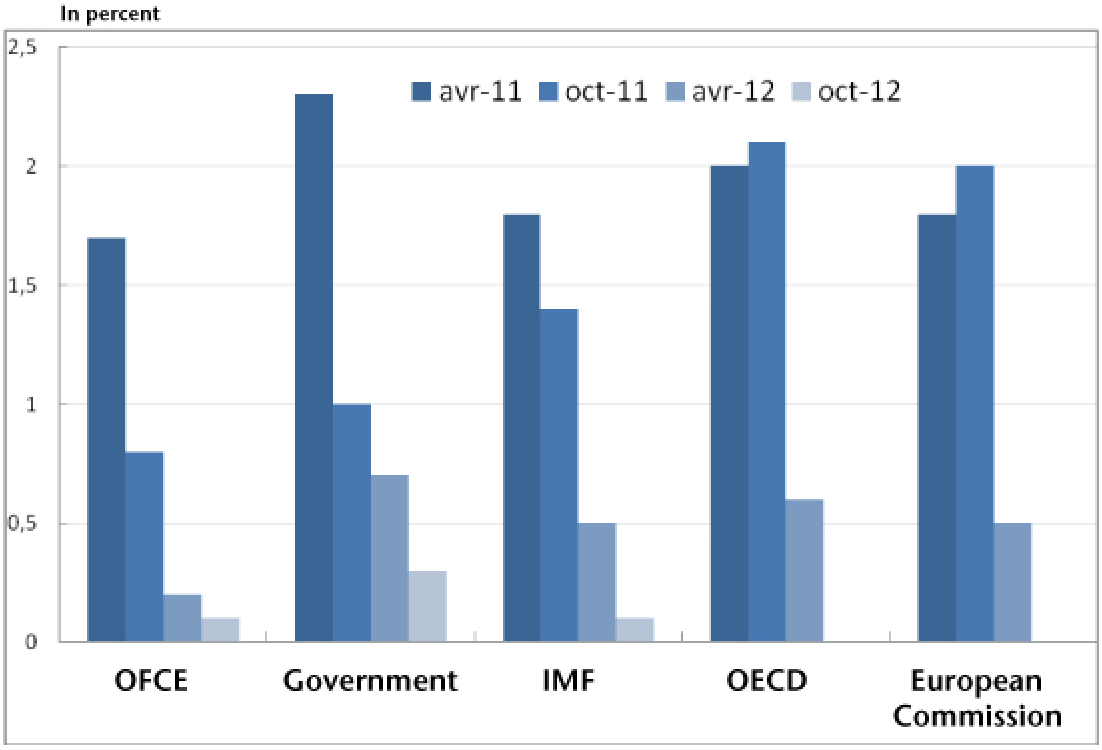
# Why has French growth been revised downwards?

By Bruno Ducoudré and Eric Heyer

In its October 2012 forecasts, the OFCE has revised its growth forecast for 2012 and 2013. The major international institutions, the OECD, the IMF and the European Commission, also regularly review their growth forecasts to incorporate newly available information. An analysis of these revised forecasts is particularly interesting in that it shows that these institutions use low fiscal multipliers in developing their forecasts. In other words, the recessionary impact of fiscal policy has been underestimated by the OECD, the IMF and the European Commission, leading to substantial revisions of their growth forecasts, as is evidenced by the dramatic shifts by the IMF and the European Commission in the size of the multipliers.

Graphique 1. Révisions of growth in French GDP for 2012




Note : Growth in 2012 is reviewed four times each year by each institution. The first revision took place in April 2011, the second in October 2011, the third in April 2012 and fthe final on in October 2012. The OECD has not yet published its latest revisions.

*Sources* : IMF, European Commission, OECD, OFCE October 2012 calculations and forecasts.

