The responsibility pact's obligation of a result

By Xavier Timbeau, @XTimbeau, OFCE

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Is the policy supply-side or demand-side? This debate takes us back decades to a time when the advocates of supply-side policy, Ronald Reagan and Margaret Thatcher, wanted to put Keynesian practices into the closet. With respect to the responsibility pact, the debate is moot. There is a clear diagnosis that companies are suffering from such low margin rates that their very survival is threatened. The losses of market share since the 2000s cannot be explained solely by the transition to a post-industrial society. It is thus a priority to boost corporate margins by whatever means necessary. But the restoration of business margins will not be sufficient to put them back on a path of increasing productivity, ensuring their competitiveness in the medium term. Getting back on this path will require numerous reforms, ranging from a better education system to a stable tax system that is as neutral as possible, while making use of the impact of agglomeration and specialization. Coordinating everyone's projects around a comprehensive strategy to make the energy transition is also a powerful instrument. But the responsibility pact remains silent on this.

To be clear, the responsibility pact aims to improve the situation of business, which could partially offset the decline in activity resulting from the 2008 crisis and the French economy's loss of competitiveness relative to its partners undergoing deflation (including Spain) or due to a rise in the euro. In so far as the pact is financed by taxes or spending cuts, this will constitute a tax depreciation, which will make consumers, employees and those on social benefits pay for the reduction in business costs. When the decrease in the cost of doing business is more focused on lower wages, then we can expect the creation of something like 130,000 jobs in five years, taking into account the financing (see for example the article by Heyer and Plane in the *revue de l'OFCE* no. 126). The counterparties, the support of the trade unions and the MEDEF employer association and the general mobilization around a shared bleak diagnosis, will not lead to the revolution that some expect, but it is part of the solution.

A fiscal devaluation at a time when the countries of southern Europe are flirting with deflation and everyone is chasing after a balanced current account, including by curbing domestic demand, will of course not lead the euro zone out of crisis, but instead keep it in prolonged stagnation. Fiscal devaluation is not the right policy for Europe. But so long as Europe has no path other than mass suicide, then fiscal devaluation is the logical response for France.

130,000 jobs will not be sufficient to reverse the trend in unemployment. In the face of the more than one million additional unemployed since 2008, it is downright derisory. But the responsibility pact could be something other than a fiscal devaluation. The obligation of a result, namely to reduce unemployment, does not leave much choice. For the responsibility pact to be accompanied by a significant reduction in unemployment, the key is not to finance it. The proposal to be made to our partners consists of laxity on our public deficit trajectory in exchange for reforms that everyone would consider structural. Public spending cuts, favourable taxation of business, the prioritization of competitiveness, are all measures that can generate some manoeuvring room.

France has made a commitment to Brussels to reduce its structural deficit by 50 billion euros. If this fiscal effort is made by 2017, almost 1 point of growth will be lopped off every year, and unemployment will virtually not decline at all by 2017. In fact, only the public deficit would be reduced, to 1.2 percent of GDP; this would open up very favourable prospects after 2017, since the public debt will fall without further budgetary cuts and therefore without hindering the decline in unemployment. It's a comfortable scenario for François Hollande's successor, assuming there is one, as they can even use the situation to lower taxes for the rich. With a combination of lower taxes, lower unemployment and a declining public debt, it will look like a "magician" has succeeded an "incompetent".

On the other hand, using the flexibility offered by the 50 billion euros, that is to say, renouncing the 50 billion goal for structural deficit reduction, would yield a very different result. Simulations at the OFCE indicate that unemployment could be cut by nearly 2 points by 2017. Admittedly, the structural deficit would remain unchanged, but the public deficit, what we see, would be on a downward trajectory: in 2017, it would come to just over 2 GDP points (against 4.2 points at end 2013), bringing the public debt into the region of a reduction in the debt-to-GDP ratio. The situation on the eve of the presidential election would be better, and the voting more open.

To develop this manoeuvring room, our partners (and the European Commission) need to be convinced of just how drastic the situation is. The results of the European elections are likely to remind them and make the obligation of a result clear to all.

Reagan had a great ability to look towards fiscal policy for the motor of his supply-side policy. He thus created the myth that lowering taxes on the rich is good for growth, with consequences for inequality that we are still seeing today. Thatcher believed until the end that reducing the public debt was the right policy. This merely prepared the ground for Tony Blair a few years later. This is the way that political cycles are made, based on results. In the same way, we are responsible for the long-term consequences of the choices we make today.

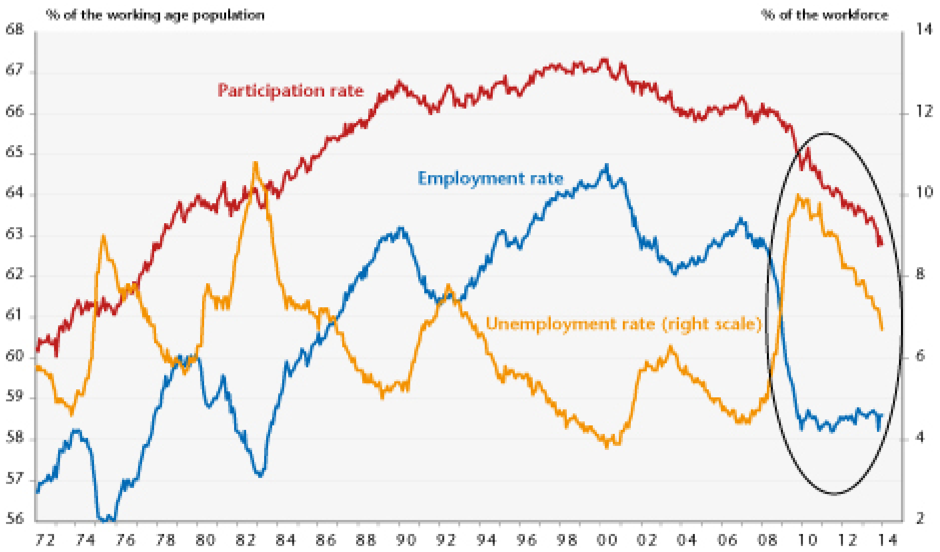
What’s masked by the fall in US unemployment rates

By Christine Rifflart

Despite the further decline in the US unemployment rate in December, data from the Bureau of Labor Statistics released last week confirms paradoxically that the American labour market is in poor health. The US unemployment rate fell by 0.3 percentage point from November (-1.2 points from December 2012) to end the year at 6.7%. The rate has fallen 3.3 percentage points from a record high in October 2009, and is coming closer and closer to the non-accelerating inflation rate of unemployment (NAIRU), which since 2010 has been set by the OECD at 6.1%. However, these results do not at all reflect a rebound in employment, but instead mask a further deterioration in the economic situation.

While the unemployment rate is the standard indicator for summarizing how tight a labour market is, this can also be considered using two other indicators, *i.e.* the employment rate and the labour force participation rate – in the US case, these give a different view of the state of the labour market (see chart).

US labour market



Source : Bureau of Labor Statistics.

After falling nearly 5 percentage points in 2008 and 2009, the employment rate has been constant for 4 years, at the level of the early 1980s (58.6%, following a peak of 63.4% at end 2006). Since then, the decline in the unemployment rate has reflected the decline in the participation rate, a trend that is confirmed by the figures for December. Over the period 2010-2013, the participation rate lost a little more than 2 percentage points, to wind up at end December at its lowest level since 1978 (62.8%, following a peak of 66.4% at end 2006).

This poor performance is due to insufficient job creation, which has a threefold impact. Despite positive GDP growth – which contrasts with the recession in the euro zone – demand is far from sufficient to reassure business and revitalize the labour market. After four years of recovery, at end 2013 employment has still not returned to its pre-crisis level. Net creation of salaried jobs in the private sector has not even been sufficient to absorb the demographic increase in the working age population. As a result, the employment rate is not improving from where it bottomed out.

