

Rent control: What is the expected impact?

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[The decree on rent control](#), which was published in the *Journal officiel* on 21 July, takes effect on 1 August 2012 for one year. The measure was announced in January 2012 during François Hollande's presidential campaign. It has now been adopted, while awaiting the major reform of landlord-tenant rental relations that is scheduled for 2013.

Difficulties in finding housing and deteriorating living conditions for an increasing share of the population point to growing inequality in housing. This inequality is undermining social cohesion, which is already being hit by the economic crisis. For many people, homeownership is becoming a problematic proposition due to the rising cost of buying, while applications for the allocation of social housing remain on hold for lack of space, and the private rental market is becoming increasingly expensive in large cities because of the soaring price of property. Rent control in these cities is serving as an emergency measure to slow the price increases. This poses a challenge of keeping investors in the private rental market, which is already characterized by a shortage in housing supply and very low rental returns (1.3% in Paris after capital depreciation).

The decree aims to significantly lower market rents [2], which are being driven up by rents at the time of re-letting, *i.e.* during a change of tenant. Unlike rent during the lease period or upon renewal of a lease, which are indexed to the IRL rental benchmark, until 31 July 2012 rents for new tenants were set freely. In 2010, this applied to nearly 50% of re-lettings in the Paris area (60% in Paris). Now, in the absence of major renovations, these will be subject to control. Only

rents for new housing that is being let for the first time or renovated properties (where the renovation represents more than one year's rent) will remain uncontrolled (Table 1).

Table 1. The method of setting rent under current law

Legal framework set by	Renewal of lease	Re-letting	First letting and new housing
Act of 6 July 1989 as modified	- Indexed to the IRL - In case of obvious under valuation, re-evaluation over 3 years or 6 years if the difference is greater than 10% - In case of renovations, increase agreed in advance between the landlord and tenant	Uncontrôle	Uncontrôle
Decree for the Paris region	- Indexed to the IRL - In case of obvious under-or renovation for an amount at least greater than 1 year's rent, authorized increase of half the difference between the last rent and the market rent or of 15% of the actual cost of the renovation (tax incl.)	Uncontrôle	Uncontrôle
Decree of 21 July 2012 (applicable in the relevant municipalities)	- Indexed to the IRL - In case of obvious under-valuation or of renovation for an amount at least greater than 1 year's rent in the private or common areas, authorized increase of either half of the difference between the last rent and the market rent or of 15% of the actual cost of the renovation (tax incl.)	- Indexed to the IRL - In case of an obvious under-valuation or of renovation for an amount between 6 month's rent and 1 years' rent in the private or common areas, authorized increase either of half of the difference between the last rent and the market rent or of 15% of the actual cost of the renovation (tax incl.) - Uncontrolled if renovation of at least 1 year's rent	Uncontrôle

By using the [data from the Observatoire des Loyers de l'Agglomération Parisienne](#), along with the hypotheses set out in the [OFCE Note \(no. 23 of 26 July 2012\)](#), "Rent control: what is the expected impact?", we evaluated the impact this decree would have had if it had been implemented on 1 January 2007 and made permanent until 2010. According to our calculations, this decree would have resulted not only in sharply slowing increases in rents for re-lettings during the first year it was applied (+1.3% in the Paris area, against 6.4% observed), but also in stabilizing or even reducing rents at the time of the next re-letting, *i.e.* in our example, three years later (in 2010, 0% in Paris and -0.6% in the Paris region). Finally, in 2010, rents would have been 12.4% lower in Paris and 10.7% lower in the Paris region than they would have been in the absence of the measure. This means that in Paris, rents would have been about €20.1 per sq.m instead of the rate of €22.6

per sq.m actually observed (Table 2). For an average size dwelling (46 sq.m) re-let in Paris, the monthly rent would thus have been €924 instead of €1,039, a savings for the tenant of €115 per month. For the Paris region as a whole, using the same assumptions, the rent upon re-letting would have fallen on average to €15.9 per sq.m, instead of the actual €17.8 per sq.m. For an average rental area upon re-letting of 50 sq.m, the gain would be €95 per month!

Over the longer term, the decree would make it possible to reduce the gap between sitting tenants in place for more than 10 years and new tenants (a gap of 30% in 2010 in the Paris region and 38% in Paris itself), and to improve market fluidity.

Currently, what possibility is there of moving if the mere fact that a couple has children increases the price per sq.m by over 15% in the Paris region? Similarly, the financial incentive to move for a couple living in a four-room 80 sq.m dwelling whose children have left home is zero, because the rent for a 60 sq.m unit with 3 rooms would cost just as much. This premium on being sedentary increases the pressure on the rental market and encourages households to stay in properties that are not suited to their needs, and even hampers labour market mobility.

Can this measure encourage mobility and restore household purchasing power? In the short term, it will certainly benefit the most mobile households by limiting the increase in the share of their budget spent on housing [3]. But these are the households facing the least constraints on income, that is to say, those with high incomes or a relatively low share of income spent on housing. It will also benefit households that are forced to move or those who are running up against the limits on their finances. For all these households, the increase in the share of income on housing will be lower than it would have been without the decree. In contrast, for low-income households whose share is already high [4], the decree

won't change anything, because they can ill afford the additional cost of re-letting.

Table 2. Simulated change in rents upon re-letting in the Paris region using the hypothesis that the decree took effect on 01 Jan 2007

	Rents noted letting on 31/12/2006	Rents after re-letting on 01/01/2007	Change in 2007	Rents on 31/12/2009 after indexing to IRL and before re-letting	Rents on 01/01/2010 after letting	Change in 2010	Gap between observed and simulated rents upon re-letting in 2010
PARIS		19 €/m ²	2.2 %	20.1 €/m ²	20.1 €/m ²	0 %	-12.4 %
Actual	18.6 €/m ²	(20.1 €/m ²)	(+ 8.3 %)	(20,9 €/m ²)	(22,6 €/m ²)	(+8,3 %)	
PARIS REGION		15.4	1.3%	16 €/m ²	15.9 €/m ²	-0.6 %	-10.7 %
Actual	15.2 €/m ²	(16.2 €/m ²)	(+ 6.4)	(16.9 €/m ²)	(17.8 €/m ²)	(+5.7 %)	

What are the risks?

While there are real benefits to be expected, these would still need to be made viable by the application of this decree, or at least by the next Act. Besides the difficulty of implementing the decree (absence both of reliable mechanisms to monitor rents in the areas concerned and of a legal framework to allow tenants to assert their new rights), the impact of this measure will be positive for tenants only if the rental supply does not shrink (by maintaining current investors in the market and continued new investment) and if landlords do not seek to offset future rent control by raising the rent at the time of the first let.

Likewise, the realization of improvements in line with the Grenelle 2 environmental consultation or simply maintenance work could wind up being abandoned due to the lengthening of the amortization period for landlords compared with the previous situation. Conversely, some owners might be encouraged to carry out major renovations (in excess of one year's rent) and "to upgrade the dwelling" in order to be able to freely determine the rent. This would give the landlord a margin of safety to offset any subsequent shortfall. These increases, if they occurred, would penalize less creditworthy

tenants and would promote the process of gentrification already at work in the areas under greatest pressure. We could then see increasing differences between the market for “rundown housing” and that for renovated housing.

This decree should in the short term limit the extent of disparities in the areas under greatest pressure, at no cost to the government. But it will not solve the problem for the poorest households of the share of income going to housing: to do this, it is necessary to increase the stock of social housing, to improve its fluidity and to significantly upgrade housing subsidies [5], which would require a major financial effort. The fundamental problem remains the lack of supply, particularly in urban areas, where by definition the available land is scarce and expensive, with higher rents simply passing on the price of property. However, to ease housing prices, more land needs to be available, with a greater density where possible, transport needs to be developed to facilitate the greater distance travelled between residential areas and workplaces, and so on. These are the levers that need to be used if we are to improve the housing conditions of less well-off households.

[1] The decree applies in municipalities where the rent increases seen over the period 2002-2010 were more than double the increase in the IRL benchmark (*i.e.* 3.2% per year) and the market rent per sq.m exceeds the national average outside the Paris region (€11.1 /sq.m) by 5%. This includes nearly 1,400 communes in 38 cities (27 in metropolitan France and 11 in overseas departments).