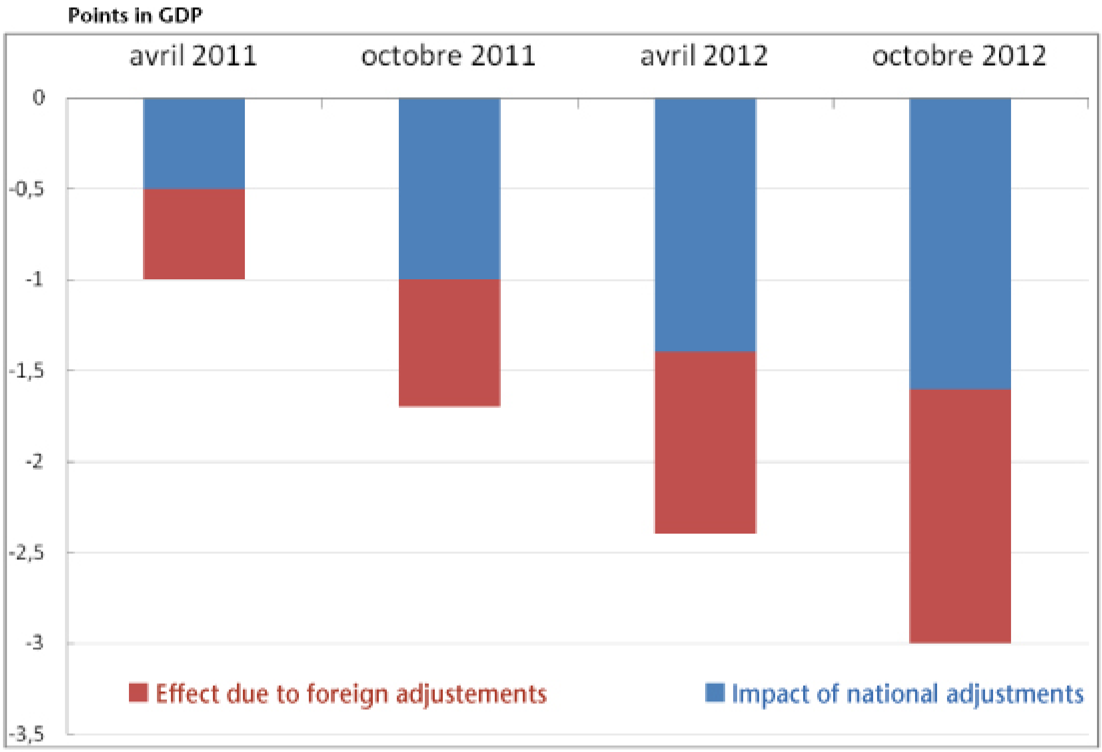
Figure 1 shows that between the forecast made in April 2011 and the latest available forecast, the government, like all the other institutions, revised its growth forecast for France sharply downwards.

The austerity policies have also been strengthened at the same time, particularly in the euro zone. The European countries undertook their stability program in order to return to balanced public finances within three years. In contrast to the years before the crisis, the implementation of these commitments is now considered a necessary or even sufficient condition for pulling out of the crisis. Moreover, in a context of financial uncertainty, being the only State not to meet its commitment to fiscal consolidation would be punished immediately by the markets (higher sovereign rates, a downgraded rating, a fine from the European Commission, implicit contagion of sovereign defaults). But in trying to reduce their deficits abruptly and synchronously, Europe’s governments are inducing new slowdowns in activity.

A vicious circle has been created: with each downward revision in their forecasts for 2012 growth, Europe’s governments implement new austerity measures to meet their deficit commitments. This has happened in France, but especially in Italy, which has virtually tripled its fiscal effort, and in Spain, which is now engaged in the greatest austerity effort of any major European country.

According to our estimates for the French economy (that is to say, using a multiplier of 1), the series of fiscal savings plans adopted at the national level have led to revising growth downwards by -1.1 points between April 2011 and October 2012 (from an impact of -0.5 GDP point to -1.6 points). Since these same policies are in force in our trading partners, this has led to revising growth for this same period by 0.9 point due to foreign trade (from -0.5 GDP point to -1.4 point) (Figure 2).