Moreover, the difficulty in finding employment is encouraging the exit or delaying the entry or return of people who are old enough to participate in the labour market. This effect, familiar to economists, is called *effet de flexion* ("bending effect") in French: young people are encouraged to study longer, women stay at home after raising their children, and unemployed people become discouraged and stop looking for work. Despite the resumption of economic growth and job creation, this effect continued to be felt in full in 2013. While the reduction in the participation rate slowed in 2011 and 2012 – the growth of the labour force was once more positive but remained lower than that of the working-age population – it accelerated in 2013 with the decline in the labour force. During the second half of 2013, 885,000 people were in effect diverted away from the labour market, due in particular to the more difficult economic and social conditions.

Companies seem reluctant to rehire in the particularly difficult economic context. The fiscal shock in early 2013 depressed activity: GDP growth fell from 2.8% in 2012 to an expected level of about 1.8% in 2013. There will be additional fiscal adjustments in 2014. Beyond drastic cuts (related to sequestration [1]) in state spending, some exceptional measures that have been in force since 2008-2009 for the poorest households and the long-term unemployed (3.9 million out of the 10.4 million unemployed) are coming to an end and have not been renewed. According to estimates by the Centre on Budget and Policy Priorities (CBPP), 1.3 million unemployed who have exhausted their entitlement to basic benefits (26 weeks) and who have enjoyed an exceptional extension will find themselves without support as of 1 January 2014 due to the non- renewal of the measure, and nearly 5 million unemployed will be affected by the end of the year.

There is a risk of growing numbers of people falling into poverty in this situation. According to the Census Bureau, since 2010 the poverty rate has been about 15%. However, again according to the CBPP, unemployment benefits would have prevented 1.7 million people from falling below the poverty line. The greater difficulties facing the long-term unemployed and the withdrawal of part of the population from the labour market are the direct result of a morose labour market, which is not indicative of a continuous decline in the unemployment rate.

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[1] See America's fiscal headache written 9 December 2013.

The trend in unemployment: no reversal in sight

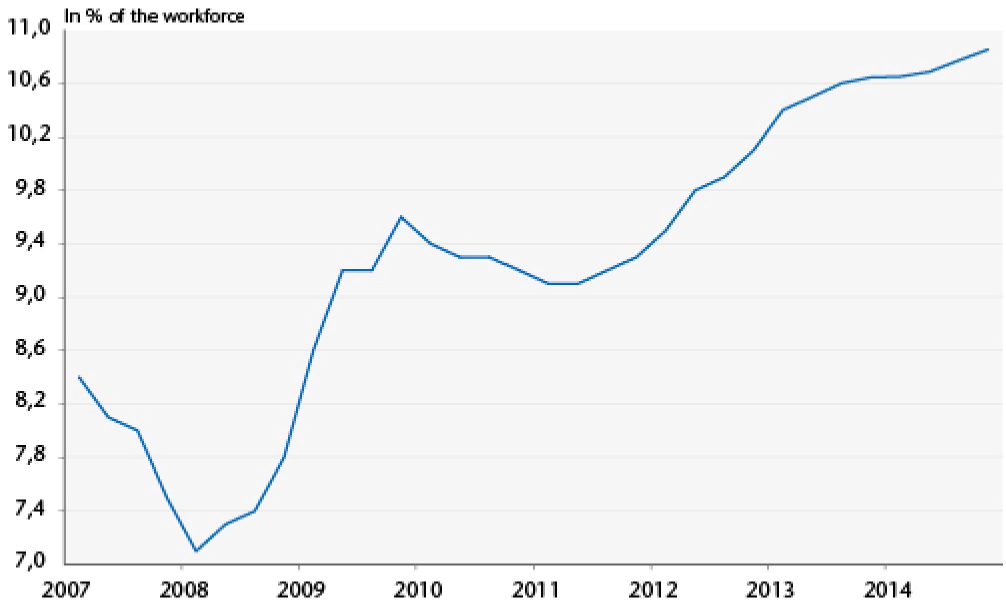
By Bruno Ducoudré

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

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

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

Figure 1. Unemployment rate (ILO definition)



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

The gradual introduction of Emplois d'avenir jobs has resulted in 31,566 hires between January and August 2013 in France. A total of 70,000 hires are expected in 2013 in mainland France and 70,000 more in 2014. There is, however, a deadweight loss for this type of programme: according to [Fontaine and Malherbet (2012)], 20% of the jobs created through the Emplois d'avenir scheme would have existed even in the absence of the subsidy. The net impact is thus expected to be 56,000 jobs created in 2013 and in 2014. The impact of this job creation will be especially important since these involve long-term contracts (1-3 years). People hired in 2013 will still be in their jobs in 2014, and the Emplois d'avenir jobs created in 2014 will indeed constitute net job creation.

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

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

Table. Employment and unemployment

Annual change, in thousands, at last quarter

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

* OFCE October 2013 forecast.
Sources INSEE and Ministry of Labour, OFCE forecasts.

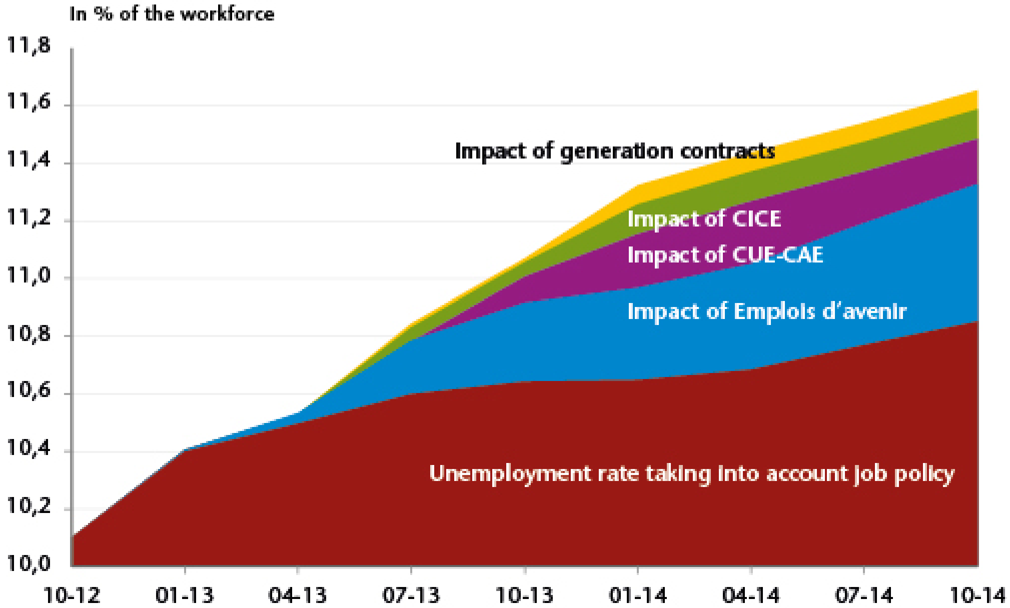
Total employment began rising again in 2014 (41,000 jobs), driven by the creation of subsidized jobs in the non-profit sector, but also by the expansion of the generation contract and CICE programmes. The CICE, which is open to all businesses, will be equivalent to 6% of payroll, excluding employer social security contributions, and corresponds to wages of less than 2.5 times the minimum wage (SMIC).

According to the assessment made by Mathieu Plane (2012) using the e- mod.fr model, the CICE will decrease labour costs in the private sector by on average 2.6%, which should result in the creation of jobs, both by promoting the substitution of labour for capital and through gains in competitiveness. In total, by 2018, five years after its establishment, the CICE will have created 152,000 jobs, thus lowering the unemployment rate by 0.6 percentage point. At the horizon of our forecast, it will have created 46,000 jobs, or half the government's forecast (91,000).

