Should tax breaks on overtime be reversed?

By Eric Heyer

Among the savings plans announced on 24 August 2011 by French Prime Minister François Fillon figures a change to the system of tax reductions on overtime hours and their exemption from social contributions,[1] a scheme that has been in force in France since 1 October 2007. This provides an opportunity to take another look at some of the main conclusions of the work carried out by the OFCE (French version) on this subject.

1 – An article to be published soon in the *Oxford Review of Economic Policy*[2] explains how the impact of this scheme will differ depending on the position of the economy in the cycle at the time the measure is applied.

- In a favourable economic climate, an increase in working hours prompted by lower labour costs and the elimination of payroll taxes would seem appropriate. The measure is of course not funded (the public deficit deteriorates), and financing it through higher levies would radically change its nature, even though this would not call into question its positive impact on employment and unemployment.
- However, this measure is poorly suited to the kind of economic downturn that the French economy is going through today. In a situation of mass unemployment, an increase of 1% in working hours has a negative impact on employment (-58,000 jobs at 5 years and -87,000 at 10 years). The unemployment rate would increase slightly (0.2 point at 5 years, 0.3 point at 10 years). The measure would have a small impact on growth (0.2 point at 5 years and 0.3 point at 10 years) and is not funded: the deficit would deteriorate by 0.5 point at 5 years

(0.4 point at 10 years).

2 – This corroborates the results of a recent study published in *Economie et Statistique*[3]. The authors examined data on 35 sectors of the French economy and estimated that a 1% increase in overtime would destroy about 6,500 jobs in the commercial sector (*i.e.*, 0.04% of commercial jobs), three-quarters of which would be temporary jobs.

Thus, in a context of a severe economic crisis, it seems that an incentive to work longer hours would hurt employment, especially temporary employment.

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[1] The government decided to reintegrate overtime hours into the general schedule of tax reductions while maintaining specific advantages on taxes and social welfare charges. Concretely, this measure will not change anything for employees: net remuneration will not be reduced, and income tax will not be increased. As for employers, they will continue to benefit from exemptions on charges for declared overtime hours, but will see smaller breaks on charges on low wages. This will take effect next January 1st and, according to the government, will generate 600 million euros in revenue from additional social contributions.

[2] Heyer É. (2011), "The effectiveness of economic policy and position in the cycle: The case of tax reductions on overtime in France", *Oxford Review of Economic Policy*, forthcoming.

[3] Cochard M., G. Cornilleau and É. Heyer (2011): "Les marchés du travail dans la crise", *Economie et Statistiques*, no. 438-440, June.

The dual mandate, the Fed and the ECB

By Jérôme Creel and Francesco Saraceno

Since 21 September 2011, the US Federal Reserve has launched Operation Twist to reallocate its balance sheet to reduce long-term interest rates. This American activism contrasts once again with the caution displayed by the European Central Bank. On 7 September 2011, a US central banker declared that an unemployment rate of 9% in the US was as serious as an inflation rate of 5% would be. He concluded that US monetary policy needed to make the fight against unemployment a priority. We believe that this should be even more the case for the euro zone economy, which leads us to re-consider the mandate of the ECB.

Through Operation Twist, the Federal Reserve will be trading in 400 billion dollars worth of short-term government bonds for long-dated Treasuries. The Fed's strategy of reallocating its balance sheet is aimed at reducing the long-term interest rate. This approach is consistent in spirit with the recent remarks of the President of the Chicago Fed.
The speech by Charles Evans on 7 September is worthy of our attention for at least two reasons. First, it indicates that today, even though the United States has slipped into crisis, with persistent unemployment and a new recession threatening, attention is being paid too much to inflation and public deficits rather than to the kind of action that would counter the crisis by conducting a policy commensurate with its scale. Using a target-function of the Fed and Okun's law, Charles Evans said that an unemployment rate of 9% of the US workforce would be as worrying as an inflation rate of 5 %: the 3-point

