Summary

This is the eighth report of the European Economic Advisory Group. Like the previous ones, it starts with an assessment of the macroeconomic outlook. In preceding reports this first chapter was usually followed by topical chapters that dealt with medium and long run issues relevant to the European economy as a whole. This year, the report is structured differently. A sense of mayhem struck the world economy in autumn 2008 as the financial crisis suddenly gathered momentum and started spreading to the real economy, which slid into recession. Chapter 2 provides a detailed account of the crisis and the various stages of its development, and highlights key policy recommendations regarding regulation of financial institutions and international financial architecture. We argue that regulations such as minimal equity requirements should be extended to all bank-like institutions rather than be confined to the commercial banking sector, that a more sophisticated definition of value-at-risk should be introduced to take into account the possibility of high liquidity premia and of asset bubbles, and that there is a need for a common system of financial regulation and supervision at the European level.

The crisis has fuelled an ongoing debate about the virtues of financial capitalism and none of its components have been spared. In particular, among the many innovations that have appeared in the last two decades are private equity firms that are under close scrutiny and criticism in some circles. Chapter 3 analyses how these firms work and how they contribute to the allocation of resources. Overall, we are sceptical of the critiques and think there is no systemic risk associated with these firms. (Their liabilities have little leverage and while they do leverage their investments, this is associated with little covenants and hence low risks of bankruptcy.)

From now on, each edition of the EEAG report will include one chapter that focuses on one EU member country. This year that chapter is devoted to France, which elected a new president in 2007 with promises of bold economic reform. We provide a mixed assessment of those reforms; having a large number of reforms does not necessarily mean large economic effects if those reforms run in different directions and may well be reversed in the future. We find more promise in the broad reform of the government than in the areas of taxation, the welfare state or product and labour market regulation, where there appear to be many inconsistencies.

Chapter 1: Macroeconomic outlook and policy

The worldwide financial crisis reached a critical stage in autumn 2008. While for a long time the problems were limited to providing liquidity to the banking sector, the situation escalated when some of the big financial institutions turned insolvent. To prevent a breakdown of the global financial system, governments had to intervene on a large scale in nearly all industrial countries. This was nevertheless not able to avert a worldwide drop in economic sentiment and subsequently large parts of the world economy fell into recession last year. After four years of rapid expansion, average world GDP growth only reached 3.4 percent in 2008 when using PPP weights or 2.3 percent when using market rates. For this year we only expect a world GDP growth rate of 1.4 and 0.3 percent, respectively.

During the first half of last year, the US economy still experienced positive growth. Although employment already started to fall in January, production increased and most of the available business cycle indicators pointed towards a continuation of moderate growth. From a demand-side perspective, a fiscal stimulus plan initiated in early 2008 was able to keep private consumption growth positive during the first half of the year. The situation changed dramatically, however, at the end of the summer. Industrial production and capacity utilisation plummeted in August. Furthermore, in September the US government decided against a bail out of the investment bank Lehman Brothers, triggering a severe drop in sentiment indicators and investment activities. From June onwards, personal consumption expenditures declined as well.

Consequently, in last year's third quarter, GDP growth turned negative in the US.

The fiscal budget deficit in the fiscal year 2008 increased to 3.3 percent of GDP. The increase in expenditures by 9 percent was the highest increase since 1990. For fiscal 2009 and as a reaction to the persistent crisis in the banking and financial systems, the US government decided to implement a sizeable rescue package. Furthermore, the Federal Reserve cut their target rate from 5.25 percent in September 2007 to only 0.25 percent at the end of last year.

Despite expansive fiscal and accommodative monetary policy, the recession in the United States will continue throughout the year. GDP will decline by 1.0 percent this year. Only at the end of 2010 is a slow recovery expected. This downturn will be so persistent mainly because US consumers have been living beyond their means for too long. To allow for a way back to a sustainable growth path, this behaviour must now be corrected. Only net exports will be able to contribute positively to economic growth in the US.

In general Asian markets have so far been able to play a stabilising role in the current crisis. Although their savings enabled the huge US current account deficit and consequently the US consumer boom in the first place, the reserves they have built up this way are now helping to stabilise the global economy. Since 2005 the growth differential between Asia and the US has increased. Still, economic growth in Asia remains dependent upon developments in the US, and the trade surpluses and the growth contributions of net exports decreased substantially.