Graphique 2. Impact of the latest fiscal adjustments on 2012 growth




*Source* : OFCE October 2012 calculations and forecasts.

For the year 2012, the OFCE’s revisions for the French economy can be explained in full simply by the escalation in the fiscal savings measures announced over the last 12 months, *i.e.* the national plans and those applied by our partner countries (Table 1).

Tableau 1. Determinants of the revisions to the OFCE forecast for France for 2012

| | April 2011 | October 2012 | Revision |
|---|---|---|---|
| GDP growth | 1,7 | 0,1 | -1,6 |
| (a) - Austerity measures (in GDP pt) | -0,6 | -1,60 | -1,0 |
| (b) – Value of the fiscal multiplier | 0,95 | 0,95 | 0,0 |
| Impact of austerity plans in France (a + b) | -0,5 | -1,6 | -1,1 |
| Impact of the austerity measures of France's partners | -0,5 | -1,4 | -0,9 |
| Other adjustment factors | | | 0,4 |

*Source* : OFCE calculations.

Leaving aside this escalation of austerity, our diagnosis of the French economy has changed very little over the last 18 months: without it, we would have even revised our growth forecast slightly upwards (0.4%).

---

# Has monetary policy become ineffective?

By Christophe Blot, Catherine Mathieu and Christine Rifflart

This text summarizes the special study of the October 2012 forecast.

Since the summer of 2007, the central banks of the industrialized countries have intervened regularly to counter the negative impact of the financial crisis on the functioning of the banking and financial system and to help kick-start growth. Initially, key interest rates were lowered considerably, and then maintained at a level close to 0 [1]. In a second phase, from the beginning of 2009, the central banks implemented what are called unconventional measures. While these policies may differ from one central bank to another, they all result in an increase in the size of their balance sheets as well as a change in the composition of their balance sheet assets. However, three years after the economies in the United States, the euro zone and the United Kingdom hit bottom, it is clear that recovery is still a ways off, with unemployment at a high level everywhere. In Europe, a new recession is threatening [2]. Does this call into question the effectiveness of monetary policy and of unconventional measures more specifically?

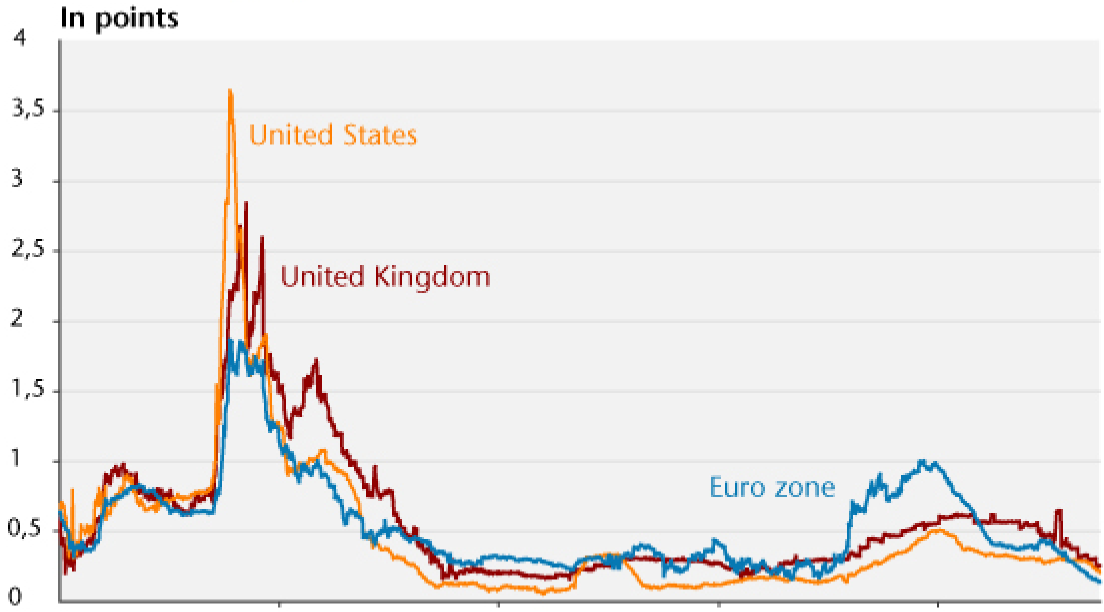
For almost four years, a wealth of research has been conducted on the impact of unconventional monetary policies [3]. Cecioni, Ferrero and Sacchi (2011) [4] have presented a review of recent literature on the subject. The majority of these studies focus on the impact of the various measures taken by the central banks on financial variables, in particular on money market rates and bond yields. Given the role of the money market in the transmission of monetary policy, the ability of central banks to ease the pressures that have emerged since the beginning of the financial crisis constitutes a key vector for effective intervention. More recently, this was also one of the reasons motivating the ECB to conduct an exceptional refinancing operation in two stages, with a maturity of 3 years. This intervention has indeed helped to reduce the tensions on the interbank market that had reappeared in late 2011 in the euro zone, and to a lesser extent in the United States and the United Kingdom (see graph). This episode seems to confirm that central bank action can be effective when it is dealing with a liquidity crisis.