gap with each of the two targets – a “natural” rate of unemployment of 6% (which he calls a conservative assumption, as the unemployment rate should fall if the United States were to recover the 8 growth points lost during the crisis) or an inflation rate of 2% (again, a conservative assumption) – is very comparable in a country like the United States that does not impose any hierarchy between the targets of inflation and of growth (more precisely, between inflation and maximum employment, see here). Evans noted that the unemployment rate in the United States has actually come to differ by 3 points from its target, but inflation hasn’t … and he then observes: “So, if 5% inflation would have our hair on fire, so should 9% unemployment.” This led Evans to consider that the inflation target, legitimate in the medium term, is not the priority, and therefore that an expansionary monetary policy should be accentuated by conventional or unconventional means, even at the cost of a short-term boom in prices (which is unlikely in an economy in crisis).
The second factor that leads us to take an interest in this discourse is the rapprochement, or rather the great difference, with European policies. Indeed, in reading these words and observing the actions of the Fed, the contrast with the discourse and actions of the ECB is striking. The ECB’s difficulties in pursuing a policy suited to the state of the euro zone result from an overly orthodox approach to monetary policy, with all due respect to certain members who have resigned from the ECB. This is rooted in the fundamental Treaty on the European Union, where priority is given to inflation rather than growth (Articles 119 par. 2 and 127 par. 1). This leads the ECB to neglect the target of growth, to minimize it or, when circumstances ultimately so require (in a period of recession or slow growth) to pursue it in a non-transparent and thus ineffective way. We only have to look at the new joint effort, between in particular the Federal Reserve and the ECB, to ensure dollar liquidity for Europe’s banks, without any change in the key rate. The repeated procrastinations in European monetary policy from 2007 to 2008

– which were of course in support of the private banks, but, because of rising commodity prices, over which the ECB has no control, did not give any impetus to active monetary policy to counter the deterioration in activity – should not be repeated today. [Consumer price inflation in the euro zone in July 2011] is close to the medium-term target imposed by the ECB (2.5%), and it is being pushed upwards by rising raw materials prices (energy, coffee, tea, cocoa), by their impact on the prices of certain services (transport), and by the products used as the basis for the taxes that governments are wont to raise to try to restore a semblance of balance in their public finances (tobacco). Ultimately, in July 2011 the rate of inflation excluding energy and processed food products came to 1.5%. The unemployment rate in the euro zone is, for its part, on the order of 10% of the workforce. To paraphrase Charles Evans, one can say that while 5% inflation would certainly raise the hair on the heads of Europe's central bankers – and fortunately we are far from this – this should also be the case when the unemployment rate reaches 10% of the workforce!
The big difference between a Fed official's expansionist drive and the ECB's policy of prudence in comparable economic circumstances (the gaps between the inflation and unemployment rates from their respective targets are more or less the same) also finds a striking parallel in the fiscal policy speeches and actions on either side of the Atlantic. While the European debates almost invariably concern the imposition of additional constraints on the fiscal policies of the euro zone countries (the adoption of "golden rules" in Germany and Spain; the litany of fiscal austerity programs, the latest being in Italy), the need in the euro zone to be able to rely on a strong economic policy instrument comes down solely to the ECB. But this is not necessarily the case in the United States, where the federal government has proposed a new plan to revive the economy in the short term, together with fiscal consolidation over the next 10 years. The speech by Charles Evans should be given by Jean-Claude Trichet, but we are a long way from that. Standing firmly on the impeccable

character of the ECB's past actions (see the nuanced critique by Paul Krugman), the ECB Chairman, when he does talk, does not seem to take the measure of its responsibility for the future performance of its current policies. If the ECB fails to take the lead in boosting activity in a period of low inflation, then the governance of the euro needs to be reviewed. Two critical choices for the future are posed. The euro could disappear, which would not take place without serious difficulties (see the note from Jean Pisani-Ferry about Greece, whose conclusions could be extended to all the euro zone countries, including Germany) and must be firmly rejected. The status of the system of euro zone central banks could be amended to give equal dignity to the goals of economic growth and inflation, along the lines of the Fed, whose performance has made it possible to minimize the fears of an explosion of inflation.

Forced borrowing: the WMD of fiscal policy

By Jean-Paul Fitoussi, Gabriele Galateri di Genola and Philippe Weil

A spectre is haunting Europe – the spectre of sovereign default. All the powers of old Europe have entered into a holy alliance to exorcise this spectre: Brussels and Frankfurt, Angela Merkel and Nicolas Sarkozy, French socialists and German Christian Democrats. Churchillian doctors, they prescribe blood, sweat and tears – fiscal consolidation, tax increases and spending cuts. They swear, for the umpteenth time, that they will never surrender: Greece will be saved, Italy and Spain will not be abandoned and the rating of France will not be downgraded. In the face of adversity, they assure us that what cannot be achieved by austerity can be achieved by more austerity. An epidemic of holier-than-thou fiscal virtue is spreading throughout Europe and is fast transforming a series of uncoordinated fiscal retrenchments into a euro-wide contraction with dire implications for growth and employment.

To be sure, eurozone policymakers are in a maddening situation. The threat to monetise public debt, which in the old days could be waved by each country to remind investors it need not ever default outright, has been removed from national arsenals. No one knows for sure whether it will ever be brandished from Frankfurt or if European treaties even allow it. Eurobonds would have every economic merit but they hurt Germany which, having been left on its own to finance reunification, is understandably cold towards *die Transfer-Union*. Creating separate northern and southern euro areas would probably precipitate the end of the single market – and where would France fit? Wide-ranging fiscal reform designed to increase tax revenue equitably, while sorely needed, is a pipe dream: it requires elusive European co-ordination in an area in which the temptation to compete is strong and it is best done at its own pace – not under the pressure of fickle market sentiment or rising sovereign spreads.