As all of the major developed economies are in recession, export- and investment-driven expansion in many Asian countries will be affected more strongly in 2009 and 2010. Although domestic demand will be able to continue to grow in most economies for some time and the global financial crisis has already triggered a complete reversal of monetary policy in the region, growth will further slow down.

The European economy

After a still relatively positive outlook at the beginning of last year, the economic climate deteriorated markedly as the year progressed. The turbulences on international financial markets as well as the collapse in sentiment seen within the industrial sector and amongst consumers throughout Europe in the second half of the year have increasingly been reflected by data on real economic output. Accordingly, most European countries are or will soon be in recession. This means that, unlike in the past, national demand shortfalls will not be offset by growth in other countries and growth in final domestic demand in the European Union will reach an all-time low. Against this backdrop, GDP will decline by 1.2 percent this year.

Overall, the consolidation of public finances stopped and both actual and cyclically-adjusted fiscal balances deteriorated; fiscal consolidation no longer is on the top of the agenda. Especially since the autumn, member states continue to announce rescue packages, first of all for the banking sector, and more recently for the other parts of the economy.

After an additional tightening at the beginning of last year due to a further appreciation of the euro, the monetary conditions in the euro area stayed at restricted levels until summer last year. Since then, the ECB has gradually been lowering interest rates, but the still strong euro prevents monetary conditions from being called loose at present.

Especially in those countries facing a sharp downturn in the property market, in particular Ireland, Spain and the United Kingdom, there were large falls in residential investment spending throughout the year. Overall, low investment will put a burden on growth in Europe this year. A combination of falling profits, tougher financing conditions and lower growth prospects has sharply reduced the willingness of firms to invest.

Whereas private consumption was still an important pillar for economic growth in Europe in 2007, it basically stagnated in 2008. Increased inflation rates during the first quarters and slowly deteriorating labour market conditions together with sharply deteriorating financial prospects thereafter have all had a negative impact on consumer behaviour. However, rapidly falling inflation rates at the end of last year allowed consumption to slowly pick up again. Of the demand components only private and public consumption will be able to positively contribute to economic growth this year. Those countries suffering a real estate crisis will face substantially lower consumption growth.

Despite the strength of the euro, net exports contributed positively to GDP growth in the European

Union last year. The slowdown in export growth was met by a comparable fall in import growth rates. Only at the end of the year did the trade surplus start to fall as imports picked up. Much weaker demand from the rest of the world will lead to a further slowdown of export growth.

The unemployment rate has been increasing since the first quarter of last year. Weak business cycle developments will lead to an increase in the unemployment rate to an average of 8.1 percent in the European Union this year, and it will continue to rise throughout the rest of our forecasting horizon.

Chapter 2: The financial crisis

Chapter 2 reconsiders the micro and macroeconomic roots of the financial crisis.

The process of securitisation

The chapter starts from the analysis of the process of securitisation of subprime mortgages in US mortgage market, where all the evil originated. Through this process, cash flows from heterogeneous mortgage contracts between borrowers and banks were transformed into homogenous asset backed securities (ABSs), with distinct ratings, traded in global markets. Per se, securitisation is a good idea: by favouring diversification of mortgage risk, it can allow intermediaries to increase lending, to the benefits of households and firms. However, because of a combination of macroeconomic factors, bad/insufficient regulation and agency problems, in the last few years this process was fundamentally flawed. First, massive undervaluation of fundamental risk and market liquidity risk caused both the origination of subprime mortgages, and the issuance of ABSs with AAA ratings derived from the underlying pool of mortgages to be excessive by any reasonable standards. Second, several layers of securitisation, each involving some form of credit enhancement and insurance, translated into high opacity of ABSs, which hampered the ability of an intermediary to assess the amount and the location of risk in its portfolio. Finally, risk diversification was only apparent, in the sense that the high-rating ABSs sold to end-investors (pension funds, mutual funds, etc) were guaranteed by intermediaries – when the crisis erupted, in large part ABSs were absorbed back by highly leveraged financial institutions. With a high level of opacity, diversification of ABSs among intermediaries actually created systemic risk by generating dangerous network externalities, which eventually undermined market liquidity for many classes of assets and financial markets.

