

Never on Sunday?*

By [Xavier Timbeau](#)

** Note from the editor: This text was initially published on 10 June 2008 on the OFCE site under the heading "Clair & net" [Clear & net] at a time when working on Sundays was a burning issue. As this is once again a hot topic, we are republishing this text by Xavier Timbeau, which has not lost its relevance.*

[In Jules Dassin's cult film](#), Ilya, a prostitute working a port near Athens, never works on Sunday. Today, according to the *Enquête emploi* labour force survey, nearly one-third of French workers say they occasionally work on Sunday and nearly one out of six does so regularly. As in most countries, Sunday work is regulated by a complex and restrictive set of legislation (see [here](#)) and is limited to certain sectors (in France, the food trade, the hotel and catering industry, 24/7 non-stop manufacturing, health and safety, transport, certain tourist areas) or is subject to a municipal or prefectural authorization for a limited number of days per year. This legislation, which dates back more than a century, has already been widely adapted to the realities and needs of the times, but is regularly called into question.

The expectations of those who support Sunday work are for more business, more jobs and greater well-being. Practical experience indicates that revenue increases for retailers that are open Sundays. Conforama, Ikea, Leroy Merlin and traders in the Plan de Campagne area in the Bouches du Rhone *département* all agree. Up to 25% of their turnover is made on Sunday, a little less than Saturday. For these businesses, it seems clear that opening on Sunday leads to a substantial gain in activity. And more business means more jobs, and since there are also significant benefits for consumers, who meet less traffic as they travel to less congested stores, it would seem to be a "win-win" situation that only a few "dinosaurs" want

to fight on mere principle.

Nevertheless, some cold water needs to be thrown on the illusions of these traders. Opening one more day brings more business only if the competition is closed at that same time. This is as true for furniture, books, CDs or clothes as it is for baguettes. If all the stores that sell furniture or appliances are open 7 days a week, they will sell the same amount as if they are open 6 days a week. If only one of them is open on Sundays and its competitors are closed, it can then capture a significant market share. It is easier to purchase washing machines, televisions and furniture on a Sunday than on a weekday. So anyone who opens on their own will benefit greatly. But ultimately consumers buy children's rooms based on how many children they have, their age or the size of their home. They do not buy more just because they can do their shopping on Sunday. It is their income that will have the last word.

It is possible that a marginally larger number of books or furniture are sold through impulse buying on Sunday, if the retailers specializing in these items are open. But consumer budgets cannot really be stretched, so more spending here will be offset by less spending elsewhere. Year after year, new products, new reasons for spending, new commercial stimuli and new forms of distribution emerge, but these changes do not alter the constraints on consumers or their decisions.

In the case of business involving foreign tourists, who are passing through France, opening on Sunday could lead to an increase in sales. Tourists could spend less in another country or after they return home. But this positive impact is largely addressed by existing exemptions.

In 2003, the strict German legislation regulating retailer opening times was relaxed. This did not lead to any change in the population's consumption or savings (Figure 1). Value added, employment and payroll in the retail sector stayed on

the same trajectory (relative to the overall economy, see Figure 2). Opening longer does not mean consuming more.

The issue of Sunday opening is a matter of social time and its synchronization as well as consumer convenience and the freedom of the workforce to make real choices about their activities. Sunday work affects many employees, so expanding it is a societal choice, not a matter of economic efficiency.

Finally, the complexities of the legislation on Sunday work and its unstable character have led economic actors to adopt avoidance strategies. For example, in order to open on Sunday [Louis Vuitton](#) installed a bookstore (with travel books!) on the 5th floor of its Champs Elysées store (the other Louis Vuitton stores in Paris are closed on Sundays). Selling luxury bags thus became a cultural activity. Large food stores (which can open on Sunday morning) sell clothing and appliances, thus justifying other ways of working around restrictions by non-food retailers, who view this as unfair competition. These workarounds render the law unjust and distort competition with a legal bluff as cover.

Any change in the law should pursue the objective of clarification and not introduce new loopholes (as did the recent amendment of December 2007 to the [Chatel law of 3 January 2008](#) extending earlier exemptions to include the retail furniture trade).

Homer, a cultured American on a visit to Athens, attempted to save Ilya from her sordid fate by introducing her to art and literature. But Homer was acting on behalf of a pimp from the Athens docks who wanted to put an end to the free-spirited Ilya's subversive influence on the other prostitutes. When Ilya learned of this, she went back to her work: trading herself for money. Her dignity came from never doing it on Sunday.

Figure 1. Germany – Savings rate

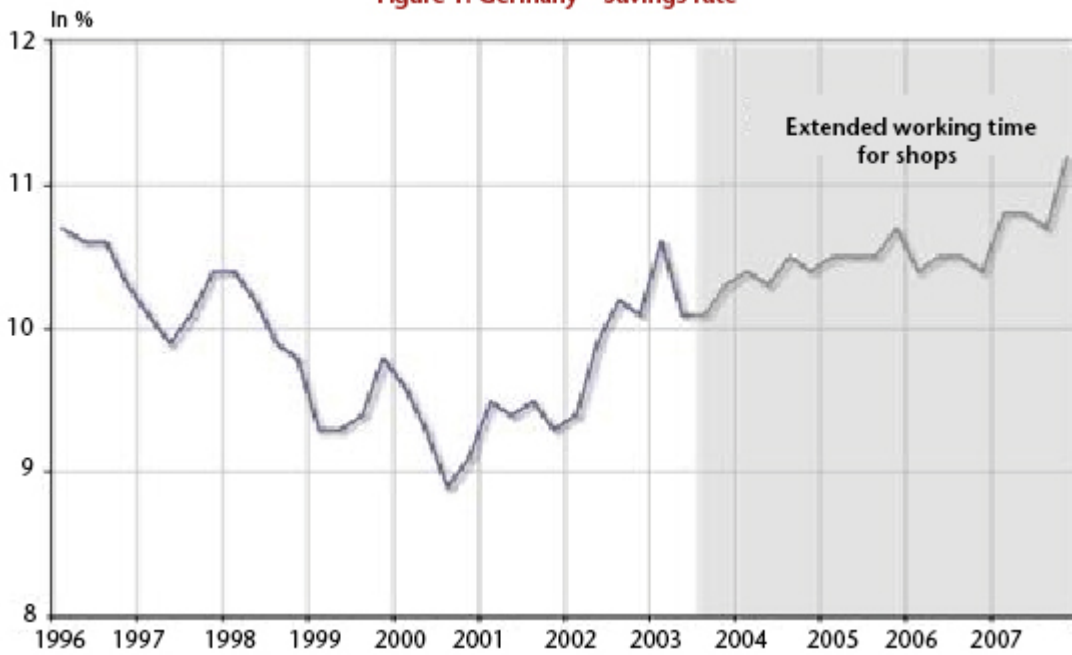
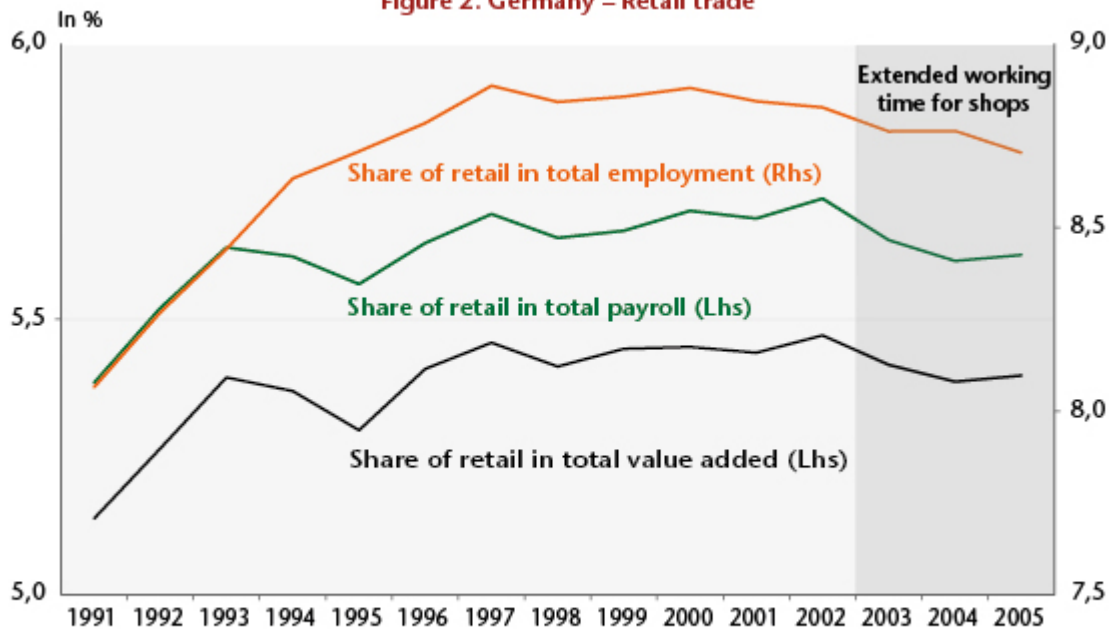


