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“Why Earn More than the Prime Minister?”

By Herman van Dijk*
*General Director, TI

An intense debate is raging in the Netherlands—in parliament and in newsmagazines—on the issue of whether public servants should be allowed to earn more than the Prime Minister’s salary. His annual income should be the highest that any public servant should receive. In this column I argue why this so-called “Balkenende (the name of the present prime minister) Norm” fails in practice. Explanations for this failure can be found in the Permanent Income Hypothesis and in the way in which the market for high professionals functions. An interesting side issue, in the context of this debate, involves the aim of the Dutch government to have excellent research and a high level of culture.

The so-called “Balkenende Norm” in the Netherlands implies that public servants (which include scientists at universities) may earn an annual income that does not exceed the salary of the Prime Minister (whose annual salary is around 175,000 euro per year). Recently, the mayor of Rotterdam stirred up a great deal of turmoil in the news by stating that a successor for him was not easy to find since the salary offered was far too low. All outrage aside, however, one observes that the “Balkenende” Norm does not hold in practice. One important explanation for this failure is the so-called Permanent Income Hypothesis from the American Nobel Laureate in Economics Milton Friedman. According to Friedman, it is not the actual income that is important for a person but the expected income over a long period. In practice, this refers to the average income over a great number of years. However, the prime minister in this country serves for a period of four years, in principle. That is a very short period compared to a full lifetime of work. During this short period the prime minister enjoys a certain salary, but after this period an ex-prime minister can earn much more. A good example is former Dutch Prime Minister Kok and internationally, of course, US presidents such as former president Clinton (in the US, however, this issue plays a very minor role). It is rather interesting to note that former Prime Minister Kok was, during his period in office, against a high reward for workers in the public sector (including researchers at universities). But after his period in office he joined the board of a major bank and publicly supported statements such as: “Top jobs that need top talented persons have to be rewarded adequately high, since otherwise such persons may leave the country and/or work elsewhere.” There are many more examples of workers in the public sector who temporarily accept a relatively low income but who know that after such a period they can enjoy a much higher income. These workers have a relatively low actual income but a high permanent income. Examples are listed almost daily in the newspapers, particularly in the health and energy sectors.

A second explanation for the failure of the “Balkenende Norm” in practice is that the job of Prime Minister is a special one and not part of a larger job market. Thus, the Prime Minister’s salary is not part of a good incentive system for high professionals in the public sector. A proponent of a maximum salary may also argue that the Dutch head of state, Queen Beatrix, is—without any doubt—the ultimate public servant in the Netherlands. However, her job is also not part of a job market for Heads of State. (I only note here that if her net salary were taken as a norm for the public sector, then the entire debate on a maximum salary for public servants would no longer be relevant in practice.) In other words, the market for high professionals would function suboptimally if such a threshold as the annual salary of the single job of Prime Minister would be
imposed. The fact that such a market of high professionals exists was stated unequivocally by Mr. Kok in the quote mentioned above. Given that there are several good alternative job opportunities within the country and abroad for these professionals, an adequate incentive system should be developed for workers in the public sector in order to keep talented persons in their job.

There are many examples of workers in the public sector who temporarily accept a relatively low income but who know that after such a period they can enjoy a much higher income.

What is the connection with adequate rewards for research and researchers? This is simple to explain. Good research requires much time and effort in order to obtain interesting results. To become a good, internationally recognized researcher requires years of hard work in a particular field, often ten to twenty years. The salary of postdoctoral fellows and of young and talented researchers has been kept at a low level in recent years in this country. For these researchers there is not much difference between an actual income and a permanent income. That is, they invest not a few years but many years in their job, and very few switch to alternative jobs in industry and government. But there exists a growing international market for top researchers, and the conclusion is that this policy of low pay will in the long run lead to less talent for the research sector, due to the low permanent income and/or a departure of highly talented persons to a country where the rewards are much higher, due to the functioning of the market. Both developments do not bode well for a country that has stated its desire to have a strong knowledge sector and has committed itself to belong to the most competitive knowledge economy in the EU. Don’t think that other countries are just going to sit around and refrain from at least trying to hold on to, let alone attract, such talent. Two examples of different income policies: high civil servants in Singapore earn 300,000 to 400,000 dollars annually; in the United Kingdom, the salaries of beginning and senior researchers were recently increased substantially.

A good incentive system requires careful thought. A recent report of the International Labour Organisation (published on October 16, 2008) indicated that extremely high pay—as recently reported in the financial sector—does not necessarily boost performance. This practice of extremely high pay, however, is very different than a salary increase of say 50-75% for top researchers. One can also learn from the salary policy and the recent increases in salary used for excellent performers of classical music, like in the Berlin Philharmonic and in the Royal Concertgebouw Orchestra, where the international market plays an explicit role. The academic market for internationally recognized scholars is also international.

