"What can Labor do to Resolve the Austerity Crisis in Europe?"

1. The Problem: Austerity Crisis, Imbalance, and Inequality

2. Alternativlos? No. Macro alternatives to address crisis

3. Alternativlos? No. An Alternative Built on EU labor institutions

4. Conclusion: Toward More Inclusive Capitalism

Richard B. Freeman Harvard, NBER,
LSE Centre for Economic Performance
European Trade Union Institute “The crisis and inequality”
September 17, 2013

1. Eurozone 2013: Sick Economy of World

The facts: EU unemp rate ~ 12%; GDP below 2007; High consumer debt ratios; divergence between core and periphery economies.

Rising inequality; increased numbers of working poor; danger of another financial crisis/recession even in economies that weathered the storm.

Austerity‘s poster child: Portugal (GDP 7.6% below 2007 level; unemployment, 16%-18%) No policy tools to grow GDP: cannot depreciate; bailout deals with EU, IMF, ECB squeeze fiscal; weak labor institutions; govt effort for fiscal devaluation fails.

Response to crisis:

In US: Return of the big banks – greater share of bank assets than in 2007; greater inequality; $$$ dominance of politics; long term drop in employment-population ratio of 5 points.

In Europe: Finance above jobs --troika loans pay back banks (and speculators who bought bonds); cuts in government spending and public sector → public austerity with no policy for private sector offset. Reduce debt by squeezing debtors with low inflation.

The result: IMF Picture of Europe (2103): "Persistent financial market fragmentation, weak bank balance sheets, low demand, and creeping uncertainty, as well as structural weaknesses … contribute to contraction of real activity."

Oxfam warns: Austerity threatening to impoverish 25 million more Europeans

By Agence France-Presse, Wed, Sept 11, 2013 20:35 EDT

"I can't think of anything new, so take your leeches and shut up."

If you believe that the road to prosperity is via years of declining GDP/ low growth, mass joblessness, increased poverty, and economic misery, I have a bridge for you in Brooklyn, with 21 elephants, and a horse drawn circus wagon driven by a man waving a hat, thrown in at half-price … Securitized with dark elephant assets. And newly created OTC swaps to protect against trolls stealing the bridge tolls

What you do when there is nothing you can do
Europe Summer 2013

2. There are macro policy alternatives

Standard response to periphery economies crisis is devaluation.

1) Break-up Eurozone to allow devaluation

2) Keep Euro but use VAT/payroll-tax swap “fiscal devaluation” to mimic floating currency (Keynes' export/import tax way around gold standard)

Standard response to high debt ratios would be some inflation

3) Loosen monetary policy to inflate a bit – See Japan, US for what happens.

4) Restructure sovereign debt so creditors lose;

1. Break up Eurozone?

It's time to break up the Euro

By Shawn Tully, senior editor-at-large September 25, 2012: 5:00 AM ET

Don't believe the politicians. The common currency can't survive as is.

Widespread view outside EU is that Euro was never optimal currency zone: too little labor mobility or fiscal sharing.

Ireland broke exchange parity with UK pound in 1979; joins Euro in 1998 with little transition cost.

How costly is orderly break up? Disorderly break up?

2 Fiscal devaluation ?

Shift taxes from firms to consumers. Lower payroll taxes, which with sticky wages, reduce cost of labor, and with flexible prices, should cut price of goods. Higher value added tax raises the price of goods. When the reduced payroll tax balances out the increased VAT, no change in prices of domestic producers, VAT raises price of imports while lower labor cost make exports more profitable for firms. This mimics currency devaluation and generates growth through expanded exports.

Calmfors, 1998; Farhi, Gopinath, Itskhoki 2013

Proposed for various EU countries: Cavallo and Cottani (2010) for Greece, Cabral (2011) for Portugal; the Hollande government adopted fiscal devaluation policy in 2012.