Figure 2. Germany – Retail trade



Sources : Annual accounts, Statistisches Bundesamt Deutschland. The savings rate is gross savings relative to gross disposable income. In the German classification, retailing is sector WZ-52. Author's calculations.

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.

[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*.

What is the value of the fiscal multipliers today?

By [Xavier Timbeau](#)

We inherited higher public deficits and greatly increased public debts from the crisis (Table 1). Reducing these will require a major fiscal effort. But a programme that is too brutal and too fast will depress activity and prolong the crisis, not only compromising the fiscal consolidation effort but also locking the economies into a recessionary spiral. The value of the fiscal multiplier (the link between fiscal policy and economic activity) both in the short term and in the long term is thus a critical parameter for stabilizing the public finances and returning to full employment.

Public deficit and public debt 2007-2012

<i>In GDP points</i>	Public deficit		Net public debt minus financial assets	
	2012	Change 2012-2007	2012	Change 2012-2007
DEU	-0.9	-1.1	52	9
FRA	-4.5	-1.7	66	31
ITA	-1.7	-0.1	96	9
ESP	-5.4	-7.3	54	37
NLD	-4.3	-4.4	43	15
BEL	-2.8	-2.7	82	9
PRT	-4.6	-1.4	81	32
IRL	-8.4	-8.5	82	82
GRC	-7.4	-0.6	134	52
AUT	-2.9	-1.9	48	17
Euro area (EA11)	-3.0	-2.3	63	20
GBR	-7.7	-4.9	74	46
USA	-8.3	-5.3	85	37
JPN	-9.9	-7.8	134	54

Source : OECD, *Economic outlook 91*.

When the multiplier (in the short term) is greater than approximately 2 (actually $1/a$, a being the sensitivity of the public deficit to the economic cycle and valued at about 0.5 in the developed countries), then fiscal cutbacks produce such a decrease in activity that the short-term deficit increases with the cuts. When the multiplier is greater than approximately 0.7 (in fact, $1/(a+d)$, d being the ratio of debt to GDP), then fiscal restraint increases ratio of debt to GDP in the short term. In the longer term, things get complicated, and only a detailed modelling can help to understand in what circumstances today fiscal restraint would lead to a sustained reduction in the debt-to-GDP ratio. The value of the multiplier in the medium term is of course crucial (it is usually assumed to be null, or zero, but in the case of cost-effective public investment, this assumption does not hold), but hysteresis effects as well as changes in expectations about inflation or about sovereign interest rates (and therefore the critical gap, *i.e.* the gap between 10-year sovereign bond rates and the economy's nominal potential

growth rate) interact with changes in the debt and in GDP.

Until recently, most economists believed that the value of the multiplier depends on the composition of the fiscal stimulus (taxes, expenditure and the nature of taxes and expenditure), the size of the economy and its openness (the more open the economy, the lower its multiplier) and the existence of anticipations of a fiscal shock (an anticipated shock would have little effect, in the long term, it would have none, with only an unexpected shock having a temporary effect)[1]. [Recent literature \(since 2009\) has taken an interest](#) in the value of the fiscal multiplier in the short term in times of crisis . Two main conclusions emerge:

1. The multiplier is higher in “times of crisis” (in the short term or as long as the crisis lasts). In “times of crisis” means high unemployment or a very wide output gap. Another symptom may be a situation where safe long-term interest rates are very low (*i.e.* negative in real terms), suggesting a flight to safety (radical uncertainty) or a liquidity trap (expectations of deflation). Two theoretical interpretations are consistent with these manifestations of the crisis. One, price expectations are moving toward deflation, or radical uncertainty makes it impossible to form an expectation, which is consistent with very low safe interest rates and leads to the paralysis of monetary policy. Or second, more economic agents (households, firms) are subject to short-term liquidity constraints, perpetuating the recessionary spiral and preventing monetary policy from functioning. In one case as in the other, the fiscal multipliers are higher than in normal times because the expansionary fiscal policy (resp. restrictive) forces the economic agents to take on debt (resp. shed debt) collectively instead of individually. In “times of crisis” the multiplier is in play including when it is anticipated and its effect persists until a

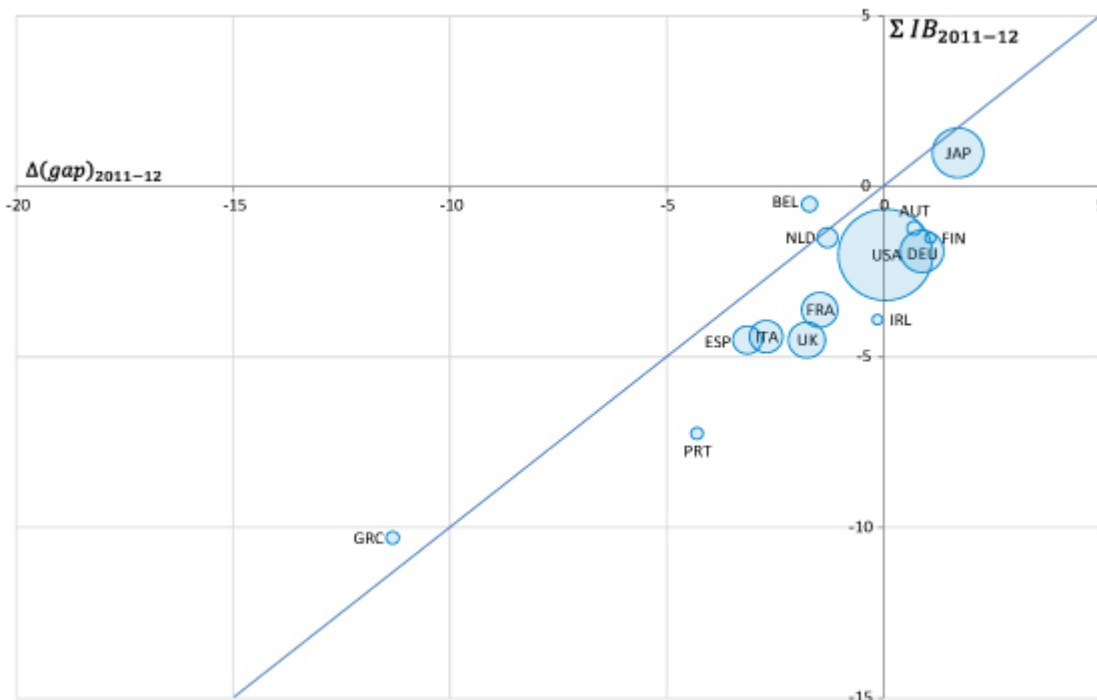
return to full employment.