Two phases of the crisis: from soft- to hard-landing

The chapter analyses two distinct phases of the crisis. During the first phase, from 2007 to the summer of 2008, policy-makers believed in a smooth exit from the crisis (the "soft-landing" scenario). The prevailing view was that the fundamental problems at the root of the admittedly dangerous pathology in money markets were relatively manageable, in the sense that they could be absorbed over time by adopting a two-armed policy approach. On the one hand, central banks would make up for the lack of liquidity in the interbank markets by providing financial intermediaries with enough cash to operate without relying on each other for credit. Liquidity provision would then buy time for banks to restructure, namely, to raise new equity capital, and write-down bad debt – while containing the need for sharp de-leveraging, with the associated negative effects on real activity. On the other hand, treasuries and central banks would intervene on a case-by-case basis to support banks under threat of failure – either as a result of a run or because of fundamental losses (the main principle driving interventions being the need to preserve the functioning of large intermediaries with many market interconnections, whose failure would have strong systemic effects).

The second phase (hard-landing) erupted when coordination of expectations on the soft landing hypothesis ended in July-August 2008. The assessment and perception of the magnitude of the financial crisis rose with new figures on mortgage delinquency rates and the Federal Deposit Insurance Corporation took over the California-based Indymac Bank, then hit by a run on deposits. In response to spreading financial turmoil, the Treasury stepped up its commitment to support Fannie Mae and Freddie Mac in July, making the government guarantee explicit at first, before placing them under federal conservatorship at the beginning of September. Most crucially, the view that the real economic sector would be spared no longer held up against the evidence.

The difficulties of the government to present a coherent and possibly co-ordinated plan to address the crisis almost cause a run on deposit in mid-October, when nervous investors started to withdraw cash from banks (many newspaper reported an unusual rise in

the demand for home safes), and many switched banks in pursuit of intermediaries backed by the strongest government guarantees.

An important element in our interpretation of the soft landing phase is the fact that, initially, the effect of the crisis on deleveraging was quite contained. In the hard-landing scenario after autumn 2008, it is quite likely that the world will experience a deleveraging cycle, possibly with an impact on the level of activity by firms and the spending plans of households. Since September 2008, global rebalancing has been proceeding in the form of substantial write-downs by financial intermediaries. Against estimates of total losses by financial intermediaries ranging from $1.4 trillion (IMF 2008) and $3 trillion, at the end of 2008 total reported write-downs amounted already to around $1 trillion.

Lessons from the crisis and proposals for reform

In the wake of the crisis, proposals of reforms abound. In this report, we focus on deriving a small set of lessons from the crisis towards the definition of broad-based principles to follow in correcting the flaws in the system. The merits of different proposals do not necessarily lie on their being radical but on their consistency with the ultimate goals of public governance of financial system.

Some of these lessons are shared by many other institutions and scholars. Intermediaries that, like banks, engage in maturity transformation and are exposed to liquidity runs should be subject to the same principles of regulation and supervision as banks. Regulation and supervision is motivated by the implicit government commitment to bail out the intermediaries when their default has systemic effects and negative externalities on the payment system. Bankruptcy of commercial banks threatens the payment system directly, via its implications for depositors. For other intermediaries, one argument is that such threat is rooted in the network externality, via the systemic implications of their bankruptcy for market liquidity and the balance sheets of other intermediaries. Indeed, with the subprime crisis, trust among banks evaporated: the interbank market virtually collapsed. A different view is that the activities of these intermediaries grew into a threat to financial stability *because* bailout guarantees according to the too-big-to-fail doctrine provide an incentive for them to grow excessively, take on excessive risk, and become too leveraged. Unless these guarantees can be eliminated completely – which is not credible in light of past and recent experiences – it is rational to associate the provision of contingent public resources to regulation and supervision.

Thus, investment banks, as well as any other institution that performs bank functions must be subjected to the same rules that apply to commercial banks. The regulatory constraints should be dependent on the type of business rather than the legal status of the bank that pursues this business. This applies in particular to capital requirements.

First of all, broad international agreements must be finally reached on the harmonisation of banking supervision. These agreements can be based on a reformed Basel-II system, which encompasses all institutions performing banking functions and takes into account systemic and cyclical factors. Minimum equity requirements in Basel II should be reconsidered, so as to increase the incentive for shareholders to pursue more prudent business models and choose more conservative incentive schemes for bank managers. In any case, failures of corporate governance controls and pitfalls in executive compensation should be addressed.

