



Can a new French economic policy be successful?*

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Abstract: François Hollande's economic strategy is ambiguous. He is convinced that there is a need for a new policy in Europe, more growth-targeted, but in order to strengthen Europe, he accepts a Fiscal Pact which constrains countries to run austerity policies. He imposes France an absurd trajectory of budget cuts, which makes fiscal policy pro-cyclical. He wishes both to reassure financial markets and to reduce their influence (in particular through regulation and financial transaction taxation). Cuts in government borrowing should be obtained in the short term by higher taxation on the wealthiest and on large companies, but in the medium term by public and social spending dramatic reduction. Strong measures are announced in the environmental areas, but environmental transition is not totally ensured. The EU discourse on the need for structural reforms is neither accepted nor clearly rejected. The government counts on social partners to reform labour market functioning, but choosing the employers' viewpoint (higher flexibility) rather the trade unions' one (preventing lay-offs). François Hollande announced a strict distinction between retail and investment banks and an increasing role of the investment public bank (IPB). At the same time, he impulses a banking union, where France would lose all control of its banking system which would be piloted by EU authorities. The government will undertake a 'competitiveness shock' strategy, a decrease by 20 billion of employers' social contributions financed by public expenses reductions and VAT increases. It aims at a 're-industrialisation' which would be achieved through direct supports, by the government, regions, from IPB to industrial companies. At the same time the means allocated to this policy are limited. The IPB is under- dimensioned. More importantly, the strategy does not organise the social mobilisation needed for a new companies' management. Thus, two scenarios can be imagined. The first one is the 'normalisation scenario': France agrees to implement progressively all EU measures, at the risk of a long recession and rising unemployment period. It is unlikely that liberal 'structural reforms', wage and public spending austerity will provoke a growth revival in France. The second is a 'rupture scenario' where France would try to find an original way, Colbertist/social-democrat/ecologist, based on public and social intervention, boosting growth, protecting the EU social model and social cohesion, preparing for environmental transition. Will France find allies in Europe to implement such a strategy?

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At the beginning of 2013, France like many other EU countries faces four challenges. French output is still below its pre-financial crisis level. Hence, French GDP stands 9% below the level it would have reached had GDP continued to grow at its pre-crisis trend. Between the first quarter of 2011 and the fourth quarter of 2012, GDP growth was close to a standstill (-0.1% in seven quarters). There is no sign of recovery in sight.

The output fall has led government borrowing to reach 5.2% of GDP in 2011. Under the pressure of financial markets and EU authorities, France has committed to cut this deficit down to 4.5% of GDP in 2012 and to 3% in 2013. This implies a fiscal tightening of around 1.5% of GDP in 2012 and 2.2% of GDP in 2013. But such a tightening will in turn reduce GDP growth. Conversely, government bonds interest rates have remained very low (at around 2.5% for 10-year bonds). Should austerity policies be run in times of recession? Should such policies bear firstly on expenditure or revenues?

France suffers from an industry problem. The French current account balance moved from a surplus of 2.6% of GDP in 1997 to a deficit of 1% in 2007, and 2% in 2012, while the German current account balance moved from a deficit of 0.4% of GDP in 1997 to a surplus of 5.7% (with the euro area continuing to run a small surplus). From 1997 to 2012, French market shares in world exports fell from 5.3% to 3.3% (-38%), i.e. in line with Italy (-37%) and the UK (-36%), while market shares declined only moderately in Germany (from 8.5% of world exports to 7.9%, i.e. -7%). In August 2012, French industrial output stood at 92 only in level (2005 basis = 100) versus 112 for Germany, and 100 for the euro area. How to restore the French productive structure is therefore a question to be asked. Is there a need for a 'competitiveness shock' in order to increase companies' profit margins? Should a tax reform be introduced to organise substantial transfers from households to companies?

Last, France should move forward to environmentally friendly growth. Three strategies can be considered: supporting existing industries, which employ a large number of workers, and in which France has specific skills; supporting innovative/high-skilled industries or environmentally friendly industries. How should this strategy be run? Can it rely on private entrepreneurs only? Or should the State also play a role?

In all these areas, France has to choose between strengthening its specificity, its social model and Colbertist tradition, or imitating the best pupils of globalisation in the world or in Europe, based on liberal or social-liberal models. But Europe is ill, suffers from low growth and is unable to implement an exit strategy from the euro area crisis. Trade and financial globalisation have initiated the 2007 financial crisis. Should France jump on a train about to derail?

In May 2012 François Hollande was elected as a President of the French Republic and the socialists and greens coalition won the legislative elections soon afterwards. This paper describes the strategy of the government in office since then and tries to assess its chances of success.

Four strategies

Four strategies were opposed in the 2012 presidential elections

- Leaving the euro (among French politicians: Marine Le Pen, Nicolas Dupont-Aignan, among economists: Jacques Sapir). According to the proponents of this strategy, France

cannot resist in face of the competition from low-wage countries. The single currency leads to unsustainable exchange rates for Southern economies, and for France. One should thus revert to national currencies (exchange rates will reflect each country's competitiveness) and protect French companies from low wage countries' imports, thanks to trade barriers. However the euro area break-up would generate strong financial (what would happen to intra-euro debts?) and trade (intra-European exchange rates would become unpredictable) shocks. Introducing trade barriers would force countries out of the WTO; trade barriers are a source of conflict: if a sector may be happy when taxation is increased on foreign competitors, other sectors will complain from having to pay higher prices for imported inputs. The French Franc devaluation, the introduction of trade barriers would lead import prices to increase substantially and hence French households' to lose purchasing power. In the end, such a violent shock could prove successful, but it is very risky.

- A radical change of strategy within Europe (Jean-Luc Mélenchon). The ECB would guarantee (and even finance) public debts; the objective of rapid cuts in public deficits would be abandoned. Economic growth would become the first objective, through stopping austerity policies, raising wages, supporting public and productive investment through the introduction of investment public banks (IPB, *Banque Publique d'Investissement*). Europe would launch a large harmonisation programme on taxation (which would allow for higher tax rates on the wealthiest, on large companies, and on the financial sector) and social systems (which would aim at unifying social protection in Europe). This programme requires to change the EU Treaties; it questions the relevance of an independent ECB and of the Stability and Growth Pact (SGP). But would EU partners (especially in Northern countries) agree on such a strategy? Besides this strategy minimises contradictions and imbalances between EU countries.

- The liberal strategy was supported by Nicolas Sarkozy, although with a number of contradictions. On the one hand, Nicolas Sarkozy was sometimes in favour of active policies in Europe, opposing binding fiscal constraints, wishing a refoundation of capitalism targeted towards industrial capitalism, and fighting the predominance of finance. On the other hand NS supported plans to cut taxes and public expenditure in France, in order to generate a supply shock, but he did not succeed in implementing it: due to the crisis, public expenditure rose from 53% of GDP in 2006 to 56% in 2011. Last, starting from 2010 NS agreed to implement the EU strategy based on strengthening the SGP, strategy which led to the Fiscal Treaty.

Nicolas Sarkozy set France the objective of following the German model, in particular by cutting substantially company taxation, but this would have required either to raise substantially households' taxation or to reduce social protection, which Nicolas Sarkozy did not undertake.

In fact, the German strategy suffers from three drawbacks which make it hardly implementable in France: in the short-term, it depresses output, consumption decreases which leads investment to fall. It takes time before competitiveness translates into economic growth recovery. Thus, from 2000 to 2005, French output grew by 7.8% (1.55% per year) while German output grew by 2.7% only (0.55% per year). Can France afford to lose 5% of output? German GDP growth based on competitiveness gains relies on external demand at the expense of domestic demand. Hence it reduces growth in Europe and contributes to increase imbalances between Northern and Southern economies. This model cannot be run in all

countries at the same time. This strategy increases social inequalities and leads part of the population to fall into poverty. Thus the poverty rate rose from 10% in 2000 to 15.5% in 2010 in Germany, while it remained at 13% in France.

In his presidential programme, Nicolas Sarkozy was planning to bring budgetary positions in balance in 2016, albeit cutting social contributions. Job/competitiveness agreements by industry branch should allow firms to maintain jobs as a counterpart of wage cuts.

In 2012, not long before the presidential elections, Nicolas Sarkozy made adopted the social VAT which should be introduced by the end of 2012. On the one hand companies benefited from cuts in employers' family contributions; on the other hand, CSG (*Contribution sociale généralisée, a flat rate on incomes*) on capital gains) and the normal VAT rate would rise. This measure was expected to improve French companies' competitiveness by allowing them either to cut their prices or increase their margins.

- François Hollande's electoral programme hesitated between two options: a European-social-liberal programme and a Colbertist-social-democrat one. Thus, François Hollande targeted rapid public finance rebalancing, through lower public expenditure in the medium-term, but a strong rise in taxes on wealthy households and companies in the short-term. No substantial rise in wages or social allowances was planned. The industrial recovery was expected to come mainly owing to funding ensured by the investment public bank (IPB) and specific support targeted to SMEs. However, strong measures were planned to be introduced to fight financial speculation, and to reform the banking system. A social conference was expected to generate active support from employers and employees on labour market reforms to create jobs. Last, François Hollande hoped to re-direct EU construction towards a growth strategy.