Finally, a remark in lieu of conclusions: proponents of the “Balkenende Norm” that are motivated by the aim of a fair distribution of income might want to take a look at some very good things said by Dutch Nobel Laureate in Economics Jan Tinbergen (in his 1975 book on Income Distribution) on the importance of a progressive income tax in this context.
Erik Plug and Andre Lucas were recently appointed as Directors of Graduate Studies for Tinbergen Institute. Plug, professor of economics at UvA, is known for his work in education and family economics, and will be responsible for the MPhil in Economics. Lucas, professor of finance at VU, is known for his work in risk management and financial econometrics, and will coordinate the new MPhil programme in finance. TI Magazine had the chance to sit down for a chat with the two new directors.

Erik, we hear that you are a big fan of Elvis. Perhaps you can tell us a bit more about that.

EP: What is there to tell? Isn’t everybody a big fan of Elvis? I think it’s all rooted in my childhood—I was ten years old when he died, and I became a fan. When I hit my teen years I felt a little bit embarrassed among my classmates, so I denied Elvis for a couple of years. But then I turned 23 and I went all the way. I had my inaugural speech in June this year, and as a present my colleagues and friends gave me a trip to Graceland, which is the house of Elvis. It was really very special. It’s as close to The King as you can ever come.

We saw that you wrote a paper in 1999 about how to tax individuals if we could ascertain their ability. Are you a supporter of the Tinbergen Talent Tax?

EP: The past is always haunting you... No, this was more or less an exercise to see if it was possible to calculate the Tinbergen Tax on talent. But there are too many hurdles.
What motivated each of you to become DGS? How does this responsibility fit in with what you want to accomplish in your career?

**EP:** I’ve always felt some kind of link with TI. I did my PhD there, and I’ve been organizing labour seminars for about ten years in a row now. It’s quite a long period, but I do it because I think TI is a very good institute, and I feel comfortable here. To be honest, when I found out that Jaap was moving to Tilburg I asked myself if this would be something for me—and I thought, yes!

**AL:** I also did my PhD at TI, and I’ve been involved in various activities, mainly in the finance area as a coordinator and helping to think out the finance track in the MPhil programme in economics. Then this whole injection of both energy and funds came through the Duisenberg School initiative to start up something in finance. This intrigued me because I like to build things. I’m also quite involved in the Duisenberg School itself for the Risk Management programme, and so in building another programme there.

What is the difference between the Risk Management programme you’re setting up and this position? Do you see a strong relation between the two?

**AL:** It’s a different market, first of all, for students. Within TI we are really trying to find the students who have a broader interest in finance and who also have a PhD interest or ambition. This is not the case for the Duisenberg programmes; the incentive there is to train people who will have a link to the industry. Organizational aspects are also very different. The commonality is the challenge to get something up and running that’s good, and to attract students.
Will future students in the MPhil Economics still be able to focus on finance, or do you see the two MPhil programmes becoming more specialized?

EP: We prefer that students with an explicit interest in finance enrol in the finance programme, and students who are interested in economics enrol in the economics programme. But you might find out that you like finance during the first year and then we offer the option that you can go for a finance field in the second year, and vice-versa.

AL: We studied other graduate programmes worldwide at top places, and what you see is that you decide for a core. But there are lots of field choices, and some of the field choices might be the core of the other programme, or the parts of the core that you skip. This creates a lot of flexibility for students later on.

According to the TI website, students from the MPhil Finance will not be able to go into a PhD in economics or econometrics. That seems a bit strange, since the econometric courses offered are the same in both MPhil programmes.

AL: If you ask me, we will change this because it will not work in practice that way. If someone from the MPhil Finance takes the advanced econometrics track and econometric field courses, and wants to do financial econometrics, I guess he will be accepted if his grades are okay. So it’s about flexibility—also in the sense that students can directly preset into what they find most interesting.

How did the idea for a new MPhil in finance come about?

AL: We had the Jorgensen committee visiting TI, stating that TI is very good...

EP: Exceptionally good...

AL: So now the next step is to really try to link up to the top of the world. Everybody should have ambition.

EP: We shouldn’t be modest.

AL: The advice there was to get additional funding and to specialize in some of the niche areas that we’re good at. If you would try to do it now it would be very hard, given the credit crisis, but at the time one of the most straightforward ways—where we had the most links at the board level of TI—was in the financial sector.

In order to cater to the ambitions stated in the Jorgensen report, the TI board decided to try to raise funding for a really good programme in finance and to attract also international visitors. The two external board members at the time, Jean Frijns and Jeroen Tinbergen...
Kremers contacted potential sponsors and that's where it started.

**EP:** We should also keep in mind that with having these two tracks we follow the international market. That's where we want to compete. We think that in Europe we've been quite successful, but we want to be even better. And this requires following international trends, which implies that we should also have a finance track.

*Quite a few partners of the Duisenberg School have been hit hard by the credit crisis. Do you think that will have an impact on their commitment to the DUISenberg School?*

**AL:** At the moment, we see that our partners also have all kinds of other business they need to take care of. Sometimes making an appointment is more difficult than in the past (general laughter).

But I don't expect this will have an influence. I've been talking with a number of these sponsors and other companies, and there's a great need for well-trained people with an analytical and a quantitative background who can engage in new thinking. That's what we try to accomplish in the MPhil programme. These are not the people who will most easily lose their jobs—even in the current crisis.