2. The multiplier is higher for expenditures than it is for compulsory levies. The argument in normal times is that higher compulsory levies acts as a disincentive and spending cuts as an incentive on the supply of labour. In a small open economy, when monetary policy also induces a real depreciation of the currency, fiscal restraint can increase activity, a result that has long allowed supporters of fiscal discipline to promise all kinds of wonders. But in times of crisis, in addition to the fact that the multipliers are higher, the logic applicable in normal circumstances is reversed. The use of taxes as disincentives for the labour supply or spending cuts as incentives does not work in an economy dominated by involuntary unemployment or overcapacity. It is in fact the expectations of a recession or of deflation that act as disincentives, which is another factor indicating high multipliers.

Econometric estimates (based on past experience of “times of crisis”) lead to retaining a fiscal multiplier of around 1.5 (for an average mix of spending and compulsory levies).

Taking together 2011 and 2012, years in which a very strong fiscal impulse was carried out, confirms this econometric evaluation. By comparing on the one hand changes in the output gap from end 2010 to 2012 (on the abscissa) and on the other hand the cumulative fiscal impulse for 2011 and 2012, we obtain the short-term impact of the fiscal consolidation. Figure 1 depicts this relationship, showing a close link between fiscal restraint and economic slowdown.

Graphe 1 : Change in the output gap and the impulse 2011-2012



Source: OECD, *Economic Outlook 91*, June 2012. The year 2012 is a projection (OFCE forecast October 2012). The area of the bubbles is proportional to real GDP in 2011 (\$ PPP).

For most countries, the “apparent” multiplier is less than 1 (the lines connecting each of the bubbles are below the bisector, the “apparent” multiplier is the inverse of the slope of these lines). Figure 2 refines the evaluation. The changes in the output gap are in effect corrected for the “autonomous” dynamic of the closing of the output gap (if there had been no impulse, there would have been a closing of the output gap, which is estimated as taking place at the same rate as in the past) and for the impact of each country’s budget cutbacks on the others through the channel of foreign trade. The bubbles in orange therefore replace the blue bubbles, integrating these two opposing effects, which are evaluated here while seeking to minimize the value of the multipliers. In particular, because the output gaps have never been so extensive, it is possible that the gaps are closing faster than what has been observed in the last 30 or 40 years, which would justify a more dynamic counterfactual and therefore higher fiscal multipliers.

Austria and Germany are exceptions. As these two countries

enjoy a more favourable economic situation (lower unemployment, better business conditions), it is not surprising that the multiplier is lower there. Despite this, the “corrected apparent” multiplier is negative. This follows either from the paradoxical effects of the incentives, or more likely from the fact that monetary policy is more effective and that these two countries have escaped the liquidity trap. But the correction provided here does not take into account any stimulus from monetary policy.

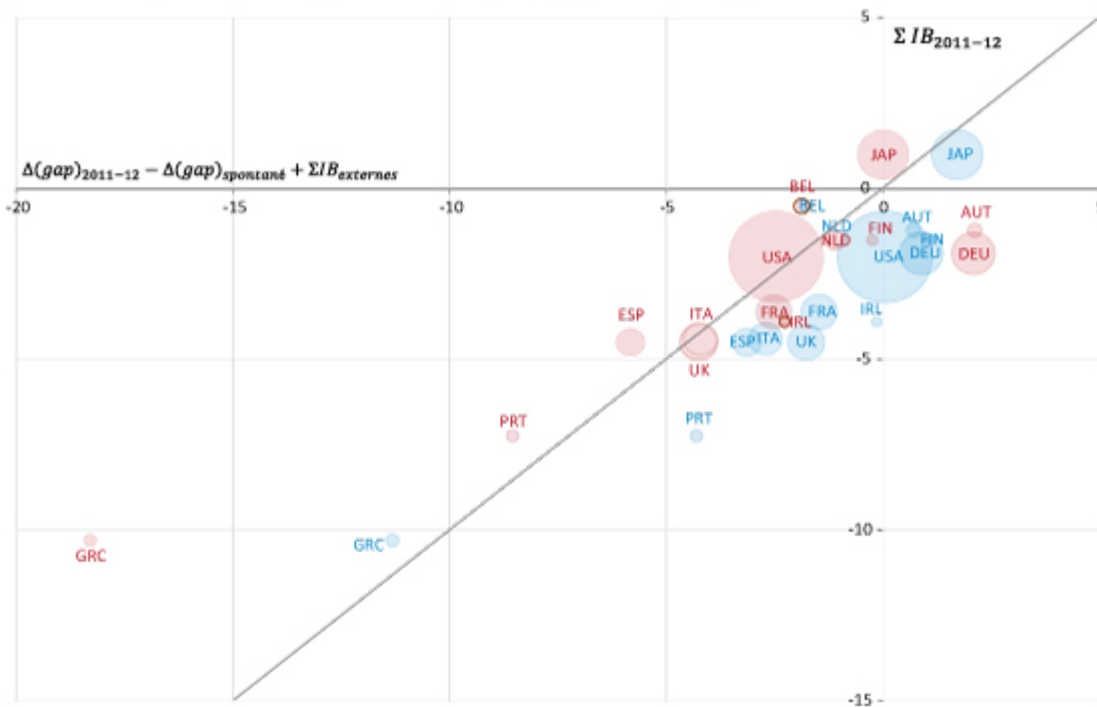
In the United States, the “2011-2012 corrected apparent” multiplier comes to 1. This “corrected apparent” multiplier is very high in Greece (~ 2), Spain (~ 1.3) and Portugal (~ 1.2), which is consistent with the hierarchy set out in point 1. This also suggests that if the economic situation deteriorates further, the value of the multipliers may increase, exacerbating the vicious circle of austerity.

For the euro zone as a whole, the “corrected apparent” multiplier results from the aggregation of “small open economies”. It is thus higher than the multiplier in each country, because it relates the impact of the fiscal policy in each country to the whole zone and no longer just to the country concerned. The aggregate multiplier for the euro zone also depends on the composition of the austerity package, but especially to the place where the measures are being implemented. However, the biggest fiscal impulses are being executed where the multipliers are highest or in the countries in the deepest crisis. The result is that the aggregate multiplier for the euro zone is 1.3, significantly higher than that derived from the US experience.