[2] There are two types of rent: the average rent is the rent of all rental housing, whether vacant or occupied; and the market rent is the rent of all dwellings available on the

rental market, *i.e.* new rental accommodation and re-lettings. This is very close to the rent for re-lettings, as residences for first-time lets represent only a small portion of the available supply.

[3] This share has increased for 15 years for households in the private rental sector, and particularly the less well-off.

[4] In 2010, more than half of private sector tenants spent an income share on housing (net of housing benefit) of over 26.9%, but above all, the share was 33.6% for the poorest 25% of households.

[5] According to the IGAS report "Evaluation of personal housing assistance", in 2010, 86.3% of rents in the private rental sector were greater than the maximum rent taken into account for calculating housing benefit. Any increase in rent is thus borne entirely by the tenant.

Social action, but no end of the crisis

Evaluation of the five-year economic programme (2012-2017)

By [Eric Heyer](#), [Mathieu Plane](#), [Xavier Timbeau](#)

The initial decisions of the five-year programme are coming amidst an extremely difficult and very uncertain economic situation. In a recent [OFCE Note](#) (No. 23 of 26 July 2012), we first analyze the macroeconomic context for François Hollande's five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe.

We evaluate both the cost to the public finances as well as the impact on economic activity, employment and the distribution of income. In part two, we analyze the public policy choices being given priority by the new government, including both those aimed at the young (generation contracts, jobs of the future), at some seniors (revision of the pension reform), and at the middle and lower classes (allowance for the start of school, boost to the minimum wage, Livret A bank accounts, rent control, revised taxation of overtime), as well as those intended to revive certain public expenditures that are deemed essential (public jobs in education, the justice system and the police in the "public finance" section, and public early childhood services).

François Hollande was elected President of the French Republic at a time when France and Europe are going through an unprecedented crisis. Unemployment in metropolitan France has increased by over 2 percentage points since the crisis began and is now (in ILO terms, 9.6% of the workforce in first quarter 2012) approaching the record levels of 1997 (10.5%). Gross domestic product per capita in terms of purchasing power has fallen since 2008 by 3%. If the growth trend for the five years preceding the crisis had continued at that same rate from 2008 until early 2012, GDP per capita would now be 8% higher than it is. The current account has deteriorated during the crisis by 1.5 GDP points (25.7 billion euros, 10 billion of which is for the oil bill), thus worsening France's net balance of trade by 7.8 GDP points. The public debt increased by 577 billion (nearly 30 GDP points), and at the beginning of 2012 represented almost 90% of GDP. Industry has paid a heavy price for the crisis (almost 300,000 jobs lost), with all signs indicating that the job losses and closures of industrial sites might be irreversible.

Yet this dire situation, which can be chalked up to the crisis that began in 2008, is not over. Due to the impact of austerity policies implemented at a time of panic at seeing

financing of the public debt dry up, the sovereign debt crisis is threatening the euro zone with a prolonged recession in 2012 and 2013. And the even worse scenario looming on the horizon – the disintegration of the euro zone – would transform the threats of recession into the risk of a major depression.

Assessments of the situation differ depending on the elements available. Some measures have been implemented by decree, while others are being discussed by the legislature, but the proposed bills do permit a quantitative analysis. Others are in the planning stage, with the main trade-offs still to be made, so our assessment tries to explore the main points.

Our assessment of the economic strategy for the five-year programme does not stop there. The outlines of the premises for a strategy to end the crisis can now be seen. The deficit reduction commitments and the initial steps taken in this direction in the budget packages in July 2012, such as those announced during the budget orientation debate of June 2012, point to a strategy whose first step is the achievement of a reduction in the public deficit to 3% of GDP by the end of 2013, regardless of the cost. Based on this fiscal virtue, this amounts to a strategy to end the crisis by stabilizing the state of the public accounts, thereby reassuring the financial markets and other economic agents and establishing the conditions for a strong future recovery. This strategy is based on cutting public expenditures and raising taxes (see the “public finance” section, government tax proposals and the taxation of the oil companies).

This strategy for ending the crisis is risky, to say the least, because it does not take full account of the crisis facing Europe today. It might be justified if we were already on course to end the crisis and if the point were simply to set priorities. But Europe remains in a situation of extreme uncertainty, living in the expectation of a massive failure of one or another Member State in the euro zone, fearing the

collapse of this or that financial institution, and suffering the consequences of a spiral of austerity that is being fueled by rising sovereign interest rates. In this situation, everything is coming together to strengthen the existence of a liquidity trap and to generate high fiscal multipliers. Given this, *ex ante* reductions in the deficit through tax hikes and spending cuts is weighing heavily on activity, and thus limiting or even cancelling out any actual deficit reductions. The factors pushing up the public debt are not being reversed, and the reduction in activity is heightening the risk that the unsustainable private debt will be socialized. The increase in sovereign interest rates is being fueled by an inability to meet deficit reduction targets and by rising public debt, and is thus pushing public deficits higher, forcing even more austerity.

One response to this dynamic that is bringing about the collapse of the euro would be one form or another of pooling public debts in Europe. This would require relatively complete control of the budgets of member countries by a federal body with strong democratic legitimacy. A response like this would therefore mean "more Europe", and would make it possible to define "more moderate" austerity policies for France as well as its major trading partners. It would make putting an end to involuntary mass unemployment and the liquidity trap prerequisites to an improvement in the public finances. It would also make it possible to ensure the sustainability of public finances without leading to the lost decades that are now gestating.

In the first part of the Note, we analyze the macroeconomic context for François Hollande's five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. The value of the fiscal multiplier is a critical parameter, and we show that the current strategy is valid only if the multipliers are low

(i.e. on the order of 0.5). However, a slew of empirical evidence indicates that, in the exceptional situation we are experiencing today, the budget and fiscal multipliers may be larger than 0.5 (between 1 and 1.5, see the Note). We detail in a second part the measures taken in the Supplementary Budget Act of July 2012 (for 2012) and the elements outlined in the budget orientation debate in preparation for the Budget Act for 2013 and for the period 2012-2017. To succeed in reducing the public deficit to 3%, it seems that there must be over 10 billion euros in additional tax revenue or in savings on expenditure, *ex ante*.

We then present an evaluation of eleven measures. Guillaume Allègre, Marion Cochard and Mathieu Plane have estimated that the implementation of the *contrat de génération* ["generation contract"] could create between 50,000 and 100,000 jobs, at the cost of a strong deadweight effect. Eric Heyer and Mathieu Plane point out that in the short term, subsidized *emplois avenir* ["jobs for the future"]-type contracts can help to reduce unemployment. Eric Heyer shows that the revision of taxation on overtime will help to cut the public deficit by 4 billion euros, without hurting the labour market. Guillaume Allègre discusses the consequences of increasing the *Allocation de rentrée scolaire* [allowance for the start of school] and shows that it mainly benefits the lowest five deciles in terms of standard of living. Henri Sterdyniak analyzes the possibilities for fiscal reform. The point is not to evaluate the government's proposals for fiscal reform, but to provide a comprehensive overview of the current system's margin for change and its inconsistencies. Henri Sterdyniak and Gérard Cornilleau evaluate the increased opportunities for retiring at age 60 and analyze the possible paths to a more large-scale reform of the pension system. Hélène Périvier evaluates the possibilities for an early childhood public service, the eventual cost of which could be covered in part by an increase in activity that would generate more than 4 billion euros. Eric Heyer and Mathieu Plane analyze the impact

of a boost in the minimum wage (SMIC) and conclude that, given the small spillover of increases in the SMIC onto the rest of the wage structure, the impact on the cost of labour is limited by the greater reduction in social charges on low wages. While the effect on employment is small, it would cost the public purse 240 million euros. Sabine Le Bayon, Pierre Madec and Christine Rifflart evaluate rent control. Hervé Péléraux discusses the compensation of Livret A bank accounts and the impact of doubling their ceiling. Céline Antonin and Evens Salies evaluate the new taxes on the oil companies, which could provide 550 million euros in tax revenue in 2012, at the risk that this tax might ultimately be passed on to the end consumer.

Obama 2012: “Yes, we care!”

By Frédéric Gannon (Université du Havre) and [Vincent Touzé](#)

On Thursday, 28 June 2012, the United States Supreme Court [delivered its verdict](#). The principle that individuals are obliged to take out health insurance or else face a financial penalty, a central plank in the 2010 reform [1] of the health insurance system (the Affordable Care Act [2]), was held to be constitutional. This reform had been adopted in a difficult political context. It includes a variety of measures intended to significantly reduce the number of Americans without health coverage. Although it will increase federal spending, new revenues and spending cuts will make it possible to reduce the deficit.

