

# Should households pay for a competitiveness shock?

By [Henri Sterdyniak](#)

France is suffering from an industrial problem. Its current account balance went from a surplus of 2.6% of GDP in 1997 to a deficit of 1% in 2007 and then 2% in 2012, while Germany went from a deficit of 0.4% of GDP in 1997 to a surplus of 5.7%. This raises the issue of France's industrial recovery. Should a major transfer take place from households to large companies for the purpose of a competitiveness shock or to redress business margins? There are many who advocate such a shock (including the MEDEF, but also the CFDT). This would reduce employers' social contributions (by at least 30 billion euros) and in return increase levies on households. The issue of France's industrial recovery is discussed in detail in the latest [Note de l'OFCE \(No. 24 of 30 October 2012\)](#).

It is out of the question to reduce the social security contributions of employees, as these finance only retirement and unemployment benefits, and thus contributory benefits that depend on the contributions paid and that cannot be financed through taxes. Only employer contributions intended for the family or health insurance can be reduced. And then it's necessary to find a substitute resource: VAT or the CSG wealth tax?

In fact, there is little difference between an increase in the CSG tax and an increase in VAT. In both cases, households will lose purchasing power. In the case of a VAT increase, this would involve higher prices. However, inflation is automatically reflected in the minimum wage and social benefits, and after wage bargaining, in salaries too, so any gain in business competitiveness / profitability is likely to be temporary unless indexing is suspended. In contrast, the

victims of a higher CSG would not enjoy automatic indexing mechanisms and would have to accept a reduction in purchasing power. Using the CSG thus makes for a more long-term option.

The big issue at the macroeconomic level is the reaction of companies, which will have to arbitrate between maintaining their prices to rebuild their margins or lowering their prices to become more competitive.

Let's imagine ourselves in a country with a GDP of 100 and exports and imports of 25. The share of wages (including employer contributions) and consumption is 80, and the share of profits and investment is 20. In the short run, wages and pensions are fixed. The reform consists of reducing the amount of employer contributions by 5 (*i.e.* 5% of GDP), while increasing the CSG tax by the same amount. Two scenarios can be adopted based on the pricing policy chosen by companies.

In the first case, the companies maintain their prices and increase their margins. There is no *ex post* gain in business competitiveness, but profitability rises. Wages suffer a loss of 6.25% of their purchasing power (*i.e.*  $5/80$ ). Will the revival in investment offset the fall in consumption? Let's use standard assumptions, *i.e.* a propensity to consume wages of 0.8 and to invest profits of 0.4, with a multiplier of 1. GDP falls in the short term by 2% and employment first drops and then eventually recovers due to the substitution of labour for capital. The measure is costly in terms of purchasing power, and higher employment is not ensured.

In the second case, the companies fully pass on the reduction in charges in their producer prices, which fall by 5%, with consumer prices decreasing by 4% (as the prices of imported goods remain stable). The purchasing power of wages is down by only 1%. The gains in competitiveness come to 5%. Will the gains in foreign trade offset the reduction in consumption? With a price elasticity of exports of 1 and of imports of 0.5, GDP increases by 1.25%. The measure is less painful.

## Should it be done?

The government needs to ask households to accept a reduction in their income, even though they have already lost 0.5% in purchasing power in 2012, consumption stagnated in 2011 and 2012, France is in a state of recession, and demand is already too low.

Should France adopt Germany's strategy: to gain competitiveness at the expense of household purchasing power, knowing that this strategy is a losing one at the level of the euro zone as a whole? Admittedly, this would replace the devaluation that is impossible today in the euro zone, but it would hurt our European partners (which could even respond, to our detriment) and it does not guarantee gains in competitiveness vis-à-vis countries outside the euro zone, which depends primarily on changes in the exchange rate for the euro. Nor would a measure like this replace a reform of the zone's economic policy. Finally, it takes time for gains in competitiveness to translate into renewed growth. For instance, from 2000 to 2005, French growth came to 7.8% (1.55% per year), and German growth to 2.7% (0.55% per year). Can France afford to lose another 5 percentage points of GDP?

France is in an intermediate position between the Northern countries which have made strong gains in competitiveness at the expense of purchasing power and the Southern countries which have experienced excessive wage increases. On a base of 100 in 2000, the level of real wages in 2011 was 97.9 in Germany and 111.2 in France (an increase of 1% per year, corresponding to trend gains in labour competitiveness). Who is wrong? Should we ask the employees in the euro zone countries, first one then another, to become more competitive than the employees of their partner countries by accepting wage cuts?