A comparison of the fiscal plans for 2011 and 2012 with the economic cycle in those years yields a high estimate for the fiscal multipliers. This confirms the dependence of the multiplier on the cycle and constitutes a serious argument against the austerity approach, which is to be continued in 2013. Everything indicates that we are in a situation where

[austerity is leading to disaster.](#)

Grphe 2 : Changes in the output gap and the impulse 2011-2012



Source: OECD, Economic Outlook 91, June 2012. The year 2012 is a projection (OFCE forecast October 2012). The area of the bubbles is proportional to real GDP in 2011 (\$ PPP).

[1] There has been an intense debate about the theoretical and especially the empirical validity of these assertions (see [Creel, Heyer and Plane 2011](#) and [Creel, Ducoudré, Mathieu and Sterdyniak 2005](#)). Recent empirical work undertaken for example by the IMF has contradicted the analyses made in the early 2000s, which concluded that anti-Keynesian effects dominate Keynesian effects. Thus, at least with regard to the short term, before the crisis and in “normal times”, the diagnosis today is that the fiscal multipliers are positive. The endogeneity of measurements of a fiscal impulse by simply varying the structural deficit interfered with the empirical analysis. The use of a narrative record of fiscal impulses addresses this issue and significantly alters estimates of the multipliers. In most macroeconomic models (including dynamic stochastic general equilibrium – DGSE – models), the fiscal

multipliers are also positive in the short term (on the order of 0.5 for a pure fiscal shock “in normal times”). In the long run, the empirical analysis does not tell us much, as the noise drowns out any possibility of measurement. The long term therefore reflects mainly an *a priori* theory that remains largely dominated by the idea that fiscal policy can have no long-term effect. However, in the case of public investment or of possible hysteresis, the assumption of a non-null effect in the long run seems more realistic.

Pigeons: how to tax entrepreneurial income? (2/2)

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

After having proposed in the [2013 Budget Bill](#) to tax gains from the sale of securities at the progressive scale used by France’s income tax, and no longer at a proportional rate of 19%, the government has now promised to correct its course, under the pressure of a group of entrepreneurs who rallied on the social networks under the hashtag #geonpi (“pigeons”, using French verlan slang, which inverts syllables). [An amendment proposed by the government](#) introduces an exemption from the income tax rate on the condition of a specified period of ownership (2 years), a percentage of ownership of the shares (10% of voting rights) and status as an employee or director. Entrepreneurs will thus remain subject to the proportional tax rate of 19%. [In a first post](#), we described how capital gains should be taxed in an equitable way with levies on income from work. In what conditions could

entrepreneurs and people with a significant stake in a company justify special treatment of their gains from the sale of securities?

At first glance, the joint taxation of capital income and labour income is particularly relevant for entrepreneurs, who can choose to pay themselves either in the form of wages or in the deferred form of capital gains. In this context, the neutrality of the tax is fair and effective in so far as it does not distort the entrepreneur's choice.

Advocates for the special treatment of entrepreneurship advance several arguments: (1) Entrepreneurship contributes a strong positive externality in terms of innovation, growth and employment. (2) Entrepreneurs are deserving (they work hard and take risks). (3) The risks taken by entrepreneurs cannot be diversified. They cannot offset their capital losses and gains, so the taxation of capital gains in itself reduces the *ex-ante* yield from entrepreneurship, and therefore the number of entrepreneurs, growth and employment.

The counter-arguments to this are:

(1) Income tax is a poor instrument for taking into account externalities: from this perspective, researchers, teachers, social workers, doctors, and in general all occupations in activities that produce externalities (health, education, culture, etc.) could claim a tax benefit (journalists have already managed to hold their own), so what is to be feared, in this context, is that the tax benefit reflects the level of influence rather than the economic externality.

(2) From the point of view of equity, there is no reason to treat labour income and the risky income of entrepreneurs differently. Young people without connections who engage in long-term studies also take a risk: like entrepreneurs, they forego an immediate wage income for an uncertain future income (they may fail in their studies or choose a poorly paid

career, etc.). The entrepreneur's income already takes into account the risk and the effort: it is because entrepreneurship is risky and demanding that it is potentially profitable. The government cannot – and should not – distinguish the share of income (labour or capital) that derives from risk, effort and talent from the share that is the fruit of chance, social networks and circumstance. Finally, taking risk into account by rewarding those who have the good fortune to emerge as winners (those with capital gains) reflects a peculiar vision of equity: in the presence of chance, equity advocates compensating the losers rather than adding to the rewards of the winners.

(3) In terms of efficiency, in the presence of a chance event, compensating the losers acts as insurance, which encourages risk-taking. Domar and Musgrave (1944) emphasized long ago that the proportional taxation of income from business encourages the taking of entrepreneurial risk. This result is based on the assumption of a negative income tax in the presence of losses, so that the State acts as a supportive partner. While this assumption is justified for large corporations that can consolidate the gains and losses of their subsidiaries and / or carry forward certain losses, it is less legitimate for entrepreneurs who cannot diversify the risks they take. The limited liability company, the limitation on the goods that the entrepreneur can pledge, the possibility of being able to refuse an inheritance so that any eventual debts (including tax and social charges) of entrepreneurs facing failure can then be wiped clean (whereas any eventual assets, if successful, may be transmitted) are all devices that favour individual risk-taking. A more favourable tax treatment for the allocation and carrying-forward of shortfalls and capital losses for entrepreneurs and individuals who hold a significant proportion of a company could enhance these opportunities and increase the incentives for entrepreneurship.

Entrepreneurs need to have the benefit of a legal and administrative environment that is simple and accessible. The authorities can strengthen the entrepreneurial ecosystem by bringing together entrepreneurs, financiers (in particular France's Public Investment Bank), incubators and research laboratories.

Ex-post, from the point of view of equity as well as efficiency, it is the entrepreneurs who fail, and not those who succeed, that must be helped via personal bankruptcy laws, unemployment compensation, and favourable tax systems for deductibility and carrying forward losses. Implicit subsidies for those who succeed, through income tax, while the potential rewards are already extremely large, are instead a form of social Darwinism.

Pigeons: how to tax capital gains (1/2)

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

After having proposed in the [2013 Budget Bill](#) to tax gains from the sale of securities at the progressive scale used by France's income tax, and no longer at a proportional rate of 19%, the government has now promised to correct its work under the pressure of a group of entrepreneurs who rallied on the social networks under the hashtag #geonpi ("pigeons", using French verlan slang, which inverts syllables). An [amendment to the Bill](#) was passed to this effect. Here we discuss the

equitable taxation of capital gains on securities. In a second post, we will discuss the specificity of entrepreneurship.

The Budget Bill reflects François Hollande's commitment to enact a major tax reform to make the contribution of each fairer: "capital income will be taxed just like work income" (Commitment 14 of the 60 commitments for France). When the capital results from the saving of employment income that was paid at a "normal" rate, taxing it poses the problem of double taxation and may seem questionable. Note, however, that in a financialized economy income from capital is not simply the result of saving, but also the direct result of an activity (see issue 122 of the special *revue de l'OFCE* issue on tax reform, and in particular Allègre, Plane and Timbeau on "Réformer la fiscalité du patrimoine? "Reforming wealth taxation"). In this sense, capital income derives from households' ability to pay, just as does labour income. The progressive tax on income must apply to all income, whether it comes from capital or labour, in order to respect the principle of horizontal equity, *i.e.* "on equal income, equal tax".