1. François Hollande's Programme

| Liberal measures | Colbertist measures |
|--|---|
| Budgetary position in balance in 2017; cuts in public spending as a % of GDP | Increased taxation on the wealthiest, large companies and capital incomes; higher marginal tax rate on incomes; increase in wealth taxation; tax reform |
| Stabilisation in the number of public servants | End of RGPP (General Review of Public Programs); increase in the number of teachers (by 40,000) |
| | Increase in the September school allowance |
| New pensions reform | Pensions at 60 for long working lives |
| | Regulation on rent prices; social housing building |
| | Progressiveness in water, gas, and electricity prices |
| | Cap on higher wages in public companies. |
| | Higher CIT rate for distributed profits; lower CIT rate on reinvested profits and SMEs. |
| | Financial transactions tax |
| | Forbiddance of bank speculative activities |
| Support to SME's | Investment public bank |
| | Fighting international relocations |

| | |
|-------------------|--|
| Social conference | Social conference |
| | Renegotiating the Fiscal pact; Eurobonds; redefining the ECB's role |
| | New trade policy in Europe |
| | Reducing the share of nuclear power in electricity output from 75% to 50%; environmentally-friendly housing; support for worldwide environmental targets |

The European strategy

François Hollande's manifesto was saying: 'I wish to change European construction; I will offer our partners a pact of responsibility, governance and growth to exit the crisis and the austerity spiral which aggravates it. I will renegotiate the EU Treaty agreed on 9 December 2011, through favouring growth and employment, reorienting the ECB's role towards that direction. I will make a proposal for Eurobonds'.

The fiscal Treaty

The fiscal Pact (the Treaty on stability, coordination and governance, TSCG). is difficult to accept for France. It imposes heavy constraints on fiscal policies in the MS, although active fiscal policies have been necessary during the crisis. It strengthens the Stability and Growth Pact (SGP) although it failed. It is new step from two attacks, one by liberals against a Keynesian economic policy, one by EU authorities against domestic fiscal policies. The Treaty aims at making the dream of liberals come true: totally paralysing fiscal policies; imposing budgets in balance at any cost. It turns its back on 75 years of economic theory.

According to article 1 of the Treaty, the rules 'aim at strengthening economic policy coordination'. But numerical binding rules on debts and deficits cannot be considered as economic policy coordination if they do not account for the economic situation.

Thus, budgetary positions close to balance are enshrined in the Treaty, although this has no economic justification. The true 'golden rule for public finances', stated by Leroy-Beaulieu in 1891, justifies on the contrary, that government borrowing is allowed to finance public investment. Besides, households, insurance companies, and financial institutions, wish to own public debt. If desired debt is around 60% of GDP and if trend growth rate is around 4% (in value terms, i.e. 2% in volume and 2% in prices), it is justified to run here also a 2.4% of GDP deficit. Also, a public deficit shall be deemed necessary when it allows for a satisfactory demand level leading to an output level neither increasing mass unemployment, nor inflation acceleration. There is no evidence that the corresponding level of public deficit is 0. Since MS do not control interest rates, exchange rates, they need degrees of freedom in terms of fiscal policies.

The Treaty imposes a rapid convergence towards this target, convergence which would be defined by the Commission without accounting for cyclical conditions. Some temporary deviations from the target would be allowed if they result from exceptional circumstances or "from a negative growth rate or from the accumulated loss of output during a protracted period of very low growth relative to potential growth", but corrective measures should be

rapidly implemented. But the Commission refuses to recognise that euro area countries have been in such a situation since 2009 and insists on imposing rapid cuts in deficits.

The Treaty is based on the structural deficit notion, i.e. 'deficit corrected from the cyclical component, excluding one-off and temporary measures'. But the measurement of this deficit is problematic, especially in the event of strong macroeconomic shocks. In fact, the estimates and methods of the Commission will have to be used. But they have two drawbacks. First, these estimates are always close to effective output, since the methods used consider as structural the fall in capital resulting from the investment fall during the crisis: this underestimates the cyclical deficit and will impose pro-cyclical policies.

Second, the estimates vary strongly over time. Hence, potential output estimates for 2006 were revised substantially downwards in 2008. Is this wise to introduce such a vague concept in an international Treaty? According to Paragraph 3 d, the structural deficit target can be lowered to 1% if debt stands below 60% of GDP. Let us consider a country with GDP growing by 2% per year and inflation growing by 2%. If this country runs permanently a 1% of GDP deficit, its debt will converge to 25% of GDP. But nothing guarantees that macroeconomic equilibrium may be ensured with *a priori* values: debt = 25% of GDP; deficit=1% of GDP.

According to article 3.2, MS have to introduce in their constitution, the balanced fiscal rule and an automatic correction mechanism if the public balance deviates from its target, or if this cannot be done, in a binding and permanent mechanism. The correction mechanism must be based on principles proposed by the Commission. Thus, unenforceable, vague and without economic rationale rules would have to be enshrined in the Constitution.

MS will have to introduce independent institutions in charge of verifying that the fiscal balance rule and adjustment trajectory path are fulfilled. This is one more step towards full technocratic management of fiscal policy.

Article 4 repeats the rule according to which public debts should come down below 60% of GDP. This rule was already part of the SGP, but the Commission could not impose it. Thus, a country running a higher than 60% of GDP debt ratio will have to reduce this ratio by at least one twentieth of the gap with 60% each year. This rule raises 3 issues:

According to article 5, a country under an EDP will have to submit for approval its budget and structural reform programmes to the Commission and the Council, which will be requested to approve it and exert surveillance on the implementation. This article is a new weapon to impose liberal reforms to MS populations

According to article 7, the Commission's proposals will be automatically adopted unless there is a qualified majority against them, the country concerned not voting. Thus, in practice, the Commission will always have the last word.

The Treaty obliges MS to run quasi-automatic fiscal policies, prohibiting any discretionary fiscal policy. But the latter are needed to allow for full stabilisation. Let us assume that the tax rate is 50% and the propensity to spend is 1; so the multiplier is 2. If private spending falls by 10 *ex ante*, without active fiscal policy answer, GDP will fall by 20 and the public deficit will rise by 10. An active expansionary policy, which increases public spending by 10 leads to the same public deficit, but avoids the output fall. This is prohibited by the Treaty, which is based on an implicit but wrong theory: the automatic stabilizers must play, but discretionary fiscal policies to support growth should be prohibited.

According to the Treaty, each country should run restrictive measures in isolation without accounting for the domestic economic situation and other MS policies. The Treaty makes the implicit assumption that the Keynesian multiplier is zero, that restrictive policies have no impact on GDP. If we consider the situation in mid-2012, this implies that all countries run austerity policies even if their public deficits are due to insufficient output levels following the bursting of the financial bubble. Also, the Treaty may impose a long period of austerity policies in Europe, which will break euro area growth and will increase imbalances in most vulnerable MS.

The Growth Pact

The new French government therefore had all reasons not to sign the Treaty in June 2012. This would have opened tough discussions in Europe, revealing disagreement on the macroeconomic strategies to follow. On the one hand, Northern countries and the European Commission advocate fiscal consolidation and strict fiscal rules, under financial markets' surveillance, structural reforms, economic policy targeting competitiveness gains. On the other hand, France insists on EU economic governance, based on fiscal policies' open coordination, ECB's public debt guarantee or Eurobonds, large industrial projects and more active fiscal and wage policies in Northern countries, more moderate austerity policies in others MS.

In fact, France did not wish to launch a crisis, fearing that this would block any progress of financial solidarity in Europe; it would raise speculation, which could lead several Southern countries to leave the euro. France did obtain neither a renegotiation of the Treaty, nor Eurobonds or ECB's guarantee. On 29 June 2012, the European Council only adopted a growth and employment Pact. In spite of this title, it is not symmetric with the fiscal Pact. It includes no explicit target in terms of jobs or growth. It mostly includes already undergoing plans, some of them being of liberal inspiration the Europe 2020 strategy, the need to guarantee pensions systems sustainability, to improve public expenditure quality, to increase young people employment, to favour labour mobility, to open competition in the areas of services, energy, public tenders.

The Pact recognises that there is no general agreement in Europe on a financial transactions tax, but opens the door to a strengthened cooperation, i.e. to an agreement among a group of countries, without the UK, which will strongly reduce its impact.

Friendly-growth measures are rather limited. A euros 120 billion amount is mentioned, i.e. 1% of euro area GDP, but these measures apply to an undefined length of time, while austerity programmes amount to 240 billion per year. The 120 billion amount can be decomposed as: 60 billion on EIB's lending capacity thanks to a 10 billion rise in capital; 5 billion Eurobonds to finance infrastructure projects, and last allotting 55 billion of structural funds already available to 'measures targeted to support growth'.

One may note that euro area growth forecasts for 2013 released by *Economic forecasts* have been cut from 0.7% in early June to 0.5% in early July. Economists were not convinced.

The French government finally agreed to ratify the Treaty, hoping is so doing that this would initiate a new move towards more solidarity and coordination in Europe. The risk is that this implies abandoning fiscal policy autonomy, while EU policy will remain

dominated by economic policies orthodoxy. The French government pretends to have obtained a change in EU policies. According to us, this is an illusion.