It seems that the macro track in the MPhil Economics has changed quite a lot over the years. Do you think the programme will now be more stable?

**EP:** I do foresee some changes in the programme, to accommodate the needs of students and teachers, and to make the programme more attractive. We'd like, for example, to organize a research seminar series, so that students not only learn tools during the core programme but also see the applications performed by our fellows.

**AL:** We would like to get one step further in terms of matching students with research ideas and with fellows. Currently, there's a workshop at the end of the first year, but we can structure that further to make the matching more streamlined. We're also giving careful consideration to ways in which we can involve students with research at an earlier stage.

What will be the difference and value added of this seminar series, compared to the other seminars TI already has?

**EP:** This research seminar series aims at multiple things. In the current year, potential supervisors from the fellows are not always that visible to first-year students. Having a platform where fellows can present their own work and increase their visibility will facilitate matching.

**AL:** And inspire students.

**EP:** Exactly. So it's not only that you are taught the tools that are required to do some independent research of your own...you actually see independent research, and this might just prove inspirational. Although this probably won't happen this year, it will probably be in the programme for the MPhil students who enrol next year.

Are there any other plans you're thinking about that you would like to share at this point?

**AL:** The other major issue is putting up the core of the finance programme. Now we are trying to settle on what the second year should look like. Of course the key should be that you major in finance, but it's also very important to see what synergy we can create between the TI and DUISenberg programmes. It already works to some extent—we're starting very modestly, very slowly—but this is something that should work well, and I think is very interesting for students.

As a final question, how are you working together now, and how are you planning to work together in the future? Do you have regular meetings?

**EP:** We have very regular meetings.

**AL:** Erik regularly sends me mp3s of Elvis, and I send him Greek poems...

**EP:** No, seriously, we meet at TI together every Tuesday and talk to each other for at least an hour...and a half. And then of course, it's not that we are fully alienated from each other, so we can also talk over coffee. I think that works out fine.

**AL:** Some of the core overlaps, so any change that's desired by one of the specializations requires close contact with the other Director to see whether it benefits students. We'll certainly have more contact in the future to redesign some things. For students it's nice to have the two specializations set up in a recognizable way, to see what's common and where the deviations are. That makes it easier for them once they apply to choose a track.
Up close

Fix it when it ain’t broken yet

Interview with Jeroen Kremers about the Dutch twin peaks model

The plan for a new supervisory framework in the US is partly based on the Dutch supervisory framework. How exactly does the Dutch situation relate to the US plans?

The current Paulson plan consists of two parts. The first step is crisis management—this is the Toxic Asset Relief Plan (TARP)—including the buying up of toxic assets. This is a fluid plan that has no particular relationship with the Dutch example. It will involve ongoing crisis management, until the financial sector stabilizes. The logical second step is to reform the regulatory framework fundamentally, once the financial sector stabilizes. This will take some time. The proposal that was sent to Congress is based on the supervisory framework of the Netherlands and Australia. This proposal was actually a response to last year’s situation, not this year’s upheaval. Remember that the crisis started more than a year ago. Working at the Dutch Ministry of Finance, I was responsible for drawing up and implementing the Dutch reform plan, working together with Dirk Schoenmaker, Annet Jonk and other colleagues at the time.

To answer your question, then, the Dutch and Australian example enters in the second step. Currently, the American supervisory landscape is chaos. The authorities themselves will say so. That chaotic landscape has developed historically. But let’s first discuss the Dutch situation before it underwent the reform, as it resembles the current American situation in the sense that it was organized by sector. The Dutch central bank (De Nederlandsche Bank; DNB) kept an eye on banks, the Pension and Insurance Chamber (Pensioen-en Verzekeringskamer; PVK) monitored insurance companies and pension funds, and another body (Stichting Toezicht Effecten; STE) supervised financial markets.

Increasingly, however, markets overlapped. Products nowadays cannot be subdivided along the lines I sketched just now—investment mortgages, for example, with a life insurance added. In this case, consumers do not see the difference between sectors, and neither do firms. The problem with these mixed products and firms is that the different regulating bodies don’t have an overall view and expertise, and that such

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The starting point should not be the stability of individual institutions, but stability of the system as a whole.

shared responsibility results in nobody being responsible.

What does the Dutch twin peaks model entail?

Like in the UK, and like Australia before us, the Dutch regulation organizes oversight across sectors, directed at meeting certain objectives. Gordon Brown took away control from the central bank and other entities, and made the FSA (Financial Services Authority) a mega-regulator for all financial firms and all regulatory objectives. The important difference is that the Netherlands has a twin peaks model, separating the two main regulatory functions.

The Dutch central bank safeguards the stability of all institutions, a task referred to as ‘prudential oversight’ at the DNB. That can now be done more effectively for all sectors. Another body (Autoriteit Financiële Markten; AFM) is responsible for the second objective, the conduct of business, which covers insider trading, transparency, reporting, and consumer protection— again, in all sectors. The old situation featured too many competing regulators, with unclear responsibilities and jurisdictions. Had the current financial crisis occurred during this time, it would not have been clear who should have taken the actions the DNB now takes to stabilize the financial firms.

