

# The sources of an industrial renewal

By [Jean-Luc Gaffard](#)

French companies in many sectors have had to deal with a relative increase in unit labour costs, a relative decline in the price of value added, and lower margin rates, meaning that many of them are facing strong competition and are relatively uncompetitive on price due to not having innovated and invested enough in the past. The result over the last decade has been a significant loss of substance in France's industrial network and a worsening foreign trade deficit. The challenge of carrying out an industrial renewal is clearly posed. This is not limited simply to manufacturing but encompasses any activity that is likely to deal with demand on a relatively large scale and is organized on an industrial basis<sup>[1]</sup>.

It is common sense to assume that the solution lies in the renewed capacity of these companies to innovate, to export and quite simply to expand, or in a word, in the ability to regain or acquire the non-price or structural competitiveness that they are currently lacking. The difficulty they face is that their lack of price competitiveness is leading them to seek immediate reductions in cost to the detriment of investment in innovation. Faced with this difficulty, economic policy makers must resolve a real dilemma: either to take measures to compete on taxation, social contributions, or even wages in an effort to restore companies' price competitiveness at the risk of further weakening aggregate demand and ultimately negatively impacting their turnover, or to keep the existing system of taxation at the risk of depriving these companies of the means to invest and innovate.

The consensus of the day naturally denies the existence of

such a dilemma. The presumed neutrality of money and the budget, coupled with the flexibility of the markets for goods and labour, is supposed to help the economy back on the path of steady, stable growth. Businesses, now reassured by the restoration of balanced public accounts and freed of excessive regulatory constraint, are again free to invest.

This consensus embodies a reductive vision of the functioning of market economies. The model of perfect competition, which is the standard in this instance, pictures a world where companies respond simply to price signals sent by the markets for goods and by factors whose operation is immunized against any power exercised by one or another protagonist in these markets. Somehow or other, this is what is meant by the assumption of efficient financial markets whose function is to discipline firms and States. The reality is very different. Markets are naturally and necessarily imperfect. Companies develop strategies on pricing, production and investment that deal with this market environment at the same time that they help to shape it. It is important to recognize this reality before trying to define economic policies suited to it.

### ***The sources of business competitiveness***

In an industrial market economy, business growth comes from *innovation*, in other words from companies' ability to develop non-price or structural competitiveness that is more robust and more lasting than just price competitiveness. Technological or organizational innovation aimed at the creation of new products or services or at the exploration of new markets entails however a *detour away from production*. Time is needed to develop a new production capacity before using it and benefiting from it.

Generally, this new capacity has a higher construction cost than the cost of simply replacing existing capacity. Additional costs must be borne before the corresponding additional income can be collected. A loss of competitiveness,

in principle temporary, is apparent. This could be reflected in increases in current prices (of old products) if the hike in costs is to be passed on immediately or, more likely, by a reduction in margins. The performance of the production of existing goods or services is thus negatively affected by the decision to innovate [\[2\]](#).

In this context, it is still necessary for the company to remain competitive on prices in the short term in order not to lose significant market share to its competitors. It is in regard to this immediate requirement that the issue of *labour costs* comes up. This is a particular issue in the euro zone where in the absence of possible adjustments via exchange rates, legal and regulatory differences on social and fiscal matters create real distortions in competition – and when, furthermore, the international fragmentation of production (in reality the relocation of segments of production to countries where wages are lower but qualifications identical) is providing businesses that have the ability or opportunity to exploit this an advantage in terms of the costs passed on in product prices, margins and investment volumes.

Maintaining or regaining immediate price competitiveness will not, however, suffice. It is still necessary to encourage companies to innovate. But when investments, including intangible investments, are irreversible and when information on the future configuration of the market is not immediately available, it is difficult for companies to do this. They cannot base their decisions on price signals alone. They must be able to secure their investments by acquiring sufficient knowledge about the future market, that is to say, not only the size of demand, but also about competing and complementary offers. The point is to ensure that competing investments do not exceed a certain threshold and that complementary investments attain a certain threshold. This is possible only thanks to practices that have to be considered monopolistic, which are related to different forms of connections between

the companies concerned[3]. This kind of *organizational strategy* foregrounds, not a particular company, but a *network of companies*, a sort of ecosystem that often brings together a local dimension and capacity to project outwards. The characteristic of these networks is to balance competition and cooperation. Practices that can be characterized as market imperfections here become incentives to innovate. They help to define the *boundaries* of the firm best suited to the decision to innovate.

What is true of investment in physical capital is equally important for investment in human capital. This investment has a gestation period that essentially amounts to the learning time. This is an essential element in developing new productive capacities. Its products must be secured. The labour relationships specific to a company and to the networks of firms between companies contribute to this. The *stability* of the employment relationship, which binds the employee to the company, is a decisive factor in the learning and retention of professional experience. The *mobility* of employees between companies is another factor. This mobility enables each company to draw on what an employee has learned in another company developing the same sort of skills. It is also a source of increases in wages, but it becomes possible only if companies are in a situation of monopolistic competition.

The difficulty of innovating even when investments are irreversible and market information is incomplete requires having access to financing in order not only to bridge the gap between the profile of costs and the profile of revenue, but especially to have a lengthy financial commitment, that is to say, stable financial relations or control of the capital. The problem most innovative firms encounter is that the assets created are not easily re-deployable (including intangible assets). This constraint, which justifies developing the organizational means to acquire credible information about the

market, requires at the same time being able to enjoy continuing financial support.

### *Goals and means of an industrial renewal policy*

Identifying in this way the stimulants of business growth should guide the policies to be implemented, which are reducible neither to competition policy nor to industrial policy. These policies concern the operation of various markets (goods markets, labour markets, credit markets and financial markets). They make use of a variety of instruments and are situated at different geographical levels.

Industrial policy should set itself the goal of stimulating *cooperation* between companies, including competing firms, and, more broadly, of contributing to the formation of ecosystems involving companies, banks and research institutions. The point here is not at all to designate products or technologies or even territories to promote *a priori*, but instead to help foster market conditions that encourage companies to invest in the ways that seem most promising. The criteria adopted for subsidies or tax relief should meet this objective, which is obviously more complex than that recently put forward of targeting sectors where competition is strong [4]. This should be the specific objective of funding for France's "competitiveness clusters", as well as of other forms of public assistance.

Industrial policy has a *regional dimension*, since companies have a tendency to group together to benefit from external effects, in particular learning synergies not only with regard to technological knowledge but also to knowledge of the market. This phenomenon is in line with the willingness of local authorities to assist in the creation of clusters. However, there is no evidence that these local authorities have the information they need or that they can avoid being

captured by lobbies. Competition between them can be expensive when it involves tax competition, which can probably improve the situation of some but only at the expense of others, and which negatively affects overall performance. This inevitably raises the issue of the competence, number and size of the local authorities.

Competition policy is not a substitute for industrial policy. It must pursue the same objective, *i.e.* to *distinguish between competition and cooperation*. From this perspective, the role that competition policy should play is to punish imperfections and distortions that are harmful to innovation and validate those that foster it. The handling of cooperation agreements in R&D is indicative of this requirement. It cannot be exclusive. Other types of agreement must be able to escape the common law on competition.

Labour market policy must set itself the goal of strengthening the ways and means of *enhancing skills*. First and foremost, this means creating the conditions for stabilizing the employment relationship, which is a source of learning for employees and of making sure that companies retain the skills acquired. These conditions are undoubtedly covered by the employment contract itself, but they are also inseparable from the constitution of the communities or clusters making up innovative business networks. These networks are "local" labour markets in which labour mobility between firms is potentially beneficial to all the partners with respect to mastering new skills. Moreover, an end needs to be put to incentives that contribute to perpetuating the privileging of low-skilled or unskilled jobs. Finally, legal and regulatory conditions that permit businesses to hold onto jobs in the event of temporary difficulties (*i.e.* the use of short-time working) should be strengthened.

