, the number of tourists has fluctuated somewhat between 2.1 million (in 2009) and 2.7 million (2000), compared with about 850,000 people who are residents of the island.

Financial services constitute the other pillar of the Cypriot economy (Table 2). Two figures give a clear idea of its significance: bank assets accounted for more than 7.2 times GDP in 2012 (with a maximum of 8.3 achieved in 2009), and the stock of FDI in the sector “Finance & Insurance” is estimated at more than 35% of GDP, *i.e.* more than 40% of all FDI inflows.

Table 1. Weight of tourism in Cyprus

	2000	2004	2009	2012
Tourist revenue				
In millions of €	2 040,1	1 678,4	1 493,2	1 926
In % of GDP	20,5	13,3	8,9	10,8
By tourist (in €)	759	715	697	781
In % of services exports	44,8	32,6	25,0	26,8
Tourists (1000s of people)	2 686	2 349	2 141	2 465

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

Table 2. Weight of the banking sector in Cyprus

	2007	2008	2009	2010	2011	2012
Banking assets						
In billions of €	92,9	118,1	139,4	135,0	131,6	128,1
Relative to GDP	5,8	6,9	8,3	7,8	7,3	7,2
Stock of FDI in the Finance and Insurance sector						
In billions of €						6,4
In % of GDP						35,6
In % of total FDI						41,6

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

As major sources of wealth for the Cypriot economy, these two sectors have played an important role by, at least until 2007,

compensating (partially) the considerable deficit in the balance of payments, which has risen continuously since the early 1990s and fluctuated at around 30% of GDP since 2000 (Table 3). The “fuel” bill has been an increasing burden on imports into Cyprus, mainly due to higher oil prices: the energy bill has tripled over the last decade, rising from 461 million euros in 2000 to 1.4 billion in 2011. As a percentage of GDP, the rise in energy costs has also been very visible, as it has shot up from 5% of GDP in 2000 to 8% in 2011.

Reducing the size of the financial sector therefore raises the question of a new growth model for the Cypriot economy, *i.e.* its “industrial conversion”.

Table 3. Extract from the balance of payments of Cyprus

In millions of € (unless stated otherwise)

		2000	2004	2007	2008	2009	2010	2011
Balance of goods								
Exports	Total	1 011	936	1 083	1 190	971	1 137	1 404
	o/w “re-exports”	600	521	578	643	491	570	777
Imports	Total	4 104	4 578	6 353	7 367	5 692	6 517	6 311
	o/w “fuels”	461	503	895	1 247	880	1 157	1 381
Exports - Imports	Total	-3 093	-3 641	-5 271	-6 176	-4 721	-5 381	-4 907
	Total (% of GDP)	-31 %	-29 %	-33 %	-36 %	-28 %	-31 %	-27 %
Balance of services								
Exports	Total	4 552	5 147	6 579	6 538	5 779	6 049	6 262
Imports	Total	1754,40	2 201	2 841	2 937	2 416	2 467	2 676
Exports - Imports	Total	2 797	2 946	3 739	3 601	3 363	3 583	3 586
	Total (% of GDP)	28 %	23 %	24 %	21 %	20 %	21 %	20 %
Balance of goods and services								
Exports - Imports	Total	-295	-696	-1 532	-2 575	-1 358	-1 798	-1 321
	Total excl. “fuels”	165	-192	-637	-1 328	-479	-641	60
	Total (% of GDP)	-3 %	-6 %	-10 %	-15 %	-8 %	-10 %	-7 %
	Total excl. “fuels” (% of GDP)	2 %	-2 %	-4 %	-8 %	-3 %	-4 %	0 %

Source: Office statistique national, Eurostat et banque centrale de Chypre. Calculs des auteurs.

The temptation to exit the euro

The plan decided by the Troika undermines the island’s growth model by penalizing the country’s hyper-financialization, and condemns it to years of recession. To avoid a long convalescence, the idea of leaving the euro zone has taken

root, as it did in Greece. However, leaving the euro zone is far from a panacea. Regaining monetary sovereignty undeniably offers certain advantages, as is described by C. Antonin and C. Blot in their note, [Comparative study of Ireland and Iceland](#): first, an internal devaluation (through lower wages) would not be as effective as an external devaluation (through exchange rates); second, fiscal consolidation is less costly when it is accompanied by a favourable exchange rate policy. Nevertheless, given the structure of the Cypriot economy, we do not think that leaving the euro is desirable.

In fact, upon leaving the euro, the Central Bank of Cyprus would issue a new currency. Assuming it remains convertible, this currency would depreciate vis-à-vis the euro. By way of comparison, between July 2007 and December 2008 the Icelandic krona lost 50% of its value vis-à-vis the euro. Such a depreciation would have two consequences:

– One, an improvement in competitiveness (the real exchange rate has appreciated by 10% since 2000), which would boost exports and help reduce the deficit in the balance of trade in goods and services (Table 1). Since the accession of Cyprus to the European Union in 2004, this balance has deteriorated as a result of several factors: first, the slowing of inflation from 2004 related to pegging the exchange rate to the euro, which encouraged the growth of real wages at a higher rate than productivity gains; and second, the boom in bank lending, with the substantial decline in risk premiums on loans as a result of accession to the EU [9]. Consumption was boosted, the competitiveness of the Cypriot economy deteriorated, and imports increased. Would exiting the euro reverse this trend? This is the argument of [Paul Krugman, who supports Cyprus leaving the euro zone](#) by evoking a tourist boom and the development of new export-oriented industries. However, according to our calculations, a 50% depreciation in the real exchange rate would result in an increase in the value of exports of 500 million euros, including 150 million from

additional tourism revenue. [10] As for imports, they are weakly substitutable, as they are composed of energy and capital and consumer goods. Given the weakness of the country's industries, Cyprus will not be able to undertake a major industrial restructuring in the short or medium term. There are therefore limits to improvements in the trade balance. Furthermore, inflation would increase, including through imported inflation, which would lead to a fall in consumer purchasing power and mitigate any competitiveness gains.

– In addition, the devaluation would substantially increase the burden of the outstanding debt, but also of private debt denominated in foreign currency. Net foreign debt in Cyprus is low, at 41% of GDP in 2012. In contrast, public debt reached 70% of GDP, or 12.8 billion euros. 99.7% of the public debt is denominated in euros or in a currency that is part of the European Exchange Rate Mechanism (and thus pegged to the euro), and 53% of this debt is held by non-residents. In addition, the deficit was 6.3% of GDP. If Cyprus no longer had the euro, it would without doubt default on part of its public debt, which would temporarily deprive the country of access to foreign capital, and thus require the kind of violent fiscal consolidation that Argentina went through in 2001.

The exploitation of natural gas resources

The crisis in Cyprus raises the question of the natural gas discoveries in the south of the island in the early 2000s. According to the US Geological Survey, the Levant Basin located between Cyprus and Israel could contain 3,400 billion cu.m of gas resources. By way of comparison, [the entire EU has 2,400 billion cu.m](#) (mainly in the North Sea).

Cyprus thus has *a priori* a major natural gas bonanza, even if all of the deposits are not located in its Exclusive Economic Zone (EEZ). At present, only one out of the twelve parcels of land belonging to the Cypriot EEZ has been subject to

exploratory drilling, and in December 2011 a deposit of 224 billion cu.m of natural gas was discovered. According to the Government of Cyprus, the value of this field, called Aphrodite, is estimated at [100 billion euros^{\[11\]}](#). The exploration of the other eleven parcels belonging to the Cypriot EEZ could prove successful (or even very successful) in terms of natural gas resources. As the licenses for the exploration of these eleven parcels are in the process of being awarded by the Cypriot authorities, the EU could have used the (sad) occasion of the rescue package to secure a portion of the aid granted to Cyprus on its gas potential. Why did the EU not seize on such an occasion?