From September 2009 to March 2010, there was a lengthy process of drafting and approving the law, with an uncertain outcome due to the lack of a majority in the Senate [3]. Since the law

passed by the House of Representatives and signed on 23 March 2010 by President Obama differed from the version passed by the Senate, amendments were introduced in a Reconciliation Act that was passed on March 30th. Opponents of the reform (26 states, numerous citizens and the National Federation of Independent Business) then decided to take the fight to the US Supreme Court. Their hopes rested mainly on the possible unconstitutionality of the law, which centered on the individual's obligation to take out health insurance, called the "individual mandate", and on the expansion of the Medicaid public insurance program.

The favourable judgment of the Supreme Court was obtained with a narrow majority: five judges voted for [4] and four against [5]. The political inclinations of the judges did not seem to have worked against the law, since Chief Justice John G. Roberts, an appointee of George W. Bush, gave his approval. The Supreme Court majority considered that the financial penalty for a failure to take out insurance is a tax [6] and that it had no cause to rule on the merits of such a tax. It passed this responsibility to Congress (the upper and lower houses) which, in this case, has already debated and approved the law. Consequently, this point of law is valid.

According to the Supreme Court, the financial penalty for failing to purchase health insurance could be viewed as an individual obligation to purchase [7], and "the Commerce Clause does not give Congress that power". But from a functional standpoint, this penalty can be regarded as a tax, in which case Congress has discretion to "lay and collect Taxes" (Taxing Clause). Hence the positive verdict of the Supreme Court. However, the Court believes that "the Medicaid expansion violates the Constitution" because the "threatened loss of over 10 percent of a State's overall budget is economic dragooning that leaves the States with no real option but to acquiesce in the Medicaid expansion".

The Supreme Court decision represents a major victory for

President Barack Obama, who had made a reform to ensure more equal access to the health insurance system one of the spearheads of his 2008 election campaign. His Democratic predecessor in the White House, Bill Clinton, previously had to abandon a similar reform due to fierce opposition from the Republicans and growing divisions among the Democrats. In order to give himself every chance of success, Obama has had to be more strategic in the programming of both the reform and the way it was presented [8]. To do this, he also assembled a team of experienced specialists [9].

The Act represents a real cultural revolution in a country where the health insurance system excludes nearly 50 million people. Besides the individual mandate requiring Americans to purchase health insurance, the ACA's main measures are:

- The creation of “exchanges” for insurance contracts where people can buy health coverage, with a government subsidy that depends on the level of income;
- Expansion of the Medicaid public health insurance program [10] (public coverage for all households with incomes below 133% of the federal poverty level) and financial penalties on states that choose not to implement this expansion (elimination of all federal funding of the Medicaid program);
- A requirement that employers offer health insurance to their employees (application of financial penalties if the obligation is not met, with exceptions for small businesses);
- New regulations on the private insurance market (obligation to offer coverage to all individuals, with no conditions on their health status).

Beginning in 2014, millions of uninsured American households should benefit from the expansion of Medicaid, which the Supreme Court has now ruled unconstitutional – this raises numerous questions [11]. How many States will be tempted not to expand Medicaid? What are the consequences for the poor

households [12] who were to benefit from this expansion? Will they have the means to afford subsidized private insurance [13]? Will they be penalized financially if they do not buy insurance? Will they be encouraged to migrate to States that have adopted the expansion [14]? It is reasonable to expect that few States [15] will boycott the expansion of Medicaid, as the ACA offers them other strong incentives (federal assumption of 100% of the additional cost from 2014 to 2016, then 95% after 2017, and 90% after 2020; loss of some federal funds if no expansion). However, adjustments in the law will likely be useful if policymakers want to avoid excluding those who are too poor to afford subsidized private insurance.

The law will come into force gradually, with the various measures to apply from 2014. According to the latest [report by the Congressional Budget Office](#) (2012), annual government expenditure (expansion of Medicaid and private insurance subsidies) should rise by about \$265 billion per year [16] by 2022 (the estimated total cost between 2012 and 2022 is \$1,762 billion), and the number of uninsured should fall by about 33 million [17]. The reform also provides for an increase in tax revenue (higher compulsory levies and new taxes) and a reduction in federal spending (primarily substitutions between the expanded Medicaid program and the old program). This will result in amply offsetting the cost of the reform. In a previous [report in March 2011](#), the CBO estimated that the total reduction in the deficit over the period 2012-2021 will come to \$210 billion. In the name of hallowed liberties, however, there is still strong opposition to the individual mandate [18], but over time it can be hoped that this mandatory principle will come to be viewed first and foremost as a basic right that protects all citizens.

[1] For an overview of the health insurance system and the reform, see Christine Riffart and Vincent Touzé, “La réforme du système d’assurance santé américain”, [Lettre de l’OFCE](#),

[n°321](#), 21 June 2010. Also see the [Wikipedia article on this subject](#).

[2] This legislation reconciles the two laws, the *Patient Protection and Affordable Care Act* and the *Health Care and Education Reconciliation Act*.

[3] “Health Care Reform: Recent Developments”, [The New York Times, June 29](#), 2012.

[4] Stephen Breyer, Elena Kagan, Ruth Bader Ginsburg, and Sonia Sotomayor, along with Chief Judge John G. Roberts.

[5] Clarence Thomas, Anthony Kennedy, Antonin Scalia and Samuel Alito.

[6] Floyd Norris, “Justices Allow the Term ‘Tax’ to Embrace ‘Penalty’”, [The New York Times, June 28](#), 2012.

[7] The legal position of the Obama administration has been to argue that the portion of the obligation to purchase insurance tantamount to a tax is the penalty paid by those who do not meet this requirement. This penalty has a regulatory function: it is designed based on the logic of an incentive, and not from the perspective of new tax revenue. Judge Jeffrey Sutton explained that if the government had clearly specified that the obligation to buy insurance was a tax, it would have been easier to justify in terms of its constitutionality. Most tax allowances or tax rebates are positive incentives (tax breaks on the acquisition of cleaner vehicles, for example). The health insurance requirement acts instead as a negative incentive by imposing a penalty / fine on those who decide not to buy insurance. Faced with these alternatives, they will choose in all rationality – according to a Pigouvian perspective – the option that they consider the most profitable or the least costly.

[8] Ezra Klein, “Barack Obama, Bill Clinton and Health-Care Reform”, [The Washington Post, July 26](#), 2009.

[9] Robert Pear, "Obama Health Team Turns to Carrying Out Law", [*The New York Times*, April 18](#), 2010.

[10] Medicaid is a public health insurance program for the poorest households (about 35 million beneficiaries). The numerous criteria (income, age, degree of invalidity, state of health, etc.) lead to excluding a non-negligible portion of society's poorest. Hence more than 20 million people living below the federal poverty level do not have access to Medicaid. On the other hand, Medicare, the other public health insurance program, which is only for those aged 65 and over, broadly covers this age group.

[11] Urban Institute-Health Policy Center, "Supreme Court Decision on the Affordable Care Act: What it Means for Medicaid", [*Policy Briefs*, June 28](#), 2012.

[12] Genevieve M. Kenney, Lisa Dubay, Stephen Zuckerman and Michael Huntress, "Making the Medicaid Expansion an ACA Option: How Many Low-Income Americans Could Remain Uninsured?", [*Policy Briefs, Urban Institute – Health Policy Center*, June 29](#), 2012.

[13] In the absence of an expansion of *Medicaid*, their health insurance spending will be capped at 2% of their income.

[14] This notion of voting with their feet was put forward in an article by Charles M. Tiebout (1956): "A Pure Theory of Local Expenditures", *The Journal of Political Economy*, 1956, vol. 64/5, pp. 416-424.

[15] Brett Norman, "Lew: 'Vast majority' of states will expand Medicaid", [*Politico*, 1st July 2012](#).

[16] In 2022, 136 billion dollars will finance public health insurance for 17 million poor people (expansion of Medicaid) and 127 billion dollars will go to subsidies for the purchase of private insurance by 18 million people.

[17] In 2022, the 27 million uninsured remaining will consist of illegal immigrants (ineligible for public and private insurance programs) and those eligible for Medicaid who do not want to take out insurance as well as those ineligible for Medicaid who also do not want insurance.