Banking policy should set itself the goal of creating *stable relationships between companies and financial institutions*. So-called relationship banks, which collect information on

borrowers, have higher costs than traditional banks, but they also have the advantage of providing resources to businesses facing liquidity problems linked to the characteristics of the innovation cycle. In fact traditional intermediation increases the growth rate of the economy and reduces its long-term volatility, as opposed to market-based funding[5]. It is also important to refocus the financial system on traditional intermediation, especially on business credit, and to return to a form of separation between the two types of activity, so that lending to business avoids the consequences of the inevitable vagaries of market activity[6].

Fiscal policy must set itself a dual objective. The short-term goal is to *reduce labour costs* by reducing the rate of employers' social contributions and increasing the tax on value added. The medium-term objective is to *penalize unproductive activities*, those whose contribution to growth is dubious. From this perspective, it is undoubtedly necessary to tax financial services and to make greater use of taxes on wealth and the transmission of wealth, as is recommended by the International Monetary Fund. Without prejudging the possible ways tax reform could be implemented, there is a two-fold importance to reform: first, to promote the production of industrial-type goods and services that are suited to international trade, and second, to carry out a redistribution of income and wealth in order to increase the potential demand for these goods and services.[7]

Industrial renewal poses a major challenge for the French economy, which is now caught between the German economy and the Spanish economy. It requires a reorientation of all the policies that affect and guide corporate behaviour, going beyond just manufacturing firms – policies that are not reducible to either the search for lower costs or to the promotion of new technologies or to compliance with the rules of free competition.

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[1] On the nature of industrial organization, see Chapter 4 of the work by N. Georgescu-Roegen, 1971, *The Entropy Law and the Economic Process*, Cambridge Mass., Harvard University Press.

[2] See C. M. Christensen, 1997, *The Innovator's Dilemma*, Harvard, Harvard Business School Press.

[3] G. B. Richardson, 1990, *Information and Investment*, Oxford, Clarendon Press. G. B Richardson, 1998, *The Economics of Imperfect Knowledge*, Cheltenham, Edward Elgar.

[4] P. Aghion, M. Dewatripont, L. Du, A. Harrison and P. Legros, 2012), "Industrial Policy and Competition", *NBER Working Paper* 18048.

[5] Bolton P., X. Freixas, L. Gambacorta, and P. E. Mistrulli, 2013, Relationship and Transaction Lending in a Crisis, *BIS Working Paper*, no. 17.

[6] T. Beck, 2013, Finance and Growth: Too Much of a Good Thing, *Vox eu*.

J.-P. Pollin and J.-L. Gaffard, 2013, "Pourquoi faut-il séparer les activités bancaires?" [Why it is necessary to separate banking activities], *Note de l'OFCE, n° 36*.

[7] Keen M., 2013, Tax Policy in (and for) Hard Times, *Vox eu* <http://www.voxeu.org/article/tax-policy-hard-times#.Um7TETxwZzA.gmail>

IMF, 2013: Fiscal Monitor, Taxing Times, World Economic and Financial Surveys <http://www.imf.org/external/pubs/ft/fm/2013/02/fmindex.htm>



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# When the OECD persists in its mistakes...

By [Henri Sterdyniak](#)

The OECD has published an economic policy note, [“Choosing fiscal consolidation compatible with growth and equity” \[1\]](#)). There are two reasons why we find this note interesting. The OECD considers it important, as it is promoting it insistently; its chief economist has, for instance, come to present it to France’s Commissariat à la Stratégie et à la Prospective [Commission for Strategy and Forecasts]. The subject is compelling: can we really have a fiscal austerity policy that drives growth and reduces inequality? Recent experience suggests otherwise. The euro zone has been experiencing zero growth since it embarked on a path of austerity. An [in-depth study by the IMF \[2\]](#) argued that, “fiscal consolidations have had redistributive effects and increased inequality, by reducing the share of wages and by increasing long-term unemployment”. So is there some miracle austerity policy that avoids these two problems?

## 1) What goals for fiscal policy?

According to the authors of the OECD study, the goal of fiscal policy should be to bring the public debt down by 2060 to a “prudent” level, defined for simplicity’s sake, we are told, as 60% of GDP. All the OECD countries must work towards this objective and immediately make the necessary adjustments.

But a target of 60% is totally arbitrary. Why not 50% or 80%? Furthermore, this goal is set in terms of gross debt (as defined by the OECD) and not debt under Maastricht. But the difference is far from meaningless (at end 2012, for France,

110% of GDP instead of 91%).

The OECD makes no effort to understand why a large majority of the organization's members (20 out of 31, including all the large countries) have a public debt that is well over 60% of GDP (Table 1). Do we really think that all these countries are poorly managed? This high level of public debt is associated with very low interest rates, which in real terms are well below the growth potential. In 2012, for example, the United States took on debt, on average, of 1.8%, Japan 0.8%, Germany 1.5%, and France 2.5%. This level of debt cannot be considered to generate imbalances or be held responsible for excessively high interest rates that could undermine investment. On the contrary, the existing debt seems necessary for the macroeconomic equilibrium.

We can offer three non-exclusive explanations for the increase in public debts. Assume that, following the financialization of the economy, firms are demanding higher rates of profit, but at the same time they are investing less in the developed countries, preferring to distribute dividends or invest in emerging markets. Suppose that globalization is increasing income inequality [\[3\]](#) in favour of the rich, who save more, at the expense of the working classes who consume virtually all of their income. Suppose that, in many countries, aging populations are increasing their savings rate. In all three cases a demand deficit arises, which must be compensated by private or public debt. Yet since the crisis of 2007-2008 private agents have been deleveraging. It was therefore necessary to increase the public debt to prop up demand, as interest rates were already at the lowest possible level. In other words, it is not really possible to reduce public debt without tackling the reason why it's growing, namely the deformation of the sharing of value in favour of capital, the increase in income inequality and unbridled financialization.

**Table 1. State of the public finances in 2012 (% of GDP)**

	Gross public debt	Structural primary balance	Output gap*	Loss in potential GDP due to the crisis	Effort required**
Austria	85	1.1	-1.6	-3.0	0.2
Belgium	104	0.3	-0.8	-4.5	1.6
Canada	85	-2.5	-0.4	-6.1	2.7
Finland	63	-1.8	-1.4	-9.7	3.8
France	110	-1.3	-2.4	-3.6	4.7
Germany	89	1.4	0.1	-1.6	0.0
Greece	166	3.2	-11.7	-17.6	8.2
Ireland	123	-1.8	-7.9	-9.6	5.8
Iceland	132	2.6	-4.2	-9.0	3.6
Italy	140	4.4	-4.5	-6.8	0.7
Japan	219	-8.1	-0.8	-3.1	18.3
Netherlands	83	-1.4	-1.5	-7.6	2.8
Portugal	139	-0.6	-6.7	-10.4	7.5
Spain	91	-1.8	-7.7	-9.1	5.3
United Kingdom	104	-5.1	-2.1	-10.4	9.2
United States	106	-5.4	-3.0	-5.7	7.7
Euro zone	104	0.6	-2.0	-4.9	2.6
OECD	109	-3.2	-2.3	-4.6	6.0

\* According to the OECD; \*\* short-term effort required to eventually stabilize the debt at 60% of GDP.

According to the OECD, gross public debt on the order of 100% of GDP, as at present, poses problems in terms of fragile public finances and a risk of financial instability. The economy could in fact be caught in a trap: households (given income inequality, aging or their justified mistrust of the financial markets) implicitly want to hold 100% of GDP in public debt (the only risk-free financial asset), interest rates are already near zero, and the financial markets are wary of a country whose debt exceeds 60% of GDP. We cannot escape this trap by reducing public deficits, as this reduces economic activity without lowering interest rates; what is needed is to reduce private savings and carry out a Japanese-style financial policy: the central bank guarantees the public debt, this debt is held by households, and the rate of compensation is low and controlled.

