

Social action, but no end of the crisis

Evaluation of the five-year economic programme (2012-2017)

By [Eric Heyer](#), [Mathieu Plane](#), [Xavier Timbeau](#)

The initial decisions of the five-year programme are coming amidst an extremely difficult and very uncertain economic situation. In a recent [OFCE Note](#) (No. 23 of 26 July 2012), we first analyze the macroeconomic context for François Hollande's five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. We evaluate both the cost to the public finances as well as the impact on economic activity, employment and the distribution of income. In part two, we analyze the public policy choices being given priority by the new government, including both those aimed at the young (generation contracts, jobs of the future), at some seniors (revision of the pension reform), and at the middle and lower classes (allowance for the start of school, boost to the minimum wage, Livret A bank accounts, rent control, revised taxation of overtime), as well as those intended to revive certain public expenditures that are deemed essential (public jobs in education, the justice system and the police in the "public finance" section, and public early childhood services).

François Hollande was elected President of the French Republic at a time when France and Europe are going through an unprecedented crisis. Unemployment in metropolitan France has increased by over 2 percentage points since the crisis began and is now (in ILO terms, 9.6% of the workforce in first quarter 2012) approaching the record levels of 1997 (10.5%). Gross domestic product per capita in terms of purchasing power has fallen since 2008 by 3%. If the growth trend for the five

years preceding the crisis had continued at that same rate from 2008 until early 2012, GDP per capita would now be 8% higher than it is. The current account has deteriorated during the crisis by 1.5 GDP points (25.7 billion euros, 10 billion of which is for the oil bill), thus worsening France's net balance of trade by 7.8 GDP points. The public debt increased by 577 billion (nearly 30 GDP points), and at the beginning of 2012 represented almost 90% of GDP. Industry has paid a heavy price for the crisis (almost 300,000 jobs lost), with all signs indicating that the job losses and closures of industrial sites might be irreversible.

Yet this dire situation, which can be chalked up to the crisis that began in 2008, is not over. Due to the impact of austerity policies implemented at a time of panic at seeing financing of the public debt dry up, the sovereign debt crisis is threatening the euro zone with a prolonged recession in 2012 and 2013. And the even worse scenario looming on the horizon – the disintegration of the euro zone – would transform the threats of recession into the risk of a major depression.

Assessments of the situation differ depending on the elements available. Some measures have been implemented by decree, while others are being discussed by the legislature, but the proposed bills do permit a quantitative analysis. Others are in the planning stage, with the main trade-offs still to be made, so our assessment tries to explore the main points.

Our assessment of the economic strategy for the five-year programme does not stop there. The outlines of the premises for a strategy to end the crisis can now be seen. The deficit reduction commitments and the initial steps taken in this direction in the budget packages in July 2012, such as those announced during the budget orientation debate of June 2012, point to a strategy whose first step is the achievement of a reduction in the public deficit to 3% of GDP by the end of 2013, regardless of the cost. Based on this fiscal virtue,

this amounts to a strategy to end the crisis by stabilizing the state of the public accounts, thereby reassuring the financial markets and other economic agents and establishing the conditions for a strong future recovery. This strategy is based on cutting public expenditures and raising taxes (see the "public finance" section, government tax proposals and the taxation of the oil companies).

This strategy for ending the crisis is risky, to say the least, because it does not take full account of the crisis facing Europe today. It might be justified if we were already on course to end the crisis and if the point were simply to set priorities. But Europe remains in a situation of extreme uncertainty, living in the expectation of a massive failure of one or another Member State in the euro zone, fearing the collapse of this or that financial institution, and suffering the consequences of a spiral of austerity that is being fueled by rising sovereign interest rates. In this situation, everything is coming together to strengthen the existence of a liquidity trap and to generate high fiscal multipliers. Given this, *ex ante* reductions in the deficit through tax hikes and spending cuts is weighing heavily on activity, and thus limiting or even cancelling out any actual deficit reductions. The factors pushing up the public debt are not being reversed, and the reduction in activity is heightening the risk that the unsustainable private debt will be socialized. The increase in sovereign interest rates is being fueled by an inability to meet deficit reduction targets and by rising public debt, and is thus pushing public deficits higher, forcing even more austerity.

One response to this dynamic that is bringing about the collapse of the euro would be one form or another of pooling public debts in Europe. This would require relatively complete control of the budgets of member countries by a federal body with strong democratic legitimacy. A response like this would therefore mean "more Europe", and would make it possible to

define “more moderate” austerity policies for France as well as its major trading partners. It would make putting an end to involuntary mass unemployment and the liquidity trap prerequisites to an improvement in the public finances. It would also make it possible to ensure the sustainability of public finances without leading to the lost decades that are now gestating.

In the first part of the Note, we analyze the macroeconomic context for François Hollande’s five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. The value of the fiscal multiplier is a critical parameter, and we show that the current strategy is valid only if the multipliers are low (*i.e.* on the order of 0.5). However, a slew of empirical evidence indicates that, in the exceptional situation we are experiencing today, the budget and fiscal multipliers may be larger than 0.5 (between 1 and 1.5, see the Note). We detail in a second part the measures taken in the Supplementary Budget Act of July 2012 (for 2012) and the elements outlined in the budget orientation debate in preparation for the Budget Act for 2013 and for the period 2012-2017. To succeed in reducing the public deficit to 3%, it seems that there must be over 10 billion euros in additional tax revenue or in savings on expenditure, *ex ante*.

We then present an evaluation of eleven measures. Guillaume Allègre, Marion Cochard and Mathieu Plane have estimated that the implementation of the *contrat de génération* [“generation contract”] could create between 50,000 and 100,000 jobs, at the cost of a strong deadweight effect. Eric Heyer and Mathieu Plane point out that in the short term, subsidized *emplois avenir* [“jobs for the future”]-type contracts can help to reduce unemployment. Eric Heyer shows that the revision of taxation on overtime will help to cut the public deficit by 4 billion euros, without hurting the labour market. Guillaume

Allègre discusses the consequences of increasing the *Allocation de rentrée scolaire* [allowance for the start of school] and shows that it mainly benefits the lowest five deciles in terms of standard of living. Henri Sterdyniak analyzes the possibilities for fiscal reform. The point is not to evaluate the government's proposals for fiscal reform, but to provide a comprehensive overview of the current system's margin for change and its inconsistencies. Henri Sterdyniak and Gérard Cornilleau evaluate the increased opportunities for retiring at age 60 and analyze the possible paths to a more large-scale reform of the pension system. Hélène Périvier evaluates the possibilities for an early childhood public service, the eventual cost of which could be covered in part by an increase in activity that would generate more than 4 billion euros. Eric Heyer and Mathieu Plane analyze the impact of a boost in the minimum wage (SMIC) and conclude that, given the small spillover of increases in the SMIC onto the rest of the wage structure, the impact on the cost of labour is limited by the greater reduction in social charges on low wages. While the effect on employment is small, it would cost the public purse 240 million euros. Sabine Le Bayon, Pierre Madec and Christine Riffart evaluate rent control. Hervé Péléraux discusses the compensation of Livret A bank accounts and the impact of doubling their ceiling. Céline Antonin and Evens Salies evaluate the new taxes on the oil companies, which could provide 550 million euros in tax revenue in 2012, at the risk that this tax might ultimately be passed on to the end consumer.

Banking union: a solution to

the euro crisis?