With respect to gains on disposal, only the change in the real value of the capital can be considered as income: if the value of a good has increased at the same rate as inflation, the nominal gain, even if positive, does not cover the implicit cost of ownership. The Bill provided that gains on disposals are entitled to an allowance based on the length of holding, which was copied from that applicable to real estate gains. The amendment reduces the durations of holding relative to the original text:

– the capital gains taxable at the income tax rate are reduced by an allowance equal to:

a) 20% of their value when the shares, units, rights or securities have been held for at least two years and less than four years at the date of sale;

b) 30% of their value when the stocks, units, rights or securities have been held for at least four years and less than six years at the date of sale;

c) 40% of their value when the stocks, units, rights or securities have been held for at least six years.

This type of allowance on the nominal capital gain is a poor instrument for taking account of inflation: if the variation of the real value of the capital is zero, then the tax should be zero (there is no real income), whereas an allowance will only reduce it; and on the contrary, if the change in the real value of the capital is much higher than inflation, then the allowance will be too favourable; the allowance is a fixed amount based on increments, while price rises are a continuous phenomenon. At least the allowance does not reach 100%, which is still the case for most real estate capital gains, which are totally exempt from gains on property that has been held 30 years. A good system would not apply an allowance to the nominal gain, but would actualize the purchase price using an index that reflects prices, which would make it possible to determine changes in the real value of the asset.

Examples: a good is purchased in January 2000 for 100. It is re-sold for 200 in January 2011. The nominal gain is 100. The allowance of 40% applies, and hence, in the system proposed by the government, the taxation would be on 60, and incorporated in the income tax. The variation in the real value of the capital is 79, which is the most reasonable basis for the taxation (we are not interested here in the rate of taxation, but the taxable base).

If, however, in January 2011 the property were re-sold for 120, the amount used by the allowance system would be 8, whereas the variation in the real value of the capital would be -1.

The following table shows the tax base according to the

allowance system and the change in the real value of the capital (in parentheses) based on the re-sale value and on the date of acquisition for a good acquired for a value of 100 and re-sold in 2012.

Year of purchase	1990	1995	2000	2005	2010	2012
Re-sale value						
110	6 (-36)	6 (-22)	6 (-14)	6 (-2)	8 (6)	10 (10)
150	30 (4)	30 (18)	30 (26)	30 (38)	40 (46)	50 (50)
200	60 (54)	60 (68)	60 (76)	60 (88)	80 (96)	100 (100)
250	90 (104)	90 (118)	90 (126)	90 (138)	120 (146)	150 (150)

Note on interpretation: For a good purchased at 100 in 1990 and resold at 110 in 2012, the tax base after deduction of 40% is 6 while the change in the real value of the capital is -36, given inflation. While the economic income is negative (there is a loss of purchasing power), with the allowance system the tax base increases. For a good purchased at 100 in 2005 and resold at 250 in 2012, the tax base after deduction is 90, while the change in the real value of the capital is 138: the allowance system is very favourable when the gain is large.

The tax base should be the capital gain after taking into account the inflation tax (variation in the real value of the capital). But this tax base should not be directly subject to a progressive tax scale. Gains on disposals are in fact deferred and should be subject to a charge equivalent to that on a regular income throughout the ownership period. Smoothing with a quotient that varies with the holding period deals with this point. This kind of system divides the income by the number of years held [1], applying the progressive scale to this "regular income equivalent", while adding the household's other income for the current year, then multiplying the increase in the tax related to the exceptional income by the number of years held [2]. An alternative is to tax the capital gains upon disposal at a constant rate equal to the principal marginal rate (30%, to which should be added the CSG wealth tax).

The following points need to be added to the comments above:

- General clearing systems between gains and losses over a long period (currently 10 years) make it possible to take into account risks and potential losses, at least for diversified investors;
- As income from employment can easily be converted into capital income (through various financial instruments and portage arrangements), aligning the two taxes could limit the temptations of tax optimization, which opens the door to tax avoidance;
- In this respect, an Exit Tax, based on the unrealized capital gains, could be used to minimize the interest of becoming a tax exile, which increases with accumulated gains and tax potential.

Donations, especially when they are made outside inheritance, should not be used to erase capital gains, as is currently the case. This provision, which was initially intended to avoid double taxation, can now be used to completely escape taxation.

[\[1\]](#) Based on the equivalence of tax treatment for a regular income and an exceptional income, it appears that the division is made using a coefficient that depends on the interest rate. In practice, for low interest rates, this coefficient is equal to the number of years of ownership.

[\[2\]](#) This calculation is equivalent to regular taxation over time if the household's current earnings are representative of its income (assuming regular income) for the duration of ownership and if the tax schedule is relatively stable.

The debacle of austerity

By [Xavier Timbeau](#)

This text summarizes [the OFCE's October 2012 forecasts](#).

The year 2012 is ending, with hopes for an end to the crisis disappointed. After a year marked by recession, the euro zone will go through another catastrophic year in 2013 (a -0.1% decline in GDP in 2013, after -0.5% in 2012, according to our forecasts – see the table). The UK is no exception to this trend, as it plunges deeper into crisis (-0.4% in 2012, 0.3% in 2013). In addition to the figures for economic growth, unemployment trends are another reminder of the gravity of the situation. With the exception of Germany and a few other developed countries, the Western economies have been hit by high unemployment that is persisting or, in the euro zone, even rising (the unemployment rate will reach 12% in the euro zone in 2013, up from 11.2% in the second quarter of 2012). This persistent unemployment is leading to a worsening situation for those who have lost their jobs, as some fall into the ranks of the long-term unemployed and face the exhaustion of their rights to compensation. Although the United States is experiencing more favourable economic growth than in the euro zone, its labour market clearly illustrates that the US economy is mired in the Great Recession.

Was this disaster, with the euro zone at its epicentre, an unforeseeable event? Is it some fatality that we have no choice but to accept, with no alternative but to bear the consequences? No – the return to recession in fact stems from a misdiagnosis and the inability of Europe's institutions to respond quickly to the dynamics of the crisis. This new downturn is the result of massive, exaggerated austerity

policies whose impacts have been underestimated. The determination to urgently rebalance the public finances and restore the credibility of the euro zone's economic management, regardless of the cost, has led to its opposite. To get out of this rut will require reversing Europe's economic policy.

The difficulty posed by the current situation originates in widening public deficits and swelling public debts, which reached record levels in 2012. Keep in mind, however, that the deficits and public debts were not the cause of the crisis of 2008-2009, but its consequence. To stop the recessionary spiral of 2008-2009, governments allowed the automatic stabilizers to work; they implemented stimulus plans, took steps to rescue the financial sector and socialized part of the private debt that threatened to destabilize the entire global financial system. This is what caused the deficits. The decision to socialize the problem reflected an effort to put a stop to the freefall.