In fact, the Pact for growth and employment has not been integrated into the major policies of the Union. The decision of the European Council, in January 2013, to reduce the budget European (as a percentage of GDP) during the coming years marks the end of the hope of an European active fiscal policy.

The Organic law

In September 2012, the French government submitted to the Parliament an “Organic law relating to the planning and governance of public finances” (*loi organique relative à la programmation et à la gouvernance des finances publiques*), which translates into French law the EU Fiscal Pact (the Treaty on stability, coordination and governance, TSCG). In fact, the government has chosen an *ad minima* reading of the Treaty, since the new fiscal procedure is not included in the Constitution.

Article 1 of the Organic Law stipulates: “In accordance with the objective of balanced government accounts as set out in Article 34 of the Constitution, the LPFP sets the medium-term targets of the government administrations referred to in Article 3 of the TSCG.”

Article 34 of the Constitution, adopted on 31 July 2008, sets out only a medium-term non-binding target. It has had no impact on the fiscal policy adopted since then. In times of crisis, the multi-year guidelines quickly cease to have any influence. This was the case, for example, in 2009. The 2009 deficit, which was set at 0.9% of GDP in the four-year budget plan passed in January 2008, and 3.9% of GDP according to the January 2009 plan, finally amounted to 7.5%. Should we give up this flexibility?

Besides, how can the budget plan “set a target” when the target flows from Article 3 of the Treaty, which clearly states that the target should be a structural deficit of less than 0.5% of GDP and that a path for an adjustment to ensure a rapid convergence toward equilibrium will be proposed by the European Commission? The ambiguity of this article actually reflects an attempt to reconcile the irreconcilable: the sovereignty of Parliament in budgetary matters with France’s commitment to follow the recommendations of the Commission?

Article 1 of the Organic Law continues: “The budget plan (LPFP) determines the trajectory of the successive annual actual balances and structural balances... The structural balance is the cyclically-adjusted balance net of one-off and temporary measures.” Article 3 states that the period covered is at least three years. Thus, the Law takes no account of the experience of the SGP : it is impossible to set a trajectory for public finances, in terms of the structural and actual deficit, for a period of three years. In January 2008, France was committed to running a balanced budget in 2012. It will not even get close. Should commitments be made that are impossible to fulfill?

The Organic Law ignores Article 5 of the Treaty, which states that a country under an Excessive Deficit Procedure (EDP) is to be placed under supervision, and has to submit to the EU Council and Commission annual budget plans and a list of the structural reforms that it will implement in order to make a sustainable correction to its deficit. This article obliges France, like many other EU countries, to do all it can to bring its deficit down to 3% of GDP in 2013, regardless of the economic situation, since, in case of an EDP, the constraint applies to the actual balance and not the structural balance.

The LPFP will cover a period of four to five years, but will be voted upon again each year, so that the constraint thus introduced can be changed by a vote on a new budget plan. This has been the case in France for as long as the SGP has existed. Thus, the LPFP does not introduce any supplementary constraint by itself, other than what is already required by European legislation.

The Organic Law sets up a High Council of Public Finance, which will give its advice on macroeconomic forecasts underlying the budget bill (LPF), the social security financing bill, the adjustment budget bills, the stability programme that France must provide to European authorities, and the budget plan (LPFP). It will assess whether France has been meeting its European commitments, and verify that the LPF (budget bill) is consistent with the trajectory announced in the budget plan (LPFP). It will give its opinion on any evocation of “exceptional circumstances”.

The main issue is questionable the High Council has room for flexibility in its assessments. Will it have the right to conclude that the path of adjustment is too restrictive, and that the medium-term objective is not realistic? What strategy will be advocated by the High Council in the event of an economic slowdown: an expansionary policy to support growth or an austerity policy to restore the public finances?

Chaired by the President of France’s Court of Audit (*Cour des comptes*), the High Council consists of four members from the Court of Audit, the Director of INSEE, five members appointed for their expertise in public finance by the Presidents of the National Assembly, of the Senate, of the two finance commissions, of the Economic and Social Council. This predominance of the Court of Audit is problematic. The judicial officers from the Court of Audit are submitted to the hierarchical authority of their president ; they are not *a priori* experts in macroeconomics, and they are more concerned with bringing public finances in balance than with growth and employment. For instance, the latest reports from the Court of Audit underestimate the output gap, support the thesis that the fiscal multiplier is close to zero, and believe that it is better to reduce public spending than to increase taxes. Among the 11 members of the Council, 9 will automatically be in favor of consolidation policy. The article 21 of the Organic Law précises the deliberations of the Council will not be secret and that not minority view will be expressed in its reports.

There is the question of what legitimacy the High Council will have. The choice of fiscal policy must be subject to democratic procedures. The assessment of economic policy is part of a scientific, democratic debate. Should it be entrusted to a High Council, composed mainly of judicial experts, rather than economists on the one hand and then representatives of the nation on the other?

The High Council will of course only give advice, which neither the government nor parliament are obliged to follow, but the risk is great that these opinions will affect the financial markets and the Commission and that it would be risky for the government to ignore them.

To ensure that countries follow effectively the adjustment path, the Treaty requires countries to introduce an automatic correction mechanism if deviations are observed with respect to this path. In the minds of negotiators of Northern European countries and of the Commission, this mechanism should ensure that if a deviation of 1% of GDP is seen in year N, the Constitution ensures that, automatically, a certain tax (*e.g.* VAT) would be raised by 0.5 percentage point

of GDP point and some expenditures (*e.g.* social benefits) would be cut by 0.5 percentage of GDP.

In fact, Chapter 3 of France's Organic Law provides that the High Council will report such a gap, the government will set out the reasons for this discrepancy and then take it into account in drawing up the next budget bill. Parliament's rights are respected, but fortunately the automaticity is not guaranteed.

In the spirit of its founders, the fiscal Pact must put an end to the possibility of autonomous national fiscal policies. Fiscal policies should become automatic. Fiscal policy should aim at balancing budgets, just as monetary policy should aim at fighting inflation; growth and employment are to be sought by means of free market structural reforms.

The Organic Law seems to be an ambiguous compromise. France is ratifying the Treaty, but implementing it only reluctantly. As with the SGP, there will be great tensions in the euro area between purists who demand the strict implementation of the Treaty and those who do not want to sacrifice growth to it.

The macroeconomic strategy

In the presidential campaign, François Hollande refuses to include the erroneously called 'golden rule' (i.e. budgets in balance) in the Constitution. He wanted to renegotiate the Fiscal Pact. At the same time, he announced that France would fulfil its commitments of a deficit cut down to 3% of GDP in 2013 and return to the equilibrium in 2017. This means he agreed on one of the most arguable elements of the pact, medium-term budgetary positions in balance, and that he imposed a stronger constraint, a trajectory for effective public balances independently of economic developments.

The programme implies a highly negative fiscal impulse in 2013 (-1.6% of GDP) in order to reach the 3% target; the fiscal impulse will remain negative afterwards, by 0.6% per year. François Hollande's programme differs from the right party's programme in the sense that strong rises in taxation are planned in the short term (2 percent of GDP from mid-2012 to 2013); but in the medium term it counts mainly on low public spending growth. The programme raises three issues:

- Can a left-wing government durably exert downward pressure on public spending, knowing the needs for social (pensions, health, family, education) and economic (companies' support, public investment) spending? In December 2012, the government initiated a process named "*Modernisation de l'action publique*" to evaluate all public policies and to try to find possible expenditures reduction; this looks like the: "*Revue Générale des Politiques Publiques*" of the previous government.

- The programme abandons the objective of filling the gap between observed and pre-crisis output. If one estimates that the negative output gap stood at 9.3 % of GDP in 2012, it would remain near to 7% in 2017. Hence, we have to accept high increases in taxation, to accept Barro's view: any public deficit translates in the end in higher taxes. If one considers that the output gap is -9.3 % of GDP, this would imply an entirely different policy: the structural deficit would already be nil in 2012 (and the structural deficit for France corresponding to the true *golden rule* can be 2.4% of GDP). A growth policy is necessary.

- The main issue is macroeconomic consistency, which depends on the size of the multiplier. Let us assume that the multiplier equals 1 for a strictly French fiscal policy measure and 1.33 for a measure applied to the euro area (see box 1), François Hollande's programme assumes that without the restrictive fiscal measures, GDP would have grown by 3.3% in 2013, and by 2.85 % from 2014 to 2017. Should we abandon this growth rebound? Should we accept to loose 4.0% of GDP in 2017, while a public deficit of 2.2% of GDP in 2017 would have been consistent with the true « golden rule for public finances » and with public debt stabilisation?