The apparent failure of the current system to elicit the use of proper models of risk assessment by intermediaries and guarantee transparency is perhaps the main sticky point for rebuilding trust in the financial system. Simply increasing a coefficient of equity requirement will not do. What matters is instead a standard of asset valuation that (eventually) addresses the main problems in prudential regulation: the possibility of mispricing due to bubbles and market illiquidity, generating non-fundamental volatility of asset prices; procyclicality of lending; and transparency and information to investors.

Second, whenever possible, derivative products, such as CDS, should be traded in transparent, organised markets and not in opaque OTC markets. A common argument is that, while centralised trade may be feasible for some derivative products, many others are specialised and designed specifically for an investor/company, so that no organised market would be economical. However, following the recent problems of marking to market when no market exists, those buying such products probably now realise a major benefit from having centralised, transparent and liquid markets for derivatives. The specific needs of customers, in many cases, can probably be addressed by forming appropriate portfolios of existing contracts traded on

liquid markets. By the same token, short sales should not be prohibited; instead vigilance of potential market manipulation should be enhanced.

Fourth, Europe needs a common system of financial regulation and supervision. The European System of Central Banks should assume an explicit role of guarantor of the system, acquire supervisory powers over European groups, and coordinate with national central banks the national financial intermediaries. We propose a two-tier system. For pan-European financial groups, supervision should be allocated to the European Central Bank. These groups should then be required to subscribe to a European Deposit Insurance Fund, to complement national deposit insurance schemes. Otherwise countries should individually have the responsibility for bearing losses created by their own intermediaries.

Fifth, the specificity of the banking sector in competition policy should be recognised explicitly and formally. This would ensure coherence between competition policy and financial stability policy, and help stem the political pressure to extend financial bailouts to other sectors of the economy.

Furthermore, it is highly advisable to reconsider limited personal liability limitations for mortgages and other real-estate loans where they exist (such as in the United States). The promotion of home ownership should be examined carefully from a financial point of view, given the potential systemic implications of incentives raising the risk profile of borrowers against public guarantees.

Chapter 3: Private equity

Private equity plays an important role in the financial system. The few years before the credit crunch were probably the most favourable that had ever existed for private equity – with abundant capital, low interest rates, increasing stock market values, and a truly amazing willingness amongst banks and other investors to provide debt financing on a scale and on terms never previously observed. This led to a huge expansion in the amount of capital allocated to private equity funds, and an associated broadening of their sights: private equity funds acquired some multi-billion euro companies, and concluded deals in virtually all sectors of the economy. Consequently, private equity funds currently control a significant fraction of the businesses in many European countries.

With this increased scale of activity has, inevitably, come increased public interest, particularly regarding one type of private equity: leveraged buyouts. Concerns have been expressed regarding the extent and sources of value creation, transparency, and taxation issues. However, much of the debate in the media and amongst politicians has been characterized by misunderstandings about the workings of private equity. This is not entirely surprising given the secretive nature of many private equity funds. The first contribution of this chapter is to provide a brief primer on private equity, which documents its growth within Europe and shines some light into the workings of the sector.

Does private equity create value?

The economic impact of private equity can be measured in various ways. Financial returns are clearly the key objective for the funds and their investors. Here the evidence within Europe is mixed: early stage venture capital has produced very poor returns on average, whereas the returns on leveraged buyouts, in recent years, appear to be impressive. However, it is difficult to benchmark these returns – for instance against those earned by publicly quoted companies – without adjusting for risk. And adjusting for risk – particularly financial risk – is critical, since the investments are highly leveraged. Indeed, in the period before the credit markets closed in summer 2007, private equity funds used record amounts of leverage, and therefore increased the risk of their portfolio companies. But little research has been produced to analyse risk-adjusted returns, given the need for information on the capital structure of the portfolio companies, which is difficult to obtain. But in the same way that leverage amplified the returns earned by private equity funds when the economy was growing, the impact of this leverage on risk will undoubtedly result in some large losses during the recession, and some significant negative returns for some funds. However, there may be fewer bankruptcies than might be expected due to the loose covenants attached to much of the lending. On the other hand, private equity funds are likely to have to retain their investments in their portfolio companies for longer.

The impact of private equity ownership on employment

Politicians and the media are often more intrigued by the impact of private equity on employment rather than value creation. The evidence here is much more difficult to interpret, as there is always the counter-

factual issue: what would employment have been in the absence of private equity? This is particularly problematic given that many targets for private equity are in need of major restructuring. In general, the evidence on the impact on employment is complex to interpret. If anything, the evidence seems to suggest that employment grows at somewhat lower rates than in comparable publicly traded companies. Whether this is a good or bad thing is another matter. But the claims of some unions and politicians that private equity funds always sack workers are based more on anecdote than systematic evidence.