Another critical area of debate concerns the ability of unconventional measures to lower interest rates in the long term and thereby to stimulate activity. This is in fact an important lever for the transmission of monetary policy. The findings on this issue are more mixed. Nevertheless, for the

United States, a study by Meaning and Zhu (2012) [5] suggests that Federal Reserve programs to purchase securities have contributed to lowering the rates on 10-year US Treasury bills: by 60 points for the first "Large-scale asset purchase" program (LSAP1) and by 156 points for LSAP2. As for the euro zone, Peersman [6] (2011) shows that the impact of unconventional measures on activity has in general closely resembled the effect of lowering the key interest rate, and Gianone, Lenza, Pill and Reichlin [7] (2012 ) suggest that the various measures taken by the ECB since the beginning of the crisis have helped offset the rise in the unemployment rate, although the impact is limited to 0.6 point.

Under these conditions, how is it possible to explain the weakness or outright absence of a recovery? One answer evokes the hypothesis of a liquidity trap [8]. Uncertainty is still prevalent, and the financial system is still so fragile that agents are continuing to express a preference for liquidity and safety, which explains their reluctance to undertake risky projects. Thus, even if financing conditions are favourable, monetary policy will not be sufficient to stimulate a business recovery. This hypothesis probably explains the timidity of the recovery in the United States. But in the euro zone and the United Kingdom this hypothesis needs to be supplemented with a second explanation that recognizes the impact of restrictive fiscal policies in holding back recovery. The euro zone countries, like the UK, are pursuing a strategy of fiscal consolidation that is undermining demand. While monetary policy is indeed expansionary, it is not able to offset the downward pressure of fiscal policy on growth.

Graphique. Tensions on the interbank markets*




* The tensions are measured by the spread between the interbank rates (Libor ou Euribor) and the overnight interest rate swap (OIS).

*Source* : Datastream.

---

[1] One should not, however, forget the exception of the ECB, which prematurely raised its key interest rate twice in 2011. Since then it has reversed these decisions and lowered the key rate, which has stood at 0.75% since July 2012.

[2] The first estimate of UK GDP for the third quarter of 2012 indicates an upturn in growth following three quarters of decline. However, this rebound is due to unusual circumstances (see Royaume-Uni: l'enlisement), and activity will decline again in the fourth quarter.

[3] Unconventional monetary policies have already been analyzed repeatedly in the case of the Bank of Japan. The implementation of equivalent measures in the United States, the United Kingdom and the euro zone has contributed to greatly amplifying the interest in these issues.