For the EU, the discovery of the natural gas reserves is good news, in the sense that the exploitation of these deposits will help it to achieve the energy diversification that it values so highly. However, several problems have arisen, problems that darken the prospects for exploiting the gas fields in the very near future. First of all, the discovery of gas reserves in the Levant basin has revived tensions with Turkey, which occupies the northern part of the island of Cyprus and which believes it has rights to the exploitation of the fields. The growing number of Turkish military manoeuvres reflects an effort to impose its presence in the areas being surveyed and could lead to an escalation of violence in the region, especially since the Greek-Cypriot authorities (the southern part) have been working with Israel to defend the gas fields. [\[12\]](#) Second, even assuming that the Greek-Turkish dispute is resolved, the exploitation of the gas will require heavy investment in infrastructure, in particular the construction of an LNG tanker whose cost is estimated at 10 billion euros. Finally, there will be no immediate return on the investment, as it will take at least eight years to put in place the necessary infrastructure. In these conditions, it is understandable why the EU did not take the opportunity to secure some of the aid to Cyprus against these gas resources: exploitation is still too uncertain and, in any case, the

horizon is too distant (given the immediacy required for a response to the crisis).

Furthermore, the EU would likely wind up in an awkward situation vis-à-vis several countries. If the EU supports Cyprus in the gas dispute, this comes down to supporting Israel, at the very time that the EU is holding negotiations on Turkey's membership and is trying to build good relations in the region, including with the regimes that have emerged from the "Arab Spring". In addition, two pipeline projects are already in competition: the South Stream project, linking Russia to Western Europe by 2015, and Nabucco, connecting Iran, via Turkey, to Western Europe by 2017. A new gas pipeline connecting the Cypriot fields to the European continent would further reduce Russia's bargaining power, by shifting the centre of gravity of natural gas southwards. This would promote greater dispersion and intensify geopolitical divisions in Europe, between a Northern Europe (including Germany) supplied by Russia and a Southern Europe dependent on the Middle East and Turkey.

Conclusion

If in the immediacy of the crisis the EU has made the right choice (that of the "bad" and "good" bank), the question is posed in the medium / long term of a new growth model for the Cypriot economy. Given the comparative advantages of Cyprus, the exploitation of natural gas seems to offer the only serious solution for the economy's conversion. However, for this strategy to be achievable, the EU will have to take a clear position in favour of Cyprus in the Greek-Turkish dispute.

Not only would the exploitation of the gas bring Cyprus energy self-sufficiency, it would also constitute a major source of revenue for the island. Energy costs would cease being a burden on the balance of payments (Table 1). This is especially important, because, even though tourism (another

pillar of the economy) has provided a stable (non-cyclical) source of income since 2000, it is not immune to geopolitical events in the region or to new competition over tourist destinations, in particular from the “Arab Spring” countries.

Consider this simple calculation. Suppose Cyprus manages to maintain its tourism revenues at the level of 2 billion euros (an assumption that, despite the caveats outlined above, is nevertheless realistic); in the absence of industrial restructuring, if the share of the banking sector in the economy is halved (as desired by the Troika and common sense), then Cypriot GDP would return to its 2003 level, or slightly less than 12 billion euros. And GDP per capita would fall by about a third...

Industrial reconversion is thus important for the Cypriot economy, just as for other economies in crisis... except that Cyprus has Aphrodite.

[1] See [Henri Sterdyniak and Anne-Laure Delatte, “Cyprus: a well-conceived plan, a country in ruins...”](#), OFCE blog, March 2013.

[2] See Céline Antonin, [Would returning to the drachma be an overwhelming tragedy?](#), OFCE Note no. 20, 19 June 2012.

[3] For more on the dithering on the rescue plan, see [Jérôme Creel, “The Cypri-hot case!”](#), OFCE blog, March 2013.

[4] These loans, granted via Emergency Liquidity Assistance (ELA), amount to 9 billion euros.

[5] Article 63 of the Treaty of the European Union prohibits restrictions on the movement of capital, but Article 64b authorizes Member states to take control measures for reasons of public order or public safety.

[6] “If the bank can’t recapitalize itself, then we’ll talk to the shareholders and the bondholders. We’ll ask them to contribute in recapitalizing the bank. And if necessary the uninsured deposit holders”, statement by Jeroen Dijsselbloem, 25 March 2013, to the *Financial Times*.

[7]

<http://www.revue-banque.fr/risques-reglementations/breve/les-c-reanciers-des-banques-mis-contribution>

[8] The tourist revenue of Cyprus depends in the main on tourists from Britain (43% in 2011), Russia (14%), Germany and Greece (6.5 % each).

[9] On the factors worsening the current accounts, see [Natixis, Retour sur la crise chypriote, novembre 2012](#).

[10] Estimation made using the elasticities calculated by the [IMF](#).

[11] Not far from Aphrodite, 700 billion cu.m of deposits were discovered in the Israeli EEZ, proof that the region is rich in natural gas.

[12] The tensions between Cyprus (southern part) and Israel were resolved (peacefully) by the signing of a treaty in December 2010 defining their respective exclusive economic zones (EEZ). The two entities also plan to cooperate in the construction of common infrastructures to exploit the gas. See [the analysis of Angélique Palle](#) on the geopolitical consequences of the discovery of these natural gas resources in the Levant basin.

And what if the austerity budget has succeeded better in France than elsewhere? [1]

By [Mathieu Plane](#)

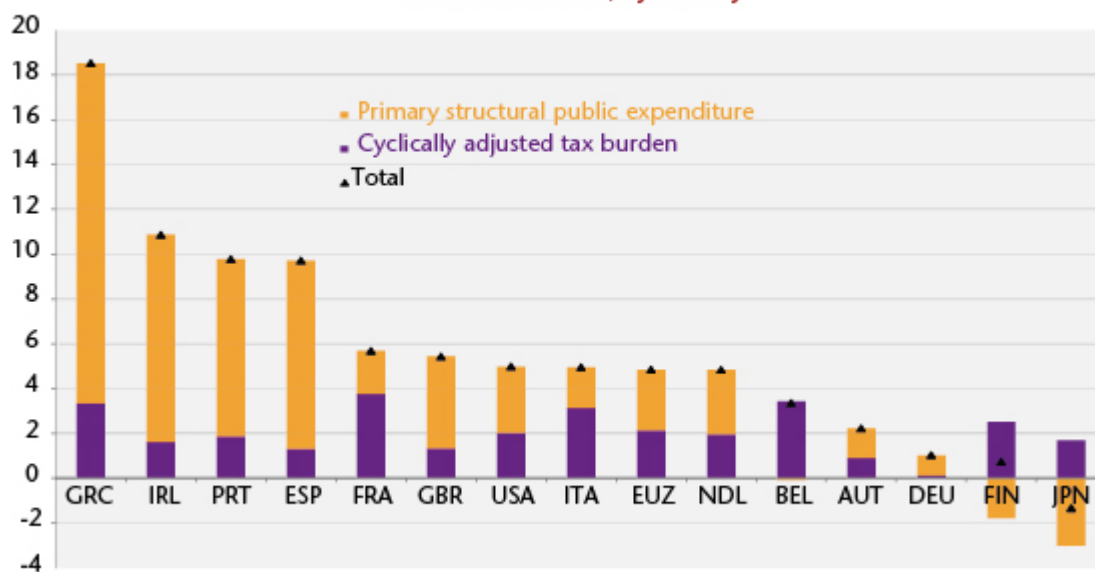
Faced with a rapid and explosive deterioration in their public accounts, the industrialized countries, particularly in Europe, have implemented large-scale austerity policies, some as early as 2010, in order to quickly reduce their deficits. In a situation like this, several questions about France's fiscal policy need to be examined:

- First, has France made a greater or lesser fiscal effort than other OECD countries to deal with its public accounts?
- Second, is there a singularity in the fiscal austerity policy implemented by France and has it had more or less effect on growth and the level of unemployment?