Another example, seen from the other side: during the pension crisis around 2000, the Dutch pension and insurance chamber took a rigid stance; pension funds were required to restore their buffers immediately, resulting in higher contributions and a fire-sale of assets. This worked out pro-cyclically, as contributions are raised during economic downturns. Currently, the DNB has issued a statement to the effect that pension funds are permitted to improve their position gradually. This serves system stability.

How does British practice compare with that of the Dutch?

Recently, the so-called Group of Thirty issued a report on oversight and regulation. They stated that the twin peaks model is “closest to optimal”— that it’s the way to go. Why is that so? The crucial thing is that the two objectives and the competences needed to reach them are really different. Monitoring systemic risks involves number crunching, stress tests, accounting and risk management. Conduct of business is something different; it’s more like a police investigation. The expertise differs importantly. The British FSA conducted a self-evaluation after Northern Rock went broke. They concluded that they might, perhaps, have focused too much on conduct of business (as that is the kind of thing that makes headlines) and too little on oversight. But stability should be improved during good times; be wary of calm waters.

Of course, the Dutch plan was designed on the drawing board, and you have to wait and see whether it works in practice. Thus far, it seems to work. The DNB and AFM have been reacting positively, and there is not much overlap. If it had turned out that the policy in the UK (with one body combining the two functions) worked better, we could have shifted to that model. The Dutch policy was therefore a no-regret policy. Germany, Switzerland and Belgium followed the UK. France and Italy also adopted the Dutch model, and Spain will follow soon, I think, with plans already underway before the crisis.

How did the reform itself evolve?

In the end, we were able to reform supervision in 2000, after which I left to take up my post at the IMF in 2002. There was a hard lobby against the reform, especially from insurers. It used to be a closed shop in which insurers, their union (verbond van verzekeraars), the Pension and Insurance chamber, and the finance department responsible all knew each other and responsibilities were blurred. Of course, you have to be a partner with market participants, but in the end each has a different role. It was not clear where public interests started and private interests ended; it was too much of a closed circle.

It’s difficult to bring about any kind of reform without a crisis. Then everyone says, ‘if it ain’t broke, don’t try to fix it’. The current crisis can give momentum to the US reform. I was astonished that AIG, one of the world’s biggest insurers, almost collapsed; they turned out to have all kinds of obscure financial products. The current US system, however, organizes oversight over insurers at the state level. This means there are fifty insurance regulators. The Dutch model cannot be applied ‘as is’ to the US. Still to be worked out, for example, is what the link will be between prudential oversight and the Fed.
The old situation (in the Netherlands) featured too many competing regulators, with unclear responsibilities and jurisdictions. Had the current financial crisis occurred during this time, it would not have been clear who should have taken the actions the DNB now takes to stabilize the financial firms.

The Fed cannot do the oversight as the DNB does, as the DNB is not a real central bank anymore.

What other reforms in banking regulation and the role of government might be desirable?

What is crucial is prudential oversight on the banking system as a whole. Basel II focuses on individual banks, ignoring system dependencies. It’s not just a case of increasing oversight; regulation has to be rethought. You want to avoid just looking at individual institutions with some assumptions about how they influence their surroundings. You’ve got to start from the other end. You find out what the systemic risks are, and deduce from them regulation principles. How to do that exactly is not evident. What is clear, though, is that the starting point should not be the stability of individual institutions, but stability of the system as a whole.

Governments will not be modest with their new regulatory measures, and I think that’s justified. Regulations will get stricter. Capitalization demands may increase. But making them anti-cyclic would be better. You also have to look at the incentives of remuneration packages. People are getting bonuses for performance measures that are irrelevant for the firm’s ultimate performance. The government should not look at the level, but at the structure of pay. There should be long-term incentives. Perhaps a clearer distinction should be made between retail and investment banks, with high walls in the market separating them. Investment banking should not be done with retail savings. Some types of bank- and financial products should perhaps be forbidden, in the sense that there must be some rules that they have to meet. I support an efficient allocation of risks, but nobody knows their own risk. In the end, while individuals try to insure their own risk, we cannot collectively insure macroeconomic risks. This micro-macro paradox is the crucial thing. How to deal with all of this is not evident. It will require some hard thinking.

There will be drastic changes—of that I’m convinced. You cannot avoid crises, but you can learn from them and mitigate the effects arising from them. There will be a recession in the coming years, but if we avoid a cataclysm then we will do it better than in the thirties, when bad policies made things turn ugly. The fear of inflation resulted in a credit squeeze. This year there was initially some fear of inflation, but now you see the opposite reaction. There are lots of capital injections and a great deal of liquidity. If that helps us to avoid a total collapse, then we have learned something from earlier crises. Coordination of countries is positive, but it is also good that central banks work in their own context, which they know best. Whatever else I say with regard to the particulars of the current crisis will otherwise soon be outdated.

What is your (academic) background, and what do you think about the interaction between academia and policy?