Let us consider things from another perspective: let us suppose that France expects GDP to rise by 3% in 2013, under neutral fiscal policies in the EU. The deficit falls automatically down from 4.5% to 4% of GDP. In fact, the constraint is to cut it to 3%. France should therefore implement restrictive policies of 1% of GDP. Since all euro area countries will do the same, forecast growth will be revised down to 1.7% and forecast deficit will reach 3.67%. There is therefore a need for a new austerity programme of 0.67% of GDP, etc.... in the end, in order to reach a 3% of GDP deficit at any cost will end in theory to successive austerity programmes, to a 3 percentage of GDP effort and a -1% of GDP growth

2. Macroeconomic prospects in François Hollande's programme

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|--|------|------|------|------|------|------|------|
| GDP growth** | 1.7 | 0.5 | 1.7 | 2.25 | 2.25 | 2.25 | 2.25 |
| Government balance* | -5.2 | -4.5 | -3.0 | -2.3 | -1.6 | -0.8 | 0.0 |
| Interest payments * | 2.7 | 2.8 | 2.8 | 2.9 | 3.0 | 3.0 | 3.0 |
| Public expenditure* | 56.3 | 56.5 | 56.3 | 55.8 | 55.3 | 54.6 | 53.9 |
| Primary expenditure** | | 0.7 | 1.3 | 1.1 | 1.1 | 0.9 | 0.9 |
| Tax-to-GDP ratio* | 43.7 | 45.1 | 46.5 | 46.6 | 46.8 | 46.8 | 46.9 |
| Fiscal impulse* | | -1.5 | -1.6 | -0.6 | -0.6 | -0.6 | -0.6 |
| <i>Neutral Policy: Fiscal impulse*</i> | | | 0 | 0 | 0 | 0 | 0 |
| <i>GDP**</i> | | | 3.3 | 2.85 | 2.85 | 2.85 | 2.85 |
| <i>Government balance*</i> | | | -3.8 | -3.4 | -3.0 | -2.6 | -2.2 |

* As a percentage of GDP; ** In %.

The Cour des Comptes' audit

In fact, as soon as he was elected, François Hollande asked the *Cour des Comptes* to audit public finances, as if fiscal policy was becoming a too serious matter to be left in the hands of government and parliamentarians. Unsurprisingly, the *Cour des Comptes* report is in line with EU Commission point of view:

- The output gap would stand at -3.8% only in 2012; the structural deficit would be 2.5% of GDP, and needs to be brought to 0.
- The fiscal multiplier is considered at 0 (since a 'credible strategy for reducing deficits could possibly lead economic agents for reduce precautionary savings')
- The 3% rule needs to be fulfilled because: 'fulfilling the reduction path for deficits is crucial to ensure the credibility of French commitments'.
- The deficit should be cut mainly via lower expenditure. If higher taxes are needed in 2012-13, 'the efforts to cut deficits should bear mostly entirely on public spending in the following years and last after the fiscal balance is reached, so that taxes can be brought back to the level they had before being increased'

The *Cour des Comptes* therefore suggests to keep the 0% growth target for public expenditure in value, which has been settled by the previous government; to pursue cuts in public sector employment and the non-price indexation of civil servants' wages, to question price-indexation on pensions and family benefits, to reduce non-contributory advantages (the fact that sickness, unemployment, maternity-leave periods are taken into account for retirement), to undermine the so-called tax advantages of families, while families are already poorer on average than single people and couples without a child, to target family benefits. This programme which will make people poorer is dangerous both from a social and economic perspective. A liberal political party may of course have such an electoral programme, but is this the role of a High level administration service to make such proposals?

Box 1. Fiscal rules and the multiplier

Let us consider the simplest model.

Public balance: $s = ty - g$ with g the discretionary fiscal policy.

GDP: $y = d + g + c(1-t)y + ny^* - ny$ with d a private spending shock.

The multiplier is 1 for a specific shock; 1.33 for a European shock. If the public balance must be stabilised, the multiplier rises to 2 for a specific shock; 4 for a European one. The economy is then more instable.

| | Specific shock | | European shock | |
|---------------------------------|----------------|------|----------------|-------|
| | y | s | y | s |
| Full stabilisation of GDP | 0 | -1 | 0 | -1 |
| Automatic stabiliser | -1 | -0.5 | -1.33 | -0.67 |
| Stabilisation of public balance | -2 | 0 | -4 | 0 |
| <i>Fiscal consolidation</i> | -2 | -1 | -4 | -1 |

Where $t=0.5$; $c=0.5$; $n=0.25$.

Let us now assume that households are Ricardian or that financial markets request a risk premium for public deficits. This is introduced by $(-hs)$ in the GDP equation: $y = d + g + c(1-t)y + ny^* - ny - hs$. Fiscal consolidation has then a weaker impact, and fiscal policy is less efficient. The economy is here also more instable.

| | Specific shock | | European shock | |
|---------------------------------|----------------|-------|----------------|----|
| | y | s | y | s |
| Full stabilisation of GDP | 0 | -2 | 0 | -2 |
| Automatic stabiliser | -1.33 | -0.67 | -2 | -1 |
| Stabilisation of public balance | -2 | 0 | -4 | 0 |
| <i>Fiscal consolidation</i> | -0.67 | -1 | -1 | -1 |

where $h=0.5$.

The 2013 budget

In September 2012, the LPFP (*Loi de Programmation des Finances Publiques*) embeds slower growth in 2012-13 (table 3). Strangely, the output gap estimate has been reduced to -0.8% of GDP in 2011, -1.1% in 2012. Potential output growth estimate is 1.3% only in 2012,

1.6% for the following years. The fiscal impulse is slightly more restrictive. Public spending are expected to grow less rapidly (0.7% per year), the tax-to-GDP ratio is expected to fall, but only in 2017.

The number of civil servants is almost stable: the rise in public service employment in some areas (education, police, justice, employment) is offset by cuts in other sectors. The general rise in public wages (*point de la fonction publique*) is set at 0. Reductions are done in the area of functioning expenditure. Some public investments (in culture, defence and justice) are cancelled. Social benefits are indexed on inflation; health expenditures are assumed to rise by 2.6% per year, i.e. slightly more rapidly than inflation but less than GDP growth in value. All in all, reductions in public expenditure would amount to 10 billion euros (i.e. 0.5% of GDP). A strict management of public spending is pursued albeit keeping the main functions of the State preserved. However, in 2013 the government wishes to launch a large negotiation on a major reform of the retirement system, which can be interpreted as an attempt to reduce significantly public pensions in the future.

The fiscal impulse is negative, by -1.8% of GDP in 2013, 0.3 percentage point apply to expenditure and 1.5 to revenues. The government makes a bet on the assumption that increasing taxes on the wealthiest and on large companies will have little impact on demand.

3. Programming law for public finances, 2012-2017

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|-----------------------|------|------|------|------|------|------|------|
| GDP** | 1.7 | 0.3 | 0.8 | 2.0 | 2.0 | 2.0 | 2.0 |
| Public deficit* | -5.2 | -4.5 | -3.0 | -2.2 | -1.3 | -0.6 | -0.3 |
| Interest payments* | 2.7 | 2.8 | 2.6 | 2.7 | 2.8 | 2.9 | 3.0 |
| Public expenditure* | 56.0 | 56.3 | 56.3 | 55.6 | 54.9 | 54.2 | 53.6 |
| Primary expenditure** | | 0.7 | 1.2 | 0.5 | 0.5 | 0.7 | 0.6 |
| Tax-to-GDP ratio* | 43.8 | 45.0 | 46.5 | 46.5 | 46.7 | 46.6 | 46.3 |
| Fiscal impulse* | | -1.5 | -1.8 | -0.8 | -0.9 | -0.7 | -0.3 |

*As a percentage of GDP ; **Growth rates.

At February 2013, the French economic outlook is weak. The GDP was nil in 2012, and, according to OFCE or the European Commission, will be nil in 2013. The public deficit will be near 3.5% en 2013. But the French government is tied by European binding constraints and financial markets, and continues to run a restrictive fiscal policy albeit hoping (without saying) that a softer fiscal stance will be agreed at the EU level.

2. Should we reduce the public debt?

The French government has decided that public debt reduction is its priority. In his policy speech in July 2012, Jean-Marc Ayrault said: "The debt burden has become overwhelming: the State pays nearly 50 billion euro per year to its creditors. This represents the first expenditure budget just before the national education budget. Debt means fewer schools, fewer nurseries, fewer hospitals, fewer public transports." But the Prime minister forgets that debt issuance is used, to a large extent, to finance public investment, schools, nurseries, hospitals. In 2011, public administrations paid 49 billion of interest, but issued in net terms 104 billion in the financial markets. Without debt and without having the possibility to borrow, public administrations should have cut their spending by 55 billion.

In October 2012, Pierre Moscovici wrote in *Le Monde*: "The debt is the enemy of our economy, of our public services, of our national sovereignty. Pierre Bérégovoy spoke once of competitive disinflation; I will speak of competitive deleveraging. One more euro for debt service is one less euro for education, or for hospital, or for security. Reducing debt will secure low interest rates. That is why the figure of 3%, a condition for debt reduction and a return to growth, is neither biased nor untenable. France can achieve this. It has too." But France currently issue debt at a rate of 2%. To cut by 1 billion the debt service, debt would have to be cut by 40 billion, which means drastic cuts in schools, hospitals, etc

In 2011, the net debt service was 2.5% of GDP, which means an apparent interest rate on debt of 3.0%, well below the nominal growth rate. Let us assume for simplicity that, in a steady state, the apparent interest rate is 4%, inflation rate is 2%, and potential growth rate is 2%. To stabilize the debt at 60% of GDP, a deficit of 2.4% of GDP ($60\% * 4\%$) is sufficient. In this case, the real cost of debt, that is to say, the primary surplus required to stabilize the debt is nil. All things being equal, if France wished to maintain a zero debt, the gain in terms of fiscal space would be zero with respect to the current situation. It is absurd to claim that interest payments are the largest public expenditure (in fact, adjusted for growth, they are nil) or that they put a constraint on fiscal policy.