With the notable exception of Japan, between 2010 and 2013 all the major OECD countries implemented policies to reduce their primary structural deficits [2]. According to the [latest OECD figures](#), these policies represented a fiscal effort of about 5 percentage points of GDP over three years on average in the euro zone, the United States and the United Kingdom. In contrast, the differences within the euro zone itself were very large: they range from only 0.7 percentage points in Finland to more than 18 points in Greece. Among the major industrialized countries of the OECD, France is, after Spain, the country that has made the greatest fiscal effort since 2010 from a structural viewpoint (5.7 percentage points of GDP over three years). In the post-World War 2 era, France has never experienced such a brutal and sustained adjustment in its public accounts. For the record, the budget effort that took place in the previous period of sharp fiscal

consolidation from 1994 to 1997 was twice as small (a cumulative negative fiscal impulse of 3.3 GDP points). Between 2010 and 2013, the cyclically adjusted tax burden increased in France by 3.8 GDP points, and the structural effort on public spending represented a gain of 1.9 GDP points over four years (Figure 1). Among the OECD countries, it was France that made the greatest cyclically adjusted increase in the tax burden in the period 2010-2013. Finally, from 2010 to 2013, the structural effort to reduce the public deficit broke down as follows: two-thirds involved an increase in the tax burden and one-third came from public spending. This breakdown is different from that observed on average in the euro zone, where the fiscal effort over the period 2010-13 involved a nearly 60% reduction in public expenditure, rising to over 80% in Spain, Portugal, Greece and Ireland. In contrast, in Belgium, the entirety of the fiscal effort came from a higher tax burden. And in the case of Finland, primary structural public spending in points of potential GDP rose over the period 2010-2013, which was more than offset by the increase in the tax burden.

Figure 1. Contribution of each component to the change in the primary structural balance from 2010 to 2013, by country

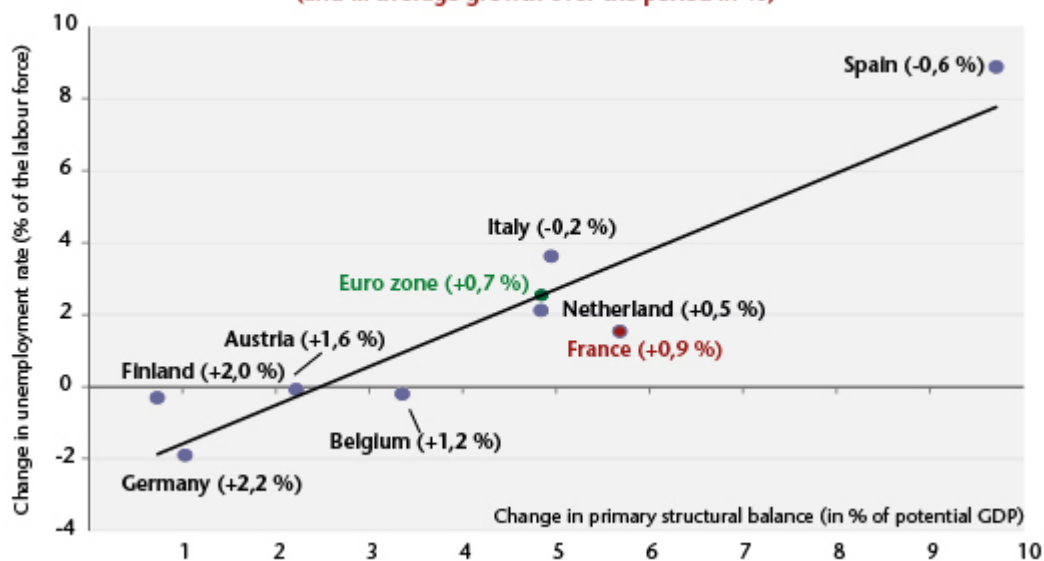


Sources: OECD, OFCE calculations.

While France's substantial budgetary efforts have undeniably had a negative impact on economic activity and employment, it

is nevertheless true that the budget decisions of the various governments since 2010 appear to have affected growth and the labour market relatively less than in most other countries in the euro zone. Within the euro zone-11, from 2010 to 2013 only four countries – Germany, Finland, Austria and Belgium – experienced average growth of over 1% per year, with unemployment rates that not only did not increase, but occasionally even fell. However, these are also the four countries that made the smallest reductions in their structural deficits over this period. France, on the other hand, is among the countries that made the greatest structural effort since 2010, and it has simultaneously managed to contain the rise in unemployment to some extent. Indeed, compared with the Netherlands, Italy and the euro zone average, France’s fiscal policy was more restrictive by about 1 GDP point from 2010 to 2013, yet the unemployment rate increased by 40% less than in the Netherlands, 60% less than the euro zone average and more than two times less than in Italy. Likewise, growth in France was higher on average over this period: 0.9% per year, against 0.5% in the Netherlands, 0.7% in the euro zone and -0.2% in Italy.

Figure 2. Change between 2010 and 2013 in the primary structural balance and the unemployment rate (and in average growth over the period in %)



Sources: OECD Economic Outlook, November 2012; OFCE calculations.

Why has the French fiscal contraction had less impact on growth and employment than in most other countries? Beyond the

economic fundamentals, some evidence suggests that the budget decisions of the successive governments since 2010 may have led to fiscal multipliers that are lower than in the other countries. After Finland and Belgium, France is the country where public spending played the smallest role in reducing the structural deficit. As illustrated by recent studies, in particular the IMF study and the article signed by economists from the central banks in Europe and the U.S., the European Commission, the OECD and the IMF, targeting fiscal adjustment through raising the tax burden rather than cutting public spending has given France smaller short-term fiscal multipliers than those observed in countries that have made the opposite choice (Greece, Portugal, Ireland and Spain). In the case of France, nearly 50% of the fiscal adjustment was achieved by an increase in the direct taxation of household and business income (Table 1). And as has also been the case for the United States, Belgium and Austria, which achieved between 50% and 75% of their fiscal adjustment by increasing direct taxation, it seems that these countries have also done best at maintaining their growth in the face of the budget cuts. Conversely, the ones that have used this lever the least in their fiscal adjustments are the southern European countries and the Netherlands.

