

# The myth of fiscal reform

By [Henri Sterdyniak](#)

On 19 November, the French Prime Minister announced that he was suspending the implementation of the “ecotax” and working on a major tax reform. This has been raised frequently in public debate, without the reform’s content and objectives being spelled out. Conflicting proposals are in fact being presented.

Some advocate a sharp reduction in taxes, which could boost the French economy by encouraging employees to work harder, households to save more, and businesses to invest and hire, which would make France more competitive. But public spending would have to be reduced further, even though the government has already committed to a 70 billion reduction by 2017. What spending should be cut in particular? Social benefits would have to be drastically reduced, which is not compatible with the maintenance of the French social model. Some want to shift the burden of social protection from businesses to households. The MEDEF for instance is calling for reducing taxes on business by 100 billion. This would require another sharp hike in taxes on households, leading to a collapse in consumption. Should France move in that direction, should it renew tax competition in Europe by lowering household income?

Others are proposing distributing the tax burden more equitably between income from labour and income from capital and strengthening the redistributive character of taxation. But France is already one of the world’s most redistributive countries, with high taxes on big earners, large estates and capital income. All these are already heavily taxed, following increases made by the Fillon and then Ayrault governments.

Some propose chasing down tax and social niches, expanding the tax brackets and reducing rates. But doesn’t this forget the

incentive role of taxation? Many programmes, even complex ones, are legitimate for reasons of equity (such as the family quotient) or as employment incentives (such as exemption from social charges on low wages or for child care) or assistance to the working poor (e.g. the PPE in-work tax allowance) or as other incentives (such as the exemption of charitable donations or union dues). Some income is of course not taxed, such as certain capital income (life insurance or PEA plans) or unrealized capital gains (but it is difficult to tax gains that are merely potential) or implicit rents (such as enjoyed by those in owner-occupied apartments), but who would dare to touch these? The point is more a patient dismantling of niches, which has been underway for several years, rather than a major reform.

Making our taxation more ecological is certainly a pressing obligation. But is there really a double dividend in jobs and in ecology? Doesn't the environmental gain have a cost in jobs, purchasing power and competitiveness? Can we increase environmental taxation in France without a worldwide agreement, which looks unlikely today? Environmental taxation is necessarily complicated if we want to avoid hitting (too hard) farmers, industry, poor people, marginal regions, disadvantaged suburbs, etc. This is the lesson of the failure of the carbon tax (in 2009) and France's ecotax (in 2013).

We must of course fight against tax evasion by the wealthy and by large corporations, but this mainly involves tax harmonization at the European level, which is not without risk if it means that France must align with the lowest bidder on taxing wealth (ISF), the corporations (IS) or income (IR).

A large-scale tax reform, one that does not alter the tax burden, inevitably means winners and losers. Who the losers will be should be made clear: retirees, homeowners, savers?

A miracle project has shot to the surface: the merger of income tax and the CSG wealth tax. But neither the terms nor

the objectives of this merger have been specified. It is running first of all into opposition on principle from the trade unions, who take a dim view of any merger of a State tax with the CSG tax, whose proceeds are allocated directly to social protection. A reform would lead towards putting the State in charge of sickness and family benefits (especially if at the same time a portion of employer contributions were taxed), with the risk that social benefits become adjustment variables with respect to the public finances.

The CSG tax currently hits employees harder than those on replacement income. A merger of CSG and income tax without specific compensation could thus be very costly for pensioners and the unemployed, and in particular for poor people who currently pay neither the CSG tax nor income tax. Conversely, capital income currently incurs a total taxation – the CSG, the Contribution to the Reimbursement of the Social Debt (CRDS) and the main social charges – of 15.5%, which is significantly higher than the 8% paid by employees. This can of course be considered as offsetting the fact that, by definition, they are not hit by employer contributions. But, as we shall see, comparing levies on different forms of income is not so easy.

A merger like this could provide an opportunity for a complete re-think of the various programmes that have gradually led to narrowing the income tax base, and in particular certain tax loopholes. But some of these tax expenditures are essential, so it would be necessary to replace them with explicit subsidies or keep them in the merged tax. The merger would not in itself solve the problem of income that is currently exempt, whether this is implicit rent or certain capital gains.

Some want to merge all the programmes helping poor people (RSA income supplement, PPE tax benefit, housing allowance) through a negative tax administered by the tax authorities, thereby ignoring the need for the kind of detailed, personalized,

real-time follow-up that France's Family Allowance Fund (CAF) is able to provide.

The lawmakers will have to decide the question of whether the merged tax should be calculated individually or jointly per family. This is an important issue: should the State recognize the right of individuals to pool their incomes and share this with their children? But should we really be launching this debate today? Is calling into question the family nature of our tax system all that urgent right now? Individual treatment would mean transferring the most significant charges, in particular at the expense of single-earner families or middle-class families. With an unchanged burden, this would imply a sharp rise in the tax burden on households. A uniform reduction in rates would be highly anti-redistributive, to the detriment of families in particular and in favour of single people without children. Individualization should necessarily be accompanied by a strong increase in benefits for children (especially large families). This would lead to a more redistributive system in favour of poor families, but better-off families would lose out, which raises difficult questions about horizontal equity.

There is also the question of what kind of levy is used. We cannot move to a simple system of withholding at source without greatly reducing the progressive, family character of the French system. A company does not need to know the income of their employee's spouse or their other income. A reform would make it possible to withhold a first tranche of income tax (of 20% of income for example), while factoring in allowances (an individual deduction, possibly a deduction for a spouse with no income, a deduction for children). The balance would then be collected (or refunded) the following year according to the tax roll. The system would hardly be simplified. Contrary to what we are told by Thomas Piketty, a CSG-income tax merger is not the touchstone of tax reform.

Should we be concerned that the evocation of a tax reform is

simply a sham, masking a refusal to address the real problems of the French economy: the difficulty of fitting into the new international division of labour; the growth of inequality in primary income due to globalization and the financialization of the economy; and the failure of the developed countries, especially the euro zone, to find new sources of growth after the financial crisis?

The problem is probably not so much the structure of taxation as it is the error in economic policy made at the level of the euro zone of adding fiscal austerity to the depressive shock caused by the financial crisis and, at the level of France, of raising taxes by 3 GDP points since 2010 (60 billion euros) to fill a public deficit attributable solely to the recession.

The French tax system takes in 46% of GDP; primary public expenditure represents 50%. At the same time, France is one of the few developed countries where income inequalities have not increased greatly in recent years. Our high level of public and social spending is a societal choice that must be maintained; the French tax system is already highly redistributive. Some reforms are of course necessary to further improve its redistributive character, to make it more transparent and socially acceptable. Nevertheless, what matters most is precisely the level of the formation of primary income. There is no miracle reform: the current system, the product of a long process of economic and social compromise, is difficult to improve.

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# Towards a major fiscal reform – at last!