The margin of French companies was 29.6% in 1973. This fell to 23.1% in 1982, rebounded to 30.2% in 1987, and was 30.8% in

2006, *i.e.* a satisfactory level. The decline occurring since then (28.6% in 2011) can be explained by the drop-off in activity and the retention of labour. It was not caused by higher taxation nor by excessive wage increases. Overall, the share of profits has returned to a satisfactory level historically. But in 1973 gross fixed capital formation was around the level of profits, while it is lower by 3 points of added value today and the share of net dividends paid has increased significantly. What commitments would business make in terms of investment and employment in France in exchange for a measure that would greatly boost profits? How could companies be prevented from increasing their dividends or their investments abroad?

Making use of an internal devaluation like this implies that France is suffering primarily from a lack of price competitiveness. However, deindustrialization undoubtedly has other deeper causes. Companies prefer to develop in the emerging countries; young people are rejecting poorly paid industrial careers with an uncertain future; France is failing to protect its traditional industries or to develop in innovative sectors; the financial sector has favoured the joys of speculation over financing production and innovation; and so forth. All this will not be solved by an internal devaluation.

France needs a big industrial leap forward. It needs to carry out a different strategy: it is growth that must rebuild business margins, and it is industrial policy (via France's Public Bank Investment [the BPI], research tax credits, competitiveness clusters, support for innovative companies and for certain threatened sectors, and industrial planning) that must ensure an industrial recovery. This should be funded by the BPI, which needs to have sufficient capacity for action and specific criteria for its interventions.

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# Some precautions for reading the results of macroeconomic simulations: The case of social VAT

By [Eric Heyer](#)

In September 2007, the OFCE conducted simulations of the macroeconomic consequences of instituting a social value-added tax (VAT) using its `emod.fr` macroeconomic model. These simulations were discussed and published as an appendix to the Besson report on the subject. Nearly five years later, the government has decided to introduce a social VAT, so we asked Mathieu Plane and Xavier Timbeau to perform another round of simulations using the same model. The initial results were presented and discussed at a one-day workshop on the topic of taxation that took place at the Sciences-Politique Institute in Paris on 15 February. Why did we conduct new simulations, and how do they compare?

## 1. The measures simulated are different

There are a number of differences between the measure simulated in 2007 and the 2012 measure:

### *a. The shocks are on a different scale*

In 2007, the measure simulated involved a rise of 3.4 points in the nominal VAT rate, which was offset by an *ex ante* reduction in employer contributions of the same amount. The measure proposed by the government in 2012 represents a 1.6 point increase in the standard VAT, which corresponds to a 1.1

point increase in the effective rate (10.6 billion euros) and an increase in the CSG tax on capital income from 8.2% to 10.2%, which amounts to 2.6 billion. The additional 13.2 billion euros in revenue will fund the elimination of employers' "family" social security contributions. Comparing the results requires at a minimum calibrating the shocks so that they are on the same scale. As our model is linear, a simple rule of three can then reassess the impact of the measure in 2007 and compare it with that of 2012. As is shown in the Table summarizing the results of this recalibration, the impacts on employment of the two versions are very similar.

Impact on employment at 5 years of a "pure" social VAT:  
Shock of 2007 calibrated to the same scale as that of 2012

2007	Version (Besson report)	2012 Version
Employment effect	51 000	48 000

*b. The shocks are not the same type*

Unlike the simulations in 2007, besides the fact that there is a dose of CSG in its funding, the reduction in the cuts in contributions proposed by the government in 2012 is not uniform. It is targeted in particular at companies with employees who are paid at 1.5 to 2.1 times the minimum wage (SMIC), which has different sectoral impacts depending on the wage structure and on the impact on the relative cost of unskilled / skilled labour. The fact that it is focused on skilled workers whose labour cost is less elastic reduces the expected impact on employment of lowering labour costs. This effect will also be reduced by the potential substitution of unskilled labor by skilled more productive labour. While this kind of effect is well documented in the literature, our econometric macro model does not yet enable us to take this into account. Our model is in the process of being enhanced, which will at some point make it possible to refine our results.

## **2. The model used (*emod.fr*) evolves in the course of re-estimations**

Finally, it is necessary to keep in mind that macroeconomic models incorporate a certain number of estimated parameters, which can influence the results. This is the case in the simulation we are interested in of the elasticities of exports and imports to their prices and the elasticity of the substitution between capital and labor. However, the estimated value of these parameters is updated regularly to keep as close as possible to reality as captured by the national accounts. Thus, for example, the price elasticity of exports has changed considerably in recent years, from 0.57 to 0.31 between the version of the model used in 2007 and the 2012 model, meaning that any decline in price was less creative of activity and therefore of jobs.

In the next issue of the *Revue de l'OFCE* we will present all the results of our simulations in detail. We will also indicate the impact of a change in the value of the key elasticities on our assessments so that readers can better understand our revisions of the impacts.