

The French fiscal devaluation, or the French Achilles strives to catch the German tortoise

By [Sarah Guillou](#)

In the 1980s, under the European Monetary System (EMS), France repeatedly carried out currency realignments – in 1981, 1982, 1983 and 1986 – that were tantamount to devaluations. For its part, Germany had – already! – adopted a rigorous strategy of competitive disinflation, which, it was said at the time, led to disciplining its companies, which could not rely on the temporary advantages gained by currency devaluations rendering its exports more competitive. They were compelled instead to make investments so as to build up their future non-price competitiveness. Which they did...

During this same period France's devaluations left it with imported inflation and companies that had less incentive to invest in non-price competitiveness. The peg to the deutsche mark and then the Monetary Union were presented as ways to break out of this endless strategy of inflationary devaluations. France belatedly wound up adopting Germany's strategy of competitive disinflation and renouncing currency devaluations, with a strong franc strategy characterizing the 1990s.

Today, the terms of the debate seem reversed, even though France is still in the position of Achilles chasing the German tortoise. A new form of competitive devaluation is in favour: not based on the exchange rate, since the euro is part of a market mechanism that determines its value, but one that involves a reduction of the labour costs borne by business,

funded in part by an increase in Value Added Tax (VAT). This is called a fiscal devaluation. In an article entitled "Changer de Modèle", P. Aghion, G. Clette and E. Cohen defend this on the grounds that it is necessary to "think differently"[\[1\]](#). The government is also implementing this through the Competitiveness and employment tax credit (CICE) and its plans in the 2015-2017 Stability Pact to cut social security charges.

How is a reduction in the cost of labour comparable to a "fiscal" devaluation? A devaluation, it should be recalled, leads to lowering domestic prices relative to foreign prices as the value of the domestic currency is decreased relative to a unit of foreign currency. A devaluation of the euro, if it were possible, would mean a higher amount of euros to buy a dollar; consequently, a European car at 10,000 euros would go for fewer dollars and thus become more attractive to an American buyer who would still be holding the same amount in dollars in his wallet. More generally, a devaluation ensures that the production cost of domestic firms becomes cheaper relative to their foreign competitors, so that the former have a cost advantage and become more competitive. Hence the term "competitive devaluation".

By lowering companies' labour costs, it is assumed that the prices of exported products (and the goods and services included) will be lowered – despite the fact that labour costs do not cover the full cost of production. By increasing VAT on all products, the price of imported products increases as well. The devaluation effect – that is to say, the reduction in domestic prices relative to foreign prices – will take place only if the competitors' prices remain constant – in other words, only so long as the competitor does not implement the same policy at the same time! Furthermore, this will really have an impact on competitiveness if the price differential existing prior to the fiscal devaluation is more than offset by the reduction in labour costs.

Two further questions arise. First, we do not know the price elasticity of the labour costs. In other words, we do not know the extent to which firms pass lower employer costs onto prices. Second, labour market studies show that wages have a positive elasticity to labour costs. In other words, in the medium term and especially for higher wages, cutting payroll taxes on wages will result in increases in pay.

The medium-term effects are then drawn on to defend the fiscal devaluation policy. The reduction in employer contributions initially gives some manoeuvring room, or rather a cash flow, that then leads companies to invest, precisely because of the recovery in their margins. Incidentally, this excludes the previous effect, *i.e.* a reduction in prices, or in any case will have a maximum impact if the price drop does not occur. It is possible however that higher margins are a side effect of a reduction in prices, which pushes up sales, while increasing the profit per unit in a cost structure with increasing returns to scale, even if this affects only a few companies. Now suppose that the margins generated translate into investments. This could improve the companies' non-price competitiveness (the intrinsic product quality) in the future. This second aspect of fiscal devaluation is often put forward in parallel with the observation that French companies, in particular manufacturers, suffer both from crippling tax and regulatory conditions that handicap their international competitiveness and from a lack of product quality. But here macroeconomic analysis can no longer be invoked, and with respect to non-price competitiveness we know much less about the microeconomic dynamics due to the reduction of charges.

Let's conclude by considering the effects expected over the longer term. As pointed out by Aghion *et al.* in a footnote on page 58, the effects of a fiscal devaluation are temporary. Indeed, as with a currency devaluation, a fiscal devaluation will lead to an increase in wages due to the dynamics described above. Moreover, if the financing of the reduction

in charges results in reducing households' purchasing power due to the VAT hike, then the latter could also demand an increase in their nominal wages. The initial reduction in relative prices will be wiped out over the longer-term by the rise in wages. The authors could draw on the quasi-deflation in Europe to deal with this side effect of a devaluation. They argue instead that the interval will give a new impetus to business. In fact, what the authors defend is not the direct effect of the devaluation but its indirect effect on the level of investment due to the increase in margins.

However, this is also undoubtedly the aim of the CICE tax credit, as it targets taxes and not employer charges directly, unlike the Responsibility Pact which is aimed primarily at employment. By granting a tax credit, the CICE seeks to generate margins for investment in order to develop non-price competitiveness. The problem is that an improvement in competitiveness is far from guaranteed (see Guillou and Treibich, [Note de l'OFCE, no. 41 of 19 June 2014](#) [in French] on the CICE and competitiveness), while the dual objective of this tax credit (employment and competitiveness) will complicate companies' decision-making.

To pick up on the suggestion by Aghion *et al.*, the memory of the French competitive devaluations of the 1980s could lead us to "really think differently", that is to say, to stop applying policies that others have already applied. To think otherwise would mean to anticipate future competition rather than to replicate a policy that other countries have already implemented, which is obviously not so simple. And the interest of the work of Aghion *et al.* is in embracing a set of reforms that, taken **simultaneously**, could put France on a **different** trajectory.

But to undertake a fiscal devaluation while all the countries of Europe potentially will do or actually have done the same would generally be insufficient and even dangerous if it leads to a race to social dumping. It would be justified only

because European integration requires a certain alignment of companies' cost conditions, and thus due to fiscal competition. Repeatedly lagging behind fiscally in an integrated European market is very costly, it is true, but the French Achilles will not catch the German tortoise that has set off early in the field of competitiveness by using the weapon of a fiscal devaluation.

A better strategy would be to get ahead of the game. In the absence of being able to harmonize companies' fiscal conditions, it is necessary to anticipate. Germany anticipated competition from the emerging countries and implemented social VAT, or a fiscal devaluation. A policy that would change the "model" should anticipate future competition in Europe and around the world. However, this competition will not be over the cost of labour. Proof of this lies in the approach of countries with a low relative cost of labour that are more and more replacing labour with capital. China for instance has already become the world's largest purchaser of industrial robots (*Financial Times*, 1 June 2014). Future competition will be structured around the pursuit of two trends already taking place: the division of the production process as it is being accelerated by technological possibilities, and the replacement of labour by technology. Most value added will be focused upstream of production in design and / or downstream in related services. In other words, the government also needs to take an interest in the cost of capital, particularly in terms of the opportunity cost of investment.

The question of labour costs concerns the employment of less-skilled workers (obviously of great importance *per se*), but it is not at the heart of the problem of competitiveness. In attempting to solve the problem of the day, the cost of labour, there is a risk of not making the investments that ensure the future. Could France stop being the Achilles that chases the German tortoise? One way to resolve Zeno's paradox would be to invent a government that maintains continuity.

Otherwise, we need to do away with a strategy of catching-up and opt for a more winning “model”.

[\[1\]](#) This is in fact the title of the first chapter of the book by P. Aghion, G. Cetto and E. Cohen, *Changer de modèle*, Ed. Odile Jacob, 2014.