The generation contract covers unemployment among both younger (under age 26) and older workers (over 57). It consists of the creation of a permanent contract (CDI) for a young person, linked to the promise of non-dismissal of an older worker for a period of 5 years. In return for this commitment, the company will receive a lump sum grant of up to 4,000 euros per year for 3 years. This type of measure runs the risk of generating significant deadweight effects.[1] Overall, the measure will result in 99,000 new jobs in the private sector, with the signing of 500,000 generation contracts over the 5-year period. In September 2013, 10,000 generation contracts were signed. Under the assumption of a gradual ramp-up by the end of 2013 (20,000 contracts signed), with 100,000 contracts signed in 2014, this should correspond to the net creation of nearly 4,000 jobs in 2013 and about 20,000 jobs in 2014.

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

Figure 2. Impact of employment measures on the unemployment rate



Sources: INSEE, OFCE forecasts October 2013.

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

to labour costs is higher for low wages.

France-Germany: is there a demographic dividend?

By Vincent Touzé

Thanks to a high birth rate, France is aging less quickly than Germany. According to Eurostat, the French population is expected to exceed the German population by 2045. France could well become a European champion. But to what extent should we be talking about a demographic dividend?

The renewal of generations is of course important. It makes it possible to maintain a workforce that is large enough to meet the social costs (pensions, health care) of senior citizens, who are living longer and longer. In this sense, France should do better than Germany. But population growth also has its share of disadvantages. Indeed, in a context of scarce resources, the size of the population is primarily a factor that splits the amounts available per capita. For example, on a rationed labour market that is struggling to keep up the positions on offer due to problems with outlets and with production costs that are not competitive enough at the global level, growth in the labour force can also be counted in the numbers of unemployed. To avoid this, a more efficient labour market that is rooted in a thriving economy is essential. The demographic dividend depends as much on the productive capacity of new generations of workers as on their size.

The latest *Note of the OFCE* (no. 5, October 11, 2013) compares the relative performance of France and Germany over the period 2001-2012. This study shows how recent economic developments have been distinctly favourable to the German economy. Despite a glorious demographic future, France is mired in weak growth and mass unemployment that is hitting young people very hard. The demographic dividend is slow in coming.

The onset of deflation

By Xavier Timbeau

This text summarizes the April 2013 forecasts of the OFCE.

The global economic and financial crisis that began in late 2008 is now entering its fifth year. For the European Union, 2012 has been another year of recession, showing just how much the prospect of an end to the crisis, heralded so many times, has been contradicted by economic developments. Our forecasts for 2013 and 2014 can be summarized rather ominously: the developed countries will remain mired in a vicious circle of rising unemployment, protracted recession and growing doubts about the sustainability of public finances.

From 2010 to 2012, the fiscal measures already taken or announced have been unprecedented for the euro zone countries (-4.6% of GDP), the United Kingdom (-6% of GDP) and the United States (-4.7% of GDP). The fiscal adjustment in the US that has been long delayed but finally precipitated by the lack of political consensus between Democrats and Republicans will take place again in 2013 and 2014. In 2014, austerity in the euro zone will ease, although it will continue at an intense level in the countries still in deficit, which are also those with the highest fiscal multipliers.

In a context of high multipliers, the fiscal effort has a cost in terms of activity. This phrase, taken from Marco Buti, chief economist of the European Commission, sounds like both a confession and a euphemism – a confession, because the acknowledgement of the high value of the fiscal multipliers came late and was neglected too long; Olivier Blanchard and David Leigh recall that this problem led to systematic forecast errors and that these errors were much larger in countries in the worst situations undertaking the largest deficit reductions.

But the undervaluation of the multipliers also meant that the hopes accompanying deficit reduction were disappointed. The "unexpectedly" heavy impact of the austerity plans on activity has meant lower tax revenues, and thus a smaller reduction in the deficit. In attempting to meet their nominal deficit targets regardless of the cost, the States have only exacerbated the fiscal effort.

A confession like this might suggest that the error was inevitable and that the lesson has been drawn. This is not the case. First, since 2009, many voices were raised warning that the multipliers might be higher than in "normal times", that the possibility of the kind of expansive consolidation described and documented by Alberto Alesina was an illusion based on a misinterpretation of the data, and that there was a real risk of neglecting the impact of the fiscal consolidation on economic activity.

In October 2010, the IMF, under the impetus even then of Olivier Blanchard, described the risks of pursuing an overly brutal consolidation. The general awareness finally emerging in early 2013 reflected an acknowledgement of such a substantial accumulation of empirical evidence that the opposite view had become untenable. But the damage was done.

Nor was the lesson learned. According to the European Commission, the multipliers *were* high. [1] The use of the past tense reveals the new position of the European Commission: while the multiplier *were* high, they are now back to their pre-crisis value. This means that, according to the European Commission, the euro zone is again in a “normal” economic situation. The argument here is theoretical, not empirical. Normally, economic agents are “Ricardian” in the sense that Robert Barro has given this term. Agents can smooth their consumption and investment decisions and are not constrained by their income over the short-term. The multipliers would therefore be low or even zero. Fiscal consolidation (which is the name given to the unprecedented budgetary efforts made since 2010 in the euro zone) could therefore continue, this time without the hassles previously observed. This argument is undoubtedly relevant in theory, but its use in practice today is puzzling. It amounts to forgetting far too easily that we are in a situation of high unemployment, that long-term unemployment is increasing, that company balance sheets are still devastated by the loss of activity that started in 2008, and have never really recovered except in Germany, that the banks themselves are struggling to comply with accounting standards and that the IMF Managing Director, Christine Lagarde, has urged that some of them be closed. It means forgetting that the famous credit that is supposed to smooth consumption and investment has collapsed, *i.e.* amidst a rampant and powerful credit crunch. It means forgetting that in this era when the injunction to prefer the private sector over the public sector is stronger than ever, panic in the financial markets is leading savers and investment advisers to opt for investments in State sovereign bonds with yields of less than 2% at 10 years. And this is taking place despite downgrades by the credit rating agencies because these States are perceived (and “priced”, to use the jargon of the trading floors) as having the lowest risk. Such are the paradoxes of a time when one voluntarily submits to taxation by accepting negative real interest rates on investments and paying dearly for default insurance.

So if the confession seems belated and not to have had much impact on the dogma for escaping the crisis, it also involves a euphemism. For what are these costs that Marco Buti refers to? The price to be paid for an unavoidable financial situation? A hard time to get through before we return to a healthy future? It is by turning away from a detailed analysis of the risks run by continuing the current economic strategy, which has finally been acknowledged as having been incorrectly calibrated, that we miss what is most important. By pursuing the short-term goal of consolidation, while the fiscal multipliers are high, the conditions that make the fiscal multipliers high in the first place are maintained or even reinforced. The period of unemployment and underutilization of capacity are thus prolonged. This prevents the reduction of private debt, the starting point of the crisis, thus perpetuating it.

The fiscal effort has been disappointing in the short term, as the consequence of a high multiplier is that the deficit is reduced less than expected, or even not at all. Public debt in turn increases, as the effect of the denominator outweighs the slower growth of the numerator (see the iAGS report for a discussion and a simple formalization). There are numerous examples, the most recent of which was France, and the most spectacular Spain. But the disappointment is not just in the short term. The persistence of zero growth and a recession changes expectations about future growth: what was analyzed a few quarters ago as a cyclical deficit is now considered structural. The disappointment also modifies the future potential. The hysteresis effects in the labour market, the reduction in R&D, the delays with infrastructure and even, as can be seen now in Southern Europe, the cutbacks in education, in the fight against poverty and in the integration of immigrants all obscure the long-term outlook.

In 2013 and 2014, the developed countries will all continue their fiscal consolidation efforts. For some, this will mean the repetition and thus the accumulation of an unprecedented effort over five consecutive years. For Spain, this amounts to a cumulative fiscal effort of more than 8 percentage points of GDP! With few exceptions, unemployment will continue to rise in the developed countries, reaching a situation where involuntary unemployment exceeds the capacity of the national unemployment insurance systems to replace the lost employment income, especially since these systems are facing budget cuts themselves. In this context, wage deflation will kick off in the countries hit hardest. Since the euro zone has fixed exchange rates, this wage deflation will inevitably be transmitted to other countries. This will constitute a new lever perpetuating the crisis. As wages decrease, it becomes impossible for economic agents to access the financial system to smooth their economic decisions. The debts that have been targeted for reduction since the onset of the crisis will appreciate in real terms. Debt deflation will become the new vector of entrapment in the crisis.