By [Guillaume Allègre](#), [@g\\_allegre](#)

At the start of the week, Jean-Marc Ayrault announced an overhaul of the French tax system that would involve, among other things, a reconciliation between income tax and the CSG wealth tax. The OFCE will definitely take part in this debate, one that it has already tried to shed light on many times, in particular on the occasion of a [special “Tax Reform” issue of the Revue de l’OFCE](#), edited by Mathieu Plane and myself, and published in April 2012.

Several contributions [all in French] can be mentioned: Jacques Le Cacheux’s article in the *Revue* discusses the purposes and methods of tax reform (“[Sustainability and economic justice](#)”), while reviewing what the fundamentals of fiscal policy actually are. Nicolas Delalande conducts a historical analysis of resistance to tax reform and assesses the constraints on the development and implementation of reform (“[The political economy of tax reform](#)”), all of which seem to be topical subjects today. He stresses that: “Indeed, it may be more difficult to bring together positive support for a measure than to temporarily rally disparate opponents with sometimes conflicting motivations, especially if this involves creating new taxes or affecting established situations.” Mathieu Plane raises the question of the consequences of a tax increase (which did indeed occur in 2012-2013): “In a context of rising unemployment, will it be possible to generate a new large-scale fiscal shock without plunging France into a new crisis? The determination to reduce public deficits solely through structural adjustment is hurting growth and unemployment” (“[Public finances: towards a new tax increase?](#)”). While the government is now announcing it wants a reform that does not change the tax burden, the

question of the impact of fiscal adjustments (this time through cuts in public spending) on growth and, ultimately, the social acceptability of a structural reform of the tax system is still posed for the period 2014-2017. Will the government be able to implement a structural reform in a context where unemployment is high and not falling?

The merger of the CSG tax and income tax raises a number of questions that were already discussed in an article in the *Revue de l'OFCE* in 2007 ([“Towards the merging of income tax and the CSG?”](#)). The legislature needs to decide the issue of either joint taxation of spouses or individualisation for the merged tax as well as how to take children into account ([“Should the family quotient be defended?”](#)). This is a particularly sensitive topic, as it affects the representation of the family and the relationship between the State and the family. It has been the subject of controversy even within the OFCE ([“Reforming the marital quotient”](#), [“In defence of the family quotient”](#)).

By intermingling private interests (what charges for which households?) and social interests (what instruments for what purpose?), the tax issue has always been at the centre of democratic debate. The role of the OFCE is to contribute to this debate with solid arguments backed by data. OFCE researchers will continue to offer their own vision of a “good” tax reform, while discussing its objectives, impact and sustainability in a transparent and rigorous fashion.

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# The trend in unemployment: no reversal in sight

By [Bruno Ducoudré](#)

The government has announced that the trend in unemployment will be reversed by the end of 2013. The number of jobseekers registered in category A with France's Pôle Emploi job centre at the end of September increased by 60,000. The number fell during August by 50,000, mainly due to a "bug" in sending SMS texts, which led to an unusually large rise in the number of terminations due to the claimant's failure to stay up to date (up 72,000 over the previous month). An increase in enrolments for the month of September due to the re-registration of jobless people who had been unduly terminated was therefore expected. The number of jobseekers registered in category A thus rose by 10,000 between July and September 2013, which meant that the trend is still upwards but at a more moderate pace than earlier in the year. These large variations in the very short term in the numbers registered with the ANPE job centre make it impossible to give a precise idea of upcoming trends in employment and unemployment. Our analysis of the labour market up to 2014, which is set out in the latest [OFCE forecasts of October 2013](#), suggests that no significant improvement in unemployment is expected by the end of 2014.

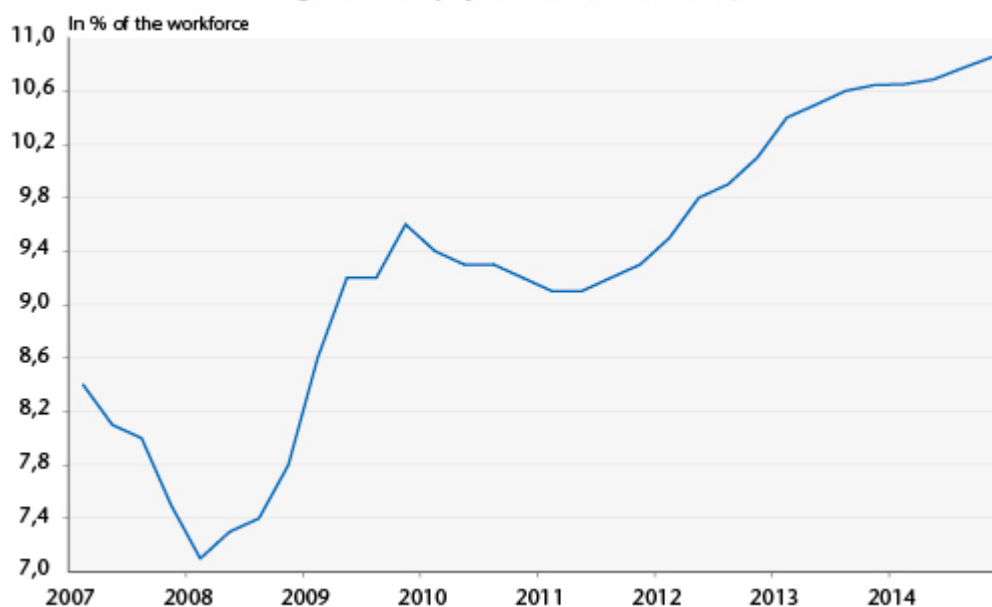
In an attempt to reverse the trend in unemployment, the government has planned for the rapid expansion of subsidized jobs in the non-profit sector (Emplois d'avenir, Contrats Uniques d'Insertion – Contrats d'Accompagnement dans l'Emploi (CUI-CAE)). Joining these programmes are the CICE tax credit for competitiveness and employment together with "generation contracts" in the commercial sector, whose impact on employment will begin to be felt in 2014. All these measures to promote employment will help to stabilize the unemployment rate by late 2013/early 2014, with continuing job losses in



the private sector until the end of the year. The unemployment rate will then begin to rise again until the end of 2014, since job creation in the non-profit sector will be insufficient to absorb the increase in the labour force.

In retrospect, an initial reversal of the trend in unemployment began in 2010 and was then interrupted in 2011, as unemployment started to rise again under the impact of a series of austerity measures. The unemployment rate was creeping toward the record levels hit in 1997, rising from 9.1% in early 2011 to 10.5% in the second quarter of 2013 (Figure 1). After a bad year in 2012 (66,000 jobs lost), the labour market continued to deteriorate in the first half of 2013, as job losses in the private sector continued at the same pace as in the second half of 2012 (-28,000 jobs on average each quarter). The number of unemployed thus continued to increase (+113,000). To try to stop this downward spiral and reverse the rise in unemployment, the government is relying in the short term on expanding the Emplois d'avenir and CUI- CAE subsidized job programmes.