We only regret that the OECD has not made a serious analysis of the cause of the swelling public deficits.

## 2) Reduce the structural primary deficits

The OECD recommends that all countries embark on extensive programmes to reduce their structural primary deficits. To do this, we must first assess these structural primary deficits. However, the OECD estimates are based on a very specific hypothesis, namely that most of the production lost due to the crisis can never be made up. That is to say, for the OECD as a whole, 4.6 points of potential GDP have been lost forever out of the 6.9 point gap in 2012 between GDP and the pre-crisis trend. Also, the OECD believes that the structural primary balance of many countries was negative in 2012 whereas it would have been positive if the loss of production could have been made up. For France, the OECD estimates the structural primary balance at -1.3% of GDP, while the balance would be 0.5% if the loss due to the crisis could be made up. Only the United States and Japan would retain a structural primary deficit under the “catch-up hypothesis”.

Assume that long-term rates remain below the growth rate of the economy and that it is not necessary to reduce the public debt ratios. Then a structural primary balance at equilibrium would be sufficient to stabilize the public debt. Only two countries would need to make fiscal efforts: Japan (for 6.7 GDP points) and the US (for 2 points). The other countries would primarily be concerned with re-establishing a satisfactory level of production.

However, the OECD assumes that the countries will suffer forever from the shock induced by the crisis, that it is imperative to reduce the debts to 60% of GDP, that long-term rates will be higher (by about 2 points) than the economy's growth rate in the very near future, and that public health spending will continue to rise. This leads it to conclude that most countries should immediately engage in a highly restrictive policy, representing 4.7 GDP points for France, 7.7 points for the United States, 9.2 points for the United Kingdom, etc.

The problem is that the OECD study assumes that these restrictive policies will not have any impact on the level of economic activity, or at least that the impact will be temporary, so that it can be neglected in a structural study of the long term. This is based on a notion that, though widespread, is wrong: that the economy has a long-term equilibrium that would not be affected by short or medium-term shocks. But this makes no sense. Real economies can go off in a different direction and experience periods of prolonged and cumulative depression. Is it possible to imagine a long-term Greek economy that is unaffected by the country's current situation? The shock induced by the strategy advocated by the OECD would mean a lengthy period of stagnation in Europe, Japan and the United States; the depressive effect would not be offset by lower interest rates, which have already hit bottom; a fiscal cutback of 6% of the OECD's GDP would result in a fall in GDP of 7.2% [\[4\]](#); and the decrease in activity would be so great that debt ratios would rise in the short term (see the explanatory box below). To believe that the economy would eventually return to its long-term trajectory is just wishful thinking. The OECD provides no assessment of the impact of such a policy produced with a macroeconomic model.

We can only wonder that the OECD continues to advocate austerity policies that were shown in the years 2012-2013 to have adverse effects on growth and a negligible impact on the level of public debt, instead of advocating a policy stimulus that, while its content is of course debatable, would be more promising for the Western economies.

### **3) Choosing the right instruments**

The bulk of the OECD study, however, is devoted to researching the policy instruments that would be most effective for achieving fiscal consolidation.

Based on previous work, the OECD assigns to each instrument an impact on growth, equity and the trade balance (Table 2). The

organization has happily discovered that in some cases public expenditure can be helpful for growth as well as equity: such is the case of spending on education, health, family benefits and public investment. These should therefore be protected to the fullest. However, the OECD does not go so far as to imagine that they could be strengthened in some countries where they are particularly low today. In other cases, the OECD remains faithful to its free market doctrine: for example, it considers that spending on pensions is detrimental to long-term growth (since reducing it would encourage seniors to remain in employment, thereby increasing output) and is not favourable to equity. One could argue the opposite: that reducing public spending on pensions would hit the poorest workers, who would then live in poverty during their retirement; the better-off would save in the financial markets, which would strengthen these and thus fuel financial instability. Similarly, for the OECD unemployment and disability benefits hurt employment, and thus growth. Moreover, subsidies would be detrimental to long-term growth, as they undermine the competitive balance, and thus efficiency, but the OECD puts all subsidies in the same bag: the research tax credit, the PPE employment bonus, and the common agricultural policy, whereas a more detailed analysis is needed. Moreover, orthodox economic theory itself recognizes the legitimacy of public action when the market fails. The OECD has a negative view of social contributions, whereas it is legitimate for public PAYG systems to be funded in this way. The organization believes that income tax hurts long-term growth by discouraging people from working: but this is not what we find in Scandinavia.

Finally, the ranking produced (Table 2) is only partly satisfactory. The OECD warns against lowering certain public spending (health, education, investment, family) and occasionally advocates higher taxes on capital, corporation tax and income tax, and environmental taxes. But at the same time it advocates cutting back on pensions and unemployment

insurance and reducing subsidies.

The OECD seeks to take into account the heterogeneity of national preferences. But it does so in a curious way. It considers that countries where income inequality is high (the United States and United Kingdom) should be more concerned with equity, but that the opposite holds for egalitarian countries (Sweden, Netherlands). But the opposite position could easily be supported. Countries that have highly egalitarian systems want to keep them and continue to take account of equity in any reforms they undertake.

Ultimately, suppose that, like France, all the countries had set up an efficient system for the control of their public finances (the [RGPP](#) then the [MAP](#)). At equilibrium, all expenses and revenues have the same marginal utility. If there is a need to save money, this should involve a reduction in costs and an increase in revenue in the same proportions. Dispensing with this strategy would require a detailed analysis of the utility of the spending and the cost of the revenue, an analysis that the OECD is incapable of providing. The fact that the OECD considers that spending on disability is generally detrimental to growth does not give it the right to advocate a strong reduction in disability spending in Finland, without taking into account the specific features of the Finnish system

**Table 2. Short-term (ST) and long-term (LT) impact of fiscal consolidation instruments on growth, equity and the trade balance, according to the OECD**

	Growth		Equity		Trade balance	Ranking*
	ST	LT	ST	LT		
<b>Spending (down)</b>						
Education	--	--	-	--	+	17
Health	--	-	-	-	++	15
Other spending	--	+	-		+	9
Pensions		++			++	2
Disability	-	+	--	-	++	11
Unemployment	-	+	-		++	4
Family	-	-	--	--	+	16
Subsidies	-	++	+	+	+	1
Investment	--	--			++	13
<b>Revenue (up)</b>						
Income tax	-	--	+	+	+	5
Social contributions	-	--	-	-		14
Corporation tax	-	--	+	+	++	6
Ecological tax	-	+	-		+	7
Consumer tax	-	-	-		+	12
Property tax	-				+	8
Other property tax	-		++	+	+	3
Sale of goods	-	+	-	-	+	10

\* The higher the figure, the less the instrument should be used in fiscal consolidation.

All things considered, the recommendations for France (Table 3) are of little use, whether this is a matter of greatly reducing the level of pensions and unemployment benefits (under the pretext that France is more generous than the average of the OECD countries!) or of reducing subsidies (but why?) or of reducing public consumption (because France needs an army, given its specific role in the world).

**Table 3. Fiscal adjustments recommended for France by the OECD (% of GDP)**

	Short term	Long term
Pensions	-0.6	-2.2
Subsidies	-0.7	-0.7
Unemployment benefits	-0.7	-0.4
Ecological tax	+0.7	
Corporation tax	+0.5	
Other public consumption	-1.2	-1.1
<b>Total adjustment</b>	<b>4.7</b>	<b>4.7</b>

Overall, the OECD does not provide any simulation of the impact of the recommended measures on growth or equity. It is



of course possible to do worse, but this still winds up in a project that would lead to a sharp decline in growth in the short to medium term and a decrease in spending on social welfare. Even though it claims to take account of the trade balance, it does not argue that countries running a surplus should pursue a stimulus policy in order to offset the depressive impact of the restrictive policies of countries running a deficit.