There is, in this situation, a particularly specious argument to justify this conduct: that there was no alternative, *i.e.* that history was written before 2008 and that the errors in economic policy committed before the crisis made it inevitable, and above all that any other choice, such as postponing the consolidation of the public finances to a time when the fiscal multipliers were lower, was simply not possible. Market pressures and the need to restore lost credibility before 2008 made prompt action essential. If the actions carried out had not been carried out just as they were, then the worst would have happened. The euro would have collapsed, and defaults on public and private debt would have plunged the euro zone into a depression like that of the 1930s, or even worse. The great efforts undertaken made it possible to avert a disaster, and the result of these measures is, at the end of the day, quite encouraging. Such is the story.

But this argument ignores the risks being run today. Deflation, the prolongation of mass unemployment, the collapse of the welfare states, the discrediting of their policies, the undermining of consent to taxation, all carry the seeds of threats whose consequences can only be glimpsed today. Above all, this dismisses the alternative for the euro zone of exercising its sovereignty and demonstrating its solidarity. This argument is based on the idea that for the States fiscal discipline is to be exercised through the markets. It obscures the fact that the public debt and currency are inseparable. An alternative does exist; it requires that the public debt in the euro zone be pooled; it requires a leap towards a transfer of sovereignty; and it requires completing the European project.

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[1] "With fiscal multipliers higher than in normal times, the consolidation efforts have been costly in terms of output and employment", Marco Buti and Karl Pichelmann, ECFIN *Economic Brief Issue* 19, Feb. 2013, *European prosperity reloaded: an optimistic glance at EMU@20*.

France, Germany: The nonworking poor

By Guillaume Allègre

"The ways of thinking society, managing it and quantifying it

are indissolubly linked”

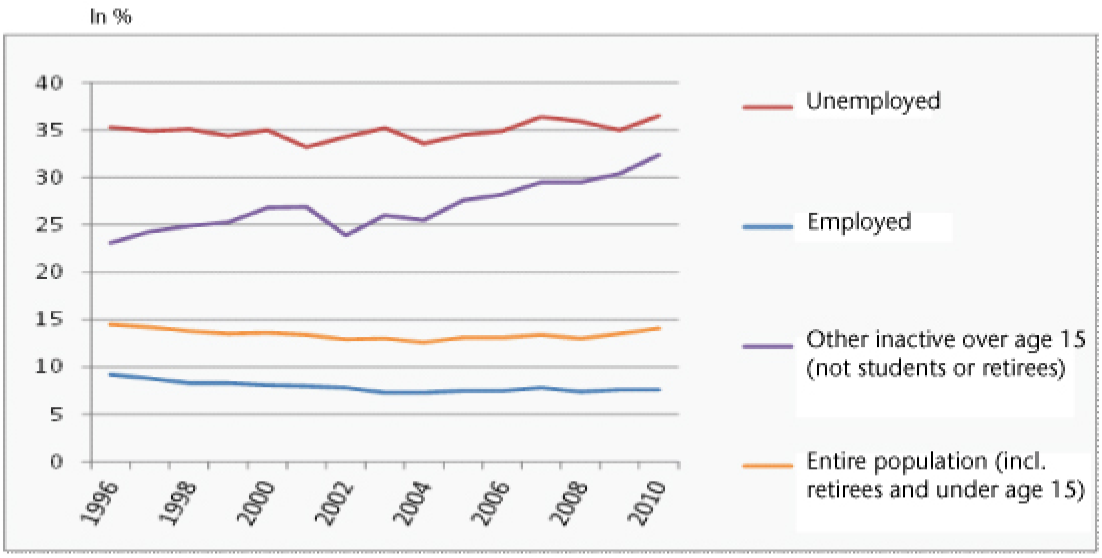
Alain Desrosières, 1940-2013

The subject of working poverty emerged in Europe in public debate and academic discussion in the early 2000s, in parallel with the implementation of policies to “make work pay”. European guidelines on employment have explicitly mentioned the need to reduce working poverty since 2003, and Eurostat set up an indicator on the working poor in 2005 (Bardone and Guio). In France, policies to make work pay have taken the particular form of earned income supplements (PPE, then RSA). In Germany, a series of reforms of the labour market and social welfare (the Hartz Laws) were introduced in the early 2000s with the aim of activating the unemployed. Critics of the German reforms often highlight the proliferation of atypical forms of employment (Alber and Heisig, 2011): the recourse to part-time, low-wage work and mini-jobs without social protection. In France as in Germany, this focus on workers has masked a less well-known aspect of the changing face of poverty: among working-age people, it is poverty among the unemployed (the “inactive” in France, the “unemployed” in Germany) that has been on the rise since the late 1990s.

Figure 1 shows the change in the poverty rate for individuals between 1996 and 2010, calculated at the threshold of 60% of the median living standard, according to their employment status. Two points stand out. First, poverty primarily affects the unemployed: their poverty rate was about 35% over this period. Second, economically inactive people over age 15, who are neither students nor retired (called “other inactive”), *i.e.* the “discouraged unemployed” and men and women (especially women!) in the home, are the group most affected by the rise in poverty. Their poverty rate was 23% in 1996, but hit 32% in 2010. At the same time, poverty among people in work fell from 9% to 8%. As a result, while the economically active with jobs accounted for 25% of the poor in 1996 and “other inactive” 12%, the latter’s share of the poor rose to

17% in 2010 while the share of the active declined to 22%. The weight of the working poor among all poor people is tending to decrease, while the weight of the inactive is rising.

Figure 1 : Poverty rates according to activity status, France



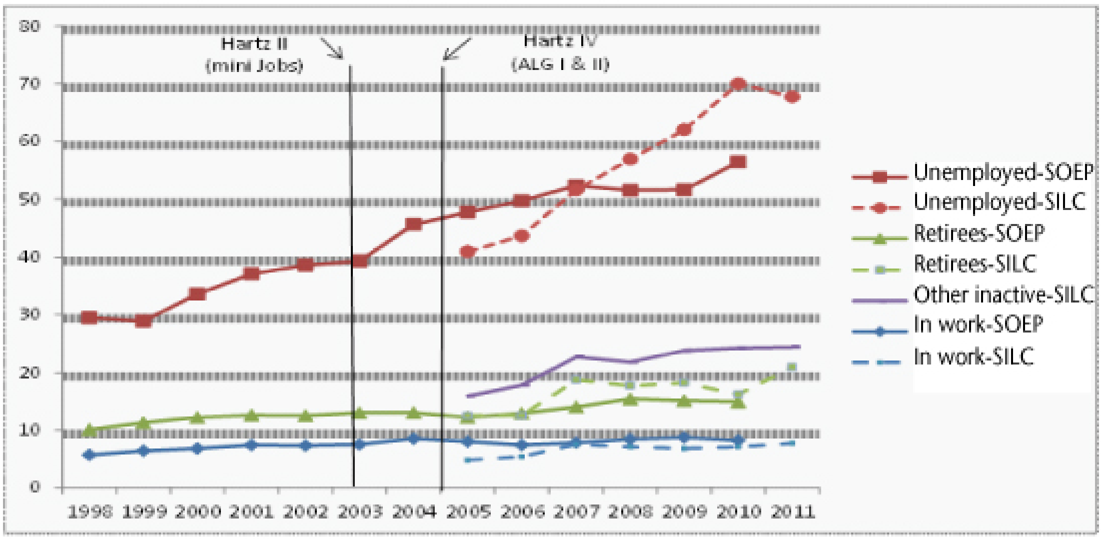
Source : Insee-DGI, Enquêtes Revenus fiscaux et sociaux rétropolées 1996 à 2004 ; Insee-DGFiP-Cnaf-Cnav-CCMSA, Enquêtes Revenus fiscaux et sociaux 2005 à 2010.