Figure 1. Unemployment rate (ILO definition)



Sources: INSEE, quarterly accounts; OFCE forecast e-mod.fr 2013-2014, October 2013.

The gradual introduction of Emplois d'avenir jobs has resulted in 31,566 hires between January and August 2013 in France. A total of 70,000 hires are expected in 2013 in mainland France

and 70,000 more in 2014. There is, however, a deadweight loss for this type of programme: according to [Fontaine and Malherbet \(2012\)](#), 20% of the jobs created through the Emplois d'avenir scheme would have existed even in the absence of the subsidy. The net impact is thus expected to be 56,000 jobs created in 2013 and in 2014. The impact of this job creation will be especially important since these involve long-term contracts (1-3 years). People hired in 2013 will still be in their jobs in 2014, and the Emplois d'avenir jobs created in 2014 will indeed constitute net job creation.

As for the CUI- CAE programme, the number of contracts budgeted at the beginning of 2013 was the same as the previous year (340,000 for the whole of France, including 310,000 for mainland France), with 50% of these in the first half year. In order to reverse the trend in unemployment by the end of the year, in June 2013 the Ayrault government announced an extension of 92,000 contracts in the non-profit sector. This brings to 262,000 the number of contracts signed in the second half year, and 432,000 for the year. As in 2013, 340,000 contracts are planned in the 2014 Budget Bill (PLF), but the budget allocation is nearly 20% larger, which will fund an increase in the stock of CUI-CAE. These will increase until the first half of 2014, reaching 250,000 by end 2014. The government is thus reactivating the social treatment of unemployment through greater use of short-term subsidized jobs (7-12 months), but at a level comparable to that seen in 2007 and in 2010.

In contrast, there will still be significant job losses in the private sector up to year-end 2013 due to companies being overstaffed (see our [October 2013 forecasts](#)). Subsidized jobs in the non-profit sector (+82,000 in the last quarter of 2013 compared to the last quarter of the previous year) will nevertheless stabilize the unemployment rate at around 10.6% in late 2013 / early 2014.

**Table. Employment and unemployment**

Annual change, in thousands, at last quarter

Year on year	2009	2010	2011	2012	2013*	2014*
Observed workforce	210	45	178	200	83	116
Total employment	-321	128	130	-66	-91	41
- Private sector	-347	65	104	-64	-121	-12
- Subsidized non-profit	38	44	-74	6	82	96
- Other jobs	-12	19	100	-8	-52	-44
Unemployment	531	-83	48	266	174	75
Unemployment rate	9,6	9,2	9,3	10,1	10,6	10,9

\* OFCE October 2013 forecast.

Sources INSEE and Ministry of Labour, OFCE forecasts.

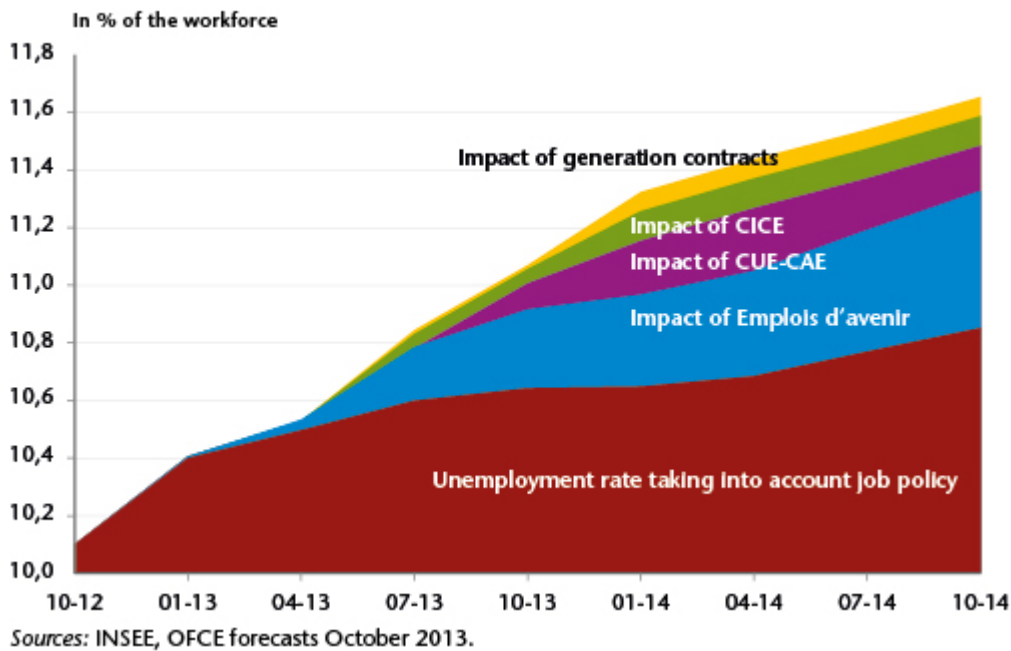
Total employment began rising again in 2014 (41,000 jobs), driven by the creation of subsidized jobs in the non-profit sector, but also by the expansion of the generation contract and CICE programmes. The CICE, which is open to all businesses, will be equivalent to 6% of payroll, excluding employer social security contributions, and corresponds to wages of less than 2.5 times the minimum wage (SMIC). According to the assessment made by [Mathieu Plane \(2012\)](#) using the e-mod.fr model, the CICE will decrease labour costs in the private sector by on average 2.6%, which should result in the creation of jobs, both by promoting the substitution of labour for capital and through gains in competitiveness. In total, by 2018, five years after its establishment, the CICE will have created 152,000 jobs, thus lowering the unemployment rate by 0.6 percentage point. At the horizon of our forecast, it will have created 46,000 jobs, or half the government's forecast (91,000).

The generation contract covers unemployment among both younger (under age 26) and older workers (over 57). It consists of the creation of a permanent contract (CDI) for a young person, linked to the promise of non-dismissal of an older worker for a period of 5 years. In return for this commitment, the company will receive a lump sum grant of up to 4,000 euros per year for 3 years. This type of measure runs the risk of

generating significant deadweight effects.[\[1\]](#) Overall, the measure will result in 99,000 new jobs in the private sector, with the signing of 500,000 generation contracts over the 5-year period. In September 2013, 10,000 generation contracts were signed. Under the assumption of a gradual ramp-up by the end of 2013 (20,000 contracts signed), with 100,000 contracts signed in 2014, this should correspond to the net creation of nearly 4,000 jobs in 2013 and about 20,000 jobs in 2014.

Despite this, unemployment will continue to rise over the two years (+174,000 in 2013 and +75,000 in 2014 compared to the same quarter of the previous year), due to a still dynamic workforce (+116,000 in 2014 after +83,000 in 2013 ) and a lack of net job creation in the private sector (see the table above). Given the subsidized jobs in the non-profit sector as well as the private sector programmes, the unemployment rate in mainland France will temporarily stabilize at 10.6 % in the fourth quarter of 2013, before gradually creeping up to 10.9% of the workforce in mainland France by late 2014. By the end of 2014 it will surpass the historic peak reached in the first half of 1997 (10.8% of the workforce), with no prospect of reversing the trend over our forecast horizon. However, without the impact of the jobs programmes, the unemployment rate would have increased much more, to 11.6 % at end 2014 (Figure 2).