I did my masters of econometrics in Tilburg. After that I went to Bristol and Oxford. I was a research assistant of David Hendry. My PhD consisted of different topics. One paper dealt with the power of unit root tests. With the Dickey-Fuller test, one does not exploit all information, which doesn’t matter in infinite samples. An error-correction model, however, allows you to increase the power in finite samples. Another paper dealt with the Dutch disease. Later I worked at the research department of the IMF. Subsequently I joined...
the Dutch Ministry of Finance (a real-world action environment) and became a part-time professor at Erasmus Universiteit. I know the academic side, but I’m not a scientist anymore. I like the analytical side of academics, but in the end I also want to see a practical result, and want to change and improve things. Academics excels in analysing problems—and most interesting problems stem from reality. In that sense, scientific research and policy can benefit from each other. I feel that econometrics has drifted apart, and is now separated. Within econometrics, there is a focus on small refinements and improvements of statistical models, but it is not always obvious how they are relevant. The application is sometimes absent; you want to bring applied economics and econometrics together.

*You're the chair of the board, what is the role of the board?*

The board makes strategic decisions. The past few years have been marked with organizing the follow-up to the Jorgenson report, in which David Hendry also participated. It was clear that Tinbergen Institute was one of the better economic institutions of continental Europe. Yet, we want to join the top of the UK and the US. We’ve formulated that aim modestly and calmly, and the ambition is there on the table. And that involves some homework. Our first task was to take a look at the criteria for naming TI fellows. The criteria were subsequently broadened, taking into account not solely journal articles, but also impact. That is an important part of science, and this step is part of growing up.

The second task was to raise more funding. Although Tinbergen Institute is well known, it is also very general (as is the aim). Sponsors, however, want a clear profile. The Duisenberg School provides that. It is a distinct sub-field, which thereby attracts funding. Tinbergen Institute, as the scientific part of the endeavour for the field of finance (providing education and research), gains from the school’s focus.

**References**

Paul Krugman

"With any luck, you will find many of these pieces extremely annoying.
My belief is that if an op-ed or column does not greatly upset a substantial number of people, the author has wasted the space. This is particularly true in economics, where many people have strong views and rather fewer have taken the trouble to think those views through—so that simply insisting on being clear-headed about an issue is usually enough to enrage many if not most of your readers."

Paul Krugman on his webpage about himself
The first time I met Paul Krugman he had just graduated and was about to leave for Yale. As an eager first-year PhD student at MIT, I asked him what he was going to do at Yale. His answer: *whacko trade theory*. Anything, as long as it upsets accepted wisdom. And boy did he deliver on that promise. Trade theory at that time was an elegant construct full of Edgeworth boxes and sliding offer curves, but largely irrelevant to the issues of the day. Strategic interactions, economies of scale and imperfect competition were touched upon, but were not at centre stage—and that is where Krugman squarely put them. So economists could finally address the Boeing-Airbus conflict, understand why most trade was in similar products instead of being driven by comparative advantage, and start to bridge the gap between economists’ advice and policymakers’ practice. He has extended his trade work to economic development, exploring the complicated interactions between labour migration, technology transfer and economic development, coming up with many unorthodox results in the process.

His impact on the profession has been immense. His work in the eighties and early nineties triggered a flood of theoretical and empirical research that shows no sign of abating yet. And a trade-theory course the way it was taught in my first year at MIT would be unthinkable these days. His work, and that of economists like Gene Grossman and Elhanan Helpman, who followed in his steps, has revolutionized the field. Yet his impact on trade policy has remained limited, probably to his own relief: the empirical evidence in favour of open borders has remained too overwhelming. Later in his career, Krugman himself expressed doubts: he was getting worried he had given intellectually respectable ammunition to the anti-free traders whose real motives were much less lofty than his elegant papers. Even that other iconoclast economist, Dani Rodrik, has included “orientation towards world trade” among his growth paradigms that work. Rightly, policymakers have by and large concluded that the issues raised by Paul Krugman ask for more active competition policy, not trade intervention.

His later fame as a columnist is pretty much in line with the way we know him as a researcher: no respect for political correctness, a scourging of people clinging to poorly thought-through prejudices, and always bitingly sharp. In any debate, go for the corner solution, and demolish your opponent (fictitious or real). The quote at the beginning says it all: Krugman wants to shake things up, and has succeeded admirably. His trenchant style probably also explains one of his greater frustrations, however: contrary to some of the other stars from his generation, like Larry Summers, for example, Krugman has never moved to the world of active policymaking (or for that matter business).

Krugman’s later work has also triggered waves of follow-up research, but has not been as paradigm shifting. His early paper on Balance of Payment Crises (really an application of earlier work by Steve Salant on commodity price fixing through buffer stocks) quickly became a classic, and focused policymakers on issues of sustainability and consistency of fiscal and monetary policies under fixed exchange rates. But mainly it amounted to an analysis of what happens if you do not follow the sort of recommendations the IMF already routinely doled out to troubled LDCs. Research in this area quickly moved on, integrating balance-of-payment crises into models with imperfect capital markets and financial intermediaries.