The transparency debate

A major issue facing private equity funds is that there is little understanding of how they add value or their impact on the companies in which they invest. This is in part due to the culture of privacy within the industry, which is a major impediment to public understanding of the role of private equity in the economy. Whilst some analysis has been published, it is often selective and partial, and frequently funded and vetted by industry associations. For many of the successful funds there is good story to tell, but to date only the large institutional investors have heard it. As a result, the claims of private equity funds are often greeted with scepticism.

One outcome of the veil of secrecy has been the push to increase transparency in many countries. Whilst no bad thing, this is likely to have limited impact. The investors in private equity funds already had access to regular, detailed reporting. There is no information asymmetry for those providing the capital, and, if there was, then as some of the largest and most sophisticated global investors they could obtain any information they desired. It is not clear that private companies should have to comply with different standards of reporting according to who the owners are. In general, the Walker review, and similar initiatives in other countries, may have some effect at the margin in terms of information flow to employees and other interested parties, but is unlikely to satisfy the critics.

Tax policies towards private equity

Another issue that has excited interest in the private equity funds has been taxation. At the corporate level, tax policies to make leveraged buyouts more difficult or costly have questionable justification and uncertain impact. The optimal capital structure will differ between companies, and restricting the tax-deductibility of debt will either raise the post-tax cost of capital or encourage tax avoidance by companies that find themselves constrained by the policy. In many cases the main impact of such policies is likely to be felt by the existing owners of companies that might be acquired by private equity funds, rather than in the returns earned by private equity funds themselves. At the personal level the taxation of private equity executives is an area that warrants careful consideration, as it is debatable whether their profit shares should be taxed as capital gains as opposed to income, or some hybrid of the two. But given the international nature of the industry, it is questionable how much money would be raised – especially in the next few years when profit shares may become a distant memory – and poorly thought-out policy might result in significant changes in the location of the funds.

The likely impact of the financial crisis on private equity

Finally, although the future returns earned by private equity funds that invested heavily in the period prior to the leverage bubble bursting in August 2007 are likely to be poor, the extent of financial distress and bankruptcy of the portfolio companies may be lower than might be expected. In large part this is due to the fact that private equity funds took full advantage of the unprecedentedly generous terms associated with debt financing during the leverage bubble. Whilst the investment banks, hedge funds and CLO (collateralised loan obligations) funds that provided the debt have witnessed spectacular losses, many of the portfolio companies themselves now enjoy long-term fixed rate, cheap debt financing with few covenants. Of course, leverage increases the susceptibility to financial distress and bankruptcy, and there is no doubt that some high-profile bankruptcies will occur. But the financial structure employed by many private equity funds may enable many of their portfolio companies to continue operating without defaulting long enough to see through the recession. What is in no doubt, is that holding periods will lengthen, investment rates will slow, the terms of future lending will return to historical norms, and that most existing funds will witness significantly reduced returns.

However, history informs us that some of the best periods to invest in private equity are at the start of a recession, when asset prices are low and the need for

rapid corporate transformations is at a premium. Private equity fundraising continues, constrained mainly by over-allocation of some institutional investors who have committed future funds assuming that realizations would continue at similar rates as in recent years. The private equity model provides an alternative form of governance, with ownership no longer separated from control. At its best, this can result in a rapid transformation of companies and the creation of significant value. Economies need a diversity of sources of capital, and public policy should let the market decide which source is most appropriate for a given company, without imposing tax or other regulatory restrictions to favour one source over another.

Chapter 4: France

In 2007 a new president, Nicolas Sarkozy, was elected in France after having promised radical change in many areas, including that of economic policy. In this EEAG report we take stock of his first year and half in office, and try to assess the country's economic performance as well as the reforms that have been undertaken.

At face value the results look positive overall, at least if one ignores the financial crisis. Unemployment had been falling until the summer of 2008, and a vast reform programme has been launched.

Closer inspection, though, suggests that one should be more cautious. The fall in unemployment is largely a cyclical factor, shared with many other European countries. The unemployment rate remains above the eurozone average and closely follows its movements. The room of manoeuvre for fiscal policy is small, because structural deficits have been the norm for the past two decades. As a result public debt tends to rise very quickly in slumps and is only stabilized in upturns, thus the margin of stabilisation is small and shrinks after each downturn. The current one is no exception and we expect France to emerge from it with a worrying fiscal position. Also, the growth performance remains modest. Finally, France has one of the largest government sector and the welfare state and the government is faced with the dilemma between fulfilling its commitment at an increasing tax cost or downsizing at considerable political costs.