By Maylis Avaro and [Henri Sterdyniak](#)

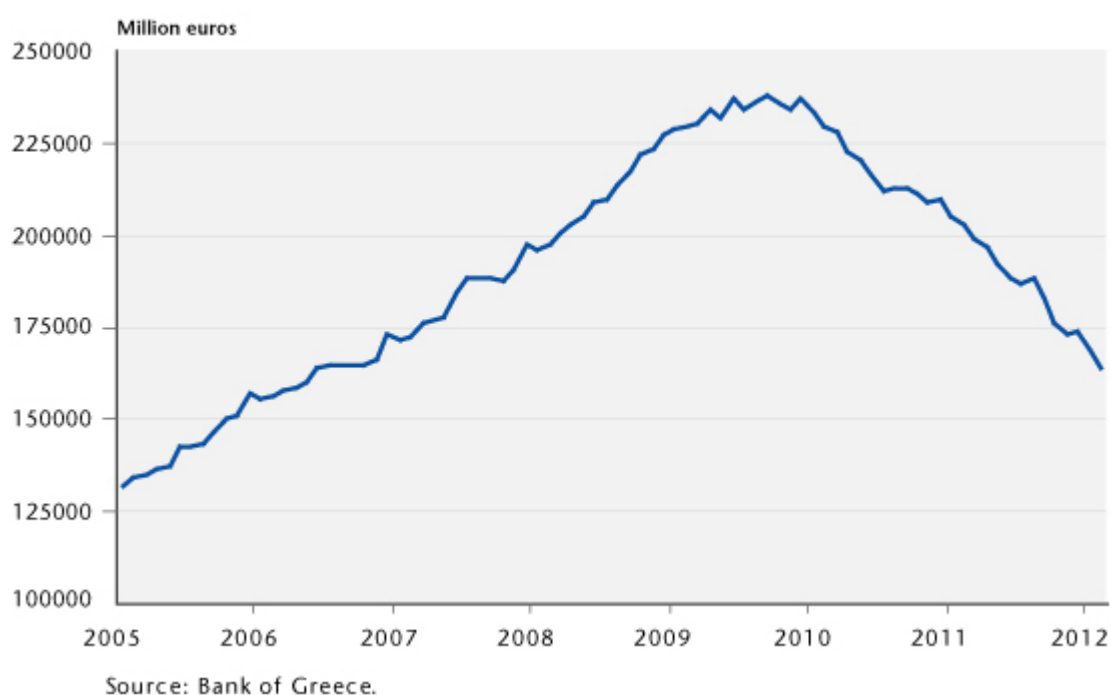
The European summit on 28th and 29th June marked a new attempt by Europe's institutions and Member states to overcome the crisis in the euro zone. A so-called Growth Pact was adopted, but it consists mainly of commitments by the Member states to undertake structural reform, and the limited funds made available (120 billion over several years) were for the most part already planned. The strategy of imposing restrictive fiscal policies was not called into question, and France pledged to ratify the Fiscal Compact. The interventions of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) will now be less rigid, as, without additional conditions, they can help countries that the financial markets refuse to finance so long as they meet their objectives in terms of fiscal policy and structural reform. But euro-bonds and the mutual guarantee of public debt were postponed. The summit also launched a new project: a banking union. Is this an essential supplement to monetary union, or is it a new headlong rush into the unknown?

The current crisis is largely a banking crisis. The European banks had fed financial bubbles and housing bubbles (especially in Spain and Ireland), and they had invested in mutual funds and hedge funds in the United States. After major losses during the crisis of 2007-2010, the Member states came to their rescue, which was particularly costly for Germany, the UK, Spain and above all Ireland. The sovereign debt crisis in the euro zone has compounded their woes: the sovereign debt that they hold has become a risky asset. The problem of regulating the banks has been raised at the international level (new Basel III standards), in the United States (Volcker's rule and Dodd-Frank law) and in Britain (Vickers report).

In June 2012, doubts about the soundness of Europe's banks

surfaced yet again. The measures taken since 2008 to stabilize the financial system have proved insufficient. When Bankia, Spain's fourth-largest bank, announced that it was requesting State assistance of 19 billion euros, worries about the balance sheets of Spanish banks rose sharply. The rate of bad loans of the country's banks, whose balance sheets were hit hard by the real estate crash, rose from 3.3% at end 2008 to 8.7% in June 2012 [1]. Furthermore, many Greeks, fearing an exit from the euro zone, began to reduce their deposits in the banks there [2].

Total deposits of business and consumers in Greece's banks



In response to these dangers, the proposal for a European banking union was given a new boost by Mario Monti. Italy's PM suggested developing the proposals in preparation for the European Commission Single Market DG, an idea that currently has the support of the Commission, the European Central Bank, and several Member states (Italy, France, Spain, etc.) On the other hand, Germany believes that a banking union is impossible without a fiscal union. While Angela Merkel acknowledged [3] that it was important to have a European supervisory authority, with a supranational banking authority

with a better general overview, she clearly rejected the idea of Germany taking a risk of further transfers and guarantees without greater fiscal and policy integration [4]. The euro zone summit meeting on 29 June asked the Commission to make proposals shortly on a single monitoring mechanism for the euro zone's banks.

This kind of banking union would rest on three cornerstones:

- a European authority in charge of centralized oversight of the banks,
- a European deposit guarantee fund,
- a common mechanism for resolving bank crises.

Each of these cornerstones suffers specific problems: some are related to the complex way the EU functions (Should a banking union be limited to the euro zone, or should it include all EU countries? Would it be a step towards greater federalism? How can it be reconciled with national prerogatives?), while others concern the structural choices that would be required to deal with the operations of the European banking system.

As to the institution that will exercise the new banking supervisory powers, the choice being debated is between the European Banking Authority (EBA) and the ECB. The EBA was established in November 2010 to improve oversight of the EU banking system, and it has already conducted two series of "stress tests" on the banks. As a result of the tests, in October 2011 Bankia reported a 1.3 billion euro shortage of funds. Five months later, the deficit was 23 billion; the EBA's credibility suffered. In addition, the London-based EBA has authority over the British system, while the United Kingdom does not want to take part in the banking union. The ECB has, for its part, received support from Germany. Article 127.6 of the Treaty on the Functioning of the European Union [5], which was cited at the euro zone summit of June 29th as a

basis for the creation of a European Banking Authority, would make it possible to give the ECB supervisory authority. On 12 June, the Vice-President of the ECB, Mr. Constancio, said that, "the ECB and the Eurosystem are prepared" to receive these powers; "there is no need to create a new institution".

European oversight implies a common vision of banking regulation. There must be agreement on crucial issues, such as: "Does commercial banking need to be separated from investment banking?" "Should banks be prohibited from operating on the financial markets for their own account?" "Should public or mutual or regional banks be encouraged rather than large internationalized banks?" "Should banks be encouraged to extend credit primarily to businesses and government in their own country, or on the contrary to diversify?" "Should the macro-prudential rules be national or European?" In our opinion, entrusting these matters to the ECB runs the risk of taking a further step in the depoliticization of Europe.

Applying the guidelines of this new authority will be problematic. A banking group in difficulty could be ordered to divest its holdings in large national groups. But would a country's government expose a national champion to foreign control? Governments would lose the ability to influence the distribution of credit by banks, which some people might find desirable (no political interference in lending), but in our opinion is dangerous (governments would lose a tool of industrial policy that could be used to finance Small and Medium Enterprises [SMEs] and Economic and technological intelligence [ETI] projects or to support the ecological transition).

For example, in a case involving Dexia, the opposition between the European Commission on the one hand and France, Belgium and Luxembourg on the other is blocking a restructuring plan. The plan includes the takeover of Dexia Credit Local's financing of local authorities by a banking collectivity that

would be created based on cooperation between La Banque postale and the Caisse des depots. In the name of fair competition, Brussels is challenging the financing of local communities by such a bank, as Dexia has received public funding for its restructuring plan. This is threatening the continuity of the financing of the French local authorities, and could put a halt to their plans; in particular, it could prevent France from providing specific secure mechanisms for financing local authorities through local savings.

The purpose of a deposit guarantee fund is to reduce the risk of a massive withdrawal of deposits during a banking panic. This fund could be financed through contributions by the European banks guaranteed by the fund. According to Schoenmaker and Gros [6], a banking union must be created under a "veil of ignorance", that is to say, without knowing which country poses the greatest risk: this is not the case in Europe today. The authors propose a guarantee fund that at the outset would accept only the strongest large transnational banks, but this would immediately heighten the risk of the zone breaking apart if depositors rushed to the guaranteed banks. The fund would thus need to guarantee all Europe's banks. According to Schoenmaker and Gros, assuming a 100,000 euro ceiling on the guarantee, the amount of deposits covered would be 9,700 billion euros. The authors argue that the fund should have a permanent reserve representing 1.5% of the deposits covered (*i.e.* about 140 billion euros). But this would make it possible to rescue only one or two major European banks. During a banking crisis, amidst the risk of contagion, such a fund would have little credibility. The guarantee of deposits would continue to depend on the States and on the European Stability Mechanism (ESM), which would have to provide support funds, ultimately by requiring additional contributions from the banks.