Does it work?-- Simulations based on econometric data on responses say “probably”

- IMF (2011) says fiscal devaluation in Portugal equal to 1% of GDP generate a short-term rise in net exports of somewhere between 0.2% and 0.6% of GDP. Franco (2011) finds them larger. De Mooij and Keen (2012) estimate that a 2.6 percentage point decline in payroll tax and a 2.7 percentage point increase in VAT would generate increase in net exports of between 0.9% and 4% of GDP
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- The Netherlands Bureau for Economic Policy Analysis (2013) has simulated effects for France, Austria, Spain and Italy and found that it has a small, short-lived expansionary effect on employment and GDP but marginally worsens the trade balance and has a permanent small expansion of employment and GDP driven by lower wage costs due to weakened bargaining position of workers weakens and redistribution from current to future generations.

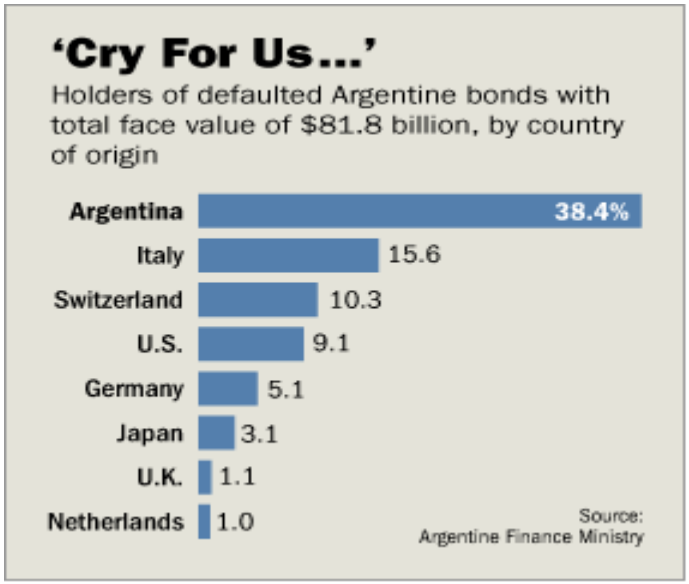
But there are problems... details, details, details

Portugal tried to cut employers 'social security contribution and raise VAT; then to cut employer contribution and increase worker contribution. Distributional consequences stopped both efforts: increased VAT is regressive and critics claimed corporations would pocket lower contribution to payroll tax (make the reduced contribution contingent on hiring – “wage subsidies” similar to Great Recession policies

Share of labor in costs is higher in not-traded services than in traded manufacturing goods, so much of cross the board cuts of payroll tax has no effect on trade. Effects depend on substitutability of imports and exports. No trade bounce if all countries do it as protectionist measure. Tends to be regressive on consumers except for increased employment.

3 &4. Inflation; Sovereign debt restructuring

- Inflation is good for debtor: IMF (2013, p 61-63) “In most historical episodes, household deleveraging was facilitated by higher inflation, and an expansionary fiscal policy... the macroeconomic context this time will be more challenging ...household deleveraging will continue to weigh down growth.”
- Debt restructuring?



Defying US courts, Argentine Congress approves swapping new bonds for defaulted debts

By Associated Press, September 12, 2013

FILE - In this March 1, 2013 file photo, lawmakers attend the inauguration... (Victor R. Caivano, File/Associated...)

BUENOS AIRES, Argentina — Argentina’s Congress has overwhelmingly approved a plan to swap new bonds for defaulted debt rather than comply with U.S. court orders to pay investors cash in full plus interest.

Wednesday night’s vote sets up a direct challenge of the U.S. judiciary only days before Supreme Court justices in Washington are to decide whether to hear an appeal from President Cristina Fernandez.

If Argentina loses, it could face similar demands from investors left holding billions of dollars in other debts unpaid since the country’s economy crashed in 2001. And if Fernandez keeps refusing to pay the plaintiffs, the US courts could stop payment to the 92 percent of other creditors who accepted Argentina’s previous debt swaps.