The return to recession thus grew out of the difficulty of dealing with the socialization of private debt. Indeed, in the euro zone, each country is forced to deal with financing its deficit without control of its currency. The result is immediate: a beauty contest based on who has the most rigorous public finances is taking place between the euro zone countries. Each European economic agent is, with reason, seeking the most reliable support for its assets and is finding Germany's public debt to hold the greatest attraction. Other countries are therefore threatened in the long-term or even immediately by the drying up of their market financing. To attract capital, they must accept higher interest rates and urgently purge their public finances. But they are chasing after a sustainability that is disappearing with the recession when they seek to obtain this by means of austerity.

For countries that have control of their monetary policy, such as the United States or the United Kingdom, the situation is

different. There the national savings is exposed to a currency risk if it attempts to flee to other countries. In addition, the central bank acts as the lender of last resort. Inflation could ensue, but default on the debt is unthinkable. In contrast, in the euro zone default becomes a real possibility, and the only short-term shelter is Germany, because it will be the last country to collapse. But it too will inevitably collapse if all its partners collapse.

The solution to the crisis of 2008-2009 was therefore to socialize the private debts that had become unsustainable after the speculative bubbles burst. As for what follows, the solution is then to absorb these now public debts without causing the kind of panic that we were able to contain in the summer of 2009. Two conditions are necessary. The first condition is to provide a guarantee that there will be no default on any public debt, neither partial nor complete. This guarantee can be given in the euro zone only by some form of pooling the public debt. The mechanism announced by the ECB in September 2012, the Outright Monetary Transaction (OMT), makes it possible to envisage this kind of pooling. There is, however, a possible contradiction. In effect this mechanism conditions the purchase of debt securities (and thus pooling them through the balance sheet of the ECB) on acceptance of a fiscal consolidation plan. But Spain, which needs this mechanism in order to escape the pressure of the markets, does not want to enter the OMT on just any conditions. Relief from the pressure of the markets is only worthwhile if it makes it possible to break out of the vicious circle of austerity.

The lack of preparation of Europe's institutions for a financial crisis has been compounded by an error in understanding the way its economies function. At the heart of this error is an incorrect assessment of the value of the multipliers used to measure the impact of fiscal consolidation policies on economic activity. By underestimating the fiscal multipliers, Europe's governments thought they could rapidly

and safely re-balance their public finances through quick, violent austerity measures. Influenced by an extensive economic literature that even suggests that austerity could be a source of economic growth, they engaged in a program of unprecedented fiscal restraint.

Today, however, as is illustrated by the dramatic revisions by the [IMF](#) and the [European Commission](#), the fiscal multipliers are much larger, since the economies are experiencing situations of prolonged involuntary unemployment. A variety of empirical evidence is converging to show this, from an analysis of the forecast errors to the calculation of the multipliers from the performances recorded in 2011 and estimated for 2012 ([see the full text of our October 2012 forecast](#)). We therefore believe that the multiplier for the euro zone as a whole in 2012 is 1.6, which is comparable to the assessments for the United States and the United Kingdom.

Thus, the second condition for the recovery of the public finances is a realistic estimate of the multiplier effect. Higher multipliers mean a greater impact of fiscal restraint on the public finances and, consequently, a lower impact on deficit reduction. It is this bad combination that is the source of the austerity-fuelled debacle that is undermining any prospect of re-balancing the public finances. Spain once again perfectly illustrates where taking this relentless logic to absurd lengths leads: an economy where a quarter of the population is unemployed, and which is now risking political and social disintegration.

But the existence of this high multiplier also shows how to break austerity's vicious circle. Instead of trying to reduce the public deficit quickly and at any cost, what is needed is to let the economy get back to a state where the multipliers are lower and have regained their usual configuration. The point therefore is to postpone the fiscal adjustment to a time when unemployment has fallen significantly so that fiscal restraint can have the impact that it should.

Delaying the adjustment assumes that the market pressure has been contained by a central bank that provides the necessary guarantees for the public debt. It also assumes that the interest rate on the debt is as low as possible so as to ensure the participation of the stakeholders who ultimately will benefit from sustainable public finances. It also implies that in the euro zone the pooling of the sovereign debt is associated with some form of control over the long-term sustainability of the public finances of each Member State, *i.e.* a partial abandonment of national sovereignty that in any case has become inoperative, in favour of a supranational sovereignty which alone is able to generate the new manoeuvring room that will make it possible to end the crisis.

OFCE growth forecasts, October 12

Annual growth in GDP, %

	2011	2012	2013
Euro zone	1,5	-0,5	-0,1
Germany	3,1	0,8	0,6
France	1,7	0,1	0,0
Italy	0,5	-2,4	-1,1
Spain	0,4	-1,4	-1,2
Netherlands	1,1	-0,2	0,3
Belgium	1,8	-0,1	0,9
Finland	2,8	0,8	1,1
Austria	2,7	1,0	0,5
Portugal	-1,7	-2,8	-1,2
Greece	-6,2	-6,2	-3,7
Ireland	0,8	-0,4	-0,1
United Kingdom	0,9	-0,4	0,3
United States	1,8	2,2	0,9
Japan	-0,7	2,4	1,3

Sources : National calculations, OFCE forecasts October 2012.

Must we choose between saving

the planet and exiting the crisis?

By [Xavier Timbeau](#)

It is up to our generation and those that follow to find a way for 10 billion people to live decently and sustainably on a planet with finite resources and capacities. As a decent standard of living requires a mode of consumption closer to that of our Western societies than the deprivation that afflicts a large part of the world's inhabitants, the task is immense – but failure is unacceptable. All this requires us to curb climate change, to anticipate falling agricultural yields, to prepare for the impact of rising sea levels, to adapt, and to halt the destruction of biomass and biodiversity while taking into account the depletion of natural resources, whether renewable or not. The list of constraints is long, and unfortunately it does not stop with these few examples (the interested reader can profit from reading the [OFCE's previous work](#) on this subject).

Yet the crisis facing the developed countries ([the Great Recession](#)) is often put in opposition to the environmental emergency, suggesting that any ethical concern for integrating human society into the limits imposed by the environment is a luxury that we can no longer afford. As we are obliged either to hope for a return to growth or to prepare the liquidation of our economies, *décroissance*, or de-growth, out of a concern for nature would be an idle fantasy, an option that only the most idealistic – and thus someone freed from the constraints of reality – could take “seriously”. How could societies that are experiencing record rates of unemployment, which need to get back to work in order to absorb the excesses of yesteryear (!), societies threatened moreover by emerging powers that will hasten the decline of anyone who fails to comply with the rules of the new world – how could they allow themselves to

become absorbed in saving the planet?

The idea that these two priorities (ending the crisis, saving the planet) have themselves to be prioritized (one realistic, the other idealistic) is a very poor way of addressing the challenge of our times. It can only lead to bad policies, to increasing the future cost of the environmental realism so necessary today and prolonging the economic crisis we are going through again and again. Three arguments are often advanced that lead to neglecting environmental issues in favour of economic issues. These arguments are especially questionable.