As for Germany, the analysis of poverty rates by employment status is fraught with discrepancies attributable to the sources, in particular with regard to changes in the poverty level among the unemployed, which according to Eurostat (EU-SILC survey) is much higher than in the national SOEP survey (see Figure 2). Despite the statistical uncertainties, it is still clear that poverty affects the unemployed above all, and that their poverty rate has risen substantially: from 30% to 56% between 1998 and 2010, according to the SOEP survey, which is generally considered more reliable than the SILC (Hauser, 2008). While poverty is increasing for all categories of the population (see Heyer, 2012), it is among the unemployed that it is most pronounced.

The increase in poverty among the jobless is the result of certain provisions of the Hartz IV laws, which are less well known than those establishing mini-jobs (Hartz II). Prior to this legislation, the jobless could receive unemployment benefits for a maximum period of 32 months, after which they could receive means-tested unemployment assistance for an indefinite period ([Ochel, 2005](#)). But unlike the ASS benefit [i] in France, the amount of this assistance depended on the net income at the last job and provided a relatively generous replacement rate (53% of net income for people without children). This system was replaced starting in 2005 by a much less generous compensation, based on the goal of employment activation. Unemployment benefit (*Arbeitslosengeld I* – ALG I) was limited to 12 months for unemployed people under age 55, and the grounds for penalties were expanded. Following this period, unemployment assistance (*Arbeitslosengeld II* – ALG II) is greatly reduced and essentially serves only as an ultimate safety net: the amount for a single person is limited to 345 euros per month, while the penalties have also been expanded and toughened [ii]. Germany's strategy to promote employment hence uses two levers: reducing income support for the unemployed, and penalties. While this policy may have contributed to lowering unemployment (see Chagny, 2008, for a discussion of the controversial impact of this reform), by its very design it has had a significant impact with regard to poverty among the unemployed.

Figure 2 : Poverty rates according to employment status and source, Germany

In %



Source : Eurostat (SILC) ; DIW (SOEP).

One paradox that needs to be examined is the only small change since the early 2000s (at least according to the SOEP survey) of the poverty rate among people in work. Indeed, during this period, the proportion of low-wage workers rose and the recourse to part-time work increased sharply, without a substantial rise in the poverty rate for people in work. In 2010, 4.9 million people (12% of people in work) held a mini-job for which they cannot receive more than 400 euros per month in earned income (Alber and Heisig, 2011). There has also been the growth of part-time work with social protection (from 3.9 million jobs in 2000 to 5.3 million in 2010). We would expect therefore to see an increase in working poverty. But this is being countered by two factors: the development of opportunities for cumulation with unemployment benefits (the third lever of the employment activation policy), and family solidarity. Indeed, part-time and low-wage jobs are predominantly held by women, who account for two-thirds of workers on low annual incomes [iii]. The income of their spouse, when they have one, often enables them to avoid poverty, as the income of all household members is aggregated to determine the standard of living and poverty. In this respect, to paraphrase Meulders and O’Dorchai, the household is a fig-leaf concealing women’s low incomes. Lone mothers, on the other hand, are especially affected by poverty: the poverty rate is about 40% among single-parent families.

From the perspective of the indicators, the use of the category “working poor” thus poses several problems. First, the category hides the role of unemployment and inactivity as determinants of poverty; by its very name, it highlights one important determinant of working poverty (“work doesn’t pay”) in relation to other determinants (“small number of hours worked” or “heavy family responsibilities”). Public policies based on this approach thus run the risk of limiting the population targeted by the fight against poverty (in France, people on unemployment benefit are excluded from the RSA-activité [income supplement for the working poor]) and of focusing on strengthening financial incentives for returning to work in order to stimulate the supply of labour, even though the high level of unemployment is related to the demand-side rationing of labour. Second, the category is blind to gender inequality: women are more often poor and constitute the majority of low-wage workers, but they are less likely to be working poor! (Ponthieux, 2004) If all that we manage well is what we measure, it is necessary that the measure be easily interpreted by policy makers. Reducing inequalities in living standards (between households) and in earned income (between individuals) are two legitimate public policy goals (as explained here [in French]), which need to be measured separately, just as these two goals require the use of specific instruments.

From the standpoint of public policy, the change in poverty based on employment status in France and Germany emphasizes that an effective fight against poverty requires addressing all forms of poverty. For the working-age population, in economies where dual-earner couples have become the norm, this means putting in place policies on full-time work and full employment policies that do not foster atypical forms of work. This requires, from a macroeconomic point of view, growth or job-sharing (and the associated income-sharing) and, from a microeconomic point of view, meeting needs with respect in particular to childcare, training and transport. While these policies are costly, more economical measures, such as strengthening financial incentives, have failed to demonstrate that they can actually reduce overall poverty.

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[i] The *Allocation de solidarité spécifique* (ASS), means-tested benefits paid to unemployed persons whose right to unemployment benefits has expired.

[ii] In total, 1.5 million penalties were applied in 2009, for 2.8 million on jobless benefits, compared with 360,000 in 2004, for 4 million on jobless benefits (according to Alber and Heisig, 2011, Tables 6-8, pp. 24-30).

[iii] Set at the threshold of two-thirds of median salary.

What monetary policy for the ECB in 2013?

By Paul Hubert

After the monthly meeting of the Board of Governors of the European Central Bank on 7 February 2013, the ECB decided to hold its key interest rate at 0.75%. The analysis of the economic situation by Mario Draghi made during the press conference afterwards pointed to contrasting developments justifying the status quo. In a recent study, we showed that the inflation forecasts of the ECB can shed new light on future trends in interest rates.

The status quo can be explained by a number of mutually offsetting factors. The banks have started to repay some of the cash obtained through the LTRO facility (140 billion euros out of 489 billion), which reflects an improvement in their financial position, while at the same time lending to non-financial firms is continuing to contract (-1.3% in December 2012) and consumer loans are still at very low levels.

From a macroeconomic viewpoint, the situation in the euro zone is not giving clear signals about future monetary policy: after shrinking by 0.2% in the second quarter of 2012, real GDP in the euro zone fell another 0.1% in the third quarter, while inflation, as measured on an annual basis, decreased from 2.6% in August 2012 to 2% in January 2013 and is expected to drop below the 2% mark in the coming months based on the figures for GDP growth and for current and anticipated oil prices.

Furthermore, the inflation expectations of private agents, as measured by the *Survey of Professional Forecasters*, remain firmly anchored around the ECB's inflation target. In the fourth quarter of 2012, expectations were for 1.9% inflation for the years 2013 and 2014. Given that the target of "below but close to 2%" has now been reached, and with a euro zone in recession and unemployment at record levels, the ECB could give a boost to real activity. However, it anticipates that economic activity should gradually pick up in the second half of 2013, partly due to the accommodative monetary policy being followed today.

Given expectations, and in light of the historically low levels of key interest rates and the lag in the transmission of monetary policy to the real economy [1], a future rate cut seems very unlikely. One final element is sending out mixed messages: the recent rise of the euro – though it is still far from record levels – could nip in the bud the weak economic recovery that is underway, and could in the eyes of some justify support for export sectors [2].

In a recent OFCE working paper (No. 2013-04), we discuss how the ECB could use its inflation forecasts to improve the implementation of its monetary policy. We propose a new element to shed light on future developments in interest rates, based on the macroeconomic projections published quarterly by the ECB. In this study on the effects of the publication of the ECB's inflation forecasts on the inflation expectations of private agents, we show that a 1 percentage point reduction in the ECB's inflation projections is associated with a key interest rate cut by the ECB of 1.2 percentage points in the next two quarters. We conclude that the ECB's inflation forecasts are a tool that helps to better understand current monetary policy decisions and to anticipate future decisions.

The latest inflation projections, published in December 2012, were 1.6% and 1.4% for the years 2013 and 2014, respectively.

The publication on March 7th of new projections could provide a further indication of the direction monetary policy is likely to take in 2013.