But the OECD also holds that there are of course miracle structural reforms that would improve the public deficit without any cost to growth or equity, such as reducing public spending without affecting the level of household services by means of efficiency gains in education, health, etc.

What a pity that the OECD is lacking in ambition, and that it does not present a really consistent programme for all the member countries with an objective of growth and full employment (to reduce the unemployment caused by the financial crisis) and of reducing trade imbalances, especially a programme with social objectives (reducing inequality, universal health insurance, and a satisfactory level of social welfare)!

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### **Box: Austerity policy and the public debt**

Consider an area where GDP is 100, the public debt is 100, the tax burden is 0.5 and the multiplier is 1.5. Reducing public spending by 1 lowers GDP by 1.5 and public revenue by 0.75; the public balance improves by only 0.25. The debt / GDP ratio rises from 100% to  $99.75 / 98.5 = 101.25\%$ . It takes 6 years for it to fall below 100%.

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[1] Boris Cournède, Antoine Goujard, Alvario Pina and Alain de Serres, *OECD Economic Policy Papers*, July 2013. A more detailed version can be found in: Boris Cournède, Antoine Goujard and Alvario Pina, “How to achieve growth-and-equity fiscal consolidation ?”, *OECD Economics Department Working Paper*, 2013.

[2] Laurence Ball, Davide Furceri, Daniel Leigh, and Prakash Loungani, “The Distributional Effects of Fiscal Consolidation”, IMF WP/13/151, June 2013.

[3] See: OECD, 2012, *Toujours plus d'inégalité* [More and more inequality], March.

[4] Using the multiplier of 1.2 from the OECD Note, 2009, “The Effectiveness and the Scope of Fiscal Stimulus”, March.

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# Renewed growth in the United Kingdom in 2013: trompe-l'oeil effects

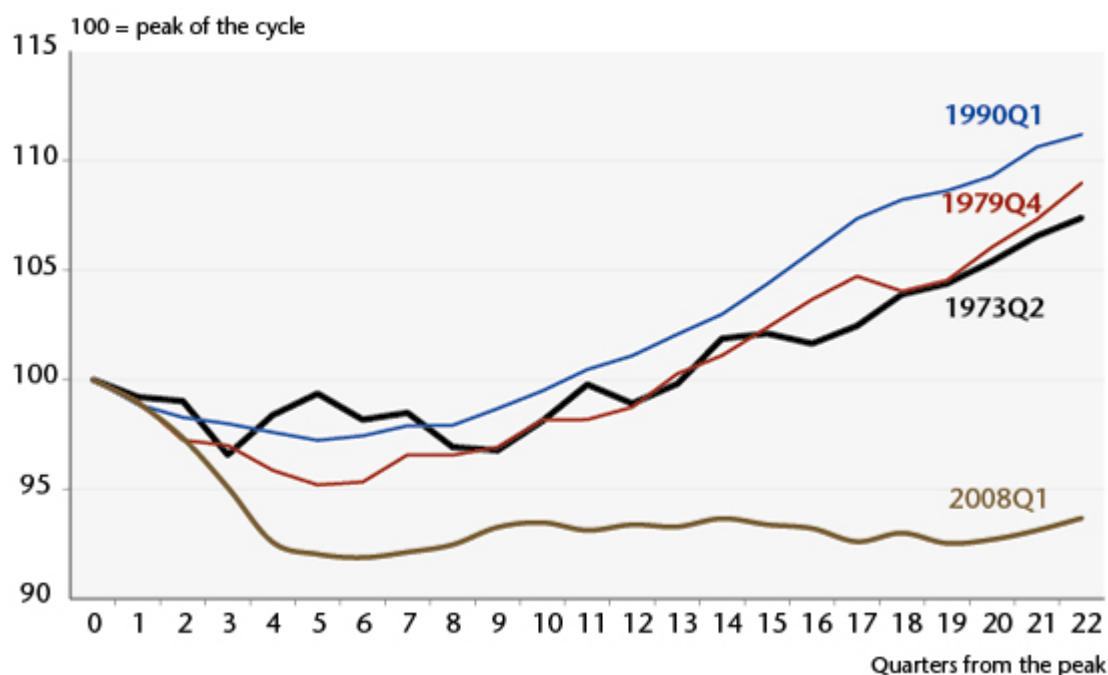
By [Catherine Mathieu](#)

The latest estimate of the British national accounts, published on 27 November, confirmed GDP growth of 0.8% in the third quarter of 2013, following 0.7% in the second quarter and 0.4% in the first quarter. This represents a sparkling

performance for the UK economy, especially in comparison with the euro zone. GDP was up 1.5% year on year in the third quarter of 2013 in the UK, against -0.4% in the euro zone, 0.2% in France and 0.6% in Germany. In the eyes of some observers, Britain's return to growth shows that fiscal austerity does not undermine growth ... on the contrary. But the argument seems at a minimum questionable.

Let's look at the numbers a little more closely. Admittedly, GDP is up 1.5% year on year in the third quarter, but it rose by only 0.1% in 2012 and is still 2.5 percentage points below its pre-crisis level: this does not really represent a great success. Even more striking has been the change in GDP since the start of the crisis: GDP initially fell 7 points between the first quarter of 2008 and the second quarter of 2009; the recovery then got underway, allowing GDP to rise 2 points in the third quarter of 2010, before it fell again. The GDP trajectory since the third quarter of 2010 has been quite unusual with respect to recoveries from previous crises (Figure 1).

**Figure 1. Change In British GDP during recessions and recoveries**



Source: Office for National Statistics (ONS).

In 2008, the United Kingdom was one of the first

industrialized countries to implement a recovery plan. Gordon Brown, Chancellor of the Exchequer in the Tony Blair government, lowered the standard VAT rate by 2.5 percentage points in December 2008 in an effort to boost household consumption. The measure, which was announced as temporary, was ended in late 2009. In 2009, fiscal policy was highly expansionary, with a fiscal impulse of 2.8 percent of GDP following a 0.6 point impulse in 2008 (Table 1). The public deficit increased under the dual impact of the recession and fiscal policy, as did the public debt.

In May 2010, the Conservatives won the election on a programme focused on reducing the public debt and deficit. This was supposed to ensure market confidence and maintain the AAA rating of Britain's public debt, and thus keep the interest rate on the debt at a low level. This was combined with a very active monetary policy, with the Bank of England maintaining its key rate at 0.5%, buying government securities and making great efforts to facilitate the refinancing of banks and kick-start lending to businesses and households. The resumption of growth was supposed to come from business investment and exports.

The fiscal policy implemented by the David Cameron government has therefore been highly restrictive. At first, the measures focused on increasing revenue by raising the VAT rate and cutting spending, including on social benefits. The resumption of growth was interrupted. Fiscal policy had also become restrictive elsewhere in Europe, so economic activity slowed in the UK's main trading partners. In 2012, fiscal austerity was sharply curtailed (Table 1). The growth figures in recent times are a long way from demonstrating the success of austerity.