**Figure 2. Impact of employment measures on the unemployment rate**



[1] See the OFCE Note of July 2012 on "[An assessment of the 2012-2017 five-year economic plan](#)". Companies will benefit from this aid, including for the jobs they would have created even in the measure's absence. The way the measure is implemented should limit the deadweight loss: aid linked to the implementation of the generation contract will for instance be reserved for companies with fewer than 300 employees. Companies with over 300 employees, where the risk of a windfall effect is greatest, will be obliged to set up the programme on pain of financial penalty. In addition, the lump sum of 2000 euros represents a total exemption from employer social charges at the level of the SMIC, and above that decreases in proportion to the salary. This helps to limit the windfall effect, since the elasticity of employment to labour costs is higher for low wages.

# Is it pointless to separate banking activities?

[Jean-Luc Gaffard](#) and [Jean-Paul Pollin](#)

It is at the European level that the last chance for a structural reform of the banking system can be found, that is to say, a separation between investment banking and retail banking. If we are to believe the banking industry and certain academic circles, such a separation is at best useless and at worst harmful. Separating risky activities from non-risky activities, or non-speculative activities from speculative activities, would, it is held, prove illusory. All banking activity is risky, if not speculative. After all, the subprime crisis in the United States, the crisis of the savings banks in Spain, and the crisis of Northern Rock in the United Kingdom were all the result of reckless risk-taking in the granting of property loans to households. Furthermore, universal banks have to some extent helped to save overly specialized institutions. In these conditions, a minimalist law on separation such as the French law or a more binding law such as proposed in the Vickers report in the UK or like the one envisaged by the Liikanen Group would be of little use in terms of achieving stability. It would be better, then, to trust to prudential regulation, which should indeed be strengthened. This is particularly true since commercial banks should be able to develop market activities to meet the needs of their customers.

First of all, the existence of economies of scope that would justify bringing together commercial banking and investment banking have never been proven. Moreover, the “business models” of the two are very different, to the point that joining them may involve a risk of weakening the commercial bank’s capacity to do its job. Furthermore, the argument set out above ignores in particular the systemic dimension of the

financial and banking crisis. When the savings banks went bankrupt in the United States in the early 1990s, the consequences were circumscribed because the financial system was relatively closed. With the subprime crisis, the real problem came from contagion that was directly related to the close connectivity that had arisen within the financial system.

This is not a matter of simply recognizing that any banking activity entails risk, but rather of taking into account the impact of the contagion that market activity is primarily responsible for. It is especially transactions in derivatives that give rise to the interconnections between financial intermediaries. These are multiple, poorly identified connections created by market activities, which have had devastating consequences on the traditional lending activity of banks because of reckless risk-taking and losses in market transactions (and not just in "proprietary trading" operations).

Naturally, in the face of systemic risk, prudential regulation does need to be strengthened. But however important it may be to regulate functions, this is undoubtedly less important than regulating the financial institutions themselves. Revenues from commercial banking are de facto relatively regular, apart from periods of severe crises, while those from an investment bank are much more volatile. An investment bank needs a commercial bank to withstand market fluctuations (and enjoy any available government guarantee), but the reverse is not true. The problem comes down to whether it is appropriate to take the risk of destabilizing the heart of the banking system in order to strengthen the pursuit of activities whose social utility is not always clear, and which should find their own means of survival.

Wisdom would thus have it that the financial system should be compartmentalized so as to limit any contagion. Regulations should specify the types of assets in which each category of

institutions could invest as well as the type of commitments that they can make. This is what stands out from the legislative and regulatory arsenal developed in the United States and Europe following the Great Depression, an arsenal that was largely dismantled in France in 1984 and the United States in 1999 when the Glass-Steagall Act was terminated. This is what should be put on the agenda again by returning to an effective separation between commercial banks and investment banks. Not only would this separation create a certain seal between the various compartments of the financial system, but it would also help to avoid the dilemma associated with institutions that are “too big to fail”. The aim is to protect the commercial bank from market risk. It is also to put an end to the implicit subsidies that universal banks have from the State, which are no longer really justified by separation and which can endanger the public purse. All these measures should be conducive to growth.

For more on this subject, please read [OFCE Note no. 39 of 19 November 2013](#) [in French] by Jean-Paul Pollin and Jean-Luc Gaffard, “Pourquoi faut-il séparer les activités bancaires?” [Why banking activities need to be separated].

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## **The chiaroscuro of the ECB’s “forward guidance” \***

By [Paul Hubert](#) and Fabien Labondance

“The Governing Council expects the key interest rates to remain at present or lower levels for an extended period of time.” With this pronouncement on 4 July 2013 at the press conference following the monthly meeting of the European



Central Bank Board of Governors, Mario Draghi initiated the adoption by the ECB of a new communication strategy called “forward guidance”. Since then these words have always been included in his speech following announcements of the ECB’s monetary policy, and he has repeated them again [today \[1\]](#). What should we expect? Forward guidance has recently been adopted by several central banks, but the methods chosen by the ECB differ and indicate that this measure will have only limited effectiveness in the euro zone.

Communication has become an integral part of the conduct of monetary policy since interest rates have been kept at a minimum level. More specifically, forward guidance consists of announcing and making a commitment to the future path of key interest rates. By doing this, the central banks want to increase the transparency of their activities and anchor expectations. The aim is to clarify both their strategy and their predictions about trends in the economy. In the present case, the central banks want to affirm their desire not to raise interest rates in the near future. They also hope to influence private expectations about short-term rates, and thus long-term rates, in order to strengthen the transmission of monetary policy, and thus support the economy.

### **From the theory...**

The promoters of the forward guidance strategy, foremost among them Eggertsson and Woodford (2003), suggest that monetary policy can be made more effective by adopting a policy of stable interest rates that is well known in advance. This proposal is justified by the fact that demand for credit is highly dependent on expectations of long-term interest rates, which depend on expectations of short-term rates. Hence, by announcing the future levels of interest rates in advance, the central bank declares its intentions and dispels any uncertainty about its future decisions. This strategy is especially relevant in a situation of a liquidity trap, when nominal interest rates are close to zero, as is the case

today. The traditional tool of central banks is then constrained, as nominal interest rates cannot be negative. Central banks can thus no longer influence the cost of the loans granted, but they can on the other hand influence volumes through unconventional measures [2]. The channel of expectations and the transmission of signals to private agents then become paramount and complement quantitative easing.