And that in no way diminishes Krugman’s position as probably the most stimulating and thought-provoking economist of his generation. Others have thought deeper thoughts, many are certainly much more competent from a technical point of view, but few if any have been so creative, and so successful in entirely redirecting the entire body of research in major and very policy-relevant areas. Judged by the impact Krugman has made on the profession, this year’s Nobel Prize is a prize well deserved.
Although Europe’s Stability and Growth Pact (SGP) requires countries to pay fines for repeated violations of the 3% deficit/GDP norm, no country has thus far paid a fine—and most experts doubt that it will ever happen. Indeed, they generally view the SGP as an instrument through which countries can impose peer pressure that will serve to stimulate other member countries to follow disciplined policies.

The interesting question is therefore how effective such a peer pressure mechanism is, in practice.

In a recent empirical contribution, we investigate to what extent planned fiscal policies in EU member countries affect the plans of other member states. We focus on planned fiscal policies rather than actual fiscal outcomes, because the former reveal more about the true intentions of fiscal authorities, while the latter are “contaminated” by the reaction of fiscal policy to unexpected economic developments (for example, unforeseen changes in the business cycle). Moreover, because the fiscal plans presented by governments do not necessarily reflect entirely their true intentions, we measure fiscal plans by using next-year fiscal forecasts published by the OECD. The OECD filters the data, at least to some extent, by basing its forecasts on existing legislation and legislation that has been approved but not yet implemented. In addition, our econometric approach filters out some of the potential systematic bias in the published plans.

Methodology
Our dataset includes 14 EU countries (all those that were EU members in 2000, excepting Luxemburg) over the period 1994-2005, which yields budgetary forecasts for the years 1995 – 2006. We regress the forecast for the cyclically adjusted primary deficit (the “planned fiscal stance”) on the average planned fiscal stance of all other countries in our sample, controlling for other factors that potentially affect planned fiscal stances, such as forecasts for output gaps and the deviation of the current deficit...
from the 3% reference level of the SGP. Our baseline estimates suggest that an average relaxation by one percentage point of the other countries’ planned fiscal stance induces an individual country to relax its own planned stance by 0.3 percentage points. This indicates a substantial spillover of fiscal plans, and we conduct a substantial number of tests to confirm the robustness of the result. As a by-product of these regressions, we find in most of the cases an a-cyclical response of the planned fiscal stance to the projected output gap. Debt/GDP ratios also seem to have no role, while there is mild evidence that future elections induce a relaxation in fiscal plans. Finally, violations of the 3% deficit norm do seem to induce a fiscal tightening both before and after the monetary unification in Europe.

**Digging deeper**

Next, we split the sample into a set of “large” countries (Germany, France, Italy, Spain and the UK) and the remaining nine “small” countries. This yields particularly interesting results. Repeating the standard regression for each group separately shows that the fiscal plans of large countries are unaffected by what the other large countries, on average, plan to do, while the fiscal plans of small countries are strongly influenced by the plans of the other small countries. However, including the average fiscal plan of the large countries in our regressions for the small countries’ plans, reveals that the plans of the other small countries no longer matter: only the average fiscal plan of the large countries matters. This strongly suggests that the plans of the large countries are a common driving force behind the fiscal plans of the small countries. Some further experimentation indicates that it is actually the one-period lag of the large countries’ plans that performs best in explaining the plans of the small countries. The figure below illustrates our finding clearly.

Note that the planned cyclically adjusted primary deficits are negative, and thus effectively correspond to surpluses. This is because they omit the interest payments on the public debt. Remarkably, starting with the year 2000, the fiscal plans of large countries progressively seem to be more relaxed, which is in line with widespread perception. In this trend, the small countries follow the large countries, although with some lag.

**So, does peer pressure work?**

What are the policy implications of this finding? Obviously, if peer pressure is supposed to work in disciplining fiscal policies in the EU, then it is important that the large member states be provided with the right incentives to follow disciplined policies. The other countries would then be expected to follow their example.

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**References**

Letters from Alumni
life after the PhD thesis defense

In the middle of a crisis
Michiel de Pooter*
Federal Reserve Board of Governors

It feels a bit odd to be writing a “letter from an alumnus” after graduating from the Tinbergen Institute just over a year ago. But an alumnus I am indeed, so I am going to try and make a valiant effort to describe that short period. Unlucky for many, but lucky for me in this case, the financial world has provided me with plenty of material to write about the relatively short period of time since I heard the “hora est”.

Before doing so, however, I first want to go back to my days as a PhD student. When I started my PhD track in econometrics at the Tinbergen Institute and the Econometric Institute in 2003 I was not entirely convinced if it would be something that I would necessarily be enthusiastic about. Before I started, I had had doubts about whether I wanted to work in practice, after having completed several internships at ABN AMRO Asset Management and Deutsche Bank, or whether I wanted to go to academia. Looking back now, I am quite happy that I decided to pursue a PhD, and that I was fortunate enough to do it at the Tinbergen Institute. During the first year and a half, I completed the TI MPhil program. Although it was already a high quality program back then (even if it lacked a proper finance trajectory) it seems to have gained more and more momentum in the five years that have passed since then. During the actual research stage of my PhD I was lucky to have an advisor who encouraged me to explore different fields of financial econometrics and to try to spend time abroad. I quickly realized that being a PhD student is a unique period ideally suited to trying out, experiencing and learning as much as possible. All this led to my thesis work consisting initially of modelling the dynamic behaviour of financial market volatility, and later that of interest rates, and to several stays abroad at the University of Chicago and, again, Deutsche Bank. Equally important to having a broad training was being part of a great group of fellow PhD students to laugh and have fun with, but also to bounce ideas off of. The members of the group I grew up with as a PhD student are now all working at high-level institutions with somewhat of an interesting bias towards central banks.