The authority in charge of this fund has not yet been designated. While the ECB appears well positioned to undertake

supervision of the banking system, entrusting it with management of the deposit guarantee fund is much more problematic. According to Repullo [7], deposit insurance should be separated from the function of lender of last resort. Indeed, otherwise the ECB could use its ability to create money to recapitalize the banks, which would increase the money supply. The objectives of monetary policy and of support for the banks would thus come into conflict. What is needed is a body that handles deposit insurance and crisis resolution and is separate from the ECB, and which must have a say on the behavior of the banks, and which would be additional to the EBA, the ECB, and the national regulators. The ECB on the other hand would continue to play its role as lender of last resort. But it is difficult to see how such a complicated system would be viable.

As the risk of a country leaving the euro zone cannot yet be dismissed, the question arises as to what guarantee would be offered by a banking union in the case of a conversion into national currency of euro-denominated deposits. A guarantee of deposits in the national currency would, in the case of an exit from the euro, heavily penalize customers of banks that suffer a devaluation of the national currency against the euro, whose purchasing power would decline sharply. This kind of guarantee does not solve the problem of capital flight being experienced today by countries threatened by a risk of default. What is needed is a guarantee of deposits in euros, but in today's situation, given the level of risk facing some countries, this is difficult to set up.

German and Finnish politicians and economists such as H. W. Sinn are, for instance, denouncing an excessive level of risk for Germany and the Nordic countries. According to several German economists, no supranational authority has the right to impose new burdens (or risk levels) on the German banks without the consent of Parliament, and the risk levels need to be explicitly limited. The German Constitutional Court might

oppose the deposit guarantee fund as exposing Germany to an unlimited level of risk. Moreover, according to George Osborne, the Chancellor of the British Exchequer, a bank deposit guarantee at the European level would require an amendment to existing treaties and the consent of Great Britain.

On 6 June, the European Commission began to develop a common framework for resolving banking crises by adopting the proposal of Michel Barnier, which has three components. The first is to improve prevention by requiring banks to set up *testaments*, that is, to provide for recovery strategies and even disposal plans in case of a serious crisis. The second gives the European banking authorities the power to intervene to implement the recovery plans and to change the leadership of a bank if it fails to meet capital requirements. The third provides that, if a bank fails, the national governments must take control of the establishment and use resolution tools such as divestiture, the creation of a defeasance bank, or "bad" bank, or an internal bailout (by forcing shareholders and creditors to provide new money). If necessary, the banks could receive funds from the ESM. Bank-related risks would therefore be better distributed: the shareholders and creditors not covered by the guarantee would be first to be called upon, so that the taxpayers would not pay to reimburse the creditors of insolvent banks. In return, bank loans and shares would become much riskier; bank reluctance about inter-bank credit and the drying up of the interbank market due to the crisis would persist; and the banks would find it difficult to issue securities and would have to raise the level of compensation. However, Basel III standards require banks to link their lending to the level of their capital. This would pose a risk of constraining the distribution of credit, thereby helping to keep the zone in recession. Based on the decisions of the summit on 29 June, Spain could be the first country whose banks would be recapitalized directly by the ESM. However, this would not take place until early 2013;

the terms of the procedure and the impact of ESM aid on the governance of the recapitalized banks still need to be determined. As can be seen in the Dexia example, what terms are set for the reorganization of a bank can have serious consequences for the country concerned: are governments (and citizens) willing to lose all power in this domain?

A banking union can help break the correlation between a sovereign debt crisis and a banking crisis. When the rating agencies downgrade a country's debt, the securities suffer a loss in value and move into the category of "risky assets", becoming less liquid. This increases the overall risk faced by the banks in the country concerned. If a bank is facing too much overall risk and it is no longer able to meet the capital requirements of Basel III, the State must recapitalize it, but to do this it must take on debt, thereby increasing the risk of a default. This link between the banks' fragile balance sheets and public debt generates a dangerous spiral. For instance, since the announcement of the bankruptcy of Bankia, Spain's 10-year refinancing rates reached the critical threshold of 7%, whereas last year the rates were about 5.5%. In a banking union, the banks would be encouraged to diversify on a European scale. However, the crisis of 2007-09 demonstrated the risks of international diversification: many European banks lost a great deal of money in the US; foreign banks are unfamiliar with the local business scene, including SMEs, ETIs and local government. Diversification based on financial criteria does not fit well with a wise distribution of credit. Moreover, since the crisis, European banks are tending to retreat to their home countries.

The proposal for a banking union assumes that the solvency of the banks depends primarily on their own capital, and thus on the market's evaluation, and that the links between a country's needs for financing (government, business and consumers) and the national banks are severed. There is an argument for the opposite strategy: a restructuring of the

banking sector, where the commercial banks focus on their core business (local lending, based on detailed expertise, to businesses, consumers and national government), where their solvency would be guaranteed by a prohibition against certain risky or speculative transactions.

Would banking union promote further financialization, or would it mark a healthy return to the Rhineland model? Would it require the separation of commercial banks and investment banks? Would it mean prohibiting banks whose deposits are guaranteed to do business on the financial markets for their own account?

[1] According to the Bank of Spain.

[2] The total bank accounts of consumers and business fell by 65 billion in Greece since 2010. Source: Greek Central Bank.

[3] “La supervision bancaire européenne s’annonce politiquement sensible”, *Les Echos Finance*, Thursday 14 June 2012, p. 28.

[4] “Les lignes de fracture entre Européens avant le sommet de Bruxelles”, *AFP Infos Economiques* 27 June 2012.

[5] Art 127.6: “The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the

prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”

[6] D. Schoenmaker and Daniel Gros (2012), “A European Deposit Insurance and Resolution Fund”, *CEPS working document*, No. 364, May.

[7] Repullo, R. (2000), “Who Should Act as Lender of Last Resort? An Incomplete Contracts Model”, *Journal of Money, Credit, and Banking* 32, 580-605.

Financing higher education: Should students have to pay?

By [Guillaume Allègre](#) and [Xavier Timbeau](#)

Is it necessary to ensure that a greater portion of the cost of higher education is borne by students in the form of higher tuition fees, which might or might not be coupled with loans? It is often argued that financing higher education through taxes is anti-redistributive. We show in a [working document](#) that from a life cycle perspective proportional taxation is not anti-redistributive.

While raising higher education fees is not on the political agenda in France, it is a subject of intense fighting, not only in Quebec, but also in Spain and Great Britain, where student protests erupted at the end of 2010. Reports in France regularly propose raising tuition fees: recently (2011), in a

note by the [Institut de l'Entreprise](#) [in French] on the role of business in financing higher education, Pierre-André Chiappori proposes “lifting the taboo on tuition fees”. In a [contribution to Terra Nova](#) [in French] published in 2011, Yves Lichtenberger and Alexandre Aïdara propose raising annual university tuition fees by about 1000 euros. Paradoxically, the authors also propose creating a study allowance that could be used anytime in a person’s life. The authors are attempting to deal with two contradictory economic dynamics. On the one hand, a study allowance would help raise the general level of education, a factor in innovation and growth, while simultaneously fighting against social self-selection in higher education:

In countries that have adopted it [the study allowance], disadvantaged social strata may have an opportunity to undertake lengthier studies even though their social origins have predestined them to short-term courses that provide quick entry into salaried employment. This is an important means of raising the general level of education and the qualifications of young people, which is a central concern of this report. (Lichtenberger and Aïdara, [p.82](#))

But on the other hand, education benefits better-off strata, and being free makes it anti-redistributive:

The fact that public higher education is virtually free leads, first, to a transfer of resources (the public cost of education) to young people who are in education the longest. This overwhelmingly means young people from better-off strata. This transfer is reflected ultimately in private returns to the beneficiaries: higher wages and then pensions, which benefit the most highly educated throughout their lives.... As things stand, higher education’s free character has no redistributive value and even aggravates inequalities. (Lichtenberger and Aïdara, [p.84](#))

Indeed, even if the anti-redistributive character of free higher education is not the only argument made by advocates of higher tuition, it is one of their main arguments. This argument relies on a static and familialist vision of

redistribution. We adopt a life cycle perspective instead. As highlighted in the second excerpt above, on average the beneficiaries of education spending enjoy a significant private benefit: they will have higher wages and pensions throughout their lives. Even assuming that tax (on income) is proportional to income (which is not the case: in reality, it is progressive), they will pay much more tax, in absolute terms, than individuals who have completed shorter studies. Above all, tax allows for the financing of education by individuals who actually receive significant private benefits, and in proportion to this benefit. People who suffer discrimination in the labour market or who were oriented towards less profitable sectors and benefit from low returns to education reimburse society a lesser amount through their taxes than those who benefit more. Financing through income tax leads people with higher incomes to contribute even when they have not had a lengthy education. The injustice would therefore lie in the transfer between persons with high incomes who are not highly educated and those who are highly educated. But if education is characterized to a great extent by significant social returns, thanks to its impact on growth ([see Aghion and Cohen](#)), then people with high incomes are actually beneficiaries of spending on education, whether or not they are highly educated themselves (for instance, self-taught entrepreneurs benefit from the availability of skilled labour).