It is important to note that the effect of forward guidance on long-term rates and thus on the economy passes through the term structure of the interest rates. Several theories attempt to explain how rates vary in accordance with the term. The term structure of interest rates can be considered from the viewpoint of the theory of expectations, which assumes that long-term rates reflect a combination of expected future short-term rates, and thus that the different maturities are perfect substitutes. For its part, the theory of a liquidity premium implies that long-term interest rates include a premium linked to the existence of one or more long-term risks. Finally, another theory is based on the assumption of market segmentation and stipulates that financial instruments with different maturities cannot easily be substituted and that their prices move independently. If investors wish to hold liquid assets, they will prefer short-term instruments over long-term ones, and their prices will vary in opposite directions. Only in the case of the first two theories will forward guidance have the desired effect on long-term rates.

### **...to the practice**

This kind of strategy had already been implemented by some central banks even before the 2008 financial crisis, in particular in New Zealand since 1997, in Norway since 2005, and in Sweden since 2007. The United States also implemented this communication strategy several times when rates were very low. The Federal Open Market Committee (FOMC) implicitly introduced forward guidance in its communications in August 2003. At a time when its target rate was at a historic low,

the FOMC stated that "...policy accommodation can be maintained for a considerable period". This terminology, specific to forward guidance, remained in FOMC communiqués until the end of 2005. It reappeared in December 2008, and in greater detail in August 2011, when Ben Bernanke, chairman of the US Federal Reserve (or the "Fed"), announced that economic conditions warranted maintaining the federal funds rate at a low level until at least mid-2013. Since then, the announcement on 13 September 2012 that the Fed will not raise its rates before mid-2015 continues this same strategy.

To understand what impact the ECB's forward guidance might have, it is important to distinguish two types of forward guidance: one for which the action of the central bank is subject to a time period, and another which depends on economic variables, including thresholds that trigger an action on the bank's part. In the case of the Fed, the first statements mentioned above refer to a period of time, but since December 2012 it has conditioned its commitment to future rate changes on cyclical thresholds that act as triggers. The Fed has also announced that "this exceptionally low range for the [Fed Funds](#) rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored". The arrival of new FOMC members in January 2014 could, however, change the timing of the next monetary tightening. Likewise, in August 2013 Mark Carney, Governor of the Bank of England (BoE), set out a forward guidance strategy indicating his intention not to raise rates so long as the unemployment rate had not fallen below 7%. This commitment is nevertheless conditional on containing inflation, on stable inflation expectations and on the neutral impact of this commitment on financial stability.

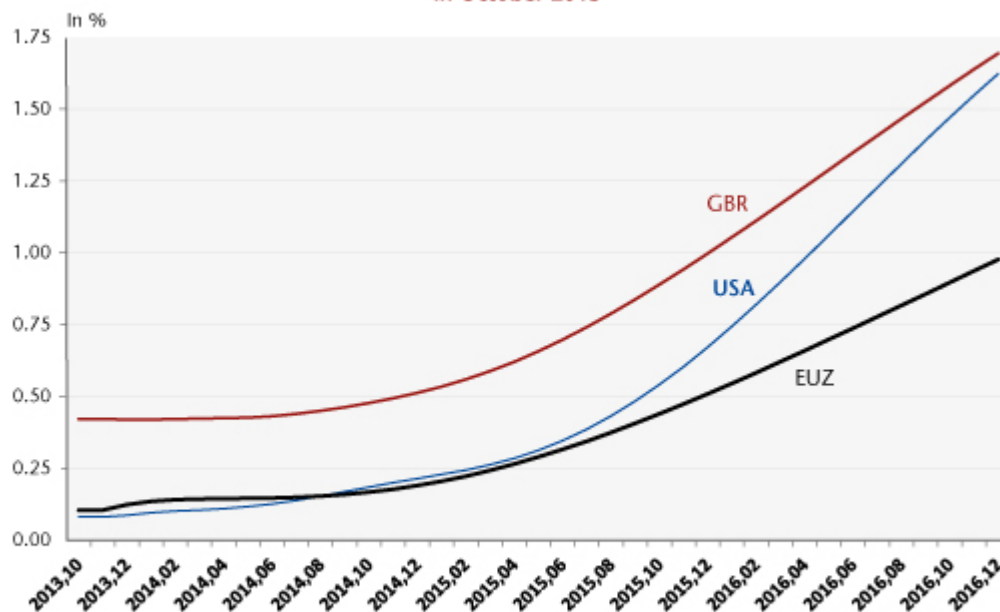
There is a major disadvantage to conditioning forward guidance

on a time period, as has been adopted by the ECB (and as will be described later): changes in economic conditions over the time period in question could render the commitment obsolete. The announcement thus has very little credibility. Conditioning forward guidance on thresholds for economic variables does not have this drawback. One criterion for the credibility of commitments conditioned on thresholds is, however, that the underlying variables chosen are observable (GDP rather than output gap) and that they do not suffer from measurement errors (inflation rather than inflation expectations), so that private agents can assess whether the central bank is acting in accordance with its commitments. Then and only then will the agents have confidence in the declarations and will the central bank be in a position to influence expectations of long-term rates. The relative advantages and disadvantages of the two types of forward guidance explain why the Fed switched from one to the other and why the BoE has also made a commitment linked to thresholds.

The establishment of forward guidance conditioned on a threshold for a macroeconomic variable may, however, contribute to muddying the waters on the ranking of the central bank's objectives. If several variables are targeted simultaneously and they begin to diverge, what will the bank decide? The Fed does not prioritize its objectives. As the economy emerges from crisis it is quite possible that the Fed may decide to ensure the strength of GDP, or to lower unemployment rather than inflation. For its part, the BoE follows a strategy of inflation targeting. It has therefore defined conditions ("knockouts") on inflation, inflation expectations and financial stability, which, when they are not met, will lead to an end to forward guidance and therefore to any commitment to keep rates unchanged. The hierarchy of objectives would thus be well respected and the BoE's credibility maintained.

How effective can forward guidance be? Kool and Thornton (2012) express serious doubts as to the results obtained through forward guidance. They assess the predictability of short-term and long-term rates in countries where this strategy has been adopted and show that forward guidance improves the ability of private agents to forecast future short-term rates only for periods of under one year, without improving the predictability of rates in the longer term. The chart below shows the expectations of 3-month rates by the financial markets in October 2013 for the coming months. Since benchmark rates change by a minimum of 0.25%, this figure indicates that no change in rates is expected for the time being, apart perhaps from the United States for the one-year horizon.

Graphique. Current 3-month rates and anticipated 3-month rates at various dates, in October 2013



Note : The short-term rate anticipations that we consider are produced from forward rate agreements (FRAs) or futures contracts on anticipated market rates at a given date for different horizons (1 month, 2 months, etc.).

Source : Datastream.

## The timid adoption by the ECB

With regard to the ECB, which for its part sets a hierarchy of goals by giving priority to inflation, the introduction of forward guidance constitutes a conditional commitment to a

period of time (“... for an extended period of time”) without any reference to thresholds. From this point of view, it goes against the current of the Fed and the BoE, which adopted conditional commitments to numerical thresholds. For the record, prior to July 4<sup>th</sup> the ECB gave clues to its decision in the following month in the form of expressions that were easily recognizable to observers. Thus, the insertion of the word “vigilance” in the ECB President’s speech at his press conference announced a probable tightening of monetary policy [\[3\]](#). By adding forward guidance to its basket of tools, the ECB wants to be less enigmatic. In particular, it seems that it wanted to respond to concerns over a possible rise in interest rates.