[4] "Unconventional monetary policy in theory and in practice", *Banca d'Italia Occasional Papers*, no.102.

[5] "The impact of Federal Reserve asset purchase programmes:

another twist", *BIS Quarterly Review*, March, pp. 23-30.

[6] "Macroeconomic effects of unconventional monetary policy in the euro area", ECB Working Paper no.1397.

[7] "The ECB and the interbank market", CEPR Discussion Paper no. 8844.

[8] See OFCE (2010) for an analysis of this hypothesis.

---

# Should households pay for a competitiveness shock?

By Henri Sterdyniak

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

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

In fact, there is little difference between an increase in the CSG tax and an increase in VAT. In both cases, households will lose purchasing power. In the case of a VAT increase, this would involve higher prices. However, inflation is automatically reflected in the minimum wage and social benefits, and after wage bargaining, in salaries too, so any gain in business competitiveness / profitability is likely to be temporary unless indexing is suspended. In contrast, the victims of a higher CSG would not enjoy automatic indexing mechanisms and would have to accept a reduction in purchasing power. Using the CSG thus makes for a more long-term option.

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

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

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

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

**Should it be done?**

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

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

per year), and German growth to 2.7% (0.55% per year). Can France afford to lose another 5 percentage points of GDP?

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

The margin of French companies was 29.6% in 1973. This fell to 23.1% in 1982, rebounded to 30.2% in 1987, and was 30.8% in 2006, *i.e.* a satisfactory level. The decline occurring since then (28.6% in 2011) can be explained by the drop-off in activity and the retention of labour. It was not caused by higher taxation nor by excessive wage increases. Overall, the share of profits has returned to a satisfactory level historically. But in 1973 gross fixed capital formation was around the level of profits, while it is lower by 3 points of added value today and the share of net dividends paid has increased significantly. What commitments would business make in terms of investment and employment in France in exchange for a measure that would greatly boost profits? How could companies be prevented from increasing their dividends or their investments abroad?

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

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

---

# Long-term competitiveness based on an environmental tax

By Jacques Le Cacheux

"Shock" or "Pact"? The debate over the loss of France's competitiveness has recently focused on how fast a switchover from employer payroll taxes to another type of financing is being implemented, implying that the principle of doing this has already been established. As France faces a combination of a deteriorating situation in employment and the trade balance, plus growing evidence that its companies are becoming less competitive compared to those of most of our partners [1] and that business margins are alarmingly low for the future, the need to reduce labour costs seems to be clear. But how and how fast are subject to debate. Should there be a rise in the CSG tax, VAT, or other charges, at the risk of reducing the purchasing power of households in an economic context that is already worse than bleak?

***The economic situation has to be managed at the euro zone level***

The value of switching a portion of charges on employers – a figure of 30 billion is often bandied about – over to another levy is often disputed by invoking the risks that such a strategy would pose to what is already sluggish growth: undermining consumption would further curtail business opportunities, hurting activity and thus employment and margins.

But France is in this depressed situation only because the European Union is committed to a forced march of fiscal adjustment that everyone – or almost everyone – now recognizes is counterproductive and doomed to failure: as the heartbreaking situation in Spain illustrates, the quest to reduce the budget deficit when the economy is in recession is futile, and "virtuous" efforts – repeatedly slashing public spending and increasing taxes – merely weaken the economy further and increase unemployment, since the fiscal multipliers are very high, as Keynes demonstrated over 70 years ago!

Fiscal support for economic activity is the only way out. But the experience of the early years of the first Socialist government is alive in all our memories: the failure was as great as were the illusions, and the "turn to austerity" made the government unpopular. An approach that failed in the context of the early 1980s, with a less open economy, an autonomous monetary policy and the possibility of adjusting the currency's exchange rate, is all the less appropriate in the context of deeper integration and the single currency. Trying to maintain the purchasing power of French households while the rest of the euro zone is in recession and French companies are less competitive could only widen the deficit without boosting growth or employment.