Adopting a life cycle perspective, we show in a [working document](#) that financing spending on non-compulsory education (beyond 16 years) by a proportional tax represents a net transfer from those with higher incomes during their careers to those with lower incomes during their careers. From a life cycle perspective, free non-compulsory education financed by taxes does not benefit individuals with more affluent parents (the transfer from individuals from better-off households to those from poorer households is not significantly different from zero). If individuals from the poorest households react to the increase in tuition fees by reducing their investment

in education, even when this is financed by loans, then there can be little doubt that they will be the first victims of this type of reform. Advocates of tuition increases generally argue for small increases in tuition fees and exemptions based on means-testing the parents. But recent developments in Australia, the United Kingdom and Canada show that, once the fees have been introduced, it is difficult to prevent governments that are seeking new funds from increasing the fees and reducing the exemption thresholds.

In higher education, the leading injustice is the lack of access to people from modest backgrounds. The surest way to ensure equity in education is still to fund it through income tax and to reform education so that it is targeted at academic success for all rather than at selection.

The euro zone in crisis: challenges for monetary and fiscal policies

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

The 9th EUROFRAME conference [\[1\]](#) was held on 8 June 2012 in Kiel on issues concerning the economic policy of the European Union. The topic was: “The euro zone in crisis: challenges for monetary and fiscal policies”. The conference was, of course, dominated by the issue of the sovereign debt crisis in the euro zone. How did it come to this? Should the blame be put on mistakes in national economic policies? Must the way the euro zone is organized be changed?

A number of fault lines appeared (*cf.* also the related [Note](#) in

French):

- Some believe that it is irresponsible domestic policies that are the cause of the imbalances: the southern countries were allowed to develop real estate and wage bubbles, while the northern countries carried out virtuous policies of wage moderation and structural reform. The southern countries must adopt the strategy of the northern countries and accept a prolonged dose of austerity. For others, the single currency has allowed the development of mirror opposite imbalances: too much austerity in the North, and too many wage increases in the South; what is needed is a convergence where stimulus in the North facilitates the absorption of the external imbalances in the South.
- For some, every country must implement policies that combine fiscal consolidation and structural reform. For others, what is needed is an EU-wide growth strategy (in particular by financing an ecological transition) and a guarantee of public debt so as to promote a convergence of national interest rates at lower levels.
- Some believe that any new solidarity measures involve developing a Union budget, which means the inclusion of binding rules in the Fiscal Compact; for others, what is needed is the open coordination of economic policies, without pre-established standards.

We provide a report that includes brief comments [\[2\]](#) in a lengthy [Note](#).

[\[1\]](#) [EUROFRAME](#) is a network of European economic institutes that includes: DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland), NIESR (United Kingdom).

[\[2\]](#) Most of the articles are available at:

<http://www.euroframe.org/index.php?id=7>. Selected articles will be published in an issue of the *Revue de l'OFCE*, in the "Débats et Politiques" collection, at the end of 2012. The report reflects the views of the authors alone.

European Council: wait and sink?

By [Jérôme Creel](#), Paul Hubert and [Francesco Saraceno](#)

The European Council meeting being held at the end of the week should have been spent, according to the wishes of the French authorities, on renegotiating the European Fiscal Compact adopted on 2 March 2012. However, renegotiation has not been on the agenda. Alas, the Fiscal Compact does need to be re-opened for debate: it should be denounced for being poorly drafted, and its overly restrictive character needs to be reviewed; ultimately, the text should be amended. The focus of the debate on the structural deficit rule, which is unfairly described as the "golden rule", is wide of the mark in so far as it is the rule on the reduction of public debt that is the more restrictive of the two rules included in the Fiscal Compact. This is the rule that demands to be discussed, and urgently, in order to avoid sinking deeper into a contagion of austerity plans that are doomed in advance...

The conflict over European growth between the French and Italians on the one side and the Germans on the other was probably defused by the agreement late last week with Spain in favour of a coordinated European recovery plan. The plan represents 1% of Europe's GDP, *i.e.* 130 billion euros, though

its contours and funding remain to be clarified. The slogan of the European Council has thus been, by a process of elimination, “banking union”, in an effort to prevent a new wave of banking and financial crises in the European Union. Is the creation of a banking union important? Certainly. Is it urgent? Less so than a return to growth, which, while it certainly cannot be decreed, can be prepared. Given the state of the current Fiscal Compact, we can conclude that what is being prepared is not economic growth, but recession [\[1\]](#).

The Fiscal Compact, which is contained in Title III of the [Treaty on Stability, Coordination and Governance in the Economic and Monetary Union](#), explicitly includes two fiscal rules. The first clarifies what constitutes a budgetary position that is “balanced or in surplus”, a term enshrined long ago in the Stability and Growth Pact. According to the Fiscal Compact of March 2012, a budgetary position that is “balanced or in surplus” means a structural deficit of at most 0.5% of GDP. The structural deficit is the cyclically adjusted public deficit, *i.e.* adjusted for the well-known automatic stabilizers; this includes interest charges, among other items. When the structural deficit is exceeded, apart from exceptional circumstances, *e.g.* a “significant” downturn in activity, an automatic adjustment mechanism, whose nature is not specified, must bring it back below this limit. The structural deficit rule is relaxed for Member States whose public debt is below 60% of GDP: the structural deficit ceiling is increased to 1% of GDP.

The second fiscal rule is also a requirement for euro zone Member States with a public debt in Maastricht terms that is greater than 60% of GDP. In 2012, this rule applies to 12 out of the 17 Member States of the euro zone. This second rule aims to reduce the public debt by one-twentieth every year. Unfortunately, the text adopted is poorly written and opens the door to different interpretations, as we show below. It is therefore inapplicable. Even worse, given the current state of

the economy, this rule is the more restrictive of the two rules in the Fiscal Compact. It is therefore urgent to pay attention to it and modify it to make it enforceable.

According to Article 4 of the Treaty, “When the ratio of a Contracting Party’s general government debt to gross domestic product exceeds the 60% reference value..., that Contracting Party shall reduce *it* at an average rate of one-twentieth per year as a benchmark...” The problem is that “it”, which we have put in italics, refers to the public debt ratio rather than to the difference between the public debt and the 60% reference value. So, in 2012 should Germany, with a public debt in 2011 of a little more than 80% of GDP, reduce its debt by 4 GDP points (one-twentieth of 80% of GDP) or by 1 GDP point (one-twentieth of the difference with the reference value of 60% of GDP)? Legally, it is essential that a clear answer can be given to this kind of question.

Moreover, the Fiscal Compact is silent on the nature of the surplus to be used to reduce the debt: if, to leave room for maneuver in case of a cyclical deficit, this rule were to address the structural deficit – which would therefore need to be explained in the Compact – the debt rule would be even more restrictive than the golden rule: a structural *surplus* would be systematically required to reduce the public debt to 60% of GDP in the 12 Member States whose debt exceeds the reference value. Again, the formulation needs to be clear.

Suppose now that the “it” in Article 4 concerns the difference between the debt and the reference value, and that the rule on debt reduction applies to the entire public deficit. The question can then be asked, which of the two rules – the “golden rule” or the debt reduction rule – places greater restrictions on the Member States, and thus needs to be applied. We have set out, in an appendix [\[2\]](#), the small set of fiscal rules compatible with the Fiscal Compact. The total deficit is the sum of the cyclical deficit and the structural deficit. The cyclical deficit depends on the difference

between actual and potential GDP, *i.e.* the output gap, which has an elasticity of 0.5 (average elasticity customary in the literature on the European countries, cf. [OECD](#)). The “golden rule” relates only to the structural deficit, while the debt reduction rule concerns the total public deficit, and thus depends on both the output gap and the structural deficit.