However, Benoit Coeuré, a member of the ECB Executive Board, said that this strategy does not call into question the rule, repeated many times at press conferences, that the ECB will never commit to future policies (“no pre-commitment rule”) and that forward guidance is to be re-evaluated at each meeting of the Board of Governors. Jens Weidmann, a member of the ECB’s monetary policy committee as president of the Bundesbank, confirmed that the ECB’s forward guidance “is not an absolute advanced commitment of the interest rate path”, while Vitor Constancio, ECB Vice-President, added an extra dose of confusion by saying that the ECB’s forward guidance “is in line with our policy framework as it does not refer to any date or period of time but is instead totally conditional on developments in inflation prospects, in the economy and in money and credit aggregates – the pillars of our monetary strategy”.

So how effective can a policy be that is poorly defined, that does not seem to have a consensus within the ECB Governing Council, and whose key to success – the credibility of the commitment – is openly questioned? Not very effective.

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\* This text draws on a study, "Politique monétaire: est-ce le début de la fin?" ["Monetary policy: Is it the beginning of the end?"], forthcoming in [The OFCE outlook for the global economy in 2013-2014 \[in French\]](#).

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[\[1\]](#) Today's 25-basis point cut in the benchmark rate is consistent with the ECB's strategy of forward guidance.

[\[2\]](#) Unconventional measures refer to monetary policy practices that are not classified as traditional policy (*i.e.* changes in interest rates). These are measures that result in a change in the content or magnitude of the central bank balance sheet through purchases of government or private securities, which is generally referred to as "quantitative easing".

[\[3\]](#) Rosa and Verga (2007) offer a description of these expressions.

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# Rental housing: the CAE wants to change the ALUR ...

By Pierre Madec and [Henri Sterdyniak](#)

On October 24<sup>th</sup>, the French Economic Analysis Council (the CAE) published a paper proposing a new policy on rental housing in France. This paper calls into question a number of government measures in the ALUR bill currently under discussion in Parliament, such as rent control and the universal rent guarantee (the GUL) [1]. Are these criticisms justified? The authors acknowledge that the housing market is very specific, that it requires regulation, and that the state needs to build social housing and assist poor families with housing. Their differences with the policy that the current government intends to follow are thus intrinsically limited, and are more related to means than ends. The free market does not work in the area of housing. There is a need for public intervention that should aim, as we shall see, at contradictory objectives, programmes whose structure is by their very nature subject to discussion.

## **The existing rental housing stock: co-management and moral hazard**

With regard to the private rental market, the authors in essence propose the introduction of a system of housing “flexicurity”, akin to what has been recommended for the labour market: diversification and liberalization of leases, new rights for the landlord, more flexible conditions for terminating a lease, and the development of a system of co-management of the private rental market built around a “housing authority” whose powers would extend from setting “benchmark” rents to managing leases. This “authority”, which would be jointly administered by tenants and landlords, would play a mediating role in conflicts between them, much like the



*prud'hommes* bodies for labour disputes. The main argument used by the authors to condemn a scheme such as the GUL universal rent guarantee is that it would create significant problems with moral hazard, that is to say, the guarantee would encourage those covered to take "too many risks". In this case, tenants, who would have a guarantee that any payment defaults would be covered by the fund, would be less concerned about paying their rent; they could therefore choose housing that is more expensive than what they really need. Owners would also be less concerned in their selection of a tenant. The authors also use the argument of moral hazard to defend the establishment of flexible leases: in their opinion, this would help in the fight against the deterioration of housing as well as in disputes with neighbours. The idea of tenants who are systematically "voluntary deadbeats" ready to degrade the housing they have leased seems simplistic and over the top. However, this idea is developed at some length by the authors. They seem to forget that the GUL will in particular cover tenants who are unable to pay their rent because of financial hardship (unemployment, divorce, etc.). This guarantee above all offers new protection for the owner – protection funded equally by landlords and tenants through a pooling system. In case of failure to pay rent, the landlord will be reimbursed directly from the fund. The latter will then examine the tenant's situation and proceed either with a mandatory collection or personalized support if the tenant is genuinely unable to pay. The GUL should allow landlords to rent to people who are in vulnerable situations (workers in precarious jobs, students from low-income families), without the latter needing to come up with deposits. Owners would have less incentive to seek safe tenants (civil servants, students from better-off families, employees of large companies). The State is fully within its role by covering a social risk that has been aggravated by the crisis and growing job insecurity. Isn't this worth the fantasized risk of an increase in moral hazard? The matter of the lease raises a question of substance. Should encouragement be given to the development of

individual landlords, which inevitably generates friction between on the one hand the owner's concern to freely dispose of their property and be as certain as possible that the rent will be paid and on the other hand the tenant's concern to enjoy a secure tenure and their demand for the right to housing? A household with a low or irregular income, which is thus more vulnerable, must also be able to find housing in the private sector. It may also seem preferable either to encourage institutional investors to invest in this sector or for households to make greater use of collective investment in housing and set up mechanisms such as the GUL, which can collectively address the issue of non-payment of rent. Housing is far from being an ordinary good. It is, and the authors do point this out, above all an essential need, a fundamental right. The massive casualization of housing through the establishment of a system of liberalized leases cannot be the solution. On the contrary, authors drawing on the German model, on the introduction of open-ended leases (the standard lease in Germany), constitute a major advance in terms of the tenant's security [\[2\]](#).

### **Rent control versus the law of the market**

With regard to [rent control](#), the authors rely on a number of studies in order to demonstrate the existence of a correlation between the state of degradation of the rental stock and rent control measures. However, the ALUR law contains provisions for taking into account any renovations undertaken. There is of course a continuing risk that the stock will deteriorate, but once this has been spelled out, we should also mention the equally likely result that the [stock could improve](#) precisely due to this provision for taking renovations into account. The authors also develop the idea that control measures will lead to a significant decrease in residential mobility. While this is a real risk for programmes designed to regulate rents during the lease and not upon re-letting (the main cause of the growing inequality in rents observed in France since the