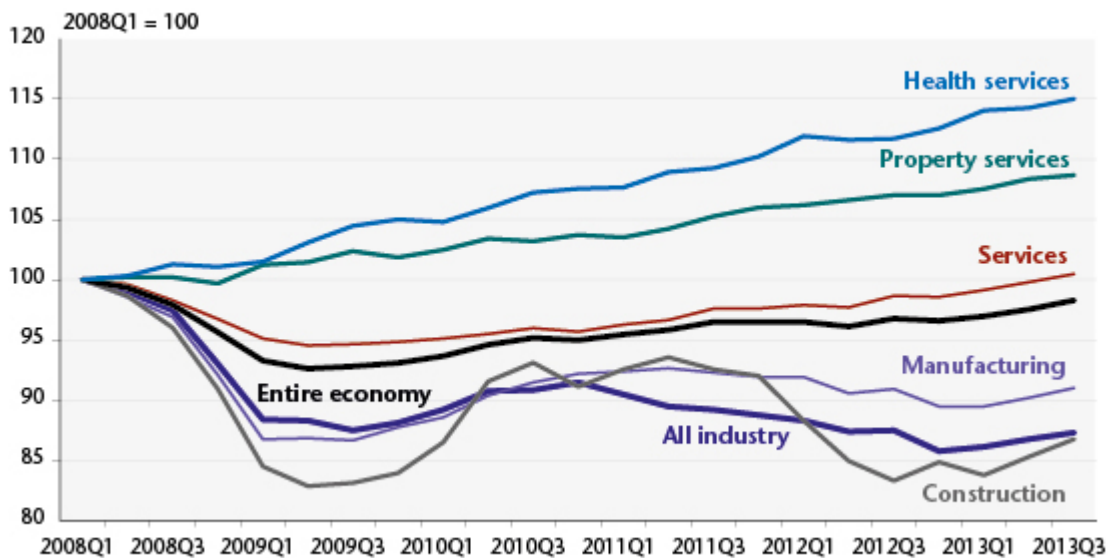
**Table 1. Growth and fiscal impulses in the United Kingdom since 2008**

	2008	2009	2010	2011	2012
Growth	-0,8	-5,2	1,7	1,1	0,1
Fiscal impulse	0,6	2,8	-2,7	-3,2	-0,5

Sources : Office for National Statistics (ONS), OECD, author's estimates.

It is also important to note that David Cameron has excluded health expenditure from his cost-cutting plan. The British are attached to their public health care system, and the newly elected Conservatives were determined in 2010 not to repeat the mistake made in the 1980s when Margaret Thatcher was head of government. So fiscal austerity has not hit the health sector. The result is clear in terms of activity: value added (by volume) in the health sector is now 15 points above its pre-crisis level – in other words, it has continued to grow at an average annual rate of nearly 3% (Figure 2). The second sector where activity has remained strong since 2008, and which has even accelerated since the end of 2012, is real estate. Property prices in the UK had risen sharply before the crisis, leading to record household debt, and have not dropped much since then. Indeed, they have remained historically high and even begun to rise from 2012 (at an annual rate of about 5%). But other sectors are lagging behind. Most services have for instance only now regained the level of pre-crisis output, and some of them are still well below this level: -9% for financial services and insurance, which is comparable to the figure for manufacturing, while output in the building sector is down 13%.

Figure 2. : Changes in added value (in volume) by sector since the onset of the crisis



Source: Office for National Statistics (ONS).

Since 2008, British growth has thus been driven in part by a public service spared from fiscal austerity and by real estate services supported by an ultra-active monetary policy... The British recovery could, moreover, give birth to a new housing bubble. Household consumption is now the main engine of growth (Table 2). The failure of investment to pick up represents one of the main setbacks suffered by the supply-side policy implemented since 2010 by the government. The government wants to make the UK tax system the most competitive in the G20, and to this end has slashed the corporate tax rate to the lowest in the G20 (the rate, lowered to 23% this year, will be only 20% in 2015). But business investment has nevertheless not picked up again. The government is also relying on exports to drive growth, but given the economic situation prevailing in Britain's main foreign markets, in particular the euro zone, this is just not realistic. After having experienced sustained growth in previous quarters, boosted by strong sales outside the European Union until the summer, exports have contributed to a sharp fall-off in growth in the third quarter (-0.8 GDP point). As the British government prepares to present its budget on 5 December, support for fiscal policy would be welcome to help keep the UK economy on the road to recovery in the coming months...

**Tableau 2. Contributions of demand components to growth**

In GDP points (except GDP)

	2010		2011		2012		2013	
	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half	2nd half
GDP, in %	1,3	0,8	0,4	0,6	-0,3	0,2	0,6	0,8
Household consumption	0,2	0,6	-0,6	0,1	0,5	0,4	0,6	0,5
Spending by general government	0,0	0,0	0,0	0,0	0,4	-0,1	0,1	0,1
GFCF	0,7	0,2	-0,4	0,1	0,5	-0,8	-0,2	0,2
Productive private	0,6	0,0	-0,2	0,1	0,4	-0,5	-0,2	0,1
Change in inventory	1,0	0,4	0,0	0,6	-1,0	0,7	-0,2	0,9
Foreign trade	-0,5	-0,3	1,5	-0,2	-0,6	-0,0	0,2	-0,9
Exports	1,1	1,1	0,7	0,2	0,1	0,3	0,2	-0,8
Imports	-1,5	-1,4	0,8	-0,4	-0,6	-0,3	-0,0	-0,1

Note: Half-year contributions, except \* 3rd qtr contributions. The sum of the contributions may not correspond exactly to GDP growth, due to rounding.

Source: Office for National Statistics.

# Has the 35-hour work week really “weighed down” the French economy?

By [Eric Heyer](#)

Did the Aubry laws introducing the 35-hour work week in France between 1998 and 2002 really make French business less competitive and lead to job losses, as is suggested in the [latest report from the OECD](#)? Has France seen its economic performance decline post-reform relative to its European partners? Have the public finances been “weighed down” by these laws?

A review of our recent macroeconomic history, coupled with international comparisons, provides some answers to these questions.

## ***Record macroeconomic performances in the private sector between 1998 and 2002...***

Leaving aside an analysis of the recent Great Recession, over the past 30 years private sector activity in France grew by an annual average of 2.1%. Since the establishment of the 35-hour work week, far from collapsing, economic growth in this sector instead accelerated sharply, from 1.8% before 1997 to 2.6% afterwards, and even hit a peak during the period in which the 35-hour week was being established (an annual average of 2.9%, Table 1). Furthermore, it is noteworthy that of the five best years recorded by the French market sector over the past 30 years, three were in the period 1998-2002 based on the criterion of GDP growth, and four if the criterion used is job creation.

The global economic environment accounts for some of this good performance, but only in part: foreign demand for French output was certainly more dynamic after 1997 than before, but this acceleration continued after 2002, and cannot therefore explain the better performances recorded between 1998 and 2002 (Table 1).



**Table 1. Macroeconomic impact of the 35-hour week in the market sector**

Growth rate, in % (unless specified otherwise), annual average

		1980- 2007	1980- 1997	1998- 2007	1997- 2002	2003- 2007
A	Added value	2,1	1,8	2,6	2,9	2,2
B	Hourly productivity	1,8	1,8	1,8	2,1	1,5
C	Productivity per worker	1,1	1,1	1,2	0,8	1,6
A-C	Employment...	0,9	0,7	1,4	2,0	0,7
B-C	... linked to the duration of work	0,6	0,6	0,6	1,2	0,0
In thousands over the period analyzed						
	Jobs created...	5 374	2 335	3 040	2 247	793
D	Gross wages*	4,3	5,1	2,9	2,7	3,0
E	Consumer prices	3,7	4,7	2,0	2,1	2,1
D-E	Real gross wages*	0,6	0,4	0,8	0,6	1,0
D-E-C	Unit labour cost*	-0,6	-0,7	-0,4	-0,2	-0,6
Global demand for French output		5,7	5,0	6,9	6,2	7,6

\* Per capita.

Source : INSEE.

### **... and better than the performance of our European partners**

Since the establishment of the 35-hour work week, France's performance has been superior to that of the rest of the euro zone, especially in comparison with our two main partners, Germany and Italy. For instance, over the decade 1998-2007 France's average annual growth was 1 point higher than for Italy and 0.8 point than for Germany (Table 2).