For what values of the public debt and the output gap is the “golden rule” more restrictive than the debt reduction rule? Answer: when the output gap is greater than 1 plus one-tenth of the difference between the original debt and the reference value. This means that, for a country like Germany, the debt reduction rule would predominate over the “golden rule” except in cases of very high growth: the real GDP would have to be at least two points higher than the potential GDP. According to the OECD economic forecast published in May 2012, Germany’s output gap in 2012 will be -0.8. The debt reduction rule is thus much more restrictive than the “golden rule”. This is also true for France (debt of 86% of GDP in 2011), which would have to have an output gap of at least 3.6 points for the “golden rule” to be binding; yet the OECD forecasts an output gap of -3.3 in 2012. The same holds true for all the countries in the euro zone with a debt greater than 60% of GDP, without exception.

Except in cases of very strong growth, the debt reduction component dominates the structural deficit component. Yet it is the latter that is the focus of all the attention.

When a treaty is open to such differences in interpretations, isn’t it normal to want to revise it? When a treaty requires intensifying austerity measures in an area like the euro zone, whose GDP is almost 4 percentage points below its potential, according to the estimates of an organization, the OECD, that is generally not suspected of overestimating the said potential, is it not desirable and urgent to renegotiate it?

[1] A recent post emphasized the risks of social instability and the potential losses that might result from austerity-induced contagion in the euro zone (cf. [Creel, Timbeau and Weil, 2012](#)).

[2] Annex:

We start by defining with def the total public deficit, which includes a structural component s and a cyclical component dc :

$$def = s + dc$$

All the variables are expressed as a proportion of GDP. The cyclical component is composed of the variation in the deficit that occurs, thanks principally to the action of the automatic stabilizers, when the economy deviates significantly from its potential. A reasonable estimate is that the deficit increases by 0.5 point per point of lost output. The cyclical component can thus be expressed as:

$$dc = - 0.5 y$$

where we define y as the output gap, *i.e.* the difference between GDP and its potential level.

The rules introduced by the fiscal compact can be expressed as follows:

$$s_1 < 0.5,$$

that is, the structural deficit can never exceed 0.5% of GDP (s_1 refers to the first aspect of the rule), and

$$def = - (b_0 - 60)/20,$$

that is, the total deficit must be such that the public debt (expressed as a proportion of GDP) is reduced every year by one-twentieth of the difference between the initial public

debt (b_0) and the 60% reference level. The debt rule can thus be re-written in terms of the structural deficit as:

$$s_2 = \text{def} - \text{dc} = 0.5 y - (b_0 - 60)/20.$$

We thus have 2 possible cases for when the structural deficit component is less restrictive than the debt reduction component:

Case 1

$$s_1 < s_2 \text{ if } y > 1 + (b_0 - 60)/10.$$

Assume the case of a debt level like Germany's ($b_0 = 81.2\%$ of GDP). Case 1 implies that the structural deficit component will be less restrictive than the debt reduction component if and only if $y > 3.12\%$, that is, if Germany has a GDP that is at least three points higher than its potential. If a country has a higher level of debt (e.g. Italy, at 120% of GDP), then $y > 7\%$!

Case 2

If the debt reduction rule concerns the structural deficit (rather than the total public deficit), then we have:

$$s_1 < 0.5$$

and

$$s_2 = - (b_0 - 60)/20$$

In this case, $s_1 < s_2$ if $1 < - (b_0 - 60)/10$, which will never happen so long as the public debt is greater than the reference level.

Would returning to the drachma be an overwhelming tragedy?

by [Céline Antonin](#)

Following the vote in the Greek parliamentary elections on 17 June 2012, the spectre of the country leaving the euro zone has been brushed aside, at least for a while. However, the idea is not completely buried, and it is still being evoked in Greece and by various political forces around the euro zone. This continues to pose the question of the cost of a total default by Greece for its creditors, foremost among them France. The analysis published in the latest [OFCE Note \(No. 20, 19 June 2012\)](#) shows that, despite the magnitude of the potential losses, several factors could mitigate the consequences for the euro zone countries of a default by the Greek state.

The withdrawal of Greece from the euro zone, which is not covered in the Treaties, would cause a major legal headache, as it would involve managing the country's removal from the Eurosystem [\[1\]](#). In case of a return to a new drachma, which would depreciate sharply against the euro [\[2\]](#), the burden of the public debt still outstanding would be greatly increased, as would private debt, which would still be denominated in euros. Many financial and nonfinancial firms would go to the wall. Legally, Greece could not unilaterally convert its debt into new drachmas. Since the country's public debt is not very sustainable and it is denominated almost exclusively in euros, Greece would certainly default (at least partially) on its public debt, including its foreign debt [\[3\]](#). Given that the main holders of Greek debt are euro zone countries, what would be the magnitude of the shock in the case of a Greek default?

While more detail about this can be found in the [OFCE Note \(No. 20, 19 June 2012\)](#), the focus here is on providing a breakdown of the exposure of the euro zone countries (in particular France) to Greek public and private debt. Exposure to Greek public debt involves three main channels:

- 1) The two aid packages of May 2010 and March 2012;
- 2) Participation in the Eurosystem;
- 3) The exposure of the commercial banks.

An analysis of these channels shows that the main source of exposure of the euro zone countries to losses is the two support plans. The maximum exposure of the euro zone countries through this channel is 160 billion euros (46 billion euros for Germany and 35 billion euros for France). Euro zone countries are also exposed to Greek government debt through their participation in the Eurosystem: indeed, the Eurosystem's balance sheet swelled dramatically to support the vulnerable countries in the euro zone, notably Greece. However, given the Eurosystem's capacity to absorb losses (over 3,000 billion euros), we believe that the potential losses for the countries of the euro zone are not likely to be realized if Greece were to default unilaterally on its public debt. Finally, the euro zone's banking system is exposed to 4.5 billion euros in Greek sovereign risk and up to 45 billion euros from the Greek private sector [\[4\]](#).

The cumulative exposure of the euro zone to Greek debt, excluding the Eurosystem, amounts to a maximum of 199 billion euros (2.3% of the euro zone's GDP, cf. Table), including 52 billion euros for Germany (2% of GDP) and 65 billion euros for France (3.3% of GDP). If we include exposure to the Eurosystem, the cumulative exposure of the euro zone to Greek debt comes to 342 billion euros (4% of euro zone GDP), including 92 billion for Germany (3.6% of GDP) and 95 billion (4.8%) for France. France is the most heavily exposed

euro zone country, due to the exposure of its banks to Greek private debt through subsidiaries in Greece. If we consider only Greek government debt, however, it is Germany that appears to be the country most exposed to a Greek default.

Summary of the exposure of different countries to Greek debt

In billion euros

	1) Support plans		2) Eurosystem		3) Commercial banks		Total	Total excl. Eurosystem
	1st plan	2e plan	SMP	TARGET2	Public debt	Private debt		
Germany	14.7	31.4	12.5	27.3	1.3	5.1	92.3	52.5
Austria	1.5	3.2	1.3	2.8	NC*	NC*	8.8	4.7
Belgium	1.9	4.0	1.6	3.5	0.1	0.0	11.1	6.0
Cyprus	0.1	0.2	0.1	0.2	NC	NC	0.6	0.3
Spain	6.5	13.8	5.5	12.0	0.1	0.5	38.4	20.9
Estonia	0.0	0.3	0.1	0.3	NC	NC	0.7	0.3
Finland	1.0	2.1	0.8	1.8	NC	NC	5.7	3.1
France	11.1	23.6	9.4	20.5	1.3	29.1	95.0	65.1
Ireland	0.9	0.0	0.7	1.6	NC	NC	3.2	0.9
Italy	9.7	20.7	8.3	18.0	0.2	1.1	58.0	31.7
Luxembourg	0.1	0.3	0.1	0.3	NC	NC	0.8	0.4
Malta	0.1	0.1	0.0	0.1	NC	NC	0.3	0.2
Netherlands	3.1	6.6	2.6	5.7	NC	NC	18.0	9.7
Portugal	1.4	0.0	1.2	2.5	NC	NC	5.1	1.4
Slovakia	0.5	1.1	0.5	1.0	NC	NC	3.1	1.6
Slovenia	0.3	0.6	0.2	0.5	NC	NC	1,6	0.9
Total EZ	52.9	107.7	45.0	98.0	2.9	35.8	342.3	199.3

[NC => NA]

NA: Not available, as the BIS gives only the exposures of Germany, Belgium, France, Italy and Spain. The totals are thus calculated without taking into account the second tier banks, except for Germany, Belgium, France, Italy and Spain and the Euro Zone Total.