The first argument is that the solution to the environmental issue has to be postponed – but it can't be. Indeed, and as an example, the capacity of the global ecosystem to absorb carbon dioxide has long been exceeded. Continuing to emit carbon because oil is cheaper than other energy sources [\[1\]](#) on the pretext that there is no other choice is a dead end. Every time a gas plant is built (shale or not), it has to be worked (to be profitable) at least 50 years. But after 10 years we will take fright at the level of carbon emissions and realize that climate change is threatening not just our comfort, but the very survival of the human species, and it will be obvious that we must reduce CO₂ emissions. So in addition to new investments to change the way we consume energy, it will then be necessary to add the scrapping of the still-unprofitable gas plant. Putting off doing what is needed does not save money – on the contrary, it increases the cost, simply because the environmental constraints cannot be put off. This is currently the diagnosis, for example, even of the [International Energy Agency](#), hardly a den of hard-core ecologists. To stop the planet's climate from heating up by more than 2°C (relative to the pre-industrial era), it is necessary to immediately take the path of reducing CO₂ emissions by around 2t of CO₂ per year per capita (down to 5 to 10 times less than current emissions in the developed

countries). Not doing this today means investing in poor solutions that will have to be mothballed before they have become profitable, and resigning ourselves to limiting the increase in the planet's temperature to 3°C or even more. It therefore means paying more for a worse level of climate stabilization that will then cost even more to adapt. Making the reduction of public debt the priority on behalf of future generations is completely hypocritical if it is done at the expense of future generations. In other words, investing in the decarbonisation of the economy, if it is done well, would have a future social profitability well above interest rates on the public debt. Not doing this means impoverishing future generations. Not doing this because cash constraints prohibit it amounts to a denial that we will not be able to justify to future generations.

The second argument is that we are not rich enough to be able to save the planet. Complying with environmental requirements and implementing solutions to reduce our impact on the environment would impoverish us, with very few exceptions, at least at first [2]. What was once cheap (e.g. producing energy with reserves accumulated underground over millions of years) would now be done with more work and more infrastructure or capital (and thus more work to produce the capital), and thus in a way that is generally less efficient. Designing products that can be recycled completely, and producing and recycling them so that the materials that compose them can be *indefinitely* reused so as not to tap into the stock of the planet's finite resources, will require more work, more energy (and thus more work) and more capital (and thus more work). Choosing to take the path of respect for the environment thus means less consumption (final consumption, or, if you prefer, fewer services from consumption or a decrease in the flow of material well-being drawn from consumption). But that does not mean a decline in production, or even less a decline in domestic production. Greater concern for the environment will mean a fall in productivity and living standards, but it will

also mean job creation (this is the simple corollary). But what happens when jobs are created by reducing productivity in a situation of massive underemployment? It may, though this is not certain, reduce inequality and unemployment. The negative overall effect on income could be compensated for part of the population by the impact on inequality. Since escaping from the rarities of resources (e.g. oil) reduces (or in an extreme case eliminates) the rents associated with those rarities, a reduction in inequality means in particular the primacy of work over property. This is how we can reconcile a reduction in inequality with the environmental transition. Less wealth is consumed, but there is less unemployment, provided that we take the opportunity offered by the environmental transition to reduce inequality, and not just by means of social tariffs but also by the creation of new production.

The third argument frequently advanced is the constraint of international competition. Since our competitors do not choose to respect the environment, their costs remain low. If we insist on burdening our companies with additional environmental costs (taxes, quotas, standards, right-to-pollute contracts), not only do we lose competitiveness and thereby destroy economic activity and employment, but furthermore, because these activities will be relocated to areas where pollution or CO2 emissions are "authorized", while the environmental degradation will not recur in our country, it will in others, and will thus ultimately increase. In short, the environmental ideal is incompatible with the harsh laws of globalization. Yet it is this argument that is deeply naive and off target, and not the environmental imperative. There are two types of possible answers, both fully compatible with globalization as it is now [little] regulated. The first involves cooperation through applying the same rules on larger and larger spaces. The European Union and its carbon market is one example. This space can be extended, as was tried by the Kyoto Protocol or as is evidenced by the recent cooperation between the European Union and Australia. But such cooperation

cannot be established on a stable basis if there is no possibility of coercion. The second possible answer is thus the environmental tax on imports, which is legitimate under the WTO agreements (protection of the environment is one of the few reasons for an exception to the principle of untaxed free trade). It should be noted, for there to be no doubt about the environmental motivation for this, that the proceeds of such import taxes should be redistributed at least in part to the countries sending the imports, or even reserved for environmental investments. This would remove any suspicion that this is a protectionist tax; it would help promote environmental issues in the developing countries; it would provide a concrete response to the notion of the North's ecological debt vis-à-vis the South; and it would be neutral when establishing an environmental tax system or a market for emissions rights in the countries concerned. It would also make it possible to retain an international division of labour (and the trade flows that go with it), which is a source of productivity and of a better allocation of capital that is still necessary to deal with all the constraints that we need to respect.

The environmental challenge and finding an exit to the crisis are issues that converge, not conflict. The first cannot be postponed without major costs or irreversible damage. The levers to act on the environment must be the same as those that will help put an end to the crisis, in particular because they reduce inequality and increase employment. There is still the issue of the public debt and the need for more manoeuvring room in the future. But submission to cash constraints ("I have to repay my debts right now or I'll collapse") amounts to the panic of a rabbit caught in the headlights of the car that is about to crush it. Yet this is exactly the kind of fiscal strategy that we are endeavouring to follow. And it is this that is inconsistent with the concern for future generations and for the environment.

[1] Just like trying to become a little more competitive by exploiting shale gas because it is twice as cheap as average oil, while in the end, and despite the more advantageous ratio of energy to carbon emitted, it leads to more emissions.

[2] Subsequently, the environmental constraints will stimulate the technical progress that will ultimately raise our overall productivity again.

Friends of acronyms, here comes the OMT

By [Jérôme Creel](#) and [Xavier Timbeau](#)

We had the OMD with its Orchestral Manœuvres in the Dark, and now the OMT with its Orchestral Manœuvres in the [liquidity] Trap, or more precisely, “Outright Monetary Transactions”, which is undoubtedly clearer. The OMT is a potentially effective mechanism that gives the European Central Bank (ECB) the means to intervene massively in the euro zone debt crisis so as to limit the differences between interest rates on euro zone government bonds. The possibility that a country that comes into conflict with its peers might leave the euro zone still exists, but if there is a common desire to preserve the euro then the ECB can intervene and play a role comparable to that of the central banks of other major states. Opening this door towards an escape route from the euro zone’s sovereign debt crisis has given rise to great hope. Nevertheless, certain elements, such as conditionality, could quickly pose

problems.

The OMT is simply a programme for the buyback of government bonds by the European Central Bank, like SMP 1.0 (the Securities Markets Programme) which it replaces but limited to States that are subject to a European Financial Stability Fund / European Stability Mechanism (EFSF / ESM) programme and thus benefiting from European conditional aid. For the ECB to intervene, the country concerned must first negotiate a macroeconomic adjustment plan with the European Commission and the European Council, and apply it. The ECB, potentially members of the European Parliament or the IMF can be a party to this (these institutions – the Commission, the ECB and the IMF – form the Troika of men in black, so famous and feared in Greece). Secondly, and more importantly, the country will be under the supervision of the Troika thereafter.