[18] Susan Stamper Brown, "Time To Clean Up The Obamacare Mess", [*The Western Center for Journalism*, June 26, 2012](#).

Banking union: a solution to the euro crisis?

By Maylis Avaro and [Henri Sterdyniak](#)

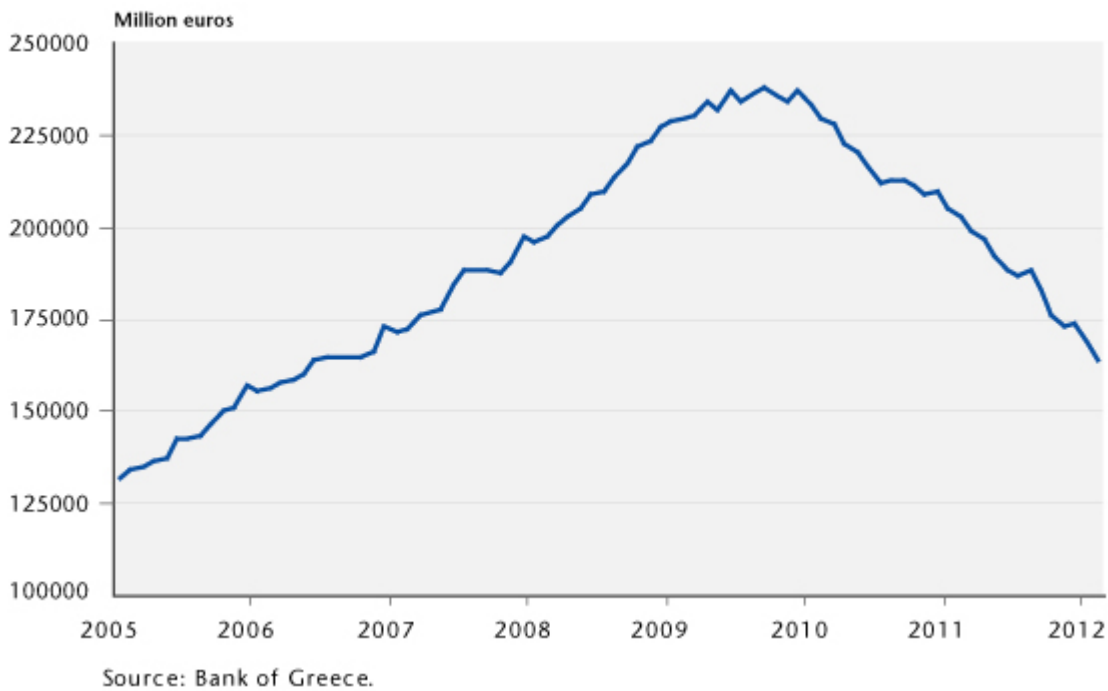
The European summit on 28th and 29th June marked a new attempt by Europe's institutions and Member states to overcome the crisis in the euro zone. A so-called Growth Pact was adopted, but it consists mainly of commitments by the Member states to undertake structural reform, and the limited funds made available (120 billion over several years) were for the most part already planned. The strategy of imposing restrictive fiscal policies was not called into question, and France pledged to ratify the Fiscal Compact. The interventions of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) will now be less rigid, as, without additional conditions, they can help countries that the financial markets refuse to finance so long as they meet their objectives in terms of fiscal policy and structural reform. But euro-bonds and the mutual guarantee of public debt were

postponed. The summit also launched a new project: a banking union. Is this an essential supplement to monetary union, or is it a new headlong rush into the unknown?

The current crisis is largely a banking crisis. The European banks had fed financial bubbles and housing bubbles (especially in Spain and Ireland), and they had invested in mutual funds and hedge funds in the United States. After major losses during the crisis of 2007-2010, the Member states came to their rescue, which was particularly costly for Germany, the UK, Spain and above all Ireland. The sovereign debt crisis in the euro zone has compounded their woes: the sovereign debt that they hold has become a risky asset. The problem of regulating the banks has been raised at the international level (new Basel III standards), in the United States (Volcker rule and Dodd-Frank law) and in Britain (Vickers report).

In June 2012, doubts about the soundness of Europe's banks surfaced yet again. The measures taken since 2008 to stabilize the financial system have proved insufficient. When Bankia, Spain's fourth-largest bank, announced that it was requesting State assistance of 19 billion euros, worries about the balance sheets of Spanish banks rose sharply. The rate of bad loans of the country's banks, whose balance sheets were hit hard by the real estate crash, rose from 3.3% at end 2008 to 8.7% in June 2012 [1]. Furthermore, many Greeks, fearing an exit from the euro zone, began to reduce their deposits in the banks there [2].

Total deposits of business and consumers in Greece's banks



In response to these dangers, the proposal for a European banking union was given a new boost by Mario Monti. Italy's PM suggested developing the proposals in preparation for the European Commission Single Market DG, an idea that currently has the support of the Commission, the European Central Bank, and several Member states (Italy, France, Spain, etc.) On the other hand, Germany believes that a banking union is impossible without a fiscal union. While Angela Merkel acknowledged [3] that it was important to have a European supervisory authority, with a supranational banking authority with a better general overview, she clearly rejected the idea of Germany taking a risk of further transfers and guarantees without greater fiscal and policy integration [4]. The euro zone summit meeting on 29 June asked the Commission to make proposals shortly on a single monitoring mechanism for the euro zone's banks.

This kind of banking union would rest on three cornerstones:

- a European authority in charge of centralized oversight of the banks,

- a European deposit guarantee fund,
- a common mechanism for resolving bank crises.

Each of these cornerstones suffers specific problems: some are related to the complex way the EU functions (Should a banking union be limited to the euro zone, or should it include all EU countries? Would it be a step towards greater federalism? How can it be reconciled with national prerogatives?), while others concern the structural choices that would be required to deal with the operations of the European banking system.

As to the institution that will exercise the new banking supervisory powers, the choice being debated is between the European Banking Authority (EBA) and the ECB. The EBA was established in November 2010 to improve oversight of the EU banking system, and it has already conducted two series of “stress tests” on the banks. As a result of the tests, in October 2011 Bankia reported a 1.3 billion euro shortage of funds. Five months later, the deficit was 23 billion; the EBA’s credibility suffered. In addition, the London-based EBA has authority over the British system, while the United Kingdom does not want to take part in the banking union. The ECB has, for its part, received support from Germany. Article 127.6 of the Treaty on the Functioning of the European Union [5], which was cited at the euro zone summit of June 29th as a basis for the creation of a European Banking Authority, would make it possible to give the ECB supervisory authority. On 12 June, the Vice-President of the ECB, Mr. Constancio, said that, “the ECB and the Eurosystem are prepared” to receive these powers; “there is no need to create a new institution”.

European oversight implies a common vision of banking regulation. There must be agreement on crucial issues, such as: “Does commercial banking need to be separated from investment banking?” “Should banks be prohibited from operating on the financial markets for their own account?” “Should public or mutual or regional banks be encouraged

rather than large internationalized banks?" "Should banks be encouraged to extend credit primarily to businesses and government in their own country, or on the contrary to diversify?" "Should the macro-prudential rules be national or European?" In our opinion, entrusting these matters to the ECB runs the risk of taking a further step in the depoliticization of Europe.

Applying the guidelines of this new authority will be problematic. A banking group in difficulty could be ordered to divest its holdings in large national groups. But would a country's government expose a national champion to foreign control? Governments would lose the ability to influence the distribution of credit by banks, which some people might find desirable (no political interference in lending), but in our opinion is dangerous (governments would lose a tool of industrial policy that could be used to finance Small and Medium Enterprises [SMEs] and Economic and technological intelligence [ETI] projects or to support the ecological transition).

For example, in a case involving Dexia, the opposition between the European Commission on the one hand and France, Belgium and Luxembourg on the other is blocking a restructuring plan. The plan includes the takeover of Dexia Credit Local's financing of local authorities by a banking collectivity that would be created based on cooperation between La Banque postale and the Caisse des depots. In the name of fair competition, Brussels is challenging the financing of local communities by such a bank, as Dexia has received public funding for its restructuring plan. This is threatening the continuity of the financing of the French local authorities, and could put a halt to their plans; in particular, it could prevent France from providing specific secure mechanisms for financing local authorities through local savings.