During this period, French companies and households spent more than their German and Italian counterparts. Business investment, which rose at an annual average of 0.8%, was more dynamic in France than in Germany (0.3%) or Italy (0.5%). As for households, consumption grew by an annual average of 1.4% in France against, respectively, 0.4% in Germany and 0.9% in Italy. Furthermore, it should be noted that the continued higher consumption in France does not reflect the behaviour of household savings. The savings rate was not only higher than elsewhere in Europe, but it has also risen since 1998. The

solid performance of French consumption is the consequence of greater dynamism in job creation in France during this period, especially when compared to what was taking place in Germany (Table 2).

**Table 2. Main macroeconomic indicators: a comparison with our principal partners**

In %, annual average

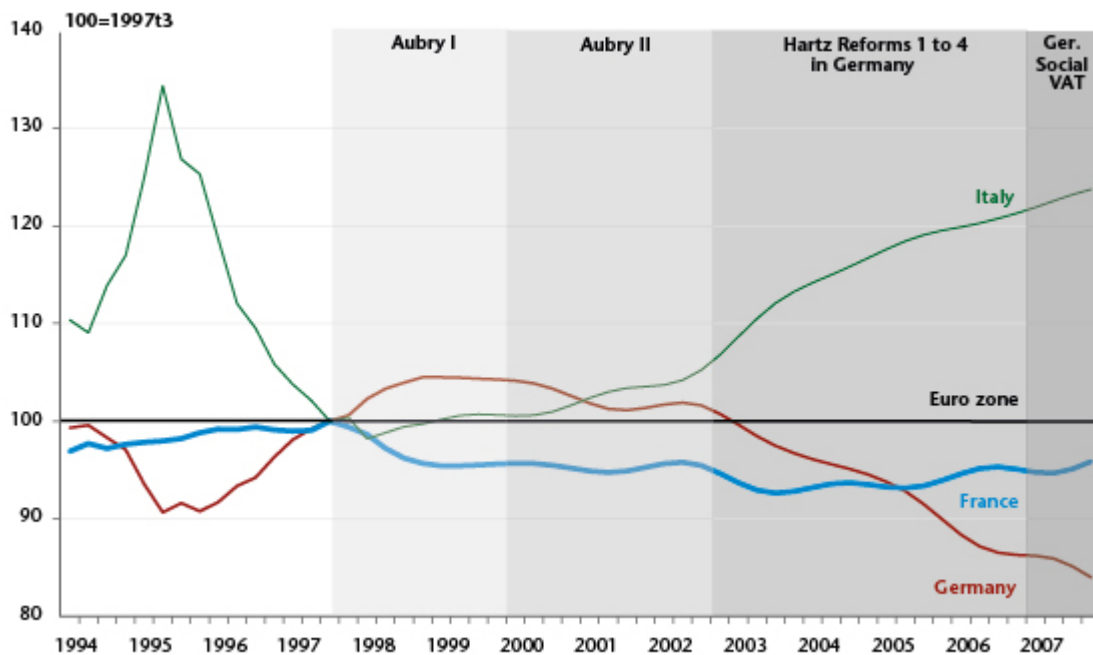
		1998-2007		
			1998-2002	2003-2007
GDP	Fra.	2,4	2,7	2,0
	All.	1,6	1,7	1,6
	Ita.	1,4	1,8	1,1
GDP per capita	Fra.	1,7	2,0	1,2
	All.	1,4	1,5	1,2
	Ita.	1,1	1,7	0,4
Total employment	Fra.	1,2	1,6	0,7
	All.	0,5	0,6	0,3
	Ita.	1,2	1,4	0,9
Current balance (in GDP points)	Fra.	1,1	2,1	-0,1
	All.	2,1	-0,4	5,0
	Ita.	-4,6	-2,6	-7,0
Public deficit (in GDP points)	Fra.	-2,7	-2,3	-3,2
	All.	-2,2	-1,9	-2,5
	Ita.	-2,8	-2,4	-3,3

Source : OECD.

### **Unit labour costs [\[1\]](#) under control**

Considering the large countries, France has cut hourly unit labour costs in the manufacturing sector the most during the period 1997-2002 (Figure 1). With respect to labour costs for the economy as a whole, only Germany has done better than France over this period.

Figure 1. Change in hourly unit labour costs in manufacturing



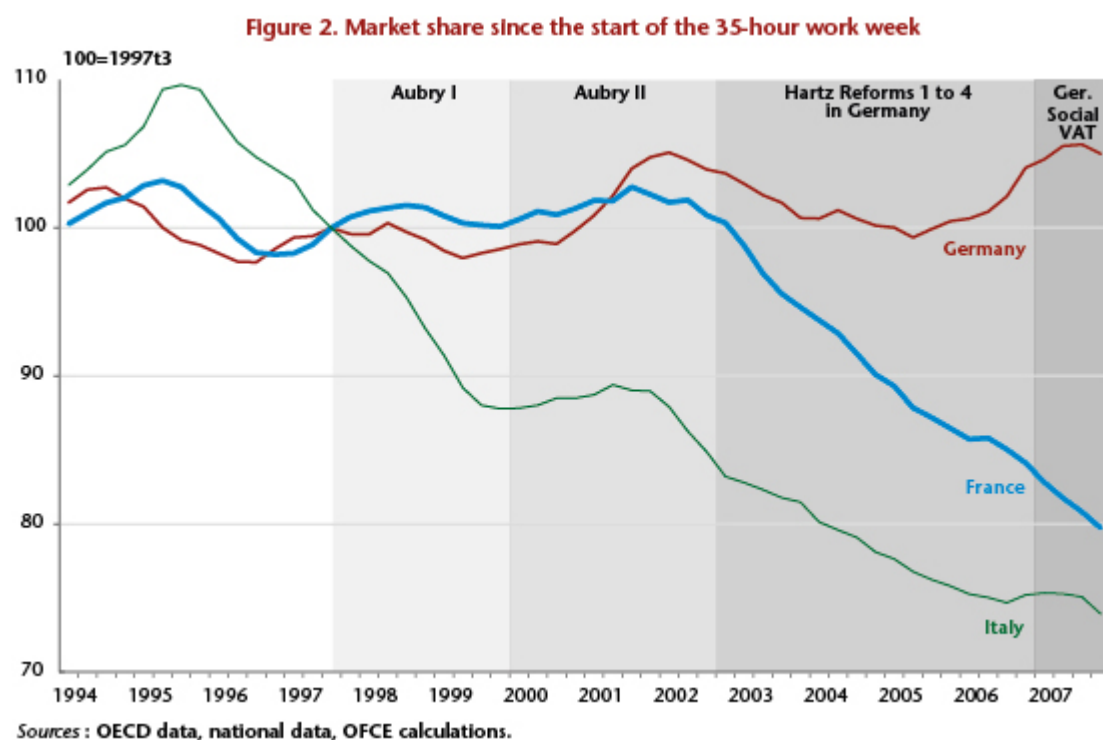
Source : European Commission.

The implementation of the Aubry laws has not therefore led to reducing the competitiveness of the French economy. The reasons why are now well known: the way the increase in hourly wages linked to the 35-hour week was offset by wage moderation; the more flexible organization of working time, which helped to boost the hourly productivity of labour (Table 1); the suppression of overtime pay; and finally State aid in the form of lower social contributions.

Between 1997 and 2002, by better controlling wage costs than most European and Anglo-American countries, France improved its price competitiveness and thereby its market share of world trade (Figure 2). The share of French exports in world trade, which was helped by the weakness of the euro and by wage moderation, reached a peak in 2001.