1989 Act), the rent control provisions in the ALUR law are, on the contrary, designed to lead to a convergence in rents [3]. This convergence, although modest, given the large gap still allowed (over 40%), will tend in the direction of greater mobility. In reality, the most important risk raised by the authors is that the number of dwellings available for rent might fall. Although it seems unlikely that landlords already on the market would massively withdraw their rental properties [4], rent control measures could discourage new investors in the rental market because of the resulting decline in yields. This would exacerbate the supply / demand imbalance in high-pressure areas. In practice, this seems unlikely. Even if there were a significant drop in the number of new investors, those already present on the existing market, given the lease conditions (and contrary to the authors' expectations), cannot easily sell their property, except to a new investor who in light of the fall in yields will demand lower prices. The tax incentive schemes ([Duflot type](#)) currently in force on the market for new housing suggest that landlords who invest will be only slightly affected by rent control. Some investors may nevertheless turn their backs on the construction of new housing, which, in the short term, would tend to push down property prices [5], thus encouraging homeownership and a fall in land prices. The public sector would however have to be ready to take over from private investors. Nearly one in three households in the first income quartile (the poorest 25%) is a tenant in private housing and is subject to a median housing burden, net of housing assistance, of 33%, an increase of nearly 10 percentage points since 1996. Rent control above all offers protection for these low-income households – households that, given the stagnation in social housing and the increasing difficulty in getting on the property ladder, have no choice other than to rent housing in the private sector. As the approach proposed by the [Duflot Act](#) consists of “putting in place a rent control framework to cut down on landlords' predatory behaviour. Not seeking to try to attract investors based on exorbitant rents and expectations of rising real

estate prices” does not seem illegitimate if it is actually accompanied by an effort in favour of social housing. Pressure on the housing market (where supply and demand are rigid) has permitted high rent increases, which is leading to unjustified transfers between landlords and tenants. These transfers hurt the purchasing power of the poorest, the consumer price index, competitiveness, and more. Conversely, these increases can stimulate the construction of new housing by pushing up the value of property, but this effect is low and slow (given the constraints on land). Rent control can help put a stop to rent increases, even if it undermines incentives for private investment in housing to some extent. It cannot be excluded *a priori*.

### **Social housing mistreated**

Even though the authors’ observations seem fair – social housing does not play its [full role](#), and the systems of construction and allocation are complex and inefficient – the solutions that they propose are less so, and are not very consistent. The debate on the role and place of social housing in France is old. Should it be reserved for poor households, thus abandoning the goal of social diversity? If this is done, should the eligibility ceilings be reduced, even though today more than 60% of the population might be entitled to social housing? Should social housing be profitable? Is there a sufficient supply of it? The idea put forward by the authors, according to which the State, through subsidized loans to housing agencies (HLMs), is to take care of housing only the poorest households, and must leave housing for the working and middle classes to competition (promoters and private investors), is open to criticism, especially in these times of economic crisis. What is needed, on the contrary, is to increase the share of social housing as well as intermediate housing at “moderate” rents that is built with public funds to house the lower classes at reasonable rents and reduce tensions in critical areas. The authors’ idea that social

housing is not a right to be granted *ad vitam aeternam* seems justified. In 2006, according to the INSEE, more than one out of ten tenants in social housing belonged to the fifth quintile (the richest 20%). Unless one believes that social housing should, in accordance with the principle of social diversity, be open to all, then it is necessary to strengthen measures to encourage these households to leave social housing and direct them to the private sector, or accession needs to be tightened, as the additional rental charges currently applied are not effective enough. But the age of the occupants has to be taken into account, along with the availability of nearby housing at market rents. For housing the lower and middle classes (that is to say, “profitable” operations), the authors also suggest developing competition between private agents (developers, private builders, etc.). Once the amortization period of the loan from the Caisse des Depots et Consignations (CDC) expires, the housing thus built could change status and either switch into the private sector or be sold. This idea gives the impression that the shortage of social housing is the consequence of a lack of available funds. However, thanks to the amounts deposited in Livret A savings accounts, there is no lack of money. The brakes on housing construction are to be found elsewhere (lack of political will, [lack of land](#), etc.). Even though it is necessary to fight against urban segregation and the way to do this is by “disseminating poor households throughout the urban fabric”, the proposals of the authors of the CAE note are not realistic. The index of spatial segregation proposed (see Box 10 in the [working paper](#)) would lead to no longer building social housing in areas where it is already significantly concentrated. However, given the land constraints in high-pressure areas, this is not feasible. The objective of the fight against segregation should not take priority over the goal of construction but complement it. Public funding that is rigidly conditioned on the value of one or two indicators, even the most transparent ones, as proposed by the authors,

would be extremely complex to implement. The SRU law establishing identical goals for communes with very different characteristics needs to be amended. Social housing needs to be built in accordance with need and demand. Currently, however, there is no match between supply and demand even in the less problematic areas (housing too big or too small, too old, etc.). According to the INSEE, 14% of social housing tenants are thus in a situation of over-occupation (twice the proportion seen in the private sector). Not only is entry into social housing difficult, but so is mobility within the sector. It is thus necessary to build social housing massively not only to accommodate new populations but also to house current social housing tenants in better conditions. Should the housing issue be de-municipalized? It is certainly a mistake to leave urban decision-making (and action) up to the municipalities alone, as some may be encouraged to give preference to selling off the available land to private developers rather than to housing agencies, whether this is directly for financial reasons or in an effort to attract a relatively affluent population without social problems. Housing policy thus requires strong incentives for the construction of social housing, including aid specifically for the municipalities where it is located, along with legal constraints and compensatory taxation targeted specifically at towns that have no social housing. The SRU Law is necessary. Note that proposals along these lines are difficult to get adopted at the political level. Thus, the measure to provide for inter-communal decision-making power regarding in particular the Local Urbanism Plan (PLU), a provision in the ALUR law, was largely rejected by the Senate, with the support of the Minister of Housing [\[6\]](#). Similarly, the Union sociale pour l'habitat (social housing union), while deploring the lack of social mobility in the sector, regularly opposes any significant changes to the allocation process that could lead to greater mobility, with each organization striving to protect its own criteria.

## Rent and housing aid between taxation and imputation

In the CAE note, the way the tax system takes account of housing costs is the subject of questionable proposals. We agree of course with the starting point: it would be desirable to achieve a certain tax neutrality between income from financial capital and implicit rents. This is necessary from the point of view of both economic efficiency (not to overly encourage investment in housing) and social justice (given equal taxable income, a landlord and tenant do not have the same standard of living). But we believe this can be done effectively only by taxing implicit rents. It is difficult to undertake such a reform today, when substantial tax increases have already occurred. It would be difficult to introduce a new tax. This would therefore have to be accompanied by an upward translation of the tax brackets, so that, if owners pay more, tenants pay less. This could, furthermore, divert some households from building housing; the proceeds would be used in part for the construction of housing, which is inconsistent with the previous proposal to use these to reduce tenants' taxes. This would thus have to be introduced only very gradually. First the property tax bases would be re-valued. Then this database (from which landlords accessing it could deduct borrowing costs) could be used to tax the rental values at the CSG (wealth tax) or IR (income tax) rates (with some deduction). Fearing that this measure would be unpopular, the authors suggest that tenants could deduct their rent from their taxable income (with a relatively high ceiling of around 1000 euros per month). This proposal is not acceptable: – it is arbitrary: why not also deduct, still with ceilings, spending on food (no-one can live without eating) or on clothing, transportation or mobile phones (now indispensable). This could go on forever. The IR tax scales already take into account the need for a minimum income level (for a couple with two children, taxation only kicks in above a wage income of 2200 euros per month). The authors' measure would privilege housing costs over other spending, with little justification;