Add to this powerlessness the terrifying failure of the old engine of European policymaking (putting the cart before the horse in the hope that the cart will conjure up the horse) and you will understand the ghoulish visions gripping our leaders. Monetary union has not begotten the expected fiscal union. Imposing, as a substitute, austerity plans from Brussels or Frankfurt, or racing to be first to impose “golden rule” constitutional strictures on parliaments that should remain sovereign in fiscal matters is stoking the fire of civil unrest. The English Civil War and American Revolution were ignited by much less. It would be wise to recall, as John

Hampden did in contesting the Ship Money tax levied by Charles I, that what leaders have no right to demand, a citizen has a right to refuse.

Yet Europe's fate is not sealed. The spectre of sovereign default and rising spreads in Italy, Spain, Belgium and other countries can be chased away in one fell swoop and the panic of contractionary fiscal policies can be stopped. National governments must simply take out of their fiscal armoury the weapon that has served them so well in war and peace alike: forced borrowing.

It consists in coercing taxpayers to lend to their government. California did this in 2009 when it added a premium to the income tax withheld from paychecks, to be repaid the following year. In France, the first Mitterand government forced rich taxpayers to fund a two-year bond issue – and both the US and UK have used moral suasion in patriotic sales of war bonds. Compulsory lending is an unconventional weapon but it is high time it be used, even on a small scale, to remind investors that sovereigns are not private borrowers: they need never default because they can always force-feed debt issues to their own residents.

Central banks have been bold and dared resort to unconventional policies to respond to the exceptional circumstances of this crisis. Large sovereign borrowers should be as defiant and intrepid. The invaluable asset of fiscal sovereignty guarantees that their public debt is completely risk-free in nominal terms. Investors who buy sovereign credit default swaps against the spectre of French or Italian default are wasting their money. Policymakers rushing to austerity should wake up from their nightmare and save growth and employment before it is too late.

Jean-Paul Fitoussi is former president and Philippe Weil is president of OFCE, the Observatoire français des conjonctures économiques in Paris. Gabriele Galateri di Genola is president *of Generali. The views expressed are their own.*

What impact will fiscal policy have on French growth?

By **Eric Heyer**

The proper framework for analyzing the French economy is a large economy that is not very open, and not a small open economy: the country's economic situation has deteriorated sharply and is still far from its equilibrium position (mass unemployment, the existence of excess capacity), and its European neighbours are adopting identical approaches to fiscal policy. Under these conditions, everything indicates that the fiscal multipliers are high. The theoretical debate about the value of the multiplier and the role of agents' expectations must therefore give way to the empirical evidence: the multipliers are positive and greater than one.

Following a deep recession, the most suitable method for making a forecast of short-term activity (2 years) is to evaluate the spontaneous return of the economy (speed and magnitude) to its equilibrium or potential level, but also and above all to quantify the impact of exogenous shocks (commodity prices, economic policy, etc.) on its spontaneous trajectory.

In our last forecast, we reported that the French economy has a significant rebound potential: corresponding to spontaneous growth of nearly 4% per year in 2011 and 2012, this would allow the economy, four years after the start of the crisis, to make up the output gap built up during that period.

Two exogenous shocks will slow down the country’s return to its potential level. The first involves the soaring prices of raw materials: this shock will mainly hit households and will weigh on their purchasing power and curtail their spending. This mechanism, which is also at work in the other Western countries, will cause a slowdown in their economies and hence their demand for French output. In aggregate, this purchasing power shock will cut the growth of the French economy by 1 point during the period 2011-2012. The second shock is related to fiscal policy: from 2011 onwards, the large (and small) developed countries, in the face of mounting debt and expanding government deficits, will be implementing policies of fiscal restraint. The generalization of this strategy will also put the brakes on economic growth; its impact is estimated at 2.8 percentage points of GDP during the years 2011-2012.

While there is relative agreement on evaluating purchasing power shocks, this is not the case for the impact of fiscal policy on economic activity.

What is the value of the fiscal multiplier?

Economic thought has been divided since the Great Depression over how to assess the impact of fiscal policy. Two major theoretical schools in the history of economic thought are at odds over the expected short-term impact of fiscal policy on economic activity.**1** On the one hand, the “Keynesian” school holds that an increase of one percentage point of GDP in public spending (or an equivalent decrease in taxes) should result in an increase in GDP of more than one point. This is known strictly as the Keynesian multiplier effect. On the other hand, there are a number of theoretical arguments that question the ability of fiscal policy to generate a more than proportional increase in GDP. Within this opposing school, it is then necessary to distinguish between those in favour of a positive fiscal multiplier (albeit less than one) and those in favour of a negative fiscal multiplier; in the latter case, we are speaking strictly of anti-Keynesian fiscal multipliers.