Sources: "The Economic Adjustment Programme for Greece – First review summer 2010", ECB, EFSE, BIS *Quarterly Review* (June 2012), Bank of Greece, author's calculations.

These amounts constitute an upper bound: they represent the maximum potential losses in the worst case scenario, namely the complete default of Greece on its public and private debt. Furthermore, it is impossible to predict with certainty all the chain reactions associated with a Greek exit from the euro zone: everything depends on whether the exit is coordinated or not, whether a debt rescheduling plan is implemented, the magnitude of the depreciation of the drachma against the euro, and so on.

The "reassuring" element in this analysis is the magnitude of the potential losses (Table): the shock of a Greek exit would be absorbable, even if it would generate a shock on each member country and widen its deficit, undermining the members' efforts to restore balanced budgets. However, this analysis also points out how intertwined the economies of the euro zone are, even if only through the monetary union, not to mention the mechanisms of the solidarity budget. A Greek exit from the euro zone could therefore open a Pandora's Box – and if other countries were tempted to imitate the Greek example, it is the euro zone as a whole that could go under.

[1] The Eurosystem is the European institution that groups the European Central Bank and the central banks of the countries in the euro zone.

[2] On this point, see [A. Delatte, What risks face the Greeks if they return to the drachma?, OFCE blog, 11 June 2012.](#)

[3] The foreign debt designates all the [debt](#) that is owed by all a country's public and private debtors to foreign lenders.

[4] This refers to a textbook case, where the drachma's depreciation would be so great that the currency would no longer be worth anything.

Taxes on wealth: what kind of reform?

By [Guillaume Allègre](#), [Mathieu Plane](#) and [Xavier Timbeau](#)

Why and how should wealth be taxed? Are France's wealth taxes

fair and efficient? In an article entitled, “Reforming the taxation of wealth?”, published in the [special Tax Reform issue](#) of the *Revue de l’OFCE* [in French], we examine these issues and propose some possible ways to reform the taxation of wealth.

We show that in recent years real economic income from capital has been very substantial. The visible income from capital (interest, dividend, rents received, etc.) exists alongside less visible income (capital gains net of the consumption of fixed capital and inflationary tax). As only a portion of potential capital gains are realized, this less visible income forms a significant part of average personal income. Between 1998 and 2010, despite two financial crises, capital gains increased real per capita income by an annual average of 12% (33% on average from 2004 to 2007). This growth was due in large part to the sharp rise in property prices.

We also show that the actual tax rate on income from wealth is low, even though the nominal interest rates on capital income are high, and the tax rate *on income that is actually taxed* is even higher due to not taking into account inflationary tax in the calculation of taxes [\[1\]](#). After taking into account all taxation based on household wealth, including wealth which is held (“ISF” wealth tax, property tax) or which is passed on (property transaction taxes *i.e.* “stamp duty”) and income from wealth (income tax, “CSG” wealth tax, etc.), the actual rate of taxation on economic income from capital [\[2\]](#) comes to an average of 11.1%. This low rate for the actual taxation of capital income is due to the fact that a large portion of this income fully or partially escapes taxation: real property gains on principal residences are totally exempt, and secondary residences are partly exempt; the housing enjoyed by owner-occupiers (“imputed rent”) is not taxable, even though, net of interest, it constitutes income; gifts serve to “purge” any capital gains, even when these are not taxed (there is a tax allowance of 159,000 euros per child for gifts to direct

heirs, which is renewable every ten years); and some financial income avoids income tax (life insurance, tax-exempt bank accounts, etc.).

Next we discuss possibilities for reform that would lead to taxing all income from wealth. We believe that income from wealth (net increased income from wealth) should be taxed in the same way as labour income. This principle is fair (in the sense that households are then taxed on their contributory capacity, regardless of the source of their income), and it would also help to combat tax avoidance. In an increasingly financialized economy, the interface between labour income and capital income has become porous. Taxing capital income differently opens the door to tax schemes. Any reform of wealth taxation should make it a priority to tax all real capital gains, in particular real property gains, which currently are subject to specific rules. In addition, since property is a fixed asset, the existing rules cannot be justified as due to tax competition in Europe. They are occasionally defended based on the need to take account of inflation or due to the unique character of the principal residence. But taking inflation into account cannot justify the total exemption of real property gains on secondary residences after they have been held for a certain time (currently 30 years, previously 22 years): not only does the exemption on capital gains seem unfair, but it can also prompt some households to keep their property, in particular during speculative bubbles. Furthermore, the specific character of property cannot be invoked once there has been a definitive withdrawal from the market. The taxation of realized capital gains, net of inflation, of the consumption of fixed capital and of renovation costs, would thus be preferable to a system of allowances based on the period of ownership. This could take place when the sale is not followed by another purchase – so as not to penalize mobility – and during inheritance (taxation of unrealized gains, before calculating inheritance tax). The taxation of real property gains upon a definitive

withdrawal from the market could gradually replace the system of property transaction taxes or “stamp duty”, which would promote mobility and greater horizontal fairness.

In light of these arguments, what do we make of the proposals by the new French President François Hollande with regard to the taxation of wealth? He proposes (1) to tax capital income at the same rate as labour income is taxed; (2) to roll back the tax breaks on the ISF wealth tax and to raise the rate of taxation on the top income brackets; and (3) to reduce the inheritance tax allowance from 159,000 euros per child to 100,000 euros (it was raised from 50,000 euros to 150,000 euros in 2007).

(1) The first point would also involve eliminating the flat-rate withholding tax and the various tax loopholes that permit tax avoidance. It is similar to our proposals, so long as the income subject to tax takes into account inflationary tax and the consumption of fixed capital. This kind of proposal would involve taxing imputed rent, which constitutes an imputed income from capital. Nevertheless, given the difficulty of estimating the tax base, imputed rent has not been taxed since 1965 (see the article by [Briant and Jacquot](#)). One solution to this difficulty is to permit renters and first-time buyers to deduct their rent or loan interest payments from their taxable income, while increasing the average income tax rate to offset this.

(2) The second point departs from our proposals, but the ISF tax offers one solution for taxing large estates bit by bit, *even when they do not procure any taxable income* (when there are unrealized capital gains but an absence of dividends or earned rent, for example). In a situation like this, the ISF tax makes sense *only if it is not capped based on the taxable income (or a similar notion)*. The ISF tax on wealth makes even more sense when the actual yields, including the unrealized gains on the assets, are not very heterogeneous (but it is then equivalent to a tax on the income from the assets) or

when the supervision of the asset owners can improve their yields (taxation based on holding the wealth, and not on income, then serves as an additional incentive “to owners to ‘activate’ their estate,” in the words of Maurice Allais). In contrast, if the asset yields are heterogeneous and strong incentives to optimize the wealth already exist, then a tax on the income from the wealth is preferable from the viewpoint of fairness and not undermining economic efficiency.

(3) Higher inheritance taxes seem legitimate from the perspective of equal opportunity. We feel, however, that this should go further, at least by eliminating the purge of capital gains, in particular when the goods have been exempted from inheritance tax.

** This text is taken from the article [Reforming the taxation of wealth?](#) published in the special Tax Reform issue of the *Revue de l'OFCE*, available on the [OFCE website](#).*

[1] As [Henri Sterdyniak](#) points out: “It is thus erroneous to claim that capital income is taxed at a lower rate. When it is *actually* taxed, this is at higher rates.”

[2] Defined as the ratio between the sum of taxes based on wealth and the net increased income from the wealth after having subtracted the consumption of fixed capital and inflationary tax.

Japan's reconstruction: constrained by the deterioration in public finances

By Bruno Ducoudré

Following the earthquake that hit Japan in March 2011, the government estimated the cost of the loss at 16.9 trillion yen (3.6 points of GDP). The response in terms of the structural deficit needed to deal with this exogenous shock conflicts with the government's desire to implement an austerity policy to reduce the deficit. The additional financing requirements are thus coming at the worst possible time, amidst the economic crisis that began in 2008, which has been accompanied by a sharp deterioration in public finances due to the need to prop up the economy.