On 6 September 2012, the French government issued 5-year bonds at 1.05%, and 10-year bonds at 2.0%, well below the expected nominal growth rate. The tax rate on interest incomes is 30% in France. A nominal interest rate of 4% is therefore an effective real rate after tax of 0.8%, well below the trend growth rate. The public debt has no costs as long as the interest rate is lower than the growth rate. It is only a problem if the interest rate (after tax) is significantly higher than the growth rate, i.e. when financial markets request risk premia.

François Hollande in his press conference of November 2012 states: "Public spending is 56% of the national wealth. It was 52% 5 years ago. Do we live better from this? No." This gives the impression that these last five years, there has been an explosion of public spending, which ultimately has served to nothing. In 2012, public spending represents 56.1% of GDP, against 52.6% in 2007. The problem is that during these five years, GDP growth has been very low, 0.5%, in the whole period, or 0.1% per year. The growth of public expenditure it was moderate 1.3% per year. Nicolas Sarkozy has generally pursued a policy of restrictive public spending. The ratio has not increased due to an explosion of public spending, but because of economic stagnation. If the French growth would have been its potential growth (1.8% per year), the share of public expenditure in GDP would have be only 51.5% in 2012

An ambitious taxation policy

François Hollande wrote: ‘I want to introduce a major tax reform. Each one’s contribution will be made fairer by a major reform merging in the future the income tax and the CSG. Capital incomes will be taxed like labour incomes.’

In fact, a number of French economists and politicians advocate for a major tax reform. But some liberal economist advocate for a strong reduction of the tax burden (which implies a corresponding decrease in public spending); this reform would boost the economy by encouraging people to work more, households to save, companies to invest and create jobs, by improving the French economy’s competitiveness. Some propose to shift the social protection burden from companies to households. Is it possible without significantly lowering households’ purchasing power and consumption? Others are in favour of a fairer distribution of the tax burden between labour and capital incomes, of increasing the redistributiveness of the French tax-benefit system, of taxing more heavily higher incomes and assets. But France already has one of the most redistributive systems, with relatively heavy taxes on the richest and on capital incomes. Some suggest a simplification of the French system, to abolish tax and social *niches*, to broaden the tax base and to lower tax rates. But, they forget the incentive role of taxation. Besides, many fiscal schemes, even if they are complex, are justified for social fairness reasons, like the *quotient familial* or for job creation incentives, such as social contributions exemptions on low wages. Making our tax system more environmentally friendly is certainly a promising direction, but this raises two issues: is there really a double dividend, jobs and ecology? Do ecological gains have a cost in terms of growth, and therefore jobs? Can France undertake such a reform without a strong European or even worldwide harmonisation, which is unlikely today?

The French tax system has four characteristics as compared with EU partners, and in particular with Germany (table 4):

- France has two income taxes (IR and CSG), but their cumulated weight is relatively low. Conversely, the property tax is relatively heavy.
- Employers’ social contributions are high; employee contributions are relatively low.
- The business tax (*taxe professionnelle*) is relatively heavy
- Capital taxation is relatively high, while consumption taxation is rather low.

Of course, there is no reason why French taxation should be brought in line with taxation in our EU partners (especially Germany). It is normal to have high social contributions in a country where social insurance benefits are high. The high level of employers’ contributions is partly offset by the level of net wages. However, these figures would suggest that France should increase the weight of its income tax and VAT, and should reduce employers’ social contributions, in other words implement a strategy of tax competition.

In 2012-13, the government strategy is to move towards a fairer taxation, weighing more on large companies, on the financial system and wealthiest households, abolishing some tax cuts that Nicolas Sarkozy (and even Chirac) had implemented for 10 years, in particular abolishing some tax and social *niches*. The government has a narrow way, between social fairness, demand support, competitiveness, financial health of banks and the risk of tax evasion by the richest.

4. Structure of taxation, in % of GDP in 2007.

| | Germany | France |
|---------------------------------|------------|------------|
| Total | 37.3 | 42.4 |
| Personal income | 9.4 | 7.0 |
| Corporate income | 1.3 | 1.5 |
| Employees' social contributions | 6.3 | 4.1 |
| Employers' social contributions | 6.8 | 11.3 |
| Others social contributions | 1.4 | 1.3 |
| Wages taxes | - | 1.3 |
| VAT and other indirect taxes | 11.1 | 10.6 |
| Business tax* | - | 1.5 |
| Taxes on capital | 0.9 | 3.4 |
| <i>Households' local tax</i> | | <i>1.1</i> |
| <i>Households' property tax</i> | <i>0.2</i> | <i>0.7</i> |
| <i>Company property tax</i> | <i>0.3</i> | <i>0.6</i> |
| <i>Wealth tax</i> | - | <i>0.2</i> |
| <i>Inheritance/donation</i> | <i>0.2</i> | <i>0.4</i> |
| <i>Transactions</i> | <i>0.2</i> | <i>0.4</i> |

Source: OECD, *Public Revenues Statistics*, 2011.

4bis. Implicit tax rates in 2010, in %

| | Labour | Consumption | Capital |
|-------------|--------|-------------|---------|
| EA17 | 34.0 | 20.7 | 23.7 |
| Germany | 37.4 | 19.8 | 20.7 |
| Belgium | 42.5 | 21.4 | 29.5 |
| Spain | 33.0 | 14.6 | 28.4 |
| France | 41.0 | 19.3 | 37.2 |
| Ireland | 26.1 | 21.6 | 14.0 |
| Italy | 42.6 | 15.8 | 34.9 |
| Netherlands | 36.9 | 27.0 | 12.5 |
| Sweden | 39.0 | 28.1 | 34.9 |
| UK | 25.7 | 18.4 | 36.9 |

Source: Eurostat, *Taxation trends in the European Union*, 2012.

The measures already decided amount to 32 billion in full year, i.e. 11 billion on firms or banks, 11 billion on richest households, 10 billion on all households (table 5).

As concerns companies, the government has not introduced measures to reduce corporate taxation on SME's or on re-invested profits. The corporate tax rate on large companies thus reaches 36%, which is the highest level in Europe (the euro area average is 26%).

As concerns higher wages, the tax rate now stands at 41%, for higher than 71,000 euros per *fiscal part*, 45% above 150,000 euro, 48% above 150,000 euro, 48% above 250,000, 49% above 1 billion, 67% above 1.5 billion. But employees also have to pay a CRDS-CSG contribution and their employers pay health and family contributions (which have no ceiling in France). The 41% rate is hence equivalent to 57.15% in terms of economic rate; 45% to a rate of 60.2%; 67% to a rate of 77.2% (advertised at 75%¹).

¹ In December 2012, The Constitutional Court refused the 75% rate as it was calculated on an individual basis, and not on a familial one. But the Government plans to re-introduces it.

5. Tax measures decided par the new government (in full year) in billion of euro

| | Households | <i>Among which higher incomes</i> | Firms/ Banks | Indirect taxes |
|---|--------------|-----------------------------------|-----------------|----------------|
| 2 percentage points increase in taxes capital revenue social contribution | +2.6 | +2.6 | | |
| End of tax exemption for extra-time worked-hours | +4.0 | | +0.5 | |
| Social contribution on participation, profit-sharing. | +1.4 | +0.5 | +1.5 | |
| Bank taxation | | | +0.55 | |
| Social contribution on non residents. | +0.25 | +0.25 | +0.5 | |
| Increase in wealth tax rates | +1.2 | +1.2 | | |
| Increase in inheritance taxation | +1.4 | +1.4 | | |
| Financial transactions tax | +0.25 | +0.25 | +0.25 | |
| VAT on books | | | | -0.1 |
| Increase in social contributions for pensions | +1.5 | | +1.2 | |
| Measures against firms fiscal optimisation | | | +1.5 | |
| Income tax rate at 45 % and 75% | +0.5 | +0.5 | | |
| Decrease of the family fiscal reduction ceiling | +0.5 | +0.5 | | |
| Non-indexation of the income tax schedule | +1.3 | +0.9 | | |
| Ceiling on <i>Quotient familial</i> | +0.4 | +0.4 | | |
| Taxation of dividends, interests and financial gains at the income tax schedule | +1.4 | +1.0 | | |
| Increase of taxation on real-estate gains | +0.7 | +0.6 | | |
| Taxation of 20% of firms interest charges at the CIT | | | +3.4 | |
| Taxation of firms capital gains | | | +1.0 | |
| Increase of the R&D tax credit. | | | -0.2 | |
| Ecological taxes | | | | +0.2 |
| Non-salaries social contributions | +1.3 | +0.7 | | |
| Social contribution of households employers | +0.3 | +0.3 | | |
| Increase in wages tax | | | +0.8 | |
| Excises on beer | | | | +0.8 |
| Pensioners' social contribution | +0.7 | | | |
| Total : 32 | +20.1 | +11.1 | +11 | +0.9 |

Interest income payments bear a tax rate of 24% up to 2000 euro; at the income tax rates from 2000 euro. But they also bear a 15.5% tax rate for social taxation. Under a nominal interest rate at 4%, and inflation at 2%, the real income will be 2% and will be taxed at 79% or 108.8%.