I am contributing to this bias as well, because in July of this year I started as an economist at the Federal Reserve Board in Washington D.C. When I was in the final stages of my PhD I revisited the question of where I wanted to go next: practice or academia. My dilemma has by now been resolved because “the Board” (in my, obviously subjective, view) seems to offer the best of both worlds: the ability to do academic research as well as having strong links with financial markets, the latter albeit of course primarily from a monetary and financial policy perspective.

Around about the time I was defending my thesis last year the current financial crisis began to erupt in full force. Due to a persistent visa issue, my start at the Board was delayed substantially, but when I was finally able to start I initially joked that I had missed out on so many developments. I have very quickly realized since then, however, that during my still short period at the Board I have seen more upheaval in financial markets than I ever could have imagined. The Federal Reserve has already played a pivotal role in trying to stem the current crisis by being very active in terms of monetary policy actions and setting up several programs to provide liquidity to (global) markets.

There is a world of difference between reading about policy actions by the Federal Reserve in the past and witnessing these actions being taken up close and personal. Despite the seriousness of being in an economic downturn, I cannot think of many better places at the moment from which to witness how the financial crisis is unfolding, and, more importantly, how policymakers here at the Board and elsewhere are doing everything within their power to turn the tide.

Although our usual disclaimer dictates that the views expressed in this letter are solely the responsibility of the author (me), and that these should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve or of any other employee of the Federal Reserve System, I think that every Board employee, and will, agree with me when I say that the Board is an extremely exciting place to work!
**Entrepeneurs and new ideas**

The paper examines how early-stage new ideas are turned into successful businesses. Promising new ideas can be unprofitable if they fail on any critical dimension, such as technical feasibility, market appeal, logistic access or patentability. Thus, an entrepreneur must evaluate the business concept according to different aspects that require different experts. Sharing an early-stage idea creates the risk that any expert might steal it. Yet, a stolen idea can be implemented only under incomplete screening, which is very risky when other experts have critical, highly complementary expertise. The entrepreneur may thus be able to bind experts and aggregate their information by offering a contingent partnership, thus granting them access to each other’s information.


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**Defending against speculative attacks**

While virtually all of the modern currency-crisis models recognise that the decision to abandon an exchange rate peg depends on how tenaciously policymakers are willing to defend it, these models seldom show how this is done. Such an omission is unfortunate, because during the onset of a currency crisis much of the pressure on the exchange rate manifests itself through policy actions aimed at defending the exchange rate in order to avoid devaluation, instead of through the ultimate fall of the currency in case of a successful attack.

This paper incorporates both the mechanics of speculation and a defence policy against speculation in the well-known currency-crisis model of Morris and Shin¹. After adding these natural elements, the new model outperforms standard models at explaining stylised features of currency crises. The paper shows that if an attack is successful, it must be followed by a substantial jump of the exchange rate. The new model both clarifies the timing of the attack and shows that stress on the foreign exchange markets might be observable well before a crisis fully hits. All of these points touch upon weak spots of traditional currency-crisis models.

Furthermore, the model connects the theoretical currency-crisis literature to an empirical literature on exchange-market pressure by bringing together its building blocks: exchange rate changes plus counteracting defence policies. This connection is then used to confirm empirically the model’s predictions.

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Errors in judicial decisions: Experimental results

In criminal cases, the task of the judge is to transform any uncertainty about the facts into the certainty of the verdict. This experiment examines the relationship between evidence of which the strength is known, subjective probability of guilt and verdict for abstract cases. The paper looks at two situations: (1) all evidence is given and (2) evidence can be acquired. Roughly half of the participants do not base their decision on a subjective belief of the probability of guilt. The others underestimate in general the probability of guilt, but this is more than compensated by a tendency to convict at too low probability of guilt. In the situation where evidence can be acquired, participants do not acquire enough evidence.

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By Joep Sonnemans (UvA), Frans van Dijk (Council for the Judiciary, The Hague), *Errors in Judicial Decisions: Experimental Results*, TI 08-089/1

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**The bias of the Gini coefficient due to grouping:** Revisiting first-order corrections

How unequally are incomes distributed? Is the redistributive effect of taxes evolving over time? These questions are of vital importance for tax and social policy, and the Gini index is applied most commonly in pursuit of the answers.

A drawback to the Gini is its downward bias if applied to data that is grouped by categories or into ranges. Such grouping commonly arises with income or tax...
This paper develops a first-order correction by treating grouping as a form of measurement error. Its main advantage is its simplicity and transparency. In addition, it also provides an exact expression for the remaining second-order bias. The performance of the first-order correction is illustrated using data on income distributions of 15 European countries and the US.