The purpose of a deposit guarantee fund is to reduce the risk of a massive withdrawal of deposits during a banking panic.

This fund could be financed through contributions by the European banks guaranteed by the fund. According to Schoenmaker and Gros [6], a banking union must be created under a “veil of ignorance”, that is to say, without knowing which country poses the greatest risk: this is not the case in Europe today. The authors propose a guarantee fund that at the outset would accept only the strongest large transnational banks, but this would immediately heighten the risk of the zone breaking apart if depositors rushed to the guaranteed banks. The fund would thus need to guarantee all Europe’s banks. According to Schoenmaker and Gros, assuming a 100,000 euro ceiling on the guarantee, the amount of deposits covered would be 9,700 billion euros. The authors argue that the fund should have a permanent reserve representing 1.5% of the deposits covered (*i.e.* about 140 billion euros). But this would make it possible to rescue only one or two major European banks. During a banking crisis, amidst the risk of contagion, such a fund would have little credibility. The guarantee of deposits would continue to depend on the States and on the European Stability Mechanism (ESM), which would have to provide support funds, ultimately by requiring additional contributions from the banks.

The authority in charge of this fund has not yet been designated. While the ECB appears well positioned to undertake supervision of the banking system, entrusting it with management of the deposit guarantee fund is much more problematic. According to Repullo [7], deposit insurance should be separated from the function of lender of last resort. Indeed, otherwise the ECB could use its ability to create money to recapitalize the banks, which would increase the money supply. The objectives of monetary policy and of support for the banks would thus come into conflict. What is needed is a body that handles deposit insurance and crisis resolution and is separate from the ECB, and which must have a say on the behavior of the banks, and which would be additional to the EBA, the ECB, and the national regulators.

The ECB on the other hand would continue to play its role as lender of last resort. But it is difficult to see how such a complicated system would be viable.

As the risk of a country leaving the euro zone cannot yet be dismissed, the question arises as to what guarantee would be offered by a banking union in the case of a conversion into national currency of euro-denominated deposits. A guarantee of deposits in the national currency would, in the case of an exit from the euro, heavily penalize customers of banks that suffer a devaluation of the national currency against the euro, whose purchasing power would decline sharply. This kind of guarantee does not solve the problem of capital flight being experienced today by countries threatened by a risk of default. What is needed is a guarantee of deposits in euros, but in today's situation, given the level of risk facing some countries, this is difficult to set up.

German and Finnish politicians and economists such as H. W. Sinn are, for instance, denouncing an excessive level of risk for Germany and the Nordic countries. According to several German economists, no supranational authority has the right to impose new burdens (or risk levels) on the German banks without the consent of Parliament, and the risk levels need to be explicitly limited. The German Constitutional Court might oppose the deposit guarantee fund as exposing Germany to an unlimited level of risk. Moreover, according to George Osborne, the Chancellor of the British Exchequer, a bank deposit guarantee at the European level would require an amendment to existing treaties and the consent of Great Britain.

On 6 June, the European Commission began to develop a common framework for resolving banking crises by adopting the proposal of Michel Barnier, which has three components. The first is to improve prevention by requiring banks to set up *testaments*, that is, to provide for recovery strategies and even disposal plans in case of a serious crisis. The second

gives the European banking authorities the power to intervene to implement the recovery plans and to change the leadership of a bank if it fails to meet capital requirements. The third provides that, if a bank fails, the national governments must take control of the establishment and use resolution tools such as divestiture, the creation of a defeasance bank, or "bad" bank, or an internal bailout (by forcing shareholders and creditors to provide new money). If necessary, the banks could receive funds from the ESM. Bank-related risks would therefore be better distributed: the shareholders and creditors not covered by the guarantee would be first to be called upon, so that the taxpayers would not pay to reimburse the creditors of insolvent banks. In return, bank loans and shares would become much riskier; bank reluctance about inter-bank credit and the drying up of the interbank market due to the crisis would persist; and the banks would find it difficult to issue securities and would have to raise the level of compensation. However, Basel III standards require banks to link their lending to the level of their capital. This would pose a risk of constraining the distribution of credit, thereby helping to keep the zone in recession. Based on the decisions of the summit on 29 June, Spain could be the first country whose banks would be recapitalized directly by the ESM. However, this would not take place until early 2013; the terms of the procedure and the impact of ESM aid on the governance of the recapitalized banks still need to be determined. As can be seen in the Dexia example, what terms are set for the reorganization of a bank can have serious consequences for the country concerned: are governments (and citizens) willing to lose all power in this domain?

A banking union can help break the correlation between a sovereign debt crisis and a banking crisis. When the rating agencies downgrade a country's debt, the securities suffer a loss in value and move into the category of "risky assets", becoming less liquid. This increases the overall risk faced by the banks in the country concerned. If a bank is facing too

much overall risk and it is no longer able to meet the capital requirements of Basel III, the State must recapitalize it, but to do this it must take on debt, thereby increasing the risk of a default. This link between the banks' fragile balance sheets and public debt generates a dangerous spiral. For instance, since the announcement of the bankruptcy of Bankia, Spain's 10-year refinancing rates reached the critical threshold of 7%, whereas last year the rates were about 5.5%. In a banking union, the banks would be encouraged to diversify on a European scale. However, the crisis of 2007-09 demonstrated the risks of international diversification: many European banks lost a great deal of money in the US; foreign banks are unfamiliar with the local business scene, including SMEs, ETIs and local government. Diversification based on financial criteria does not fit well with a wise distribution of credit. Moreover, since the crisis, European banks are tending to retreat to their home countries.

The proposal for a banking union assumes that the solvency of the banks depends primarily on their own capital, and thus on the market's evaluation, and that the links between a country's needs for financing (government, business and consumers) and the national banks are severed. There is an argument for the opposite strategy: a restructuring of the banking sector, where the commercial banks focus on their core business (local lending, based on detailed expertise, to businesses, consumers and national government), where their solvency would be guaranteed by a prohibition against certain risky or speculative transactions.

Would banking union promote further financialization, or would it mark a healthy return to the Rhineland model? Would it require the separation of commercial banks and investment banks? Would it mean prohibiting banks whose deposits are guaranteed to do business on the financial markets for their own account?

[1] According to the Bank of Spain.

[2] The total bank accounts of consumers and business fell by 65 billion in Greece since 2010. Source: Greek Central Bank.

[3] “La supervision bancaire européenne s’annonce politiquement sensible”, *Les Echos Finance*, Thursday 14 June 2012, p. 28.

[4] “Les lignes de fracture entre Européens avant le sommet de Bruxelles”, *AFP Infos Economiques* 27 June 2012.

[5] Art 127.6: “The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”

[6] D. Schoemaker and Daniel Gros (2012), “A European Deposit Insurance and Resolution Fund”, *CEPS working document*, No. 364, May.

[7] Repullo, R. (2000), “Who Should Act as Lender of Last Resort? An Incomplete Contracts Model”, *Journal of Money, Credit, and Banking* 32, 580-605.

Financing higher education: Should students have to pay?

By [Guillaume Allègre](#) and [Xavier Timbeau](#)

Is it necessary to ensure that a greater portion of the cost of higher education is borne by students in the form of higher tuition fees, which might or might not be coupled with loans? It is often argued that financing higher education through taxes is anti-redistributive. We show in a [working document](#) that from a life cycle perspective proportional taxation is not anti-redistributive.

While raising higher education fees is not on the political agenda in France, it is a subject of intense fighting, not only in Quebec, but also in Spain and Great Britain, where student protests erupted at the end of 2010. Reports in France regularly propose raising tuition fees: recently (2011), in a note by the [Institut de l'Entreprise](#) [in French] on the role of business in financing higher education, Pierre-André Chiappori proposes “lifting the taboo on tuition fees”. In a [contribution to Terra Nova](#) [in French] published in 2011, Yves Lichtenberger and Alexandre Aïdara propose raising annual university tuition fees by about 1000 euros. Paradoxically, the authors also propose creating a study allowance that could be used anytime in a person’s life. The authors are attempting to deal with two contradictory economic dynamics. On the one hand, a study allowance would help raise the general level of education, a factor in innovation and growth, while simultaneously fighting against social self-selection in higher education:

In countries that have adopted it [the study allowance], disadvantaged social strata may have an opportunity to

undertake lengthier studies even though their social origins have predestined them to short-term courses that provide quick entry into salaried employment. This is an important means of raising the general level of education and the qualifications of young people, which is a central concern of this report. (Lichtenberger and Aïdara, [p.82](#))

But on the other hand, education benefits better-off strata, and being free makes it anti-redistributive:

The fact that public higher education is virtually free leads, first, to a transfer of resources (the public cost of education) to young people who are in education the longest. This overwhelmingly means young people from better-off strata. This transfer is reflected ultimately in private returns to the beneficiaries: higher wages and then pensions, which benefit the most highly educated throughout their lives... As things stand, higher education's free character has no redistributive value and even aggravates inequalities. (Lichtenberger and Aïdara, [p.84](#))

Indeed, even if the anti-redistributive character of free higher education is not the only argument made by advocates of higher tuition, it is one of their main arguments. This argument relies on a static and familialist vision of redistribution. We adopt a life cycle perspective instead.