On the growth front, 2011 was a difficult year for Japan, coming on the heels of a 4.4% rebound in GDP in 2010 following a 5.5% drop in 2009. While the economy saw renewed growth in Q3 of 2011 (1.9% GDP growth quarter-on-quarter), after two quarters of falling GDP, at year end floods in Thailand again disrupted the supply chains of Japanese firms, and the economy faltered (zero growth in Q4 and -0.7% growth for 2011). The period of reconstruction begins in 2012.

In fiscal year 2011, four additional budget bills were passed for a total of 3.9 percentage points of GDP, mainly to cope with emergency expenses (1.3 GDP points) and to prepare for reconstruction (2.3 GDP points). The services of the State have estimated the total bill for reconstruction at 23 trillion yen (4.8 GDP points). The reconstruction will be spread over the next ten years, with the main effort

concentrated on the period 2012-2016. The government decided to allocate 0.8 GDP points for reconstruction in fiscal 2012, three-quarters of which is to be funded by debt (Table).

Contrary to expectations, the series of plans passed in 2011 have not resulted in a rapid surge in public spending: public consumption grew by 2.1% in 2011, unchanged from 2010 and less than in 2009, and public investment fell by 3.1% in 2011. Reconstruction costs were partly substituted for other expenses. Also, part of the budget adopted was set aside and so is just beginning to be spent. Public orders for construction work rose by 20% in Q4 of 2011 yoy, and public works in progress rose sharply at year end. Thus, the additional expenses related to the reconstruction costs already approved will be spread in part over the coming quarters, and even beyond fiscal year 2012.

Japan's fiscal situation is actually precarious. The expenditures needed to rebuild the devastated areas were decided in a context of high levels of deficit and debt related to the crisis. The budget deficit has indeed deteriorated sharply since the beginning of the crisis, rising from 2.2% of GDP in 2008 to 8.1% in 2010, while the debt has risen by 31.2 GDP points since 2007, to reach 199% of GDP in 2010. In 2011, the deficit widened to 9.3% of GDP mainly due to the increased debt burden, higher social security spending and the fall in GDP in 2011. The government announced that some plans would be financed by a combination of restrictions in other areas of expenditure, surplus tax revenues related to the improvement in activity in 2010, and the accumulated reserves from past budgets (for a quarter of the budget dedicated to reconstruction in 2011-2012).

In the short term, the government has nevertheless chosen to favor growth over fiscal consolidation. We expect, for instance, a fiscal stimulus of 0.4 GDP point in 2012 and 0.5 GDP point in 2013, and the Japanese economy should see average annual growth of 1.9% in 2012 and 1.5% in 2013 (see ["Japan:](#)

[reconstruction time](#)", in our forecast dossier, in French). In these circumstances, the budget deficit will be stable at 9.2% of GDP in 2012, and will worsen to 9.8% of GDP in 2013.

**Provisional budgets for 2011-2012 for reconstruction
Central government**

In % GDP

	2011	2012
Revenue and financing	3.9	0.8
Tax revenue	0.3	0.1
Non-tax revenue	0.0	0.1
Bond issues	2.1	0.6
Surplus from previous years	1.1	0.0
Reduction in expenditure	0.4	0.0
Expenditure	3.9	0.8
General expenditure, including:	3.3	0.7
<i>Public works</i>	1.4	0.2
<i>Other expenditure</i>	1.9	0.6
Transfers to local government	0.6	0.1

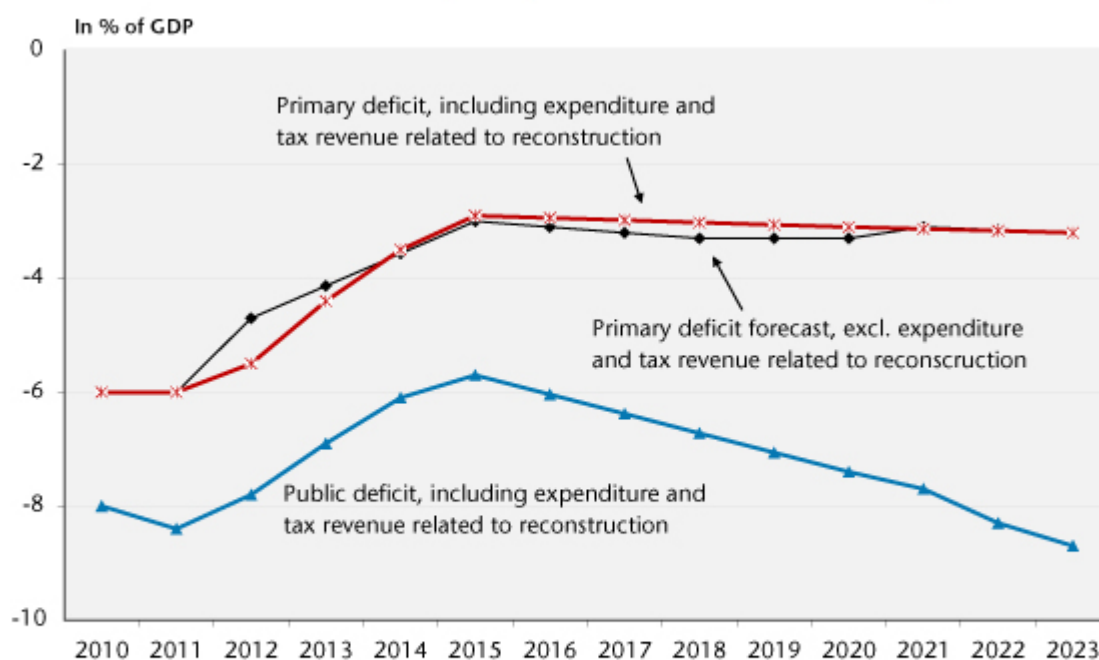
Sources: Cabinet Office, Ministry of Finance, OFCE calculations.

However, beyond 2013, there is still uncertainty about the direction of government economic policy. In the Japanese government's [medium-term fiscal strategy](#), decided in 2010, it aimed to halve the primary deficit of central and local government by 2015 compared to the level in 2010 (6.4% of GDP), and to break even by 2020. According to our calculations, balancing the primary structural deficit would require the implementation of a major fiscal consolidation effort. This would involve a negative fiscal impulse on the order of 1.1 GDP points a year in 2014, which is nevertheless a slower pace than the consolidation policies planned in the euro zone in 2012-2013 (see "[He who sows austerity reaps recession](#)" in our forecasting dossier). To this end, an increase of 5 points in the consumption tax is to be considered during the current session of the Diet, Japan's parliament, which will wind up in June. This increase would occur in two stages and yield 2.5 GDP points in tax revenue. According to [the latest medium-term forecast of the Japanese](#)

[government](#), this will not be sufficient to meet its targets (Figure 1). Moreover, the means to achieve a balance by 2020 have not been clarified, and the government has not indicated how the debt built up to finance reconstruction would be repaid. Finally, given the continuing growth of the public debt, the interest burden, which currently is low (1.8 GDP points in 2011), will place an increasing burden on state finances in the future. This will exacerbate the government's difficulties in implementing any budgetary changes aimed at stabilizing the debt-to-GDP ratio by 2020, and then to bring it down even further.

Despite all this, Japan does not seem to need a brutal fiscal consolidation, as it is currently borrowing at low interest rates (0.86% for the last issue of 10-year government bonds). Furthermore, the share of the debt held by non-residents is still low (6.7% in Q4 of 2011), and the abundant savings of the Japanese population, together with the Japanese Central Bank's programme of share purchases, considerably reduces the risk of a sovereign debt crisis like the one seen in the euro zone.

Government forecasts of the primary deficit over the reconstruction period



Note: These forecasts are based on the hypothesis of a rise in the VAT rate from 2013 and a nominal GDP growth rate of about 2% on average over the period. This includes a rise in tax revenue distributed evenly over 10 years to finance reconstruction-related expenditure. The forecast covers only central and local government.

Source: Cabinet Office.

This text refers to the economic analysis and forecast for 2011-2012, which is available on the [OFCE website](#).

Fiscal reform: Now or never*

By Nicolas Delalande (*Centre d'histoire at Sciences Po*)

While the question of taxation was one of the major economic issues of the presidential election, it must not be forgotten that there often exists a gap between the political and media attention received by a set of campaign promises (what political scientists would call the “politics”) and their practical implications in terms of public policy (the “policies”). It is also worth asking whether any such tax

reform will actually take place.