Taxation at the income tax rate apply to dividends, after a 40% rebate, which accounts for the fact that concerned dividends have already been taxed at the corporate tax rate. So the dividends economic taxation rate (for a person at the marginal income tax rate of 41%) is in fact of 60.9%.

For capital gains on equities, taxation at the income tax rate leads (given the CIT, inflation, CSG and social contributions) to an economic tax rate of 83.6% (decreasing to 69.5% after 12 years of holding these assets).

Let us consider a person taxed at a marginal tax rate of 41%, who invests 100 in the shares of a company whose profitability is 8%. The company pays 2.75 as CIT, gives 3 for dividends (on which it pays a tax of 0.09) and retains 2.16. At the end of the year, the value of the share is theoretically 104.16 (if inflation is 2%). If the shareholder sells his shares, his gains, in legal terms, are 4.16. He will therefore pay 1.11 for CSG-CRDS-PS (15.5% * 7.16) and 2.79 as income tax (41%*0.949*7.16), reduced to 1.67 after 12 years. In total, taxation will amount to 6.74 (a tax rate of 84.25%) and 5.62 after 12 years (a tax rate of 70.25%). *Ex post* the investment profitability will be 1.26% or 2.38 %.

Thus, the choice of the government to reduce the budget deficit through measures focusing mainly on the richer and large firms leads to an original heavy and redistributive tax system in Europe. This is rational after a crisis which should have shown the risk in terms of economic stability introduced by increases in incomes inequalities. But France is isolated. Wealthier people threaten to leave France for Belgium or UK. Will France be able to maintain this system?

Social policy

On the whole, France has until now maintained a high level of social protection, which leads to income inequalities and poverty rates lower than in Mediterranean and Anglo-Saxon EU countries; and not deteriorating as in Nordic countries and Germany (Table 6).

6. Poverty rates in Europe

| | 1997 | 2007 | 2010 | Variation |
|-----------------|------|------|------|-----------|
| Germany | 12 | 15.2 | 15.6 | +3.6 |
| Austria | 13 | 12 | 12.1 | -0.9 |
| Belgium | 14 | 15.2 | 14.6 | +0.6 |
| France | 15 | 13.1 | 13.5 | -1.5 |
| The Netherlands | 10 | 10.2 | 10.3 | +0.3 |
| Spain | 20 | 19.7 | 20.7 | +0.7 |
| Greece | 21 | 20.3 | 20.1 | -0.9 |
| Italy | 19 | 19.9 | 18.2 | -0.8 |
| Portugal | 22 | 18.1 | 17.9 | -4.1 |
| Denmark | 10 | 11.7 | 13.3 | +3.3 |
| Finland | 8 | 13 | 13.1 | +5.1 |
| Sweden | 8 | 10.5 | 12.9 | +4.9 |
| Ireland | 19 | 17.2 | 16.1 | -2.9 |
| UK | 18 | 18.6 | 17.1 | -0.9 |

Source: Eurostat.

There was no large commitment in François Hollande's programme in terms of wage growth or social benefits increases. The minimum wage was increased by 2% in July 2012, but this increase anticipated the automatic increase induced by inflation, such that the '*coup de pousse*' was only 0.6%. The September school benefit (*Allocation de rentrée scolaire*) was increased by 25%, but this was financed by lowering the *quotient familial*.

The government did not plan to increase family benefits and the RSA (minimum income) above consumer price inflation, although these price-indexed benefits have been losing

purchasing power relative to average earnings over the past years. In December 2012, to fight against the poverty, the Prime minister promises to increase the RSA by 10%, and to increase the benefit for the poorer single families or with many child families. But, in February 2013, he asks the Family Council President to make proposals to reduce the family benefits by 2.6 billion before 2016.

In June 2012, the right to retire at 60 has been restored for workers having started to work at 18 or 19 years and having paid contributions for at least 42 years (otherwise the retirement age would have been 62 for people born in 1955 and after). This measure is expected to increase by 140,000 the number of pensioners and to cost 2.8 billion euros (partly offset by a 0.8 billion decrease in unemployment benefits). The measure will be financed by a 0.5 percentage point increase in the social contribution rate (equally split between employees and employers) that would raise 2.7 billion euros.

The economic crisis has worsened the financial situation of pension schemes. Their share in GDP is expected to increase from 13.5% in 2008 to 15% in 2050 (assuming a continuing fall of the ratio pension/wage, by 18% in 2050) or to 17% (if the replacement rates are stabilised). The government plans to launch a large debate on a major pension reform in 2013. Some economists recommend to move towards a points system, which would allow to balance the pension system by lower pension levels (but retirees would lose any guarantee on their pension level), or toward a notional accounts system, where every individual would have to chose between postponing their retirement age or accepting a lower pension (but in times of mass unemployment, is there really a possibility for everyone to make such a choice?). There is a major risk of deteriorating the pension system under the pretext of ensuring its sustainability. As the employers, the government refuses to increase the social contributions and projects, in the short run, to reduce the pension deficit by decreasing the pension level and by delaying the retirement age.

Employment policy

In the beginning of 2013, the French unemployment rate reached 10%. With potential labour force growing by 0.6% per year, and accounting for firms' labour-hoarding due to the 2008-12 crisis, GDP should grow by an annual 3.2% to bring the unemployment rate to 7% in 5 years.

Young people have been particularly affected by the crisis; their employment rate fell by 3.5 percentage points, while their unemployment rate rose by 2.5 percentage points (table 7). Conversely, the older workers' activity rate rose sharply by 8.7 percentage points, of which 1.8 percentage points is due to a rise in the unemployment rate and 7.0 percentage points to a rise in the employment rate. The postponing of the retirement age continues, but, in crisis times, the price seems to be paid by young people.

7. Young and old people employment, since 2008

| | 15-25 years | | | 25-49 years | | | 55-65 years | | |
|------------|-------------|---------|--------|-------------|---------|--------|-------------|---------|---------|
| | 2008-Q1 | 2012-Q3 | | 2008-Q1 | 2012-Q3 | | 2008-Q1 | 2012-Q3 | |
| Rates | | | | | | | | | |
| Employed | 31.9 | 28.4 | -11.0% | 83.5 | 80.9 | -3.1% | 37.9 | 44.9 | +18.5 % |
| Unemployed | 6.6 | 9.1 | +37.9% | 5.7 | 8.0 | +40.4% | 1.7 | 3.5 | +106% |
| Active | 38.5 | 37.5 | -2.6% | 89.2 | 88.8 | -0,5% | 39.6 | 48.3 | +22.0% |

To reduce young people unemployment in disadvantaged areas, the government plans to create 150,000 'jobs for the future' (*Emplois d'avenir*). The State finances 75% of the costs of jobs created for a 1 to 3 years period mainly in the non-market sector, preferably in areas expected to expand (white jobs, tourism, new technologies).

Generation contracts should encourage firms to simultaneously recruit a young (below 25) employee, while maintaining in employment an older employee (aged over 57). Firms with less than 300 employees will receive a contributions' rebate of 4000 euro per contract per year, which will have a budget cost of around 2 billion if, as expected 500,000 contracts are signed. The risk of such a scheme is of course the windfall effect. The agreement between employers and trade unions stipulates that these contracts should be implemented within the framework of an agreement including job creation. Companies with more than 300 employees should implement these agreements under penalties threats, without benefiting from the rebate.

President Hollande aims to reform labour market functioning and social protection, through social dialogue between trade unions and employers. So far, social dialogue has hardly made any progress in France. For instance, in 2000, the 35 hour working week had to be imposed by the State, in the absence of agreement between social partners. A "social conference" took place in July 2012 and a social roadmap has been established. Social dialogue will be enshrined in the Constitution. The challenge is that France abandons a State-leading model to move towards to a social democratic model (with peaceful relations between trade unions and employers, with mutually beneficial agreement) rather than towards the liberal model (where unions' role is denied). But can this succeed in times of rising unemployment, when firms want more flexibility in terms of layoffs, hours, wages and unions want more security and more control on layoffs?

In January 2013, the employers' organisation (the Medef) and 3 (among 5) employees' trade-unions signed an agreement, the ANI, which will facilitates lay-offs, internal flexibility and agreements between salaries and firms cutting worked hours and wages in case of firms' difficulties. In compensation, the agreement discourages very-short partial time jobs and generalizes supplementary health insurances. For many economists, companies will hire more easily since they will no longer be paralyzed by the fear of not being able to lay off. For others, the risk is great to increase the precariousness of employment. Thus, the Government and some unions seem to be aligned with the thesis that it is the rigidity of the labour market which explains the level of unemployment in France.

Ecological issues

France, like all nations, must tackle seriously the ecological issue and prepare the ecological transition. This comes at a cost (since we need to change production techniques, to save energy and raw materials, to invest in renewable energies). The first country to implement this strategy will lose competitiveness, if, for example, firms have pay higher energy prices. At the same time, the ecological transition can stimulate demand (collective transportation, urban renovation, renewable energies, energy savings). The pioneer country can take strong positions in the industries of the future. But pioneer investments are risky.