As highlighted in the second excerpt above, on average the beneficiaries of education spending enjoy a significant private benefit: they will have higher wages and pensions throughout their lives. Even assuming that tax (on income) is proportional to income (which is not the case: in reality, it is progressive), they will pay much more tax, in absolute terms, than individuals who have completed shorter studies. Above all, tax allows for the financing of education by individuals who actually receive significant private benefits, and in proportion to this benefit. People who suffer discrimination in the labour market or who were oriented towards less profitable sectors and benefit from low returns to education reimburse society a lesser amount through their taxes than those who benefit more. Financing through income

tax leads people with higher incomes to contribute even when they have not had a lengthy education. The injustice would therefore lie in the transfer between persons with high incomes who are not highly educated and those who are highly educated. But if education is characterized to a great extent by significant social returns, thanks to its impact on growth ([see Aghion and Cohen](#)), then people with high incomes are actually beneficiaries of spending on education, whether or not they are highly educated themselves (for instance, self-taught entrepreneurs benefit from the availability of skilled labour).

Adopting a life cycle perspective, we show in a [working document](#) that financing spending on non-compulsory education (beyond 16 years) by a proportional tax represents a net transfer from those with higher incomes during their careers to those with lower incomes during their careers. From a life cycle perspective, free non-compulsory education financed by taxes does not benefit individuals with more affluent parents (the transfer from individuals from better-off households to those from poorer households is not significantly different from zero). If individuals from the poorest households react to the increase in tuition fees by reducing their investment in education, even when this is financed by loans, then there can be little doubt that they will be the first victims of this type of reform. Advocates of tuition increases generally argue for small increases in tuition fees and exemptions based on means-testing the parents. But recent developments in Australia, the United Kingdom and Canada show that, once the fees have been introduced, it is difficult to prevent governments that are seeking new funds from increasing the fees and reducing the exemption thresholds.

In higher education, the leading injustice is the lack of access to people from modest backgrounds. The surest way to ensure equity in education is still to fund it through income tax and to reform education so that it is targeted at academic success for all rather than at selection.

Let's negotiate a global carbon price signal – quickly!

By Stéphane Dion [\[1\]](#) and [Éloi Laurent](#)

Two decades after the Rio Conference, and just as a new climate conference is opening in Bonn on Monday 14 May 2012, we must admit to collective failure in combating human-induced climate change. We cannot escape serious climate disruption if we continue down this same path. We must change direction, and we must do it quickly.

The International Energy Agency forecasts warming of over 3.5°C by the end of the 21st century if all countries respect their commitments, and by more than 6°C if they content themselves with their present policies. At that level of warming, climate science warns us that our planet will become much less hospitable for humans and all other forms of life.

At the Durban Conference in December 2011, the countries expressed their grave concern about the gap between their commitments and achieving the objective of a 2°C limit on increased global warming (relative to the pre-industrial era). They promised to re-double their efforts to bridge this gap. But they failed to make any commitment to achieve more stringent targets. We are thus facing an increasingly untenable gap between the urgent need for action and the inertia of international negotiations.

The developed countries are refusing to strengthen their climate policies so long as the other major emitters don't do the same. But the emerging economies, particularly China and

India, with annual GDP growth rates of 8 to 10%, will not accept in the foreseeable future targets for the reduction of the volume of their greenhouse gas (GHG) emissions. On the other hand, these countries might be more open to the idea of setting a price per ton of CO₂ that was standardized at the global level, from which they would derive revenue, and which their economic competitors would also be required to levy.

We believe that the best instrument for the international coordination needed to combat climate change is a global carbon price signal. This is why we are proposing that the forthcoming negotiations focus on this crucial goal.

Here is what we are proposing (for more detail, see, in French, <http://www.ofce.sciences-po.fr/pdf/dtravail/WP2012-15.pdf> and, in English): every country would make a commitment to introduce, in their respective jurisdictions, a carbon price aligned with a scientifically validated international standard, in order for the world to achieve or at least come as close as possible to the objective of keeping global warming below 2°C. Each country would decide whether to extract this levy through taxation or through a system of ceilings and trading in emissions permits (a “carbon market”).

Governments would be free to invest, as they see fit, revenues from the carbon emission levy and from the corresponding elimination of fossil fuel subsidies. They could, for example, invest in research and development in clean energy and public transportation, etc. They could also choose to address social inequalities with respect to access to energy.

Developed countries would be required to set aside part of their revenues to help developing countries introduce policies to mitigate emissions, to adapt facilities and to create carbon sinks (by means of reforestation, for example). The contributions of each country would be based on what their respective GHG emissions represent relative to the total

emissions of all the developed countries.

Under this international agreement, countries would have the right to levy border taxes on products from countries that have not established a carbon price in accordance with the international standard. The message would be clear to all large emitters: if you do not levy a carbon tax on your products before you export them, the other countries will do so in your place, and it is they who will collect the revenues. Each country will understand that it is in its own commercial interests to comply with the international agreement, to tax its own emissions and to use the corresponding revenues as it sees fit.

In this way, the world would have available an instrument that is vital to its sustainable development. At last, carbon emitters would be required to pay the environmental price for their actions. Consumers and manufacturers would have an incentive to choose lower-carbon-content goods and services and to invest in new emission-reducing forms of technology.

We need to negotiate a global carbon price signal, and quickly. What better place to do this than at Rio, where the problem of climate change was first recognized by the international community 20 years ago?

[\[1\]](#) Stéphane Dion is a Member of the House of Commons of Canada; as Canada's then Minister of the Environment, he chaired the 11th Conference of the Parties to the United Nations Framework Convention on Climate Change, held in Montréal in 2005 (COP 11).

Competitiveness and industrial demand: The difficulties facing the French-German couple

[Jean-Luc Gaffard](#)

The obsession with competitiveness has returned to centre stage with the election campaign. This reflects the reality that French companies are indeed suffering a loss of competitiveness, which is behind the deterioration in foreign trade for almost a decade. This loss is clear vis-à-vis the emerging markets and explains the trend towards relocating abroad. It is also clear vis-à-vis firms from other developed countries, mainly in the euro zone and in particular German companies. This latter situation is especially serious, as it challenges the coherence of European construction ([cf. OFCE, note 19: Competitiveness and industrial development: a European challenge in French](#)).

The gap in competitiveness that has emerged with Germany is clearly based on non-price competition. One of the reasons for this is Germany's superior business model, which is characterized by the maintenance of a network of local businesses of all sizes that focus on their core business and on the international fragmentation of production. This model is especially suitable for business development that is targeted at global markets, and it largely protects the countries hosting these companies from the risk of deindustrialization.

It would, nevertheless, be a mistake to ignore that this development is also the product of an adverse change in price competitiveness. This reflects labour market reforms in Germany, which lowered the relative cost of labour, as well as

strategies that are based on the segmentation of production and the outsourcing of intermediate segments, which have also contributed to lowering production costs.

Germany has thus managed to virtually stabilize its market share of global exports by increasing their level in the European Union (+1.7% in the 2000s) and even more so in the euro zone (+2.3%), while France has lost market share in these same areas (3.1% and 3.4%, respectively).