– the tax savings achieved in this way would be zero for non-taxable persons, and low for those near the taxation threshold: a family with two children and an income of 3000 euros per month with 600 euros in rent would pay 700 euros less tax; a wealthy family taxed at the marginal rate of 45% could save 5400 euros in tax, or 450 euros per month, that is to say, more than the housing benefit of most poor families; – the measure would be very costly. The authors do not give us a precise estimate, but lowering the taxable income of 40% of the 18 million taxable households in France (the proportion of tenants) by 10,000 euros could reduce IR tax revenue by 14 billion. In fact, this must necessarily be offset by a downward translation of the tax brackets. At the end, here, too, if the tenants pay less, the landlords pay more. Furthermore, the measure would be less effective economically than the taxation of implicit rents, since it would introduce a bias in favour of housing costs and does not take into account the value of the property occupied. The authors propose integrating the housing allowance into the IR tax and having all this managed by the tax administration, which would be responsible for developing a coherent redistributive policy on behalf of people on low incomes. While the current system of housing assistance [can of course be improved](#), once again the authors' analysis is one-sided, and does not include all the aid given to the poorest (the "RSA socle" – basic income supplement for the unemployed; the "RSA activité" – income supplement for the working poor; and the "PPE" – in-work negative income tax). They forget that helping low-income people requires personalized support, in real time, on a monthly or quarterly basis, which the tax administration is unable to provide. In fact, they wind up with a system that is hardly simplified: the tax authorities would determine housing assistance for non-taxed households that the CAF Family Allowance fund would pay monthly and which would be adjusted by the tax administration the following year. But it is left unsaid whether the same formula would apply to the RSA income supplement. For taxable persons, the assistance would be



managed by the tax authorities. The authors tell us that, “the aid could not be less than the current housing allowance”, but their proposal would greatly increase the number of untaxed households for whom it would be necessary to compare the tax savings and the allowance using the old formula. This is not manageable. It would of course be desirable to simplify the calculation of the housing allowance and to better integrate it with the RSA income supplement. This should be included in a reform of the RSA that the government needs to undertake (see the Sirugue report and the criticism of it by [Guillaume Allègre](#)), but the overall arrangement must continue to be managed by those who know how to do this, the CAF family fund, and not the tax authorities.

***Readers interested in housing-related issues should see the [Revue de l'OFCE “Ville & Logement”, no. 128, 2013.](#)***

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[\[1\] Trannoy A. and E. Wasmer, « La politique du logement locatif », Note du CAE, n°10, October 2013](#) and the [document de travail associé](#) [both in French].

[\[2\]](#) Note that the German market is very different from the French market (majority of renters, little demographic pressure, etc.), and that its rules cannot therefore be transposed.

[\[3\]](#) Currently, in the Paris region and more generally in all the so-called high-pressure neighbourhoods, the difference in rent between those who moved during the year and tenants who have been in their homes over 10 years exceeds 30% (38% for Paris) (OLAP, 2013).

[\[4\]](#) Indeed, “old” investors potentially have higher rates of return than do “new” investors.

[\[5\]](#) As the number of new households is tending to fall (Jacquot, 2012, “La demande potentielle de logements à

l'horizon 2030", *Observation et statistiques*, N°135, Commissariat au Développement Durable).

[6] An amendment according a low level for a blocking minority to France's "communes" during changes to the PLU (25% of communes and 10% of the population) was adopted by the Senate on Friday, 25 October – an amendment thereby reducing in practice inter-communal authority in this area.

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## No surprises from the Fed\*

By Christine Riffart

Not surprisingly, at its meeting on 29 and 30 October the Monetary Policy Committee of the US Federal Reserve decided to maintain its unconventional measures and to leave the federal funds rate unchanged. Since the end of 2012, the Fed has been making massive purchases of securities (government bonds and mortgage debt) at a rate of \$85 billion per month. The aim is to put pressure on long-term rates and to support economic activity, including the real estate market.

The Federal Reserve, which is committed to a strategy of transparency and communication aimed at orienting investor expectations, also confirmed that it will hold the rate at between 0 and 0.25% so long as: the unemployment rate is greater than 6.5%; forecasts of inflation over 1 to 2 years do not exceed the long-term inflation target, set at 2%, by more than a half-point; and long-term inflation expectations remain stable. According to our forecast in October (see [The United States: capped growth](#)), the unemployment rate, which was 7.2% in September, could fall to 6.9% by end 2014. Finally, inflation, which was at 1.5% in the third quarter of 2013, should not exceed 1.8% in 2014. In these conditions, no rate

increase is expected before the second half of 2015. Policy will thus remain particularly accommodating.

There is greater uncertainty about the withdrawal of the unconventional measures than about keeping long-term rates at artificially low levels. A cessation or reduction of these measures was announced last May and is thus expected by the markets, and in any case they were not meant to last. Between May and September 2013, foreign private and public investors had anticipated the beginning of their withdrawal and began offloading some of their securities. This influx of securities depressed prices and led to a one-point increase in long-term public rates in just a few weeks. But the fragile character of growth, inadequate job creation and especially the public relations efforts undertaken by the central banks to reassure the financial markets led to putting off the actual date the purchases are to be curtailed. Long-term rates fell once again, and have continued to fall in recent weeks following the October budget crisis.

If, in retrospect, it appears that it was premature to anticipate an early withdrawal of the unconventional measures, the question of timing still remains. In its press release, the Committee stated that any decision will depend on the economic outlook as well as on a cost-benefit analysis of the programme. However, the economic situation is not expected to improve in the coming months. If Congress reaches a budget agreement before December 13, this will certainly be on the basis of cuts in public spending. This new fiscal shock will further dampen growth and penalize the labor market yet again. The issuance of new debt, which was compelled in 2013 by the statutory debt ceiling, might then grow very slowly in 2014 due to budget adjustments. Faced with this moderate growth in the supply of securities, the Federal Reserve could reduce its own purchases to the benefit of other investors. This could help maintain equilibrium in the securities market without a sharp fall in asset prices.

This normalization of monetary policy instruments should not be long in coming. But there are risks involved, and a sharp rise in long-term rates cannot be excluded. The markets are volatile, and the events of May and June have not been forgotten. But much of the movement has already been taken on board by the markets. The Federal Reserve will therefore have to beef up its communication strategy (by for example announcing in advance the date and scope of its decision) if it is to succeed the difficult balancing act of maintaining a highly accommodative monetary policy while gradually dispensing with its exceptional measures to maintain low interest rates. Let us assume that the exercise will be a success. Long-term public rates, at 2.7% in third quarter 2013, should not exceed 3.5% by the end of 2014.

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\*This text draws on the study “Politique monétaire: est-ce le début de la fin ?” [Monetary policy: Is it the beginning of the end?], which is to appear soon in the OFCE 2013-2014 outlook for the global economy.