As for the numerous reforms that have been undertaken, we have some concerns about the lack of quantitative significance of many of them as well as the existence of contradictions and the absence of a clear direction.

Traditionally, French reforms have suffered from three flaws. First, they typically are incremental. Rather than aiming at a deep change of the existing system, most often reform intervenes at its margin, often by adding new limited schemes. The Sarkozy measures are no exception. Second, the regulatory environment is complex. The more complex the system, the more difficult it is to operate. This means that policies do not have their intended effect, either because their interaction with the pre-existing system is neglected, or because lower levels of authority have considerable discretion in applying the law, as it is practically impossible to apply it entirely. Instead of tackling that complexity, the current reforms mostly increase it through incremental add-ons. Third, reforms have often been reversed. If reforms are highly reversible, economic agents will ignore them when setting their strategy but be happy to cash-in whatever benefits are available. The end result is that policy is ineffective.

The lack of a clear direction is due to the diversity of inspirations underlying the reforms. This reflects various strands of the public debate and ideological stances; we identify four competing paradigms.

Some reforms are motivated by the will to liberalise markets and foster competition, which is traditionally part of the Right's ideological stance. Some are motivated by economic nationalism ("France Inc."), i.e., the desire to boost employment and activity for French businesses with little regard for whether the policies are efficient or pro-competitive. Some are motivated by a corporatist paradigm that tends to ascribe a high institutional weight to so-called "social partners" (employees and employer's representative), ignoring the anti-outsider bias which is inherent in such a process, as well as the fact that it can deliver modest reforms at best. Finally some policies are motivated by the view that there should constantly be "social progress", implying that any redistributive measure is irreversible. This explains the secular rise in government size, or in the number of workers paid the minimum wage, which now stands at a staggering 16 percent of total employment.

These competing motivations explain why some of the Sarkozy reforms offset each other. For example, reductions in taxes granted by the first wave of

reforms were then nullified by new taxes that were meant to finance some new social expenditures.

So do we conclude that the government's policy is essentially hot air and that we expect France to remain a land of low growth, few jobs and little economic opportunity? Not quite, for we find two reasons for more optimism. First, while reforms are small, equally small ones have failed in the past because of organised protests. The catch-all reform strategy of the Sarkozy administration has made it more difficult to coordinate such protests. As a result many reforms have succeeded that were initially thought to be candidates for failure, and reforms in general have gained legitimacy. Second, a quiet revolution (called the general revision of public policy, RGPP) is underway in the public sector in the form of a plan to merge and rationalise public services and increase the scope for economic incentives, competition and autonomy. While it is the textbook case of a project where "the devil is in the details", if conducted properly this reform will eventually reduce the size of the public sector to the level of a normal OECD country rather than that of a Scandinavian country. This will make possible a reduction in taxes by say 3 to 6 percentage points of GDP, which in turn will ignite a virtuous circle between greater private employment and lower social expenses. Furthermore, by reducing the number of attractive top-level positions in the public sector, the reform may also cure a long debated French "disease", which is that the most talented individuals work for the bureaucracy rather than more innovative sectors; this is likely to be reversed when the public sector becomes less attractive, and it is expected that it will have positive effects on innovation and growth.

Our main recommendation is that the administration should use its freshly acquired political capital to focus on a few key reforms. One of them is underway, the RGPP, and we think it could go faster and be given more care if one dispensed with a host of other marginal reforms. Another, which is far more taboo, would be a reduction of the minimum wage. We argue that an important opportunity has been lost with the introduction of an earned income tax credit (RSA), a supplementary welfare scheme that eliminates a poverty trap for welfare recipients. While RSA increases the supply of labour for low-skilled workers, it does nothing on the demand side. Many of the corresponding jobs are not going to be created because it is not profitable for firms to do so. Instead, RSA should have been packaged with a reduction in the minimum wage. This would have set the stage for the progressive replacement of that distortionary scheme by a far less distortionary earned income tax credit system; it would have reduced the excessive proportion of workers at the minimum wage; and it would have stimulated labour demand as a counterpart to the labour supply stimulus of the RSA.