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[1] On average, a change in the key rates is estimated to have an impact on inflation after 12 months and on GDP after 18 months.

[2] Remember, however, that about 64% of trade in the euro zone is conducted with euro zone partners, and thus is independent of fluctuations in exchange rates.

Is the euro crisis over?

By Catherine Mathieu and Henri Sterdyniak

As of early 2013, it is possible to make two contrasting assessments of the crisis. On the one hand, the euro has survived. Europe's institutions and Member states have of course been slow and hesitant to react, and their reluctance has often fueled speculation. But its institutions have gradually managed to develop solidarity mechanisms, such as the European Financial Stability Facility and then the European Stability Mechanism, and they were able to impose strong fiscal discipline on Member states (strengthening the Stability and Growth Pact, adjustment programs, fiscal treaty).

The Member states have agreed to implement austerity policies and structural reforms. From the beginning of the crisis, the European Central Bank was willing to put in place unconventional policies, and it has supported the public debt of countries in difficulty by intervening in the secondary markets. It then undertook to commit unlimited resources to support countries in trouble that implemented satisfactory policies, which helped to reassure the financial markets and to lower risk premiums.

On the other hand, the euro zone has been unable to regain a satisfactory level of growth or to recover the 9 points of activity lost to the crisis. The Member states have been forced to implement austerity policies during a recession. According to the outlook of the Commission itself, the unemployment rate is expected to stay at about 11.8% in 2013. Imbalances between countries persist, even if they are somewhat mitigated by the deep depression that has engulfed the countries of southern Europe. The rigid standards that have been imposed on the Member states, with no real economic foundation, cannot replace the genuine coordination of economic policies. The solidarity mechanisms implemented are conditional on the loss of any autonomy and the introduction of drastic austerity policies. In the future, national policies will be paralyzed by European constraints and by the threats of the financial markets. Social Europe is not making progress, and, even worse, Europe is requiring countries in difficulty to call into question universal health care and to cut pension, unemployment and family benefits. Tax competition is continuing, and the crisis has not been seen as a time to challenge tax havens and tax evasion. While Europe is at the forefront of the fight against climate change, it is hesitating to make a robust commitment to the ecological transition. Although many countries in the area are suffering from continuing deindustrialization, no industrial policy has been implemented. A banking union will be established, but its content is not being democratically decided. The European authorities are persisting in a strategy – paralyzing national policies and imposing free market structural reforms – which has so far failed to boost growth and has made Europe unpopular. Europe is sorely lacking a socially unifying project, an economic strategy and a means of functioning democratically.

* Issue 127 of the "Debates et Politics" collection of the *Revue de l'OFCE*, which appeared in January, contains analyses that provide contrasting insights into the origins of the euro zone crisis and into strategies for resolving the crisis. This issue brings together twelve papers following the 9th EUROFRAME conference [1] in June 2012 on issues concerning the European Union's economic policy.

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[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

A recession is not inevitable

By Marion Cochard, Bruno Ducoudré and Danielle Schweisguth

The cold blast from the autumn forecasts continues with the publication of the European Central Bank's latest forecasts. Revising its growth outlook for the euro zone downwards (to -0.3% for 2013, against the forecast of 0.9% in September), the ECB in turn is now pointing to the reinforced austerity measures and the growing impact of uncertainty in the financial markets. It is clear that the intensity of the fiscal consolidation is paralyzing growth in the euro zone through the interplay of the fiscal multipliers, while not managing to restore confidence. In this note we show that the recessionary spiral that the euro zone is getting sucked into is not an inevitability.

In the first edition of the 2013 iAGS report, which was produced in partnership with the German IMK institute and the Danish ECLM institute, the OFCE offers an alternative strategy to the current fiscal consolidation policy. This alternative would make it possible to restore growth in the medium term while still meeting the European budget commitments. As Jérôme Creel showed in his latest post, "Could France have a different fiscal policy?", there is room for budgetary manoeuvring in a way that is consistent with the current treaty framework.

Under the aegis of the European Commission, the European countries have pledged to continue their austerity programmes from 2013 to 2015 on a relatively large scale, especially if we take into account the efforts already made. Apart from Germany, where the cumulative fiscal impulse will be virtually nil, most European countries are planning to reduce their primary structural deficit by more than 2 GDP points between 2012 and 2015 (from -1.4 points for Finland to -7.5 points for Greece, cf. the table).

Table. Cumulative fiscal impulses in the euro zone

In GDP points

	Germany	France	Italy	Spain	Netherlands	Belgium	Greece	Portugal	Ireland	Austria	Finland
2010-2012	0,1	-4,1	-4,7	-7,0	-2,3	-1,5	-18,3	-9,1	-8,3	-1,1	-3,3
2013-2015	-0,3	-2,9	-2,1	-4,2	-2,9	-2,2	-7,5	-2,6	-5,7	-1,8	-1,4

Source : Eurostat data, iAGS simulations.

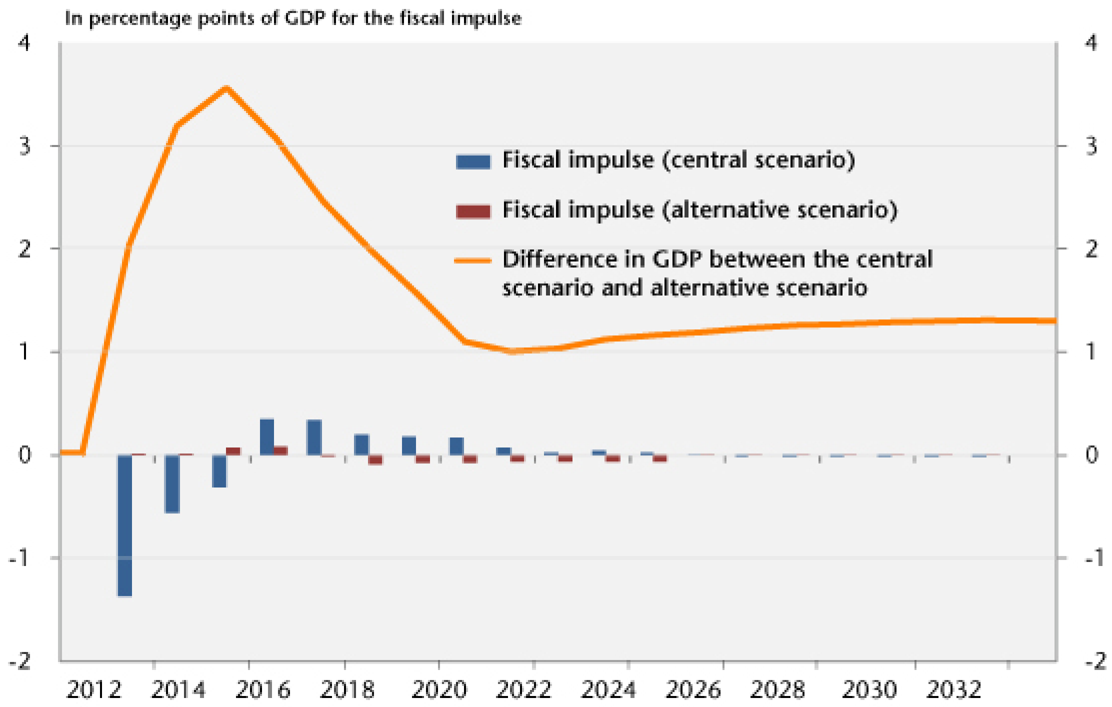
These adjustments are being undertaken in a very poor economic climate, which has been marked by austerity budgets from 2010 to 2012: growth in the euro zone will be -0.4% in 2012 and -0.3% in 2013. However, according to a series of recent theoretical and empirical studies[1], the fiscal multipliers turn upwards as the economic cycle heads downwards. In this context, the speed and magnitude of the fiscal adjustment is especially costly in terms of growth, and thus counter-productive in terms of the fiscal consolidation.[2] Encouraging a return to growth by easing the austerity would enable the economies of the euro zone to pull out of their recessionary spiral, which is marked by a steep rise in unemployment.