That would push Argentina into another default and cause serious harm to an already shaky economy.

What should unions consider in assessing these solutions?

- Long term vs short term effects – is possible job gain worth long term drop in payroll tax
- Bargains that may be struck to offset increases in inequality
- Risk involved in different policy scenarios
- Details, details, details

- Questions for assessment: What is the best outcome for all workers/normal citizens in each case and what is worst outcome? Is there something better?

3. Alternative micro-workplace based solution built on EU's social partner institutions

"Marshall style" **Social Partner Investment Plan** developed and lead by private sector social partners; orthogonal to battles over austerity and preserving banks; independent of big banks and rapacious finance and political shenanigans.

Four parts to plan

1) equity or loans for productive investment in firms whose workers trade wage cuts/freezes for equity or profit-sharing,
2) for troubled economies (and others)
3) for S&M firms that seek capital to modernize or expand.
4) seek sectors/firms likely to prosper in recovery or with big input-output effects on economy

What can a Social Partner Investment Plan Do?

Macro effects

1. Mimic devaluation to help periphery troubled economies adjust through wage tradeoff for equity (but not inflationary).

2. Ignite self-sustaining recovery through investments in key sectors

Micro effects

3. Improve productivity through greater incentives to regular employees who gain stake in firm; create stable employment

4.Reduce inequality by giving workers/pension funds greater share of capital income.

Improve long term economic situation and take back economic policy for real economy from finance.

Examples where this has worked on “small scale”

Some US Employee Stock Ownership Plans formed as concession bargainingfirms saved jobs and firm but some fail.

Great Recession bailout of US auto industry with govt moneys, Chapter 11 bankruptcy and union cost concessions saves sector, so that recovers pre-2007 sales. Workers get huge bonuses:

Detroit Worker Bonuses Approach Records on Rising Profits

(Bloomberg, Feb 2013). Ford’s $8,300 Chrysler $2,250. GM expected to exceed $7,325. For new Ford hires, paid about half what senior workers make, $8,300 adds 23 percent to annual of $36,000 compensation.

Auto-related industries and after-market service businesses employed 3.1 million vs 4.7 million employed in Portugal.

Critical questions:
Q1--Who has the money?

Worker-related sources

1. European worker-related financial institutions:

   private pension funds (Netherlands, UK, German Riester pensions)

2. Norwegian Sovereign Wealth Fund
3. Non-EU Pension funds (US, Australia,elsewhere)

Non-Worker-related sources

4. Sharia Capital from wealthy Arabs
5. China banks, billionaires etc
6. Hedge and equity funds (especially those handling pension fund moneys)

Q2-- Are there really barriers to investments/ undervalued assets?

IMF (2013b):"the credit channel has been broken during the crisis, particularly in stressed markets … small and medium-sized enterprises in hard-hit economies appear to most affected...monetary transmission in periphery and stressed markets remain impaired", citing higher private interest rates; declines in cross-border banking flows; periphery banks relying on deposits → **fragmentation of financial markets.**

IMF policy recommendation: ECB should support the banks. Social Partner Investment Plan supports the S&M enterprises that need the funds! "Bail out the businesses not the banks."

Hedge fund and pvt equity looking for bargains

Q3--Will wage trade-off reduce worker spending?

In principle, trade-off of wages for equity/profit-sharing can maintain worker lifetime income by transferring lower wage pay today for higher income tomorrow, adjusted for risk. In that case no reduction in consumer spending.

Wage concession lowers price of goods, which could increase spending dependent on demand elasticity while capital investment raises productivity, which should increase spending.

But if there are liquidity constraints, tradeoff could reduce consumption spending.

Q4. Is this too risky for private sector pensions?

If organize investments through mutual fund, diversity will lower risk. Fund could mix long term investments (public infrastructure) which have low cyclicality with short term cyclical investments.