Thus, the current French government is divided between the Greens who press for immediately starting to implement the ecological transition and an industrialist wing, in favour of promoting industrial competitiveness. The debate is particularly accurate on nuclear power and on shale gas. Until now, France's nuclear programme enables low electricity prices (table 8), which is a competitive advantage.

8. Electricity prices for firms (excluding VAT)

| 2012 | |
|-----------------|-------------|
| Finland | 6.98 |
| France | 7.17 |
| Sweden | 8.62 |
| The Netherlands | 9.17 |
| UE27 | 9.66 |
| Germany | 9.83 |
| Belgium | 10.02 |
| UK | 10.03 |
| Spain | 11.12 |
| Italy | 11.55 |

Source: Eurostat.

There is also a debate on diesel: some suggest taxing this highly polluting energy, while others want to preserve the purchasing power of users and the French automotive sector, which has made the wrong choice.

The Government organised an environmental conference in September 2012. President Hollande's commitments were reaffirmed: the share of nuclear power in electricity output will fall from 75% to 50% in 2025; the Fessenheim nuclear power plant will be closed and shale gas will not be extracted; thermic housing renovation will be supported (1 million flats per year); the Investment Public Bank is responsible for financing energy transition.

At the world level, France will promote ambitious targets for greenhouse gases reduction. Environmentally-friendly taxation will increase (from 1.9% of GDP), its rise should be used to encourage virtuous behaviours, but counterparts should be introduced either to maintain the purchasing power of the poorest, or to maintain the competitiveness of exposed sectors. A border adjustment mechanism should be put in place, but is it realistic? France must first persuade its European partners.

Banking policy

In his programme, François Hollande had committed to 'split banking activities useful to investment and jobs from their speculative activities'. His first commitment was to create an investment public bank (IPB) to support small and medium-size firms. The doubling of the 'Livret A' and of the LDD (durable development account) ceilings should allow to finance public banking activities.

The weight and influence that the IPB will have is therefore a major question. On the one hand, the IPB will have regional branches where social partners and regional authorities will attend. On the other hand, there is a risk that the IPB will be managed only from a financial

perspective, that IPB managers wish to show their independence and refuse to support jobs and innovation. The IPB should have been given precise and non-standard management criteria. Last, the IPB is expected to be allocated only 3 billion by years, which is very limited.

France approves the European Banking union project. This means putting the domestic banking sector in the hands of EU authorities. The Liikanen's Commission report considers stricter bank controls; banks will have to put their riskier business in an isolated financial institution. But in the European project, banks are requested to diversify internationally, thus to lose contact with their country, companies, and government administrations; governments may depend even more on financial markets. Bank lending capacity will depend on their equities and on markets' valuation and not of the need of the economy. Governments will lose their capacity to have an impact on bank credit supply, which is desirable according to some views (no political interference in credit), but is dangerous in our view (governments will lose an industrial policy tool which could be used to finance SMEs or to boost environmental transition). This project, based of free market rules, comes in contradiction with the establishment of an IPB and a public bank to finance French local government (after Dexia failure).

France should have to fight for another project: restructuring the banking sector, with banks having to focus on the heart of their job (lending, based on a precise expertise, to national or local companies, households and local administration). Their solvency would have been ensured, not by financial ratios, but by forbidding them to run risky or speculative operations and by public support.

France has adopted in early 2013 a "law of separation and regulation of banking activities" intended to implement the promise of François Hollande. In fact, the government has refused to question the French model of Universal Bank. Speculative activities, narrowly defined, will not be forbidden to deposit banks, but they will have to be put in a separate financial institution. Thus, the Law does demand banks to spin off their market activities "unrelated to customer service."

Banks can continue to practice operations "that have proved useful for the economy." But the notion of utility is not questioned. Is the development of financial activities useful? Should banks induce non-financial agents, to use toxic loans, structured products and derivatives? Similarly, it is regrettable that the term *client* has not been specified not to apply to hedge funds and certain investment funds. Activities for their own account are theoretically prohibited, but remain allowed the provision of financial services to customers (for hedging), the coverage of the institution's own risk (interest rate risk or credit risk) and market making activities. Detention of hedge funds is prohibited, as well as unsecured loans to these funds, but the so call secured loans remain allowed. Remain at the level of deposit banks: the assembly of structured financial products such as derivatives activities. In total, the project will only isolate only 2% of the banking business.

Speculative activities will have to be confined to an autonomous financial subsidiary, which is not guaranteed by the parent company (and therefore by public money), which will be financed independently, which will be able to go in bankruptcy, which will have to develop a resolution plan showing that its bankruptcy may be supported by its creditors.

Moreover, the Prudential Control and resolution Authority (PCRA) may prohibit certain activities and the Minister of Finance may require banks to limit the size of financial

operations carried out by the parent company. The PCRA will manage a guarantee deposits and resolution funds (GDRF). Banks will have to develop a plan for bank resolution, which must be approved by the PCRA. A bank may be brought before the PCRA by the Governor of the Bank of France or the Treasury Director. The PCRA will be able to change the bank manager, to transfer the institution to another bank, to make the GDRF intervene, to oblige shareholders or certain creditors (subordinate or junior) to bear the losses, to ask them to bring new funds, to prohibit the distribution of dividends, to appoint a temporary administrator, to suspend bank manager compensation. A Financial Stability Board is created. It may increase the capital requirements imposed on banks to prevent excessive credit growth or financial system destabilizing operations; it may establish standards for credit to avoid excessive increases in asset prices or debt.

The government refused to prohibit banks to undertake operations in tax and regulations havens, but the banks will have to publish a list of their foreign subsidiaries and indicate the amount of their activities in each country.

This law may appear absurd to the extent that it decides on topics that should not be of national competence in two years with the Banking union falls into place. It once again raises the question of the relationship between the national and the European level decisions. For example, the PCRA may prohibit certain activities, says the French law, but how if these activities remain authorized at the Banking Union level? Will the Minister of Finance have still some authority on banks in two years?

An ambitious industrial policy

The French economy suffers from a rising trade deficit due to industrial trade. Four views are opposed as concerns the reasons of the deteriorating French deficit:

- French traditional industries have been destroyed by competition from low-wage countries. Companies have an incentive to relocate their production in emerging economies, both to reduce their costs and to benefit from buoyant demand. The euro is overvalued.
- France, like Southern Europe economies is a victim of Germany's strategy to gain competitiveness.
- French competitiveness is poor because of a high social contributions level.
- France lacks from industrial dynamism. It has not been able to offset the losses in traditional industries by gains in *haut de gamme* industries. French companies do not make sufficient profits and can therefore not make the requested efforts to adapt to today's situation. French companies also suffer from excessive legislation, especially as concerns labour law. Taxation is too heavy on companies and firms' managers and professionals.

François Hollande's programme was insisting on the need to 'relaunch production, employment and growth'. Four policies were put forward:

- establishing an Investment Public Bank
- supporting SME's, especially through extending the R&D tax credit (*Credit Impôt Recherche*), orders from the public sector, the IPB, a single public interlocutor for SMEs

- Taxing international relocation (French companies relocating production abroad), supporting companies investing, producing and relocation in France, reduced corporate taxes for SME's, different tax rates for dividends and reinvested benefits.
- A new trade policy in Europe: fighting unfair competition, implementing reciprocity agreements on social and environmental areas, climate-energy developments, decreasing the euro *vis-à-vis* the dollar and the Yuan.

The new government includes a ministry for productive revival (*Ministère du redressement productif*) with representatives appointed in each region in order to detect and support companies in difficulty. The IPB is designed to finance innovative companies. The Minister wishes to re-value the 'made in France', to make clear that France produces high quality and friendly-environmental products, to develop economic 'patriotism' and push households to buy French products.

At the EU level, France would like the Competitiveness Council to evolve and implement an industrial policy, allowing public support to innovating firms or to threatened sectors, sector grants and a protecting trade policy. But France has not find allies in Europe to undertake such policies.

Thus the French strategy would involve a substantial government role. The government would decide on the sectors to be protected and the sectors to be developed. These sectors would receive support through taxation, specific aids (investment, innovation), and the IBP. The productive revival would be piloted by the ministry, the IBP, regions, social partners, and not only by firms' managers or owners. This ambitious strategy needs to be implemented accounting for all its implications. How to detect sectors for the future and make relevant choices in terms of research and technological innovation? What criteria should the IBP use? To what extent should a sector in difficulty be supported? Should measures be decided according to a specific situation or should rules be defined?

At the same time, because of environmental constraints, the industrial choices which pave the way for our economic development cannot be left in the hands of shareholders, pension funds in search of short-term profitability, not even to large companies' top managers. The government should guide industry development towards green and innovative products and production techniques.

Can such a strategy be implemented today? Can it be consistent with EU constraints, with the functioning of a capitalist system? Will the government be able to mobilize workers in concerned companies, civil servants in its ministry, bankers in the IPB, regions, firm's managers to impulse a new growth model?

A competitiveness shock?