Two developments have particularly hurt France's industry. Its network of industrial SMEs has fallen apart. They were hit less by barriers to entry than by barriers to growth. All too often SME managers have been inclined or encouraged to sell the enterprises to large corporations rather than to ensure their growth. This is due both to the lack of genuine partnerships with these corporations and to the difficulties experienced in obtaining permanent financing from the banks and markets. For their part, the large industrial firms, both those operating on a multitude of local markets and those in the international markets, have chosen to focus on acquisitions and on the geographical decentralization of both their operations and their equipment and services suppliers. This strategy has been designed to meet geographical shifts in demand and to deal with the demand for immediate profitability set by volatile shareholders, but this has come in part at the expense of the development of local production networks. This process involved a vast movement of mergers and acquisitions that primarily drew on financial skills. The financial institutions were, in turn, converted to the universal banking model, abandoning some of their traditional role of being lending banks and investment banks. These concomitant developments have proved disastrous for overall competitiveness, particularly as hourly labour costs in industry were rising simultaneously.

There are two requirements for restoring the competitiveness of French companies and thereby encouraging the country's re-

industrialization. The first is to allow immediate control of labour costs and the restoration of profit margins; this could be helped in particular by tax measures that would adjust the financing of a portion of social protection. The second requirement is to promote the reorganization of industry through the creation of a network of stable relationships between all those involved in the industrial process, especially by the use of aid that is conditioned on cooperation between large and small firms in “competitiveness clusters”.

This medium-term effort will nevertheless largely remain ineffective if cooperative policies are not implemented across Europe. These policies need both to stimulate supply through the implementation of technology development programmes and to boost internal demand wherever it is clearly insufficient to satisfy production capacity.

Plea for a growth pact: the sound and fury hiding a persistent disagreement

By [Jean-Luc Gaffard](#) and [Francesco Saraceno](#)

The emphasis on the need to complement fiscal restraint by measures to boost growth, which is rising in part due to the electoral debate in France, is good news, not least because it represents a belated recognition that austerity is imposing an excessively high price on the countries of southern Europe.

Nevertheless, there is nothing new about invoking growth, and this may remain without consequence. In 1997, as a result of a

French government intervention, the Stability Pact became the Stability and Growth Pact, but this had no significant impact on the nature of strategy, which remained fully oriented towards the implementation of strict monetary and fiscal rules and a constant search for more flexible markets.

Last week, [Mario Draghi](#), along with [Manuel Barroso and Mario Monti](#), were worried not only about the recession taking place in Spain, Portugal, the Netherlands and Great Britain but also about the need to respond formally to a request that may come from a new French government. They too are arguing for a negotiated Growth Pact, while taking care to note that it must consist of a common commitment to carry out structural reforms wherever they have not yet been made. This position echoes the February [letter](#) of the eleven Prime Ministers to the European authorities. In other words, nothing is to change in the doctrine that determines the choice of Europe's economic policy: growth can be achieved only through structural reform, in particular of the labour markets.

There are two grounds for criticizing this position. [It is far from sure](#) that structural reform is effective, unless, that is, it is wielded in a non-cooperative spirit to improve the competitiveness of the country that undertakes the reform at the expense of its trading partners, as Germany was able to do with the Hartz reforms. Secondly, widespread reform, including where this is justified in terms of long-term growth, would initially have a recessionary impact on demand [\[1\]](#), and hence on activity. Reform cannot therefore deal with what is actually the immediate top-priority requirement, namely stemming the spreading recession.

The real challenge facing Europeans is to reconcile the short term and the long term. The solution proposed so far, general fiscal austerity aimed at [restoring the confidence of private actors](#), which would be complemented by structural reforms intended to increase the potential growth rate, just doesn't work. This can be seen by developments in Greece, as well as

in Portugal and Ireland, which are model students of Europe's bailout plans, and also in Britain, Italy and Spain. The fiscal multipliers remain firmly Keynesian (see [Christina Romer](#), and [Creel, Heyer and Plane](#)), and any "non-Keynesian" effects on expectations are limited or nonexistent.

Growth can neither be decreed nor established instantly, unlike the deflationary austerity spiral in which more and more European countries are currently trapped.

Growth is likely to materialize only if fiscal consolidation is neither immediate nor drastic – in fact, only if the consolidation required of countries in difficulty is spread over time (beyond the year 2013, which in any case will be impossible to achieve) and if the countries that are able to carry out a more expansionary fiscal policy actually do this in such a way that at the European level the overall impact is neutral or, even better, expansionary. This strategy would not necessarily be punished by the markets, which have shown recently that they are sensitive to the requirement for growth. Otherwise, steps should be taken by the ECB to deal with the constraints imposed by the markets. This short-term support must be accompanied by substantial medium-term investment made through European industrial programs financed by the issuance of Eurobonds – which would mean, finally, a European budget on a scale large enough to handle the tasks facing the Union. This method of coordinating short- and medium-term choices would be an important step towards the establishment of the kind of federal structure that alone will allow the resolution of the "European question".

[1] R.M. Solow, Introduction to Solow, R.M. Ed. (2004), *Structural Reforms and Macroeconomic Policy*, London: Macmillan).

The middle class: baseless fears or genuine hardship?

By Louis Chauvel

The term “middle class” is one of those social science concepts that provoke controversy due to its complex definition and dynamics and the political debate it generates. The fact that it is surrounded by sharp controversy should not therefore come as a big surprise. [In a note by the OFCE](#) – where a multifaceted definition of the middle class is proposed [1] – we review several dimensions of the social malaise afflicting this social group, which is often considered to be relatively privileged, in an effort to understand the actual situation.

Two theses are considered here:

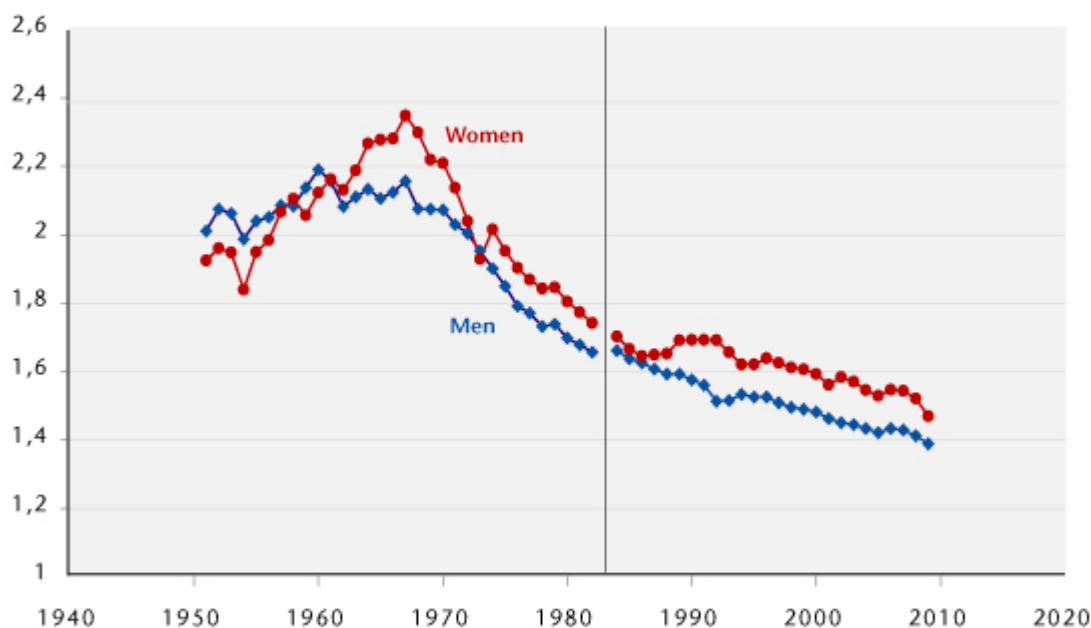
– on the one hand, the thesis of the middle class maintaining its former status, the strengthening of the protection its members enjoy and confirmation of their economic ascent [2] – a thesis that makes the “fear of decline” that haunts them a paradox;

– on the other hand, the thesis of an objective increase in social problems that were previously limited to people in lower strata (employees and workers, two social groups whose hourly wages are similar), with the upwards diffusion of the problems through capillary action now less blocked [3].

Proponents of the optimistic thesis, that of maintenance, argue that “contrary to popular belief”, the fall in status of the middle class is a “fiction”, as this social group “simultaneously embodies a ‘France holding its own’ and a ‘France that’s rising’” (Goux and Maurin). In this view, fear of decline is a psychological reaction of the middle class with no real cause.