Table. Contribution of each component to the change in the primary structural balance between 2010 and 2013, by country

In % of potential GDP															
	GRC	IRL	PRT	ESP	FRA	GBR	USA	ITA	EUZ	NLD	BEL	AUT	DEU	FIN	JPN
Primary structural balance (PSB)															
(= a + b)	18,5	10,9	9,8	9,7	5,7	5,4	5,0	4,9	4,8	4,8	3,4	2,2	1,0	0,7	-1,3
Cyclically adjusted tax burden (a)	3,3	1,6	1,9	1,3	3,8	1,3	2,0	3,1	2,1	2,0	3,4	0,9	0,1	2,5	1,7
o/w increase in direct taxes on household and business income	1,5	3,2	1,9	1,2	2,7	0,0	2,4	1,2		0,8	1,7	1,7	0,1	0,6	0,9
Primary public spending (b)	15,2	9,2	7,9	8,4	1,9	4,1	3,0	1,8	2,7	2,9	-0,1	1,3	0,9	-1,8	-3,0
Contribution of primary public spending to the change in the PSB	82	85	81	87	34	76	59	36	56	60	-2	59	89	-242	225

Sources: OECD Economic Outlook, November 2012; OFCE calculations.

[\[1\]](#) This post makes use of certain parts of the article

published in [Alternatives Economiques, M. Plane, "L'austérité peut-elle réussir en France ?", Special issue no. 96, 2nd quarter 2013.](#)

[2] The primary structural deficit measures the structural fiscal effort made by general government (*les administrations publiques*). It corresponds to the public balance, excluding interest charges, that would be generated by the government if the GDP of the economy were at its potential level. This measure is used to adjust the public balance for cyclical effects.

Zero interest loans: only for the rich?

By Pierre Madec

On 1 January 2013, a new version of the zero-interest loan (*prêt à taux zéro – PTZ*) came into force. It is more restrictive than previous versions, with lower eligibility ceilings and a sharper focus on new housing (and old “HLM” council housing). Here we review the measure’s possible consequences.

Given the great pressure on today’s rental market ([Le Bayon, Madec and Riffart, 2013](#)), the goal of facilitating access to homeownership for first-time buyers with low down payments is commendable. Nevertheless, some questions need to be asked: are the poorest households the primary beneficiaries? Does a

PTZ loan trigger the purchase of a first principal residence (an incentive effect) or does it simply accompany the purchase (a windfall effect)? Has the development of PTZ loans and their long-term implementation significantly helped expand supply on the market for new properties? And is the budgetary expenditure associated with the measure cost-effective in light of the overall results?

Established in 1995 to facilitate access to homeownership for poorer households, zero interest loans have evolved since then along with budgetary constraints and political decisions. In 2005, the scheme, previously reserved for the purchase of a new home (or an existing home needing extensive renovation), was extended to include the acquisition of existing homes with no conditions on renovation in order to increase homeownership in areas with a shortage of land (including Paris). This led to doubling the number of PTZ loans granted in 2005. Similarly, in 2011, the removal of eligibility ceilings allowed the programme to set a record with the grant of nearly 352,000 PTZ loans. In the context of the fiscal and real estate crisis, the reappearance in 2012 of ceilings on income and the elimination of old dwellings (excluding HLM housing) from the programme's eligibility list reduced the number of PTZ loans to a historically low level (64,000).

On paper, the principle of this “reimbursable non-interest-bearing loan” is simple: in return for the agreement of a loan at zero interest, the banks benefit from a tax credit in the amount of the uncollected interest. This loan, which is limited to a certain loan-to-value ratio [\[1\]](#), must be associated with a mortgage, or principal loan, and can therefore be considered as a personal contribution during the acquisition of the principal residence, thus at the time the principal loan is granted.

In fact, calculating the volume of PTZ loans granted is complex, as it involves [ceilings on income](#) and on the [transaction amounts](#), which depend on the geographical area and

the loan-to-value ratio. Similarly, the terms of repayment (the duration and grace period) are defined based on membership in an “[repayment bracket](#)” (*tranche de remboursement*) that is calculated based on the household’s resources and composition.

Are PTZ loans stimulating the supply of housing on the market for new properties?

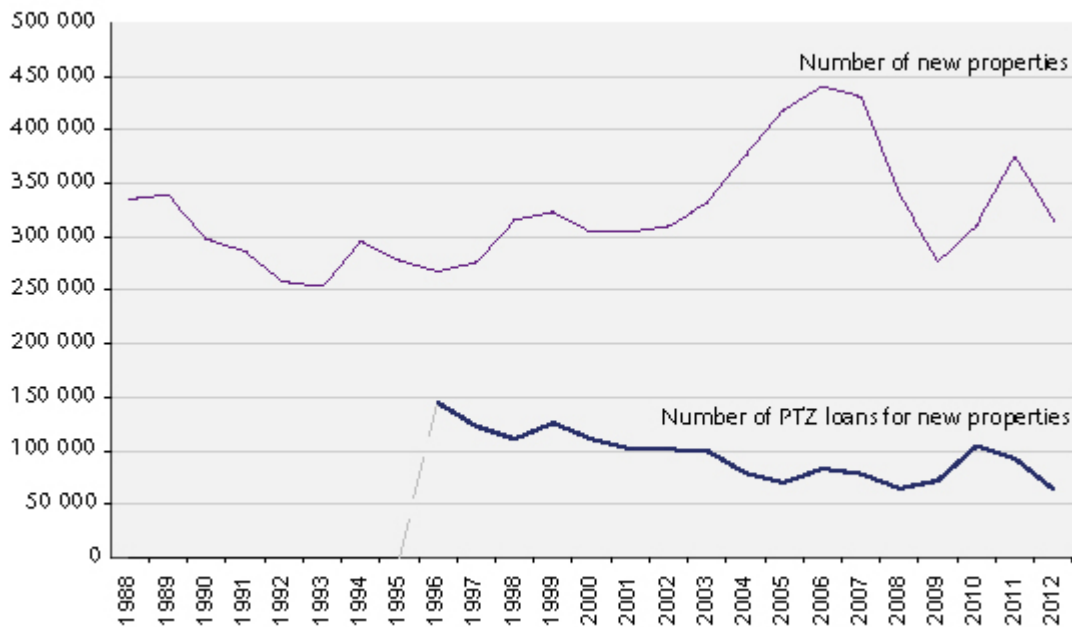
One of the stated objectives when creating the programme was to support and boost a sluggish market for new properties. It is actually difficult to assess the impact of PTZ loans on the construction market. Observing the evolution of the number of dwellings constructed before and after the implementation of PTZ loans (Figure 1), it does not appear that the 150,000 PTZ loans granted in 1996 had a significant impact on the volume of new housing units. From this quick observation seems to emerge the idea that even without the programme, and taking into account the rather mild economic situation, the housing market would have been equally dynamic. Similarly, the growth observed on the new property market over the period 1999-2007 is not attributable to the programme to facilitate homeownership [\[2\]](#).

According to the latest available statistics ([SGFGAS 2012](#)), as with incentive schemes for rental investment ([Madec 2013](#), [Levasseur 2011](#)), the zones established during the implementation of PTZ loans leave it very difficult to direct investment into the areas under the greatest pressure. Thus, in the third quarter of 2012, more than half of PTZ loans were granted for purchases in Zone C, that is to say, the area least susceptible to market pressures (against 15% for Zone A [\[3\]](#)). This is largely explained by the extreme scarcity (and high cost) of land in Zones A and B. It was in order to end this form of geographical discrimination that in 2005 the system was opened to old housing. Over the period 2005-2011, more than a million PTZ loans were granted for the acquisition of an existing dwelling, thereby betraying one of the initial

objectives of the programme.

Finally, despite a willingness to promote high environmental quality housing, including through the provision of higher loan-to-value ratios for energy-efficient housing (BBC) [4], the PTZ loans have played only a small role in the construction of BBC housing, as in the third quarter of 2012 two-thirds of the loans granted were for the purchase of housing that does not meet BBC standards.