Key is that worker willingness to do wage tradeoff is valuable insider information about prospects – a form of collateral from workers

Can Wall Street Madoffs game this? They game anything, so need rules/regulations to limit ripoffs.

Q5.Are there good targets that will give quick returns when the distressed economy recovers?

Want sectors/firms that are very sensitive to:

Cycle: high dProfits/dSales and dSales/dGDP

Labor costs :high dProfits/dcosts and dcosts/dlabor costs

New equity/loans: high dProfit/dI and dI/d New Equity

Invest in the first in recession when they are bargains and reap rewards in recovery. More likely to ignite growth spurt

A big enough set of expenditures will under some conditions – existence of profitable investment in a boom – create a self-sustaining recovery.

Q6 How much new equity/loan needed to ignite recovery?

Depends on I-O links – want sectors/firms that will demand local products and services ("backward linkages") or whose output will induce expansion in users ("forward linkages") . Impact studies of particular industries/firms/projects (sports stadium; new plant) provide evidence on these but most studies are one-offs. For example, they estimate effect of VW plant in Tennessee on local economy but rarely compare effect of different activities.

Acemoglu et al (2012; 2013) stress the effect of the linkages on promulgating economic shocks.

Input-Output Links;US

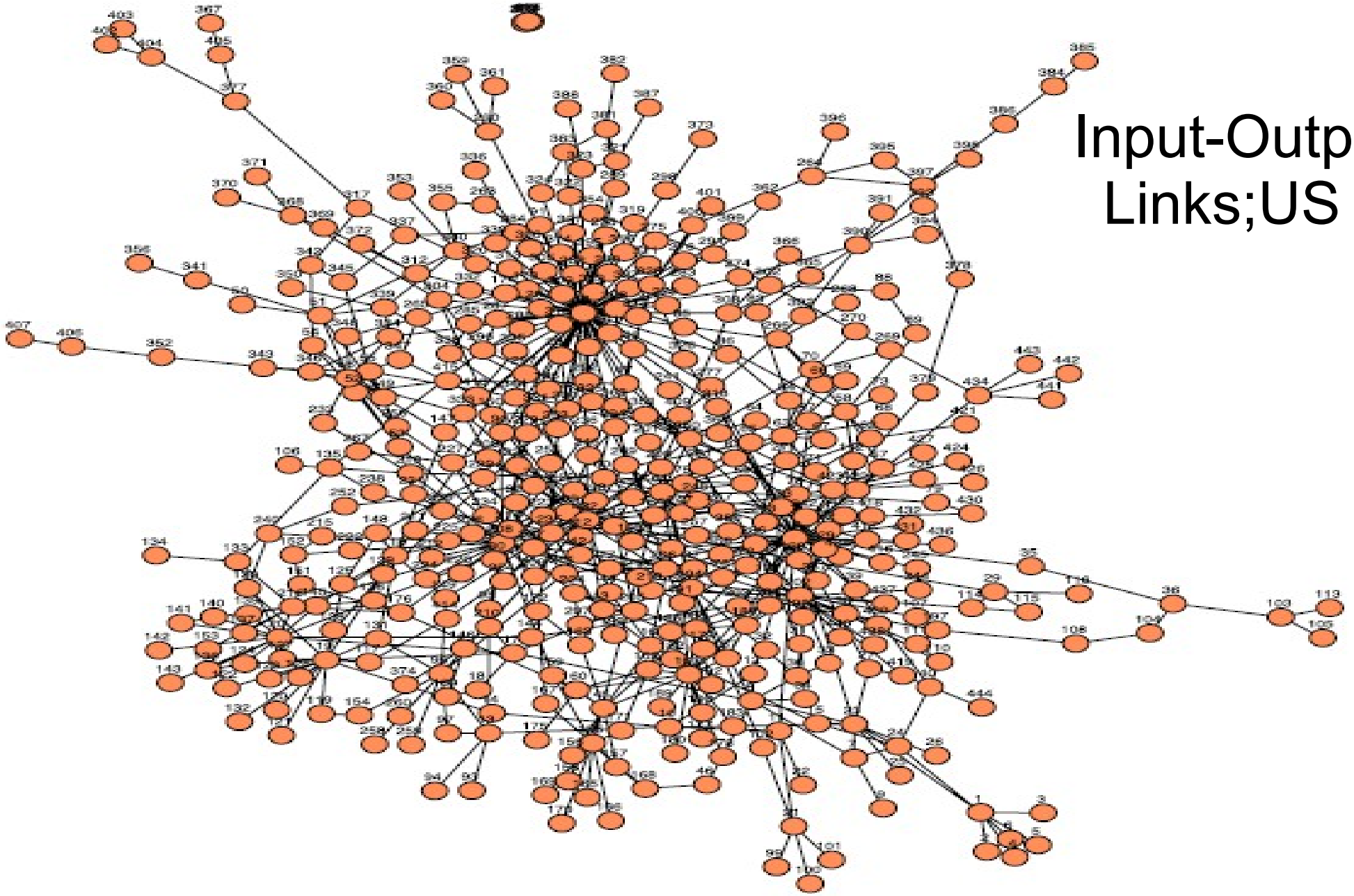


FIGURE 3.—Intersectoral network corresponding to the U.S. input–output matrix in 1997. (Source: Bureau of Economic Analysis. See Section 4 for more details on the data.) Each vertex corresponds to a sector in the 1997 benchmark detailed commodity-by-commodity direct requirements table. For every input transaction above 5% of the total input purchases of a sector, a link is drawn between that sector and the input supplier.

Q7 Could governments/international financial agencies help the Social Partner Investment Plan succeed?

Yes: with tax breaks:

encourage investments via tax breaks for investors similar to tax-breaks for mandated private pension schemes or for share ownership schemes.

give tax benefits to returns on fund

with insurance for investments,

for instance guaranteeing capital in fund so pension funds risked returns but not capital

With cyclical tax reductions/write offs