Since 2002, France's market share has declined considerably, for two basic reasons: first, the loss of price competitiveness of French exports subsequent to the appreciation of the nominal effective exchange rate in France, comparable to that observed in the early 1990s, and second, Germany's commitment to a policy of drastically reducing

production costs. Since 2002, Germany has engaged in a process of improving its supply by restricting income and social transfers ( Hartz reforms , social VAT), which led to lower unit labour costs in absolute terms but also relative to its other European partners, including France. It is this policy that accounts for the 30% loss in market share experienced by France in the period 2002-2007.



The loss in market share is thus not peculiar to France. The policy being implemented in Germany has enabled it to gain market share in countries that are geographically and structurally close to it, *i.e.* the large European countries. In this respect, France is not the only country to have suffered from this strategy, as Italy too has lost market share during this period<sup>[2]</sup>.

In total, since the introduction of the 35-hour week, Italy has lost even more market share than the French economy (-27% for Italy against -20% for France).

### ***A limited cost for the public purse***

Since the implementation of the Aubry laws, the relief on

charges on low wages has cost general government an annual average of nearly 22 billion euros. But this amount is not attributable solely to the Aubry laws, since even before that such measures had been established by the Balladur and Juppé governments in the early and mid 1990s. The additional relief generated by the Aubry laws, which was made more long term by the "Fillon" measures, comes to nearly 12.5 billion euros per year. But this amount does not represent the cost actually incurred by general government. Indeed, as the Aubry laws have created jobs (350,000 over the period 1997-2002 according to official figures □□by the DARES and used by the INSEE), the cost for the public purse has been smaller: this job creation generates four billion euros in additional payroll taxes; this has reduced the number of unemployed, and thus unemployment benefits by 1.8 billion euros; and finally this has boosted household income, and the consequent consumption is generating additional tax revenues (VAT, income tax, etc.) in the amount of 3.7 billion euros. In sum, once the macroeconomic feedback is taken into account, the additional cost of these reductions comes to 3 billion euros annually, or 0.15 percentage point of GDP.

A review of our macroeconomic history does not therefore corroborate the thesis that the 35-hour week has "weighed down" the French economy: business growth and job creation were higher during the period from 1997 to 2007 than in the rest of the euro zone, and the competitiveness of the French economy, as measured by unit labour costs, fell by less than in the rest of the euro zone, with the exception of Germany. In this regard, it appears that the strategy conducted in Germany from 2002 (Hartz reform and social VAT) better explains the losses in market share by both the French economy and our other European partners. It is rather in the public sector, including hospitals, that the 35-hour work week has proven ineffective.

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## **The different measures relaxing the 35-hour week**

### **I –The Fillon law of 2003**

The Law of 17 January 2003 has two main provisions:

#### ***(1) Regulation of overtime***

By increasing the overtime quota from 130 to 180 hours, this law permits companies to use overtime structurally. Allowing for an additional 4 hours per week throughout the year enables companies to stay on a 39-hour week if they so wish. Specific industries also have the right to negotiate a higher amount. The Decree of 9 December 2004 brought the regulatory overtime quota to 220 hours per year.

The Law also reduces the cost of overtime. For companies with 20 employees or fewer, overtime begins only with the 37th hour, and the rate of extra pay is only 10%. For other firms, this may be negotiated between 10% and 25% by an industry agreement.

#### ***(2) Measure easing social contributions***

The provisions for the reduction of employer social contributions introduced by the Aubry laws were henceforth disconnected from the length of the work week. All companies, whether or not they had shifted to the 35-hour week, now benefited. Structural aid beyond 1.6 times the minimum wage (SMIC) was eliminated.

### **II – The tax exemption of overtime hours in 2007**

This measure had several provisions:

#### ***(1) Lump-sum reduction in payroll taxes***

This measure introduced a lump-sum reduction in payroll taxes of 1.5 euros per hour of overtime worked by companies with

fewer than 20 employees and 0.50 euros in enterprises with more than 20 employees.

### **(2) Alignment of extra pay for overtime**

This measure provided that extra pay for overtime be aligned at the minimum rate of 25% for all companies.

### **(3) Exemption from income tax**

This measure allowed employees to exempt their pay for overtime hours from income tax, up to a limit of 25% extra.

### **(4) Exemption from social contributions**

This measure also included a reduction of payroll taxes equal to the amount of the CSG / CRDS tax as well as all legal and contractual contributions.

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#### **For more information:**

Philippe Askenazy, Catherine Bloch-London and Muriel Roger, 2004, "La réduction du temps de travail 1997-2003: dynamique de construction des lois 'Aubry' et premières évaluations" [The reduction of the work week 1997-2003: dynamics of the development of the Aubry laws and initial evaluations], *Economie et Statistiques*, no. 376-377.

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Alain Gubian, Stéphane Jugnot, Frédéric Lerais and Vladimir Passeron, 2004, “Les effets de la RTT sur l’emploi: des simulations ex-ante aux évaluations ex-post” [Impact of the shorter work week on employment: from ex-ante simulations to ex-post evaluations], *Economie et Statistiques*, n° 376-377.

Éric Heyer and Xavier Timbeau, 2000, “35 heures : réduction réduite” [35 hours: the reduction reduced], *Revue de l’OFCE*, no. 74, July.

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[1] The unit labour cost is the ratio of the hourly cost of [labour](#) to the hourly [productivity](#) of the [work](#).

[2] Other factors may of course explain Germany’s better performance, such as the emergence of China. For a recent version of this idea, see Chen R., G.M. Milesi-Ferreti and T. Tressel (2013).

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## 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.

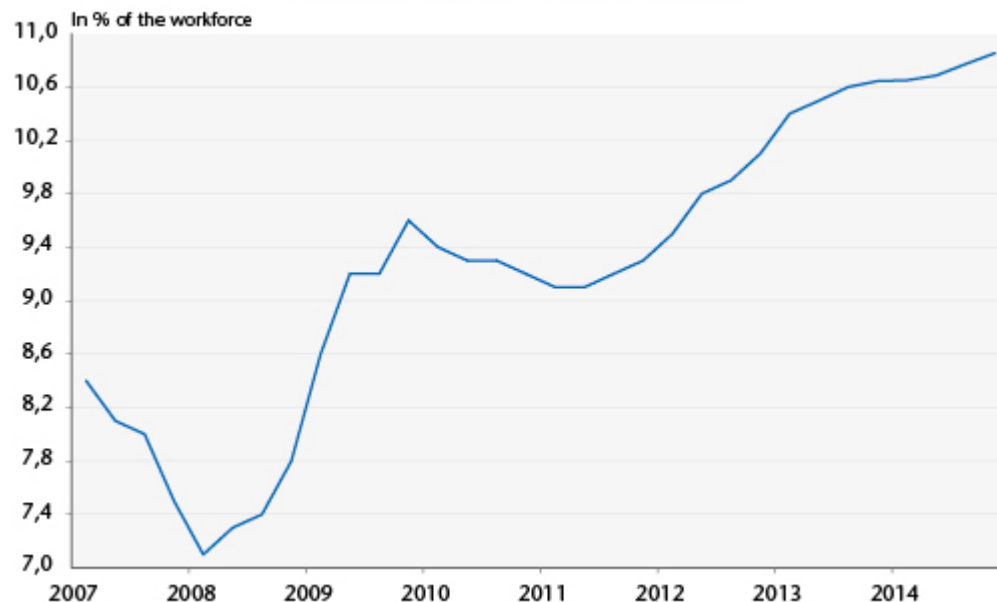
In an attempt to reverse the trend in unemployment, the government has planned for the rapid expansion of subsidized jobs in the non-profit sector (Emplois d'avenir, Contrats Uniques d'Insertion – Contrats d'Accompagnement dans l'Emploi (CUI-CAE)). Joining these programmes are the CICE tax credit for 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