So if Italy and Spain want to benefit from the purchase of their bonds by the ECB, then their governments will have to submit to an EFSF or ESM adjustment programme. This does not necessarily imply that the plan imposed will be more drastic in terms of austerity than what these governments might have already devised or implemented (the doctrinaire approach in the management of public finances is highly contagious in Europe), but it will require the two countries to submit *ex ante* to outside scrutiny of any adjustment plan they develop and *ex post* to control by the Commission and the Council. If the country under surveillance starts *ex post* to veer away from implementing the adjustment plan, then it could, of course, withdraw from the programme, but its sovereign bonds would no longer be covered by OMTs. They would lose the support of their peers and would thus sail into the financial markets in uncharted waters. That would probably be the first step towards a default or an exit from the euro.

Furthermore, the ECB has not committed itself to absorbing all the bonds issued and thus maintains a real threat capacity: if the country were to rebel, it could be obliged to face higher

rates. The OMT thus introduces both a carrot (lower rates) and a stick (to let the rates rise, sell the bonds the ECB holds in its portfolio and thereby push rates upward), upon each new issue. The OMT is therefore akin to being put under direct control (conditionality) with progressive sanctions and an ultimate threat (exiting the programme).

The ECB says that its interventions will mainly cover medium-term securities (maturity between 1 and 3 years), without excluding longer-term maturities, and with no quantitative limits. Note that short / medium-term emissions *usually* represent a small proportion of total emissions, which tend to be for 10 years. However, in case of a crisis, intervention on short-term maturities provides a breath of fresh air, especially as maturing 10-year securities can be refinanced by 3-year ones. This gives the Troika additional leverage in terms of conditionality: the OMT commitment on securities is only for three years and must be renewed after three years. The financial relief for countries subject to the programme may be significant in the short term. For example, in 2012 Spain, which has not yet taken this step, will have issued around 180 billion euros of debt. If the OMT had reduced Spain's sovereign borrowing rates throughout 2012, the gain would have amounted to between 7 and 9 billion for the year (and this could be repeated in 2013 and 2014, at least). This is because, instead of a 10-year rate of 7%, Spain could be benefitting from the 2% rate at which France borrows for 10 years, or instead of its 4.3% rate at 3 years, Spain could have borrowed at 0.3% (France's 3-year sovereign rate). This is the maximum gain that can be expected from this programme, but it is significant: this roughly represents the equivalent of the budgetary impact of the recent VAT hike in Spain (or a little less than one Spanish GDP point). This would not alter Spain's fiscal situation definitively, but it would end the complete nonsense that saw Spaniards paying much more for their debt to compensate their creditors for a default that they have been striving arduously not to trigger.

It can even be hoped (as can be seen in the easing of Spanish sovereign rates by almost one point following the ECB announcement on Thursday, 6 September 2012, or the almost half a point reduction in Italian rates) that the mere existence of this mechanism, even if Spain or Italy do not use it (and thus do not submit to control), will be enough to reassure the markets, to convince them that there will be no default or exit from the euro and therefore no justification for a risk premium.

The ECB announced that it would terminate its preferred creditor status for the securities. This provision, which had been intended to reduce the risk to the ECB, led to downgrading the quality of securities held outside the ECB and thus reducing the impact of ECB interventions on rates. By acquiring a government bond, the ECB shifted the risk onto the bonds held by the private sector, since in case of a default the Bank was a preferred creditor that took priority over private holders of bonds of the same type.

The ECB explained that its OMT operations will be fully sterilized (the impact on the liquidity in circulation will be neutral), which, if it is taken at its word, implies that other types of operations (purchases of private securities, lending to banks) will be reduced correspondingly. What do we make of this? The example of the SMP 1.0 can be drawn on in this regard. SMP 1.0 was indeed also accompanied by sterilization. This sterilization involved short-term deposits (1 week, on the ECB's liabilities side), allocated in an amount equal to the sums involved in the SMP (209 billion euros to date, on the ECB's assets side). Each week, the ECB therefore collects 209 billion euros in short-term fixed-term deposits. This is therefore a portion of bank deposits that the ECB assigns to the sterilization instrument, without there being sterilization in the strict sense (because this does not prevent an increase in the size of the ECB's balance sheet nor does it reduce the potential liquidity in circulation). The

mention of sterilization in the OMT appears to be an effort at presenting this in a way that can convince certain states, such as Germany, that this monetary policy will not be inflationary and therefore not contrary to the mandate imposed on the Bank by the Treaty on the European Union. Currently, and because the crisis remains unresolved, private banks have substantial deposits with the ECB (out of fear of entrusting these deposits to other financial institutions), which gives it considerable flexibility to prevent the announced sterilization from affecting the liquidity in circulation (the ECB has a little more than 300 billion euros in deposits that are not mobilized for sterilization). The ECB can then probably use the current accounts (by blocking them for a week), which poses no difficulty since the ECB lends to the banks on tap through long-term refinancing operations (LTROs). At worst, the ECB would lose money in the sterilization operation in case of a gap in compensation between the fixed-term deposits and the loans granted to banks. Sterilization could therefore lead to this kind of absurd accounting, but wind up, in a situation of monetary and financial crisis, having no impact on liquidity. On the other hand, if the situation normalizes, the constraint of sterilization would weigh more heavily. We're not there yet, but when we do get there, the ECB needs to limit lending to the economy or to accept an increase in liquidity if the OMT continues to be implemented for some euro zone members.

The deal that is now on the table places the euro zone countries in a formidable dilemma. On the one hand, acceptance of the Treaty on Stability, Coordination and Governance of the euro zone (TSCG) determines eligibility for the EFSF and the ESM [\[1\]](#), and therefore now determines eligibility for the OMT programme. Refusing to sign the fiscal treaty means rejecting in advance the potential intervention of the ECB, and thus accepting that the crisis continues until the breakup of the euro zone or until a catastrophic default on a sovereign debt. On the other hand, signing the treaty means accepting the

principle of an indiscriminately restrictive fiscal strategy (the rule on public debt reduction included in the TSCG will be devastating) that will trigger a recession in the euro zone in 2012 and perhaps in 2013.

Signing the treaty also means relieving the pressure of the markets, but only to wind up submitting solely to the Troika and to the baseless belief that the fiscal multipliers are low, that European households are Ricardian and that the sovereign debt is still holding back growth. It is true that lowering sovereign interest rates, particularly those of Italy and Spain, will create some breathing room. But the main gain from lower rates would be to spread the fiscal consolidation over a longer period of time. Interest rates place a value on time, and reducing them means granting more time. The debts contracted at negative real interest rates are not ordinary debts, and do not represent the same kind of burden as debts issued at prohibitively high rates.

It would be a terrible waste to gain new maneuvering room (the OMT) only to bind one's hands immediately (the TSCG and the Troika's blind fiscal strategy). Only a change in fiscal strategy would make it possible to take advantage of the door opened by the ECB. In short, saving the euro will not help if we do not first save the EU from the disastrous social consequences of fiscal blindness.

[\[1\]](#) Paragraph 5 of the preamble to the Treaty establishing the European Stability Mechanism states: "This Treaty and the TSCG are complementary in fostering fiscal responsibility and solidarity within the economic and monetary union. It is acknowledged and agreed that the granting of financial assistance in the framework of new programmes under the ESM will be conditional, as of 1 March 2013, on the ratification of the TSCG by the ESM Member concerned and, upon expiration of the transposition period referred to in Article 3(2) TSCG

on compliance with the requirements of that article.”

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 Riffart 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.

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.