Figure. Number of new properties built and of PTZ loans granted



Sources : Minister of Housing, SOFGAS.

Do PTZ loans facilitate homeownership for poorer households?

One of the main criticisms of PTZ loans is the poor quality of the targeting. Whereas the purpose of the programme is to help households in the greatest difficulty by financing an initial down payment, the particularly high level of the income ceilings (when they are not simply eliminated entirely as in 2011) has meant eligibility for households with no *a priori* need for the State in order to acquire property. For example, the eligibility ceiling in 2012 was 43,500 euros annually for one person wishing to acquire a principal residence in Zone A. This ceiling made 90% of households in the Paris region

eligible for PTZ loans (source: INSEE) [\[5\]](#).

Furthermore, numerous studies have attempted to measure the impact of PTZ loans on household financing capacity ([ANIL 2011](#), [Beaubrun-Diant 2011](#), [Gobillon and Le Blanc 2005](#), [Thomas and Grillon 2001](#)). Gobillon *et al.* thus concluded that PTZ loans “trigger the purchase” for only 15% of homebuyers. In other words, according to the model proposed by the authors, 85% of households have access to the property with or without the PTZ. Similarly, recent studies on the profile of homebuyers ([Le Bayon, Levasseur et Madec 2013](#), [Babès Bigot Hoibian 2012](#), [INSEE 2010](#)) highlight how it is becoming increasingly difficult for poorer households to purchase a home. Thus, according to Le Bayon *et al.*, households in the lowest quartile of living standards, the households targeted by the homeownership programme, have seen their chance of acquiring a principal residence halved between 2004 and 2010. In view of these various results, it seems that the PTZ loan programme is having difficulty, at least in its earlier versions, playing a role in helping low-income households to become homeowners. This conclusion may need to be nuanced, however, if we look at the latest statistics provided by the SGFGAS. According to these data, workers and employees accounted for 25% and 33% respectively of the recipients of PTZ loans in the third quarter of 2012. Similarly, one out of three recipients belonged to the lowest “repayment bracket”. However, as the calculation of these brackets takes into account particularly high income ceilings, membership in the first repayment bracket is not really equivalent to meeting “poverty criteria”.

Finally, by increasing demand for new housing on a market with low supply elasticity and by allowing many households to acquire more expensive housing, programmes to assist homeownership have long been reproached for their inflationary effects ([ANIL, 2002](#)).

The PTZ programme: how much does it cost?

For 2012, the cost to the State for the PTZ programme was 1.34 billion euros. Given the number of beneficiaries, this may seem expensive, but, like all public assistance programmes, it needs to be analyzed in terms of efficiency.

A quick assessment can be made of the impact of the PTZ programme on housing investment. To estimate the multiplier effect of the PTZ programme in 2012, we used the latest available statistics (SGFGAS 2012) and made the following assumptions [6]:

- 50% of the beneficiaries belonging to the lowest (*Tranche 1*) repayment bracket are what are called “triggered” households (*i.e.* 15 % of all beneficiaries);
- Thanks to a PTZ loan, “non-triggered” households increase the amount of their purchase by 3%.

Table. Breakdown of PTZ loans by repayment bracket and evaluation of the Impact on housing Investment

Repayment bracket	Membership	Membership in %	Average amount of the operation (€)	Average amount of PTZ loan granted	Impact of PTZ on investment in housing (billion €)
1	19 200	30	173 000	38 620	+ 1 711
2	6 400	10	178 000	32 077	+ 34
3	6 400	10	184 000	32 500	+ 35
4	6 400	10	183 000	29 000	+ 35
5	12 800	20	170 000	23 000	+ 65
6	12 800	20	188 000	21 000	+ 72
Total	64 000	100	179 000	29 800	+ 1 953

Source: SGFGAS, author's calculations.

Overall, therefore, according to our estimates and under the assumptions spelled out above, in 2012 the PTZ programme stimulated almost 2 billion euros in investment in housing at a tax cost of 1.3 billion euros. The multiplier effect was therefore 1.5. This is in the lower range of what has been observed in other countries with similar programmes (1.5 to 2). This multiplier could be much higher if households were targeted more rigorously. Indeed, for the “Tranche 1”

repayment bracket, under the above assumptions and considering that this segment accounts for half of the tax expenditure (a generous assumption), the multiplier is 2.6. However, we are still far from the optimal theoretical multiplier of 6 estimated by Gobillon and White [\[7\]](#).

What about the 2013 version of the PTZ?

To deal with the various criticisms that have been raised, on 1 January the government attempted to improve the conditions for access to the PTZ programme by:

- Reducing eligibility ceilings from 17% (in zone A) to 30% (in zone C);
- Freezing ceilings on the transaction cost in new housing and ex-HLM (council) housing;
- Lowering the loan-to-value ratios;
- Re-establishing repayment deferrals of up to 15 years for households in the lowest repayment bracket.

For the most part, these measures will help to target assistance for homeownership more accurately. However, some improvements could still be made. In 2013, the income ceilings for Zone A still include about 80% of inhabitants of the Paris region. In addition, the possibility of acquiring existing HLM council housing, which is potentially very energy-consuming, seems inconsistent with the promotion of new energy-efficient housing. For low-income households in high-demand areas, would it not be better to promote the purchase of housing that, while not new, has energy characteristics closer to what is required for new housing?

Likewise, re-establishing the principle of repayment deferrals of up to 15 years could prove objectionable. Indeed, it may lead to undermining the solvency of some households by reducing the duration of their principal loan. The banks, taking into account the deferral, tend to align the duration of the principal loan with the duration of the deferral in

order to avoid an excessive jump in the future monthly repayment. So, the deferral may on the contrary increase the risk of default, as, once the deferral is over, households may be hit by a surge in their monthly payments ([Bosvieux and Vorms, 2003](#)).

Finally, the freeze on transaction ceilings cannot be sustained given first, the growing gap that exists between the ceilings and market prices, and second, the continuous increase in construction costs resulting from the normative inflation experienced by the sector.

To conclude, it is important to take note of the existence of a debate over the very need for a programme to assist homeownership: should the State encourage, assist or finance homeownership for renters? Should taxpayers help renters to become homeowners, as with tax incentives for investment in rental housing? For the poorest households, who find it impossible to come up with a sufficient personal contribution for a purchase, it may seem reasonable to assume that the State is playing its role by helping the most vulnerable to follow the standard residential trajectory, from cohabitation with parents to rental and then ownership. For others, we cannot rule out the existence of significant windfall effects, as outlined above. To avoid these problems and improve the financial positions of the households originally targeted by the programme, a thorough overhaul of programmes to promote homeownership (social or otherwise) is essential.

[\[1\]](#) That is, a maximum percentage of the amount of the transaction.

[\[2\]](#) The new property market was, for the period under consideration, boosted strongly by programmes to stimulate rental investment (see Le Bayon *et al.* 2013).

[\[3\]](#) Paris, the near suburbs and part of the outer suburbs.

[4] In 2012, for purchases in Zone A, the loan-to-value ratio was 38% for new energy-efficient (BBC) housing versus 26% for non-BBC.

[5] For an annual income of 43,500 euros, assuming a rate of 3.2%, borrowing capacity came to an average of 260,000 euros (excluding the PTZ loan), *i.e.* a housing unit of at least 50 sq.m in the near Paris suburbs (excluding the communes bordering Paris).

[6] These assumptions are in accord with the results of the modelling proposed by Gobillon and Le Blanc (2005). The latter found a multiplier effect for the PTZ programme on the order of 1.1 to 1.3.