possibly related to increase in government tax revenues

4. CONCLUSION

- The orthodox "leechers" cannot think of an alternative to austerity. This has opened door to chaos, economic disaster, a lost decade or more for many European economies.
- But there are alternatives, from macroeconomic fiscal devaluation to deal with trade imbalances to greater inflation to deal with household deleveraging debt.
- The door is also open to more fundamental changes that would address not only the austerity crisis but rising inequality and the dominance of banks and finance in economic policy.
- 1930s-1950s saw fundamental changes in capitalism: bigger role for govt; control over finance; large unions. The Great Recession did not create such reforms – policy sought to restore the economic order despite its disastrous performance.

Next Steps to Explore The Potential

Social Partners establish commission to assess benefits and risks of proposal, recommend legal changes to effectuate it and, assuming positive readings, move to establish a Social Partners Investment Plan.

The assessment should involve simulation studies of possible effects of details; independent research groups probing strengths and weaknesses. Involve the expertise of business and labor, of socially-minded financial institutions, and of greed-driven equity/hedge funds.

This can move ideas and policy from a small group of economists and policy analysts to center stage.

Is it a slam-dunk?

Of course not. If it was, economists would earn more than NBA superstars.

But consider the Alternativlos:

resuscitating banks and finance with the hope that maybe next time they will behave differently.

continuing along the path of greater inequality and instability

taking the leeches because “they” don't what else to do.

Equity

In the English language equity has two meanings:

Fairness – equitable solutions to problems; equitable division of the rewards of production

Ownership – equity in one's company and ownership of the fruits of one's own labor.

The Social Partners Investment Plan offers a way to surmount the austerity crisis in both senses: a path to improve the operation of European economies by creating a more inclusive form of capitalism with employees having ownership through shares or profit-sharing and pension fund investment designed to escape the mess

EQUITY FOR ALL.
HURRAY!