Many empirical studies have attempted to settle this theoretical debate. A review of the literature on this subject tells us that the fiscal multiplier is always positive, and that the following situations push it higher:

1. The budget policies of the partner countries are synchronized;
2. The instrument used relies more on public expenditure rather than taxation (Haavelmo, 1945);[2]
3. Monetary policy is ineffective (IMF, 2010).[3]

In a recent article, the OFCE highlighted a fourth factor, which concerns the position in the economic cycle: the multiplier is higher when the economy is at the bottom of the cycle.

What can we say about the current economic situation?

The implementation of austerity policies in all the European countries (criterion 1), focused on reducing public expenditure (criterion 2), and acting in a situation of a persistent “liquidity trap” (criterion 3) describes the context for a high multiplier.

Only an assumption that the economic crisis did not simply cause a drop in production but also may have had a strong impact on the economic potential of the euro zone economies could render the current strategy of fiscal consolidation optimal (criterion 4): based on this assumption, the rise in structural unemployment would be identical to that of actual unemployment, and the fiscal multipliers would be low in the short term and zero in the long term.

If on the other hand the growth potential of the economies did not significantly change during the crisis, then this strategy would lose its apparent effectiveness, which would confirm the relevance of the first three criteria and strengthen the impact of the fiscal consolidation.

On this crucial point, the strong stimulus imparted by economic policy renders any evaluation of the economy's new potential path more hypothetical and makes more complex the choice of a policy to end the crisis as well as the tempo of policy implementation. In any case, the violence of the initial shock can, it seems, lift any ambiguity about the case of the developed countries: even if it were agreed that this crisis has had a powerful impact on the economy's growth potential, this would still not cancel out the overcapacity generated by the crisis over three years.

What other scenario could lead to recovery?
A neutral fiscal policy instead of the austerity policy
Summary of the impact of a neutral fiscal policy on exchange rates and public finances

In points of deviation from the central scenario

	2011	2012
GDP	1.7	1.1
Gov't financial balances (GDP points)	-0.6	-0.6
Unemployment rate	-0.9	-1.5

Sources : INSEE; OFCE calculations *e-mod.fr*.

It is also possible to enrich the analysis by approaching it this time from the perspective of unemployment rather than production: unemployment rose brutally and spectacularly from the very start of the crisis, from 7.2% in early 2008 to 9.3% in late 2010. This increase in unemployment cannot be regarded as an increase in equilibrium unemployment: during this period, there were no significant changes in labour market institutions or practices, *i.e.* the main determinants of equilibrium unemployment. In the short term equilibrium unemployment could of course have been modified by a poor sector allocation of capital and labour resources. Some reallocation may also result from reduced productivity. But in any case there is no evidence of a lasting increase in equilibrium unemployment. The situation today is indeed a situation of involuntary unemployment as compared to what we could have seen, without inflation, with the full use of the available workforce.

Under these conditions all the evidence indicates that the multipliers are high: the country's economic situation has deteriorated sharply and is still far from its equilibrium position (mass unemployment, the existence of excess capacity); monetary policy has little bite; and all the developed countries are in the same configuration and will therefore carry out the same policy.

The proper analytical framework is therefore that of a large, not very open economy, and not that of a small open economy. The theoretical debate about the value of the multiplier and the role of agents' expectations must therefore yield to the empirical evidence: the multipliers are positive and greater than one.

A simulation of a neutral budget policy indicates that the choice of fiscal consolidation proposed by the developed countries will thwart the start of a virtuous circle: without it, growth in "the Hexagon" would have been higher by 1.7 points in 2011 and 1.1 points in 2012 (Table 1). This would have allowed the unemployment rate to fall significantly (-1.5 point), eventually to 7.8% by 2012, close to the level prevailing before the crisis. The general government deficit would also have benefited from the boost in activity: it would have declined, although certainly less than in the case of the austerity policies set out (5 GDP points), reaching 5.6 GDP points in 2012 (Table 1). By raising the unemployment rate by 1.5 points compared to the baseline, *i.e.* the situation without a policy of fiscal restraint, the cost of a reduction of 0.6 GDP point in the general government deficit seems extremely high.

1. In the long term, the effectiveness of fiscal policy vanishes. [↩]

2. Haavelmo T. (1945), “Multiplier effects of a balanced budget”, *Econometrica*, vol. 13, no. 4, October, pp. 311-318. [↩]
3. IMF (2010), “Recovery, Risk, and Rebalancing”, *World Economic Outlook*, Chapter 3, October. [↩]