[7] This multiplier was estimated by assuming perfect targeting for the programme, that is, that all the beneficiaries are “triggered” households.

Cyprus: a well-conceived plan, a country in ruins...

By [Anne-Laure Delatte](#) and [Henri Sterdyniak](#)

The plan that has just been adopted sounds the death knell for the banking haven in Cyprus and implements a new principle for crisis resolution in the euro zone: banks must be saved by the shareholders and creditors without using public money. [1] This principle is fair. Nevertheless, the recession in Cyprus will be deep, and the new extension of the Troika's powers further discredits the European project. Once again the latest developments in the crisis are laying bare the deficiencies in euro zone governance. It is necessary to save the euro zone

almost every quarter, but every rescue renders the zone's structure even more fragile.

Cyprus never should have been accepted into the euro zone. But Europe privileged expansion over coherence and depth. Cyprus is a banking, tax and regulatory haven, which taxes companies at the rate of only 10%, while the balance sheet of its oversized banking system is nearly eight times its GDP (18 billion euros). Cyprus is in fact a transit hub for Russian capital: the Cypriot banks have about 20 billion euros in deposits from Russia, along with 12 billion euros in deposits of Russian banks. These funds, sometimes of dubious origin, are often reinvested in Russia: Cyprus is the largest foreign investor in Russia, to the tune of about 13 billion euros per year. Thus, by passing through Cyprus, some Russian capital is laundered and legally secured. As Europe is very committed to the principle of the free movement of capital and the freedom of establishment, it has simply let this go.

Having invested in Greek government debt and granted loans to Greek companies that are unable to pay due to the crisis, the island's oversized banking system has lost a lot of money and has fostered a housing bubble that burst, resulting in heavy losses. Given the size of the banking system's balance sheet, these losses represent a significant share of national GDP. The banking system is in trouble, and as a consequence the markets speculated against Cypriot government debt, interest rates rose, the country plunged into a recession, and the deficit deepened. In 2012, growth was negative (-2.5%); the deficit has reached 5.5% of GDP, the public debt has risen to 87% of GDP, the trade deficit stands at 6% of GDP, and the unemployment rate is 14.7%.

The country needed assistance both to finance itself and to recapitalize its banks. Cyprus requested 17 billion euros, the equivalent of its annual GDP. Ten billion euros of loans were granted, of which nine will be provided by the ESM and one by the IMF. From a financial point of view, the EU certainly did

not need that billion, which merely gives the IMF a place at the negotiating table.

In exchange, Cyprus will have to comply with the requirements of the Troika, *i.e.* reductions of 15% in civil servant salaries and 10% in spending on social welfare (pensions, family allowances and unemployment), the introduction of structural reforms, and privatization. It is the fourth country in Europe to be managed by the Troika, which can once again impose its dogmatic recipes.

Cyprus is to lift its tax rate on corporations from 10 to 12.5%, which is low, but Europe could not ask Cyprus to do more than Ireland. Cyprus must increase the tax rate on bank interest from 15 to 30%. This is a timid step in the direction of the necessary tax harmonization.

But what about the banks? The countries of Europe were faced with a difficult choice:

- helping Cyprus to save its banking system amounted to saving Russian capital with European taxpayers' money, and showed that Europe would cover all the abuses of its Member States, which would have poured more fuel on the fire in Germany, Finland and the Netherlands.

- asking Cyprus to recapitalize its banks itself would push its public debt up to more than 150% of GDP, an unsustainable level.

The first plan, released on 16 March, called for a 6.75% contribution from deposits of less than 100,000 euros and applied a levy of only 9.9% on the share of deposits exceeding this amount. In the mind of the Cypriot government, this arrangement had the advantage of not so heavily compromising the future of Cyprus as a base of Russian capital. But it called into question the commitment by the EU (the guarantee of deposits under 100,000 euros), which undermined all the banks in the euro zone.

Europe finally reached the right decision: not to make the people alone pay, to respect the guarantee of 100,000 euros, but to make the banks' shareholders pay, along with their creditors and holders of deposits of over 100,000 euros. It is legitimate to include those with large deposits that had been remunerated at high interest rates. It is the model of Iceland, and not Ireland, that has been adopted: in case of banking difficulties, large deposits remunerated at high rates should not be treated as public debt, at the expense of the taxpayers.

Under the second plan, the country's two largest banks, the Bank of Cyprus (BOC) and Laiki, which together account for 80% of the country's bank assets, are being restructured. Laiki, which was hit hardest by developments in Greece and which was more heavily involved in the collection of Russian deposits, has been closed, with deposits of less than 100,000 euros transferred to the BOC, which takes over Laiki's assets, while it also takes charge of the 9 billion euros that the ECB has lent it. Laiki customers lose the portion of their deposits over 100,000 euros (4.2 billion), while holders of Laiki equities and bonds lose everything. At the BOC, the excesses of deposits above 100,000 euros are placed in a bad bank and frozen until the restructuring of the BOC is completed, and a portion of these (up to 40%) will be converted into BOC shares in order to recapitalize the bank. Hence the 10 billion euro loan from the EU will not be used to resolve the banking problem. It will instead allow the government to repay its private creditors and avoid a sovereign bankruptcy. Remember that the national and European taxpayers are not called on to repair the excesses of the world of finance.

This is also a first application of the banking union. Deposits are indeed guaranteed up to 100,000 euros. As requested by the German government, the banks must be saved by the shareholders and creditors, without public money. The cost of bailing out the banks should be borne by those who have

benefited from the system when it was generating benefits.

From our viewpoint, the great advantage is ending the poorly controlled financial status of Cyprus. It is a healthy precedent that will discourage cross-border investment. It is of course regrettable that Europe is not attacking other countries whose banking and financial systems are also oversized (Malta, Luxembourg, the United Kingdom) and other regulatory and tax havens (the Channel Islands, Ireland, the Netherlands), but it is a first step.

This plan is thus well thought-out. But as was modestly acknowledged by the Vice-President of the European Commission, Olli Rehn, the near future will be very difficult for Cyprus and its people. What are the risks?

Risk of a deposit flight and liquidity crisis: unlike the initial plan, which called for a levy on all deposits, the new plan is consistent with reopening the banks relatively quickly. In fact, the banks are staying closed as long as the authorities fear massive withdrawals by depositors, which would automatically lead to a liquidity crisis for the banks concerned. However, as small depositors are not affected and large depositors have their assets frozen until further notice, it seems that the risk of a bank run can be ruled out. A problem will nevertheless arise when the large deposits are unfrozen. Their almost certain withdrawal will very likely result in a loss of liquidity for the BOC, which will need to be compensated by specially provided liquidity lines at the ECB. Some small depositors who take fright could also withdraw their funds. Similarly, holders of large deposits in other banks, although in less difficulty and thus not affected, could worry that the levies will be extended in the future and therefore try to move their money abroad. Cyprus remains at the mercy of a liquidity crisis. This is why the authorities have announced exceptional controls on capital movements when the banks reopen, so as to prevent a massive flight of deposits abroad. This is a novelty for the EU. But

the transition, which means shrinking the Cypriot banking sector from 8 times the island's GDP to 3.5 times, could well prove difficult and may have some contagion effects on the European markets, since the banks will have to sell a significant amount of assets.

Risk of a long recession: the halving of the size of the banking sector will not take place painlessly, as the entire economy will suffer: bank employees, service partners, attorneys, consultants, auditors, etc. Some Cypriot companies, along with some wealthy households, will lose part of their bank holdings.