In the Note, which upholds a different view, we review several aspects of this analysis to understand the objective basis for the malaise of the middle class. We show that the increasing difficulties faced by lower strata – for example, the risk of unemployment – are seeping into the intermediate middle classes, who can no longer be said to be protected. This is an element of the “theory of the lump of sugar at the bottom of the cup of coffee”: while the upper and middle parts of society still seem intact, erosion is continuing through the capillary-like action of the immersed part and, if nothing is done, it threatens inevitable deterioration.

Ratio between the net annual full-time salary of the intermediate professions and that of manual workers (men and women, separately)



Note: An in-depth examination shows that over the last 50 years workers and employees have experienced similar changes in wages.

Source: DADS data, private and semi-public sector.

The relative standard of living of the intermediate middle

class peaked in what the French call the “Trente glorieuses”, the three decades of post-war prosperity: since the end of this golden age, stagnant wages and incomes, the reduction of wage differentials with the lower classes holding jobs (see chart), the unprecedented risk of unemployment, the numerical expansion of diplomas to numbers that go well beyond the space available in the intermediary professions, and the consequent devaluation of education, etc., were a number of the problematic issues analyzed in this paper that highlight the existence of a very real malaise. It is thus possible to show that, in terms of diplomas, the intermediate middle class population increasingly consists of a share of potential managers (based on their level of education) who have not actually managed to enter the upper middle class, due to a lack of sufficient places, and on the other hand survivors of the intensified competition, a reflection of the growing number of people with the same level of education who have fallen into the lower classes.

In this note, we therefore consider the cause of the destabilization of the project of “middle class civilization” (Alexandre Koyré) that had emerged in the context of the growth and modernity that marked the 1960s to 1980. The corresponding social dynamics were not based simply on the numerical expansion of the intermediate middle class, but also on a coherent social and political project that has now become unstable. What are the ways to reconnect with this dynamic? How would it be possible to escape the vicious circle whereby the middle classes disintegrate and we develop policies targeted at those most in need without seeing that they feed the fall of groups that were previously better situated but that haven’t been supported? The answer lies in productive investment in sectors with long-term promise. Without coming to terms with the real causes of the malaise of the intermediate middle class and dealing with the root problems, we may be preparing ourselves for a difficult decade.

[1] The middle class is defined in their plurality as falling into the upper middle classes, comparable to the “executives and intellectual professions” who make up about 10% of households, and the intermediate middle classes, which corresponds to the 20% located immediately below, and thus close to the intermediary professions as defined by the INSEE.

[2] D. Goux and E. Maurin, 2012, *Les nouvelles classes moyennes*, Seuil, Paris. Most of these ideas were already presented in S. Bosc, 2008, *Sociologie des classes moyennes*, La Découverte.

[3] L. Chauvel, 2006, *Les classes moyennes à la dérive*, Seuil, Paris.

Is our health system in danger? Reforming the reimbursement of care (3/4)

By [Gérard Cornilleau](#)

Health is one of the key concerns of the French. Yet it has not been a major topic of political debate, probably due to the highly technical nature of the problems involved in the financing and management of the health care system. [An OFCE note](#) presents four issues that we believe are crucial in the current context of a general economic crisis: the third issue, presented here, concerns the reimbursement of health care, in particular long-term care, and the rise in physician

surcharges.

The reimbursement of care by the French Social Security system currently varies with the severity of the illness: long-term care, which corresponds to more serious conditions, is fully reimbursed, whereas the reimbursement of routine care is tending to diminish due to a variety of non-reimbursed fixed fees and their tendency to rise. In addition to this structural upwards trend there is a rise in non-reimbursed doctor surcharges, which is reducing the share of expenditure financed by Social Security. As a result, the share of routine care covered by health insurance is limited to 56.2%, while the rate of reimbursement for patients with long-term illnesses (“ALD” illnesses in French) is 84.8% for primary care [1]. This situation has a number of negative consequences: it can lead people to forego certain routine care, with negative implications for the prevention of more serious conditions; and it increases the cost of supplementary “mutual” insurance that paradoxically is taxed to help compulsory insurance on the grounds of the high public coverage for long-term illness. Finally, it puts the focus on the definition of the scope of long-term illness, which is complicated since in order to draw up the list of conditions giving entitlement to full reimbursement it is necessary to consider both the measurement of the “degree” of severity and the cost of treatment. The issue of multiple conditions and their simultaneous coverage by health insurance under both routine care and long-term illness is a bureaucratic nightmare that generates uncertainty and expenditure on relatively ineffective management and controls.

This is why some suggest replacing the ALD system by setting up a health shield that would provide for full reimbursement of all spending above a fixed annual threshold. Beyond a certain threshold of average out-of-pocket expenses (e.g. corresponding to the current “co-payment” level) after reimbursement by compulsory health insurance, which was about

500 euros per year in 2008^[21]), Social Security would assume full coverage. A system like this would provide automatic coverage of the bulk of expenses associated with serious diseases without going through the ALD classification.

One could consider modulating the threshold of out-of-pocket expenses based on income (Briet and Fragonard, 2007) or the reimbursement rate, or both. This possibility is typically invoked to limit the rise in reimbursed expenses. This raises the usual problem of the support of better-off strata for social insurance when it would be in their interest to support the pooling of health risks through private insurance with fees proportional to the risk rather than based on income.

The establishment of a health shield system also raises the issue of the role of supplementary insurance. Historically mutual insurance funds “completed” public coverage by providing complete or nearly complete coverage of anything in the basket of care not reimbursed by basic health insurance (dental prostheses, eyeglass frames, sophisticated optical care, private hospital rooms, etc.). Today these funds function increasingly as “supplementary” insurance that complements public insurance for the reimbursement of health expenses on the whole (coverage of the patient co-payment, partial refund of doctor surcharges). The transition to a health shield system would limit their scope of reimbursement to expenses below the fixed threshold. It is often assumed that if mutual insurance were to abandon its current role of blind co-payment of care expenditures, it could play an active role in promoting prevention, for example, by offering differential premiums based on the behaviour of the insured ^[31]. But where would their interests lie if the shield came to limit their coverage beyond the threshold not covered by public insurance? Even in the case of maintaining a substantial “co-payment” beyond the threshold because of doctor surcharges, for example, they would undoubtedly remain relatively passive, and there would not be much change from

the situation today, which isolates them from the bulk of coverage for serious and expensive diseases.

A system in which public insurance alone provides support for a clearly defined basket of care is surely better: this would require that the health shield increases with income, with the poorest households receiving full coverage from the first euro. If affluent households decide to self-insure for expenses below the threshold (which is likely if the latter is less than 1000 euros per year), the mutual insurance funds might withdraw almost entirely from coverage of reimbursements of routine care expenses. On the other hand, they could concentrate on the coverage of expenditures outside the field of public health insurance, which in practice would mean dental prostheses and corrective optics. They could intervene more actively than now in these fields to structure health care delivery and supplies. Their role as principal payer in these fields would justify delegating them the responsibility of dealing with the professions involved. However, this solution implies that a system of public coverage would be needed to give the poorest strata access to care not covered by the public insurance system (in a form close to France's current CMU universal coverage system, which should however be extended and made more progressive). There is thus no simple solution to the question of the relationship between public insurance and supplementary private insurance.

The merger of the two systems should also be considered, which in practice means the absorption of the private by the public. This would have the advantage of simplifying the system as a whole, but would leave partially unresolved the question of defining the basket of care covered. It is quite likely that supplementary insurance would relocate to the margins of the system to support incidental expenses not covered by the public system because they are deemed nonessential. The reimbursement of health costs should certainly remain mixed, but it is urgent to reconsider the boundaries between private

and public, otherwise the trend towards declining public coverage will gain strength at the expense of streamlining the system and of equity in the coverage of health expenditures.

[\[1\]](#) In 2008. This is a level of coverage that excludes optical. Taking optical into account, the rate of coverage by health insurance falls to 51.3% (Haut Conseil pour l'Avenir de l'Assurance Maladie [High Council for the Future of Health Insurance], December 2011).

[\[2\]](#) HCAAM, 2011 (*ibid*).

[\[3\]](#) It is not easy to take into account the behaviour of the insured. Beyond the use of preventive examinations, which can be measured relatively easily, other preventive behaviours are difficult to verify. Another risk inherent in private insurance is that insurers "skim" the population: to attract "good" clients, coverage is provided of expenditures that are typical of lower-risk populations (for example, the use of "alternative" medicines), while using detailed medical questionnaires to reject expenditures for greater risks.