In order to develop this alternative strategy, we used the iAGS model to carry out simulations for the euro zone countries over a period of 20 years. These were conducted in two steps:

1. In our central scenario, we integrated the planned budget cuts announced by the various countries up to 2015. Starting from 2016, we calculated the fiscal impulses needed to achieve the 60% debt threshold by 2032, while limiting the size of these impulses to +/-0.5 GDP points per year. As shown in Figure 1 (central scenario), the structural adjustment carried out between 2010 and 2015 is significant enough in most countries to allow a relaxation of economic policy starting in 2016, while meeting the debt criterion by 2032.
2. For each country, we then decided on an alternative budget strategy by staggering the reduction of the structural deficit over time. This strategy consists in starting in 2013 with the implementation of fiscal impulses of a more limited amount in absolute value than those announced by the current governments (maximum +/-0.5 GDP points per year), and doing this until the adjustment is sufficient to achieve the debt target of 60% of GDP by 2032. This strategy leads to more measured

fiscal adjustment for the euro zone countries in difficulty and to slightly positive fiscal impulses in countries whose debt trajectory is in better shape (Germany, Finland, and Italy). For the zone as a whole, the fiscal impulse is almost zero in 2013 and 2014, with the bulk of the adjustment spread from 2017 to 2024.

Figure 1. Fiscal impulses and difference in GDP between the central and alternative scenarios

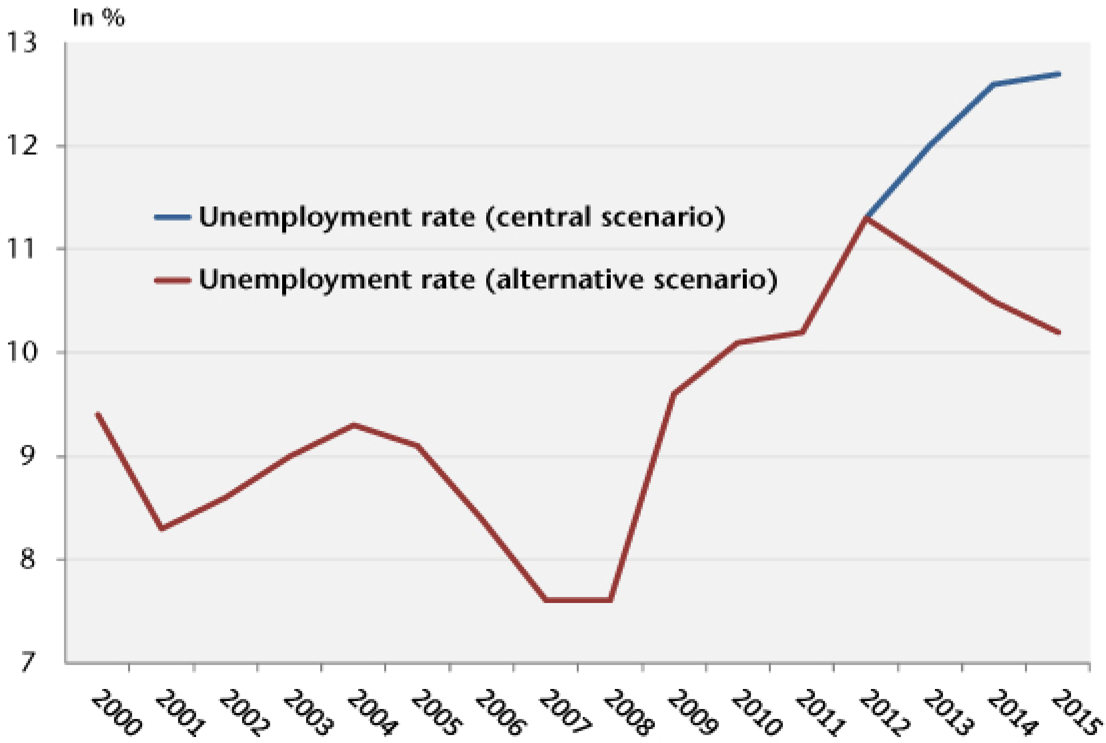


Source : iAGS, authors' calculation.

Figure 1 shows the difference in the level of GDP between the two scenarios. Limiting the size of the fiscal impulses helps to achieve a higher level of GDP and is compatible with a debt target of 60% of GDP by 2032 (alternative scenario). The effectiveness of the fiscal consolidation is enhanced when it is being conducted in an environment that is less unfavourable to the economy. This strategy achieves the same debt target with a cumulative fiscal adjustment that is 50 billion euros less than in the central scenario.

According to our calculations, the alternative scenario would restore a 2% growth rate in the euro zone in 2013, compared with -0.3% if the planned fiscal policies are carried out. The revival of activity would boost the labour market and help to turn around the unemployment rate in 2013, with a decline to 10.2% in 2015, compared with 12.8% if the austerity policies are continued, representing 3 million fewer unemployed people in 2015.

Graphique 2. Unemployment rate in the euro zone – Central and alternative scenarios



Source: Eurostat data, iAGS simulation.

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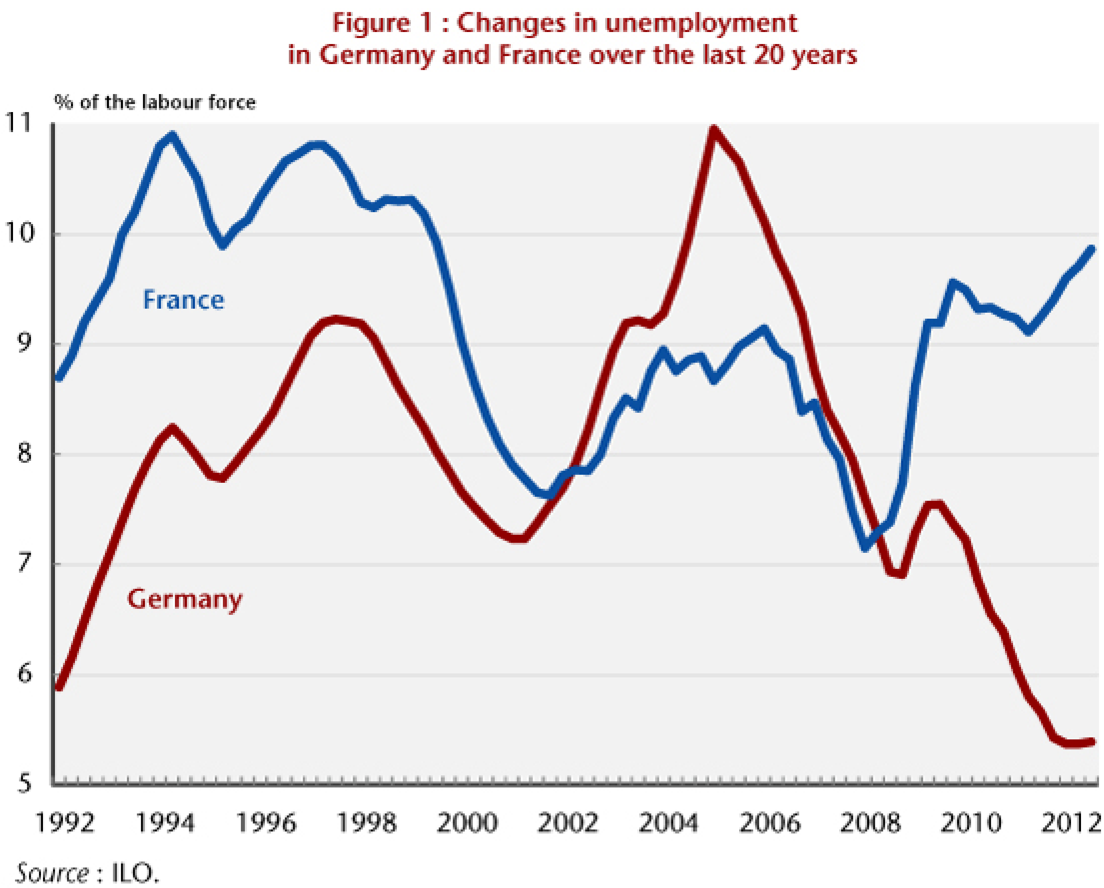
[1] A review of the recent literature on fiscal multipliers: size matters!