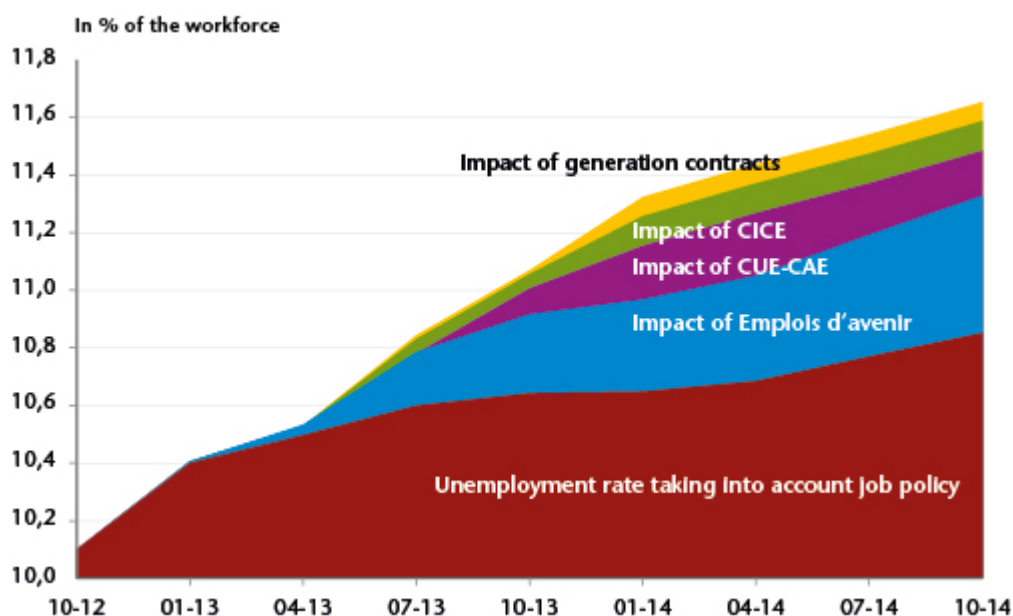
businesses, will be equivalent to 6% of payroll, excluding employer social security contributions, and corresponds to wages of less than 2.5 times the minimum wage (SMIC). According to the assessment made by [Mathieu Plane \(2012\)](#) using the e-mod.fr model, the CICE will decrease labour costs in 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.<sup>[1]</sup> 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**



Sources: INSEE, OFCE forecasts October 2013.

[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.

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## **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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# 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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## **The energy companies: Green is making them see red**

By [Sarah Guillou](#) and [Evens Salies](#) [1]

Does the common energy market unduly favour renewable energy sources ("renewables")? This is the opinion of the [nine energy companies that appeared before the European Parliament](#) in September. According to them, meeting the target of having 20% of final energy consumption in the EU come from renewable sources by 2020 would have a negative impact on the electric energy sector, and in particular could harm both the energy companies' financial results and the security of the electricity supply. There is no denying that since the late 1990s the EU has conducted a very active policy promoting RES in this field. The European Commission (EC) has made numerous suggestions to the Member States about ways to meet the 20% target (see [Directive 2009/28/EC](#)), including guaranteed purchase prices for electricity produced from renewable energy sources, tax credits, etc. Moreover, in 2011 this set of measures has enabled the EU-27 to hit a level of 22% of electricity generated from renewables, hydroelectricity included ([Eurelectric, 2012](#)) [2].

How does this policy hurt the historical producers or threaten the security of the supply? Let's look at a few stylized facts about the consumption and management of electricity production. Average consumption is lower at night ("base" period) than in the daytime when it experiences a peak or two (periods called "spikes"). As electricity is not storable, the least expensive way to meet the base-to-peak transition is to draw on power plants according to their "order of merit". A producer using several sources of energy then calls on them in order from the least flexible (slow start-up, low marginal cost) to the most flexible (fast start-up, high marginal cost). In theory, the stack is/was: nuclear-coal for the base period, nuclear-coal-gas for the peak period [3]. It is during peak demand, when the wholesale price can soar, that producers earn the most money. The production of RES plants is in turn contingent on the vagaries of the weather ("intermittent"): these plants produce only when the associated primary resource (wind, sun, etc.) is sufficient; they are then prioritized for meeting electricity consumption.

The integration of RES into the generation fleet changes the merit order. The stack above becomes wind-nuclear-coal for the base, and wind-nuclear-coal-gas at peak, with wind substituting for some uranium, coal and gas. Given that for RES plants the marginal cost of production is close to zero, their integration in the energy mix, however minimal, reduces the average price on the wholesale markets. As a result, with the integration of RES, fossil fuel plants are less well paid. As for the RES plants, they always enjoy a guaranteed purchase price (in France, 8.2 c€/kWh for wind and between 8 and 32 c€/kWh for solar, etc.) [4]. The loss in earnings is greatest during periods of peak demand. Producers have less incentive to invest in the construction of fossil fuel power plants, whose output is nevertheless needed during these periods. Hence the risk to the security of supply: with the gap between available capacity and peak demand potentially reduced, there is a greater risk that the real gap between output and

consumption becomes negative.

One possible solution is the creation of a “market for capacity”. In this market, making the output capacity of a power plant available well in advance would be remunerated, even if there is no actual output. The nine energy companies considered this kind of market as interesting, insofar as they are equipped with gas power plants and / or are sellers of gas, which is what is demanded in peak periods. In France, the [NOME Law](#) of 2010 provides for the establishment of such a market at the end of 2015.

It is also worth noting that since a substantial share of fossil fuel plants are not at the end of their physical life, the integration of RES is adding capacity to a European market for electricity that is already characterized by overcapacity. This is now being exacerbated by the economic crisis, which is hitting energy demand. This mainly concerns gas plants that already face stiff competition from coal-fired plants, which have become more profitable since the import of surplus US coal, which has been supplanted by shale gas. The excess supply is, however, helping to contain electricity prices.

In the end, the hearing involving the nine energy providers in the European Parliament reveals two major difficulties facing any energy transition policy. The first is the cost of adjusting to the new energy mix. The energy companies are, like these nine, complaining (rightly) that this cost is jeopardizing their profitability and that in order to cope some of them will be forced to close or even dismantle production sites ([Eon in Germany](#)). The consumers, for their part, are financing among other things the obligation to buy electricity – in France, through the contribution to the public electricity service ([700 million euros in 2010](#)). The cost of adjusting is inevitable and even necessary to the adjustment: it is because the providers have to bear an additional cost that they will change their energy portfolio. The second problem comes down to a single question: how can

support for RES be reconciled with a secure supply? While energy policy is contributing to a genuine improvement in air quality, it still seems ineffective in managing the security of supply, which is nevertheless a public good.

The EC is moving toward cooperative solutions. As in the case of the coordinated development of the interconnection of the national transport networks, led by the network managers, it is considering the feasibility of a [common market for the exchange of electricity generation capacity](#). The EC would also like the Member states to coordinate the setting of guaranteed purchase prices. These rates could in practice create a windfall, especially for equipment makers (see [Guillou, S., 2013, Le crépuscule de l'industrie solaire, idole des gouvernements, Note de l'OFCE No. 32](#)) [Guillou, S., 2013, "The twilight of the solar industry, the darling of governments", OFCE Note 32]. What remains is to find ways to facilitate the coordinated management of the security of the EU's electricity supply, while making room for RES. The hearing of the energy providers in the European Parliament should lead to a more general consideration of the security of supplies in the EU with respect to all sources of energy.

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[\[1\]](#) We would like to thank Dominique Finon, Céline Hiroux and Sandrine Selosse. Any error is, however, our own responsibility.

[\[2\]](#) The figure of 20% covers a number of sectors, beyond just the electrical energy sector.

[\[3\]](#) This principle was especially true before the liberalization of the wholesale markets, at a time when a vertically integrated producer decided which power plants to start to meet national demand.

[\[4\]](#) Guaranteed purchase prices were introduced so that the technology for producing electricity from renewable energy

sources, which was not yet mature, was not put at a disadvantage.