The paper’s findings indicate that the bias in the Gini due to grouping is similar in the 16 countries. It rises at an increasing pace when the number of income categories are lowered, and is substantial relative to the sampling variability of the Gini index, its evolution over time, and cross-country differences in the value of the Gini. The paper further illustrates the performance of its first-order correction term, and shows that it considerably reduces the bias due to grouping in all countries. Finally, similar conclusions are reported from a case study on the performance of the correction term in restoring the income inequality ranking if countries differ in the number of income groups.

By Tom Van Ourti (EUR), Philip Clarke (University of Sydney), The bias of the Gini coefficient due to grouping: Revisiting first-order corrections, Tl 2008 – 095/3

Reciprocity and incentive pay in the workplace

Why do firms like Southwest Airlines perform so well, while giving weaker financial incentives to employees than other firms in their industry? Many management scientists argue that this is because of the superior working environment in these firms that is provided by senior management. This raises the issue of how the managerial ‘supply’ of a good working environment is affected by financial incentives for employees. With the help of a principal-agent model and supported by empirical evidence, this paper argues that firms face a trade-off between giving financial incentives to workers and preserving
incentives for managers to provide for a healthy working environment: strong incentives for workers make managers more lax in their tasks, resulting in a darker working environment and less-motivated workers. The firm may do better by committing to low levels of financial incentives, so as to induce managers to make better use of the social motivational tools of management (giving attention, showing respect, backing ‘your’ people at personal cost, etc.). The paper also makes the case that replacing bonus schemes for workers with career opportunities can greatly improve firm performance, since such competition among workers does not impair the incentives for managers to manage.

By Robert Dur (EUR, CESifo), Hein Roelfsema (Utrecht University), Reciprocity and Incentive Pay in the Workplace, TI 08-080/1

Essays on firm heterogeneity and quality in international trade

Firm heterogeneity implies a reallocation effect of international trade: the least productive firms are squeezed out of the market and more productive exporting firms gain market share at the expense of less productive domestic producing firms. This thesis analyses different firm heterogeneity models, showing that firm heterogeneity in an oligopoly setting also leads to a reallocation effect with unambiguous welfare gains from freer trade in the long run. The reallocation effect operates through more product market competition squeezing mark-ups— in contrast to the conventional Melitz model, where competition for scarce labour resources drives the reallocation effect. The model also finds that a larger market leads to lower prices, but finds that this can accompany situations in which there are either more firms or fewer firms in the market, depending on the distribution of productivities.

In two models, firms are heterogeneous with respect to quality and trade leads to a reallocation of market shares towards higher quality goods with higher prices. This brings the firm heterogeneity models in line with the empirical findings that goods from richer, more productive countries display higher and not lower prices. Another model in the thesis can account theoretically for a different empirical finding that more skill-abundant countries export higher quality goods. A final model of the thesis explains the low success rate of new exporters from the fact that tastes differ across countries and that firms are uncertain about these tastes. A fraction of the firms that start exporting thus drop out of the exporting market because their variety is not popular enough in the foreign market.

The first essay introduces heterogeneity in the productivity of firms, and shows that workers who apply twice always send both applications to the same type of firm. This, however, is inefficient. A social planner would like them to diversify their applications.

The second essay analyses whether workers send the right number of applications. Sending multiple applications is more costly, but can also result in a higher wage offer. The model is estimated using wage and aggregate labour force data. Again, inefficiency is found. Too many workers do not search at all, while a small fraction sends too many applications. A marginal increase of the minimum wage or unemployment benefits is shown to increase social welfare.

The last essay in this thesis studies the effect of on-the-job search in a model of simultaneous search. An important feature of the model is that workers can communicate their current wage to the firms, which subsequently condition their wage offers on this information. Firms face a trade-off with regard to which applicant they choose. Unemployed workers are cheaper since they have fewer outside options, but the competition from other firms for these workers is higher than it is for an employed worker. The resulting equilibrium wage distribution is non-monotonic, which is in line with what is typically observed in data.

Essays on simultaneous search equilibrium

Labor markets in the real world exhibit phenomena that are hard to explain with the standard textbook model of supply and demand. Vacancies and unemployment coexist, and seemingly identical workers often earn very different wages. In recent decades, economists have therefore been developing new models that allow for information and coordination, and provide better explanations for these observations. This thesis adds to that literature by describing three new models in which workers apply simultaneously to multiple firms with vacancies. The first essay introduces heterogeneity in the productivity of firms, and shows that workers who apply twice always send both applications to the same type of firm. This, however, is inefficient. A social planner would like them to diversify their applications.

The second essay analyses whether workers send the right number of applications. Sending multiple applications is more costly, but can also result in a higher wage offer. The model is estimated using wage and aggregate labour force data. Again, inefficiency is found. Too many workers do not search at all, while a small fraction sends too many applications. A marginal increase of the minimum wage or unemployment benefits is shown to increase social welfare.

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