[2] What is the value of the fiscal multipliers today?

Higher unemployment in France, greater poverty in Germany

By Eric Heyer

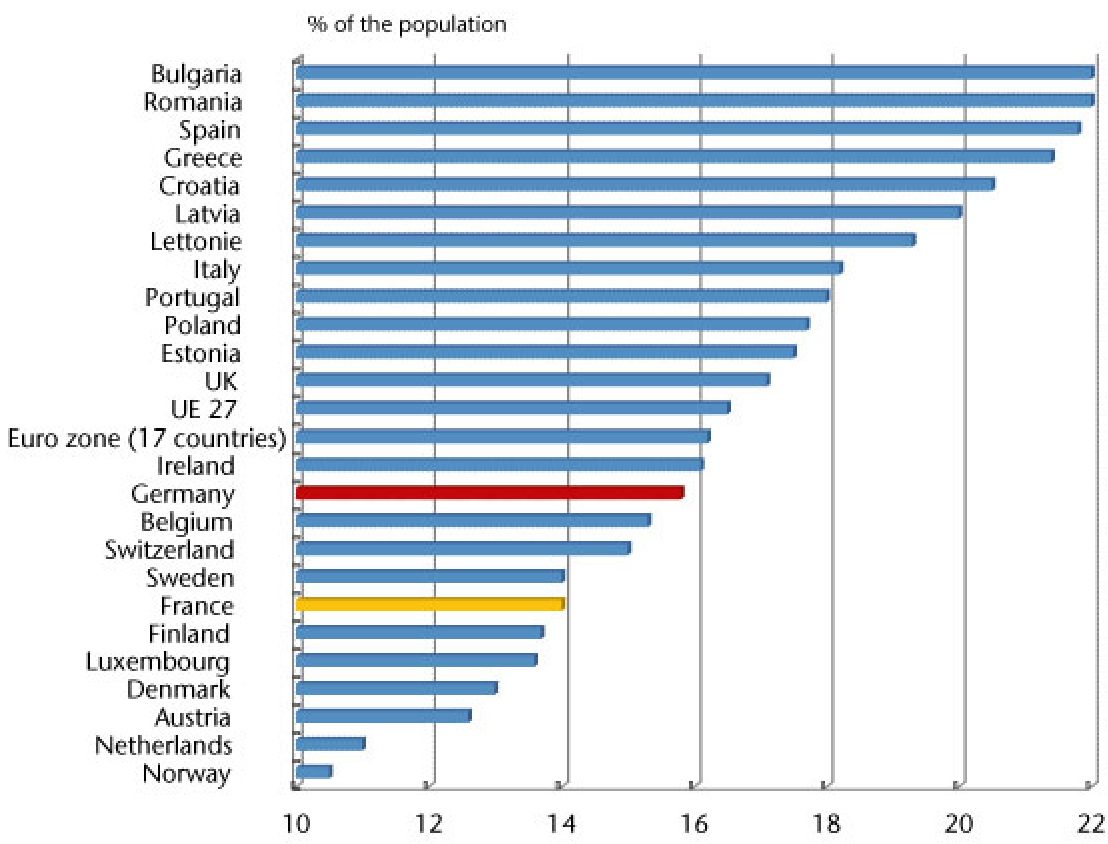
Will France be the new Greece, as *The Economist* has argued? Should French reforms be accelerated and be modelled on those implemented in Germany ten years ago? For German public opinion, for its authorities and for a large number of economic experts, the answer is obvious. Not only does Germany have a lower deficit, but unlike its French neighbour it has also managed to significantly reduce its unemployment rate. Starting from a similar level in the early 2000s (close to 7.7% at end 2001), the unemployment rate now stands at 5.4% of the labour force in Germany, 4.5 percentage points below the level in France (Figure 1).



The purpose of this note is not to revisit the reasons for this difference, which have already been the subject of posts on this blog (see in particular the impact of demography, by [G. Cornilleau](), of the reduction in working hours, by [E. Heyer and M. Plane](), and of the rise in male-female inequalities, by [H. Périvier]()). The point rather is simply to note that the reduction of unemployment in Germany has been accompanied by a steep rise in poverty.

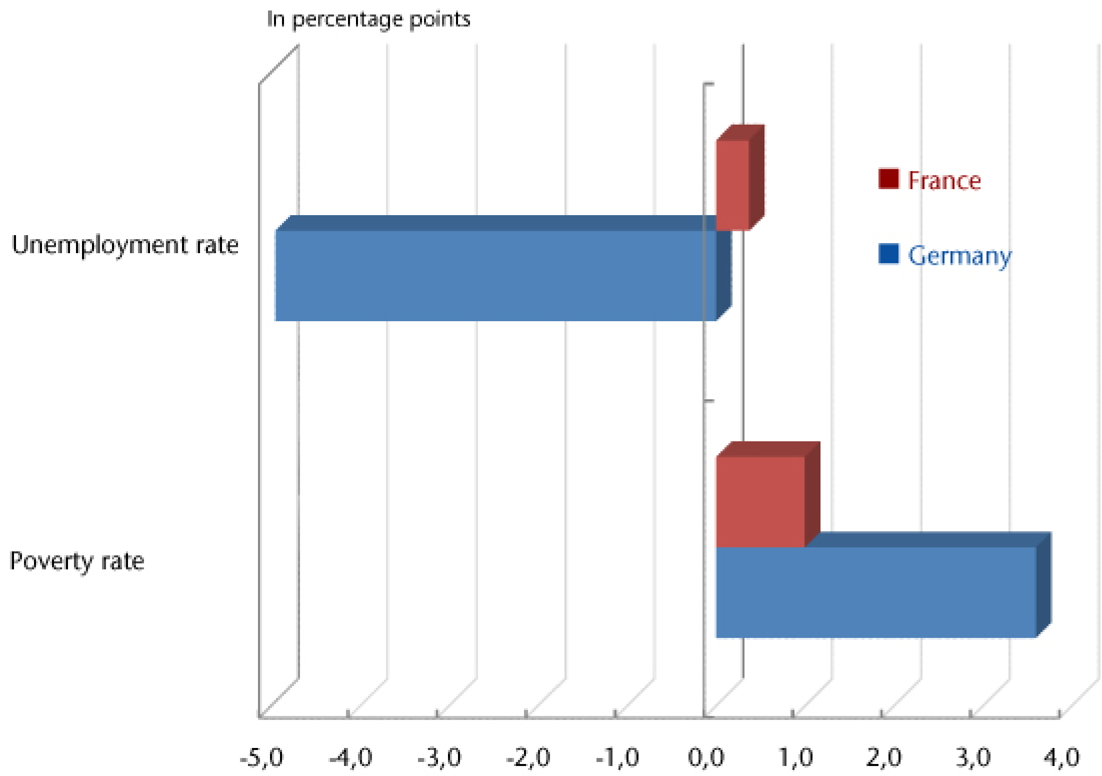
According to Eurostat, over the past six years the poverty rate (measured at the threshold of 60% of median income) has risen by 3.6 percentage points in Germany, four times more than the rise observed in France (0.9 point). In 2011, despite the sharp drop in unemployment and the large differential with France, the poverty rate in Germany was 1.8 points higher than the level observed in France, *i.e.* a difference of over 11% (Figures 2 & 3).

Graphique 2 : Poverty rate (60 % of median income) in 2011



Source : Eurostat.

Figure 3 : Changes in the unemployment rate and poverty rate (60 % of median income) in France and in Germany (2005-2011)



Source : Eurostat.

There is, therefore, a hidden side to the reforms implemented in Germany over the past ten years, which have led to lower unemployment but greater poverty.