In view of the deterioration of the French economic performance, many (among them the MEDEF, the employers' association, and also the CFDT, a reformist employees' trade union) advocate a competitiveness shock. The plan is to cut employers' contributions by at least 30 billion euro, and as a counterpart to increase households' taxation, via VAT or CSG (a flat social contribution upon all personal income). In February 2012, the former government had decided such a measure at a limited scale (cutting employers' contributions by 13 billion, financed by a rise in VAT (11 billion) and a rise in taxes on households' capital income gains

(2 billion). The measure was to be introduced by October 1st 2012. The government in office since May 2012 has abolished this measure. But the government has asked Louis Gallois, former head of EADS, who had expressed his opinion in favour of the competitiveness shock to prepare a report on this topic.

In fact, there is little difference between increasing CSG or VAT. However, a rise in VAT increases price inflation, and this automatically affects the minimum wage rate (SMIC), and social benefits, which are fully price-indexed and, after wage bargaining, other wages, which means that the gain in terms of companies' competitiveness/profitability may be short lived. On the contrary, the victims of a rise in CSG would not benefit from indexation rules and would have to accept a lower purchasing power.

The issue is to decide if companies are going to respond by keeping their prices unchanged in order to rebuild their margins, which would entail a substantial loss in French households' purchasing power by reducing their prices in order to gain competitiveness.

Let us consider a country where GDP equals 100, while exports and imports both equal 25. The wage share amounts to 80; profit share is 20. Investment amounts to 20, of which half is imported. Consumption amounts to 80 (of which 15 is imported). In the short run, we assume that wages and social benefits are stable. The reform consists in cutting by 5 the amount of employers' contributions, i.e. 5% of GDP, and in raising by as much the CSG.

In the first case, companies keep their prices unchanged and hence increase their profits. *Ex post*, there is no competitiveness gain. Wages loses 6.25% in purchasing power. The relative wage cost decreases by 6.25%. The question is: will the rise in investment offset the fall in consumption? Let us consider standard assumptions: consumer propensity to consume wages: 0.8; firm propensity to invest profits: 0.4; multiplier: 1; capital/labour substitution: 0.3. GDP falls by 2% and employment remains stable owing to labour/capital substitution.

In the second case, output prices fall by 5%; consumer prices fall by 4%. Wages' purchasing power falls by 1% only. Competitiveness gains amount to 5%. Relative wage costs fall by 3.75%. Let us consider standard assumptions, with export price elasticity equal to 1, import price elasticity equal to 0.5. GDP will rise by 1.25%, and employment will rise by 2.35%.

But in this case, the policy is non cooperative. It will have no impact if implemented by all countries and a little impact if implemented by all EU MS.

The philosophy of the 'competitiveness shock' is that households accept a strong fall in purchasing power in order to improve companies' profitability or competitiveness. The project raises five issues:

1. The government have to request households to accept a fall in their incomes, although the latter have already declined by 0.5% in 2012, although consumption has stagnated in 2011 and 2012, although the French economy is in recession. This would come in contradiction with the decision to abolish the VAT rise which been announced by the former government.
2. What will be companies' commitments, in terms of investment and jobs in France, in exchange of a measure that would substantially increase their profits? How to avoid that companies increase their dividends or investment abroad?
3. Should France follow the German strategy: winning competitiveness at the expense of households' purchasing power, knowing that this strategy would be catastrophic if it was implemented at the euro area level? Of course, this kind of measures is a

substitute for a devaluation which has become impossible in the monetary union. But it is harmful for euro area partners (who would respond in proceeding like us), and there is no certainty that there will be competitiveness gains vis-à-vis non-euro area countries, as they depend mainly on euro exchange rate developments. It cannot be a substitute for a reform of the euro area economic policy framework.

4. France is in an intermediate position between Northern countries which have gained substantial competitiveness gains at the expense of domestic households' purchasing power; and Southern countries, where wage growth was excessive. In 2000, the wage share in value added stood at 66.8% in Germany, 66.9% in France, and 65.5% in the euro area as a whole. In 2007, it has decreased to 61.2% in Germany (-5.6 percentage point), 62.8% in the euro area (-2.7 percentage point), 65.7 in France (-1.2 percentage point). Should workers compete in Europe to agree on a lower wage share? On a 2000 basis=100, the real wage level was 97.9 in Germany in 2011, 111.2 in France (i.e. +1% per year, the trend growth rate of productivity). Where is the error?
5. The gross operation surplus share in company value added stood at 29.6% in 1973. It fell to 23.1% in 1982, and increased to 30.2% in 1987 (see table 9). It stood at 30.8% in 2006, i.e. a satisfactory level. Since then, the ratio has fallen due to the output fall and labour hoarding, which in principle is a temporary phenomenon. It was not caused by higher taxation, or excessive wage increases. Introducing a measure leading consumption (and hence GDP) to fall, will translate into a new rise in the profit share. The latter should increase through a 'growth shock'. The profit share has reached again a satisfactory level in 2011. The problem in that gross fixed investment was similar in terms of size to profits in 1973; while it is now 3 to 4 percentage points of value added below. Should the profit share be increased without any guarantee on investment?
6. Using internal devaluation means that France suffers mainly from price-competitiveness deficit. But, des-industrialisation probably has other deeper roots. Companies prefer to expand their activities in emerging countries, scientific education is a not a first choice, the young refuse to start a career in industry because this is too risky and wages are too low. France has succeeded neither to protect its traditional industries, nor to develop innovating sectors, the financial sector prefers speculation to financing production and innovation, etc. This would not be solved by devaluation. France needs an industrial rebound, which has already started with competitiveness poles, R&D tax credit which should be financed by the IPB, the capacities of which should be increased and the intervention criteria précised.

9. Companies' ratios to value added

in %

| | 1973 | 1982 | 1987 | 2006 | 2011 |
|-------------|------|------|------|------|------|
| Margin rate | 29.6 | 23.1 | 30.2 | 30.8 | 28.6 |
| Profit | 23.5 | 18.2 | 25.0 | 24.8 | 24.3 |
| Investment | 23.7 | 20.0 | 18.7 | 20.1 | 21.2 |

Source: INSEE (2012).

In November 6, 2012, the Government has actually decided to embark on this strategy. Companies will benefit from a tax credit for competitiveness and employment (CICE) 20 billion,

calculated as 6 percent of their salary mass between 1 and 2.5 times the minimum wage. These 20 billion would be financed for 10 billion by a decrease in public expenditure; for 7 billion by an increase of VAT and for 3 billion by an increase of ecological taxation in 2016.

This tax credit is not subject to any condition, but companies will have to establish a report showing that these credits were used for investment, employment or R & D. These 20 billion represent only a decrease of 2.5% of the total wage cost; only one-third will benefit to the industry

One can fear that the leftist Government renounces, more or less, to any a pro-active industrial strategy to favor a liberal policy: to increase the firm profit of the companies in praying that they will invest.

Conclusion

François Hollande's economic strategy is ambiguous. He was convinced that there is a need for a new policy in Europe, more growth-targeted, but in order to strengthen Europe, he accepted a Fiscal Pact which constrains countries to run austerity policies. He imposes France an absurd trajectory of budget cuts, which makes fiscal policy pro-cyclical. He wishes both to reassure financial markets and to reduce their influence (in particular through banking regulation and financial transaction taxation). Cuts in government borrowing should be obtained in the short term by higher taxation on the wealthiest and on large companies, but in the medium term by public spending reduction of about 3% of GDP, which will oblige to strongly reduce the social spending. Strong measures are announced in the environmental areas, but environmental transition is not totally ensured. The EU discourse on the need for structural reforms is neither accepted nor clearly rejected. The government counts on social partners to reform labour market functioning, choosing rather the employers' viewpoint (higher flexibility) than the trade unions' one (preventing lay-offs). François Holland pronounced for a strict distinction between retail and investment banks, for an increasing role of the investment public bank. But, he accepts banking union, where France would lose all control of its banking system which would be piloted by EU authorities. The French banking law is very limited. The government undertake a 'competitiveness shock' strategy, a decrease by 20 billion of employers' social contributions financed by public expenses reductions and VAT increases. It aims at a 're-industrialisation' which would be achieved through direct supports, by the government, regions, from IPB to industrial companies. At the same time the means allocated to this policy are limited. The IPB is under- dimensioned. More importantly, the strategy does not organise the social mobilisation needed for a new companies' management. The risk of this ambiguity is that the government will not be able to convince firms' managers and entrepreneurs, hilted by the rises of taxes 2012-13. He will not mobilized salaries, disappointed by the lack of social measures, the pursue of austerity, the shyness of economic strategy and the continued rise in unemployment.

In the middle of 2012, two scenarios could be imagined. The first one was a 'rupture scenario' where France would try to find an original way, Colbertist/social-democrat/ecologist, based on public and social intervention, boosting growth, protecting the EU social model and social cohesion, preparing for environmental transition. France would have to find allies in Europe to implement such a strategy, with the risk of bursting of the Euro zone. The second is the 'normalisation scenario': France agrees to implement progressively all EU measures, at the

risk of a long recession and rising unemployment period, at the risk of deteriorating the French Social model. It is unlikely that wage and public spending austerity and liberal 'structural reforms', provoke a growth revival in France. Should the French left surrendered without even having fought?