However, the plan requires simultaneous fiscal austerity measures (on the order of 4.5% of GDP), structural reforms and the privatizations so dear to Europe's institutions. These austerity measures, coming at a time when key economic activity is being sacrificed, will lead to a lengthy recession. The Cypriots all have in mind the example of Greece, where consumption has fallen by more than 30% and GDP by over 25%. This shrinkage will lead to lower tax revenues, a higher debt ratio, etc. Europe will then demand more austerity measures. Seeing another country trapped in this spiral will further discredit the European project.

Some desire to pull out of the euro zone has been simmering since the beginning of the crisis in Cyprus, and there is little chance that it will die out now.

It is therefore necessary to give new opportunities to Cyprus (and to Greece and Portugal and Spain), not the economic and social ruin imposed by the Troika, but an economic revival involving a plan for industrial reconversion and reconstruction. For example, the exploitation of the gas fields discovered in 2011 on the south of the island could offer a way out of the crisis. It would still be necessary to finance the investment required to exploit them and generate the financial resources the country needs. It is time to

mobilize genuine assistance, a new Marshall Plan financed by the countries running a surplus.

Risk of chain reactions in the banking systems of other Member States: the European authorities must make a major effort at communications to explain this plan, and that is not easy. From this point of view, the first plan was a disaster, as it demonstrated that the guarantee of deposits of less than 100,000 euros can be annulled by tax measures. For the second plan, the authorities must simultaneously explain that the plan is consistent with the principle of the banking union – to make the shareholders, creditors and major depositors pay – while clarifying that it has a specific character – to put an end to a bank, fiscal and regulatory haven, and so will not apply to other countries. Let's hope that the shareholders, creditors and major depositors in the banks in the other Member States, particularly Spain, will allow themselves to be convinced. Otherwise significant amounts of capital will flee the euro zone.

Risk of weakening the banking union: the Cypriot banking system was of course poorly managed and controlled. It took unnecessary risks by attracting deposits at high rates that it used to make profitable but risky loans, many of which have failed. But the Cypriot banks are also victims of the default on the Greek debt and of the deep-going recession faced by their neighbours. All of Europe is in danger of falling like dominoes: the recession weakens the banks, which can no longer lend, which accentuates the recession, and so on.

Europe plans to establish a banking union that will impose strict standards for banks with respect to crisis resolution measures. Each bank will have to write a "living will" requiring that any losses be borne by its shareholders, creditors and major depositors. The handling of the Cyprus crisis is an illustration of this. Also, the banks that need capital, creditors and deposits to comply with the constraints of Basel III will find it harder to attract them and must pay

them high rates that incorporate risk premiums.

The banking union will not be a bed of roses. Bank balance sheets will need to be cleaned up before they get a collective guarantee. This will pose a problem in many countries whose banking sector needs to be reduced and restructured, with all the social and economic problems that entails (Spain, Malta, Slovenia, etc.). There will inevitably be conflicts between the ECB and the countries concerned.

Deposit insurance will long remain the responsibility of the individual country. In any event, it will be necessary in the future banking union to distinguish clearly between deposits guaranteed by public money (which must be reimbursed at limited rates and must not be placed on financial markets) and all the rest. This argues for a rapid implementation of the Liikanen report. But will there be an agreement in Europe on the future structure of the banking sector between countries whose banking systems are so very different?

The Cypriot banks lost heavily in Greece. This argues once again for some re-nationalization of banking activities. Banks run great risks when lending on large foreign markets with which they are not familiar. Allowing banks to attract deposits from non-residents by offering high interest rates or tax or regulatory concessions leads to failures. The banking union must choose between the freedom of establishment (any bank can move freely within the EU countries and conduct whatever activities it chooses) and the principle of liability (countries are responsible for their banking systems, whose size must stay in line with that of the country itself).

In the coming years, the necessary restructuring of the European banking system thus risks undermining the ability of banks to dispense credit at a time when businesses are already reluctant to invest and when countries are being forced to implement drastic austerity plans.

In sum, the principle of making the financial sector pay for its excesses is beginning to take shape in Europe. Unfortunately, the Cyprus crisis shows once again the inconsistencies of European governance: to trigger European solidarity, things had to slide to the very edge, at the risk of going right over the cliff. Furthermore, this solidarity could plunge Cyprus into misery. The lessons of the past three years do not seem to have been fully drawn by Europe's leaders.

[1] The over 50% reduction of the face value of Greek bonds held by private agents in February 2012 already went in this direction.

The Cypri-hot case!

By [Jérôme Creel](#)

In advance of a more in-depth study of the crisis in Cyprus and its impact on the euro zone, here are a few thoughts on the draft agreement reached last Monday morning, 25 March, between the Cypriot Presidency and some of the donors.

This [proposal](#) provides for the winding up of a private bank, Laiki, and shifting of its insured deposits (under 100,000 euros) to another private bank, the Bank of Cyprus, as part of its recapitalization. Deposits in the Bank of Cyprus in excess of 100,000 euros will be frozen and converted into shares. Ultimately, the Bank of Cyprus should be able to achieve a capital ratio of 9%, complying with applicable EU banking legislation. In exchange for these provisions and for an increase in taxes on capital gains and corporate profits, the

European institutions will contribute 10 billion euros to Cyprus. Bank deposits guaranteed under the rules in force in the EU will still be insured, while the increase in capital gains taxes will reduce the remuneration of deposits in Cyprus, which have been above the European average.

In one week, the negotiations between the Cypriot authorities, the IMF and Europe's institutions have led to radically different results. For the part of the rescue plan needed for the viability of the banking system, the Cypriot President was apparently faced with a choice between a levy on all depositors, including "small savers", and a bank failure that would entail financial losses only for shareholders, bondholders and "big savers" (those with deposits of over 100,000 euros). It thus took a week for the democratically elected representative of a Member State of the European Union to give in and uphold the interests of the many (the general interest?) over the interests of the few, a handful of bankers.

The March 25th draft agreement also included a very interesting reference to the issue of money laundering. Cypriot banks will undergo audits to better understand the origin of the funds they collect. This time it did not take a week, but rather years for members of the Eurogroup to deal formally with a basic question about the operation of the Cypriot economy. Beyond Cyprus itself, there is reason to wonder whether there isn't funny money in the EU too.

One final thought about the International Monetary Fund, the donor partner that together with the European Central Bank and the European Commission makes up the Troika. It seems that it set many of the requirements: should we conclude that the IMF has much more bargaining power than the ECB and the European Commission, that it is the leader of this Troika? If this is so, it would raise some problems: first, the ECB and the Commission are supposed to defend the interests of Europe,

which would not be the case if these two institutions were under the thumb of the IMF. Second, we should not forget that during the recapitalization of April 2009, the IMF received additional funds from the EU countries, which was a wise decision on their part if their representatives anticipated that soon they would need recourse to bailout funds, with the funds allocated to the IMF returning back to the EU in the form of loans. That said, having the IMF dictate drastic conditions for qualifying for bailout funds that have largely been contributed by from the EU itself is questionable, and would undermine the process of European integration.

How to reform the reduction on payroll taxes?

By Mathieu Bunel, Céline Emond, Yannick L'Horty

More than 20 billion euros are spent every year by the State to compensate the general exemptions from social security contributions, making this the leading employment policy plank in France, both in terms of the total budget and the numbers concerned – more than one employee out of two benefits from the reduction in contributions. In these times of fiscal pressure and the inexorable upward trend in unemployment, questions are being raised about the sustainability of such a scheme, whose scale, which was unified by the 2003 Fillon reform, consists of a reduction that shrinks as the wage rises, up to the level of 1.6 times the minimum wage (SMIC). At the level of the SMIC, the reduction comes to 26 points (28 points for firms with fewer than 20 employees).