For over a year, commentators and politicians have repeatedly argued that taxation would be a key question in the presidential election. Many saw it as one of the only real issues distinguishing the outgoing majority, which with the TEPA law of August 2007 had bet on a strategy of "fiscal shock" to unleash growth (50% cap on taxes, reduction of inheritance taxes, exemption of overtime, etc.), from the Left opposition, which has been quick to denounce the injustice and inefficacy of measures that undermine progressive taxation without obtaining the expected economic benefits, while deepening the deficit. The promise of reform, or even a tax "revolution", was high on the political agenda, particularly for the Left. However, intense conflicts and debates over taxes do not guarantee that the election of Francois Hollande will be followed by a genuine transformation of the French tax system. There may very well be a gap between the political and media attention received by campaign promises (the "politics") and their practical implications for public policy (the "policies"). However much tax reform may be touted during the campaign, it may well be distinctly less popular when it comes time for implementation, when political will runs up against varied forms of sometimes unanticipated resistance.

There has, nevertheless, been a felt need almost everywhere in Europe to increase the taxation of the wealthy, not so much to solve the problem of government deficits as to restore a semblance of fairness and shared effort in a time of economic crisis. A number of countries have embarked on this path (the top marginal rate of income tax is 57% in Sweden, 50% in Britain, and 45% in Germany), even though some have already sounded the retreat (David Cameron's Conservative government has proposed cutting the top marginal rate back to 45% in 2013). Even billionaires like Warren Buffett in the United States have called for raising taxes on better-off strata to put an end to the most blatant inequalities. This kind of

reform actually consists of backing off the policies of the last fifteen to twenty years by reversing the trend to erode the progressivity of the tax system: strictly speaking, this is less a matter of reform than of cancelling previous reforms. Increasing tax revenue no longer results as before from creating new tax measures but from removing the tax reductions and exemptions enacted in recent years. Hence the debate, both in the US and Europe, over the real nature of the “tax increases”: the Republicans accuse the Democrats of increasing the tax burden, while the latter claim to be merely reversing exemptions that they consider unwarranted and inefficient. Reform thus amounts to nothing more than the restoration of the situation *ex ante*. In France, for example, the Socialists have pledged to cancel what remains of the tax package of 2007 (after having removed the tax cap in 2011), to significantly reduce tax loopholes and to establish a new income tax bracket: the reference point for these proposals is in fact the actual system as it existed only five to ten years ago, with the exception of the promise added during the campaign to create an exceptional 75% bracket on incomes of over 1 million euros.

A more ambitious structural reform, for example along the lines proposed in the recent [book](#) by Camille Landais, Thomas Piketty and Emmanuel Saez, would involve an entirely different scale. Opening the “black box” of the redistribution machine actually implies a much wider debate on the missions of the tax system, its administrative organization and its relationship to social and family policy. This is where the “costs” of policy reform, such as the eventual cancellation – or modulation – of France’s “family quotient” tax-splitting system, may be felt most directly. In any case, the erosion of the belief that the only reforms that could possibly be any good involve reducing the tax burden means that the current environment has never been more favourable for initiating this debate. The political, social and financial implications of this new configuration will certainly be complex and demanding

in terms of democracy, but, in light of the numerous critics of the failings of the existing system, there is little doubt that 2012 offers a unique opportunity for undertaking ambitious reform. Tax reform implies the need for an effective political coalition to overcome the various social, institutional and technical obstacles that are likely to arise and to be able to take advantage of the favourable circumstances in which ideologies and beliefs that were thought to be firmly established are now on shaky ground. From a historical standpoint, it should not seem absurd that the current economic crisis, which is often compared to the 1930s, calls for and indeed even requires a renegotiation of the fiscal pact on a scale as significant as that experienced by Europe and America in the first third of the 20th century. The process of reform will, however, inevitably be more complex than before: the systems for collection and redistribution, now more sophisticated than ever, are based on an array of measures that have arisen in different periods and in unique political, economic and social contexts.

** This text is taken from the article [“The political economy of tax reform: a historical analysis”](#), which was published in a special Tax Reform issue of the OFCE Revue and is available on [the OFCE web site](#).*

Underlying deflation

[Christophe Blot](#), Marion Cochard, Bruno Ducoudré and [Eric Heyer](#)

A look at the latest statistics on price trends indicates that the risk of deflation seems to have given way to renewed

inflation in the major developed countries. So do we really need to fear the return of inflation, or are these economies still structurally deflationary?

First, note that the nature and scale of the economic crisis we have been living through since 2008 are reminiscent of what led to past periods of deflation (the crisis of 1929, the Japanese crisis of the 1990s, etc.). The recessionary pattern that began in 2008 has followed the same path: the shock to activity led to a slowdown in inflation – and sometimes lower prices or wages – in most of the developed countries. However, a fall in prices is not necessarily synonymous with deflation: this has to be long term and, above all, it must be anchored in expectations and a vicious cycle of debt deflation. But this deflationary scenario did not materialize. Far from sitting by idly, at the end of 2008 governments and central banks took fiscal and monetary measures to stabilize activity and limit the rise in unemployment. Moreover, independently of the response by economic policy, price trends were strongly influenced by changes in commodity prices. While the collapse in oil prices in the second half of 2008 accelerated the deflationary process, the rise in prices since 2009 has fuelled more general price rises and held off the risk of deflation. Moreover, business has partially cushioned the impact of the crisis by accepting cuts in margins, which has helped to mitigate rising unemployment, a key factor in the deflationary process.

In a study by the OFCE published in its journal of forecasts ([Prévisions de la Revue de l'OFCE](#)), we start from a wage-price model to develop a method for assessing the way that oil price dynamics and labour market adjustments affect changes in inflation. We show that if oil prices had continued their upward trend after they peaked in the summer of 2008, and if the adjustment on the labour market had been, in all countries, the same as in the US, then the year-on-year change in inflation in second quarter 2011 would have been lower, by

0.7 points in France to 3.4 points in the UK (Table 1). This confirms that these economies are still structurally deflationary.

Despite the central banks' repeated efforts at quantitative easing, they need not fear the return of inflation. The macroeconomic environment is still characterized by a risk of deflation, and therefore by the need for an accommodative monetary policy.

Impact of shocks on consumer prices

Year-on-year change

	Impact on the inflation rate...	2010				2011	
		Q1	Q2	Q3	T4	Q1	Q2
Germany	... of the speed of productivity adjustment	0.3	0.5	0.6	0.8	0.8	0.8
	... of the change in oil prices	0.0	0.2	0.2	0.3	0.4	0.4
	Total impact	0.3	0.7	0.8	1.0	1.2	1.3
France	... of the speed of productivity adjustment	0.0	0.0	0.0	0.1	0.1	0.1
	... of the change in oil prices	0.2	0.4	0.2	0.3	0.5	0.6
	Total impact	0.2	0.4	0.2	0.4	0.6	0.7
Italy	... of the speed of productivity adjustment	0.3	0.3	0.3	0.3	0.2	0.1
	... of the change in oil prices	0.6	0.8	0.6	0.5	0.6	0.6
	Total impact	0.8	1.2	1.0	0.8	0.8	0.8
Spain	... of the speed of productivity adjustment	0.0	-0.1	-0.2	-0.2	-0.3	-0.4
	... of the change in oil prices	0.0	0.3	0.3	0.3	0.4	0.5
	Total impact	0.0	0.2	0.1	0.0	0.1	0.1
UK	... of the speed of productivity adjustment	0.7	1.3	1.8	2.2	2.8	3.1
	... of the change in oil prices	0.1	0.1	-0.1	-0.1	0.1	0.3
	Total impact	0.8	1.4	1.7	2.2	2.9	3.4
USA	... of the speed of productivity adjustment	0.0	0.0	0.0	0.0	0.0	0.0
	... of the change in oil prices	0.5	0.4	0.1	0.0	0.2	0.4
	Total impact	0.5	0.4	0.1	0.0	0.2	0.4
Japan	... of the speed of productivity adjustment	0.6	0.8	0.9	1.0	1.1	1.2
	... of the change in oil prices	0.0	0.2	0.2	0.2	0.3	0.4
	Total impact	0.6	1.0	1.1	1.2	1.3	1.6

Source : National data, OFCE calculations.