In an article published in the [Revue de l'OFCE \(Varia, no.](#)

[126, 2012](#)), we evaluate the impact of a complete removal of the general exemptions as well as of a number of partial reforms of the thresholds for exemption from social security contributions, using the latest data suited to the analysis. In our estimate, the simple elimination of all general exemptions would lead to the destruction of about 500,000 jobs. We also explore the effects of reorganising the exemption thresholds, by screening a number of possibilities that would affect the various parameters that define the exemption arrangements. In every case, a reduction in the amount of exemptions would have a negative impact on employment, but the extent of the job losses would vary from simple to double depending on the terms of the reform. To ensure the least negative effect would require that the reductions in the exemptions spare the sectors that are most labour-intensive, which means better treatment for the exemption schedules that are most targeted at low wages. Since the goal is to improve the unemployment figures, it is important to concentrate the exemptions on lower wages, and thus to give a boost to the sectors that are richest in terms of labour.

However, concentrating exemptions too much in the vicinity of the minimum wage would increase the cost to employers of granting wage rises, which would be favourable neither to purchasing power nor to the quality of the jobs that condition future employment. While a new balance can always be sought in order to meet the urgent budget situation, to be sustainable it must be good for today's jobs without neglecting those of the future.

20 billion euros in reductions on employer payroll taxes on low-wages. But will it create jobs?

By [Eric Heyer](#) and [Mathieu Plane](#)

Every year the State spends nearly 1 percentage point of GDP, *i.e.* 20 billion euros, on general reductions in employer payroll taxes on low wages. It is thus legitimate to ask whether a programme like this is effective. A large number of empirical studies have been conducted to try to assess the impact of this measure on employment, and have concluded that it creates between 400,000 and 800,000 jobs.

As these estimates are performed using sector models, they do not take into account all the effects resulting from a policy of reduced social contributions on low wages, and in particular the impact of macroeconomic feedback, *i.e.* the effect of income gains, competitiveness gains and the financing of the measure.

In a recent study published in the [Revue de l'OFCE \(Varia, no. 126, 2012\)](#), we have attempted to supplement these evaluations by taking into account all the impacts resulting from a policy of reducing contributions on low wages. To do this, we performed a simulation of this measure using the OFCE's macro-econometric model, *emod.fr*.

We were able to break down the various impacts expected from these reductions on employment costs into two basic categories:

1. An overall "substitution effect", which breaks down into a macroeconomic capital-labour substitution, to which is

added what can be called an “assessment effect” linked to the targeting of the measure at low wages;

2. A “volume effect”, which can be broken down between rising domestic demand due to lower prices and higher payroll, competitiveness gains due to improved market share internally and externally, and the negative effect of the measure’s financing, whether that involves raising the tax burden (*prélèvements obligatoires*) or cutting public spending.

Based on our assessment, summarized in Table 1, the exemptions from employer social contributions on low wages lead to creating 50,000 jobs in the first year and about 500,000 at the end of five years. Of the 503,000 jobs expected within five years, 337,000 would be due to the overall substitution effect, with 107,000 linked to the macroeconomic capital-labour substitution and 230,000 to the “assessment effect” linked to the sharp reduction in labour costs on low wages. In addition, 82,000 jobs are generated by the addition to household income and 84,000 by competitiveness gains and the positive contribution of foreign trade to the change in GDP. On the other hand, the “volume effect” on employment becomes negative if the measure is financed *ex post*: increasing a representative mix of the fiscal structure reduces the overall impact of the measure by 176,000 jobs at 5 years; reducing a representative mix of the structure of public spending reduces employment by 250,000 at 5 years.

Table 1. Impact on employment of the exemptions on employer social security contributions on low wages without taking into account the reaction of our trade partners

1000s

Effect at...	Substitution effect		Volume effect		Total w/o financing	Ex post financing		Total w/ financing
	Capital/Labour	Assessment effect	Domestic demand	Competitiveness		Tax mix	Public spending mix	
...1 year	4	24	13	9	50	-26	-71	24 -21
...5 years	107	230	82	84	503	-176	-250	327 253

Source: OFCE calculations, *e-mod.fr*.

Some of the jobs created come from competitiveness gains related to taking market share from our trading partners due to lower prices of production following the reduction in labour costs. This price-competitiveness mechanism works only if, first, firms pass on the reductions in social contributions in their prices of production, and second, our trading partners are willing to lose market share without a fight. We therefore simulated a polar opposite case in which it is assumed that our trading partners respond to this type of policy by enacting similar measures, which would negate our external gains.

While this does not modify the impact on employment related to the “substitution effect”, this assumption does change the “volume effect” of the measure, eliminating 84,000 jobs from gains in market share and increasing the negative effect of *ex post* financing due to the measure’s multiplier effect on weaker activities. In total, in the scenario in which the measure is funded *ex post* and does not allow gains in competitiveness, the exemptions on employer social security contributions on low wages would create between 69,000 and 176,000 jobs within five years, depending on how it is financed (Table 2). This result puts the initial figure of 500,000 jobs into perspective.

Table 2. Impact on employment of exemptions on employer social security contributions on low wages if our trade partners do adopt a similar policy

1000s

Effect at...	Substitution effect		Volume effect		Total w/o financing	Ex post financing		Total w/ financing
	Capital/Labour	Assessment effect	Domestic demand	Competitiveness		Tax mix	Public spending mix	
...1 year	4	24	13	0	41	-35	-79	6 -38
...5 years	107	230	82	0	419	-244	-350	175 69

Source: OFCE calculations, *e-mod.fr*.

The death throes of the “Confederation of Europe”?

By [Jacques Le Cacheux](#)

Will the institutions that the European Union has developed – from the Treaty of Maastricht in 1992, which created it and defined the roadmap that led to the launch of the euro in 1999, to the Treaty of Lisbon in 2009, which took up the main articles of the constitutional treaty that the French and Dutch had refused to ratify in referendums in 2005 – be sufficient to resolve the crisis facing the EU today? After five years of economic stagnation and nearly four years of persistent pressure on national debts, it had seemed that fears about the sustainability of the European Monetary Union had been appeased by the determination shown in early autumn 2012 by Mario Draghi, President of the European Central Bank, to ensure the future of Europe’s single currency at any cost. But the results of the recent general elections in Italy have once again unsettled the European sovereign debt markets and

revived speculation, while the euro zone has plunged back into a recession even as the wounds of the previous one lay still unhealed.

How much longer will we be content with mere expedients? Would it not be better to make a real institutional revolution, like the one undertaken between 1788 and 1790 by the framers of the Constitution of the United States of America, as they faced an acute crisis in the public debt of the Confederation and the confederated states? In his Nobel Lecture, which the OFCE has just published in [French](#), Thomas Sargent invites us to consider this through an economic and financial reading of this critical episode in the institutional history of the United States, and through a parallel with the current situation of the euro zone that some may find audacious, but which is certainly enlightening.

There are of course many differences between the situation of the former British colonies ten years after independence and the Member States of the European Monetary Union. But how is it possible not to see certain similarities, such as the inability to find a collective solution to the national public debt crises or the inanity of the agreement in February 2012 on the future EU budget? *Mutatis mutandis*, it is a question of fiscal federalism, as well as political, in one case as in the other.