We must therefore continue the fight in Europe: to slow down the pace of deficit reduction; to implement a more accommodative monetary policy in the euro zone, which would have the double advantage of reducing the cost of debt, public and private, thereby making them more sustainable, and of exerting downward pressure on the exchange rate of the euro, boosting external competitiveness at a time when the US and Japanese central banks are seeking to reduce the value of their own currencies, which would automatically push the euro up; and to jointly engage in a coordinated European policy to support growth, by funding research and investing in trans-European transport and electricity and in education and training.

***The national productive capacity must be supported and stimulated***

The lack of competitiveness of French industry is not reducible to a problem of labour costs. And it is well known that a downward spiral of wage moderation and social dumping, which we can already see is wreaking havoc in Europe, can only lead the euro zone into a deflationary spiral, comparable to what these same countries vainly attempted in the 1930s in their “every man for himself” effort to escape the Great Depression.

Reducing social spending cannot therefore be an answer, while rising unemployment and the precarious situation of an increasing number of households, workers and retirees are pushing up the needs on all sides. Lowering wages, as some countries have done (Greece and Ireland in particular), either directly or through an increase in working hours without an increase in pay, is not a solution, as wage deflation will further depress demand and thereby feed yet another round of social dumping in Europe.

Improving cost competitiveness by reducing the charges on wages may be part of the solution. But this option does not necessarily send the right signals to businesses and will not necessarily lead to a decrease in their selling prices or an increase in hiring: windfall gains are inevitable, and the greatest affluence is likely to go to shareholders as much as to customers and employees. Reductions in social security contributions could be targeted for certain levels of pay, but they cannot be sectoral or conditional or else they would violate European rules on competition.

It is also necessary to encourage and assist French companies in modernizing their supply capacity. The new Public Investment Bank [*Banque publique d'investissement* – BPI] can help by funding promising projects. But we can also make use of the taxation of corporate profits, including through incentives for investment and research that allow tax credits and depreciation rules: this is a way of more directly using incentives for businesses and conditioning public support on conduct that is likely to improve their competitiveness.

***Environmental taxation: a lever for long-term competitiveness***

Which charges should now bear the cost of these measures to boost business? Discussions on the respective advantages and disadvantages of VAT and the CSG tax abound. Suffice it to recall here that the VAT has been created to anticipate the reduction in tariff protection, which it replaces very effectively without discriminating on the domestic market between domestic products and imports but while exempting exports: an increase in VAT therefore differs little from a devaluation, with very similar pros and cons, especially with regard to its non-cooperative character within the euro zone. But also recall (see our post of July 2012) that consumption is now relatively less taxed in France than a few years ago, and less than in many of our European partners.

The recourse to a genuine environmental tax would, with regard to the other options for financing these concessions, have the great advantage of promoting sectors that are less polluting and less dependent on fossil fuels – while at the same time diminishing our problems with trade balances, which are partly due to our energy imports – and putting in place the right price and cost incentives for both businesses and consumers. In particular, taking a serious approach to the energy transition demands the introduction of an ambitious carbon tax that is better designed than the one that was censored by the *Conseil constitutionnel* in 2009. Its creation and its step-by-step implementation need to be accompanied by reforming both the direct levies on household income and the main means-tested benefits so that compensation is kept under good control (cf. article in the work "Réforme fiscale", April 2012).

A "competitiveness shock" therefore, but also a "sustainable competitiveness pact", which encourages French companies to take the right paths by making good choices for the future.

---

[1] See in particular the post of 20 July 2012.

---

# 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 / Re-sale value | 1990 | 1995 | 2000 | 2005 | 2010 | 2012 |
|---|---|---|---|---|---|---|
| 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 (currently10 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 euro zone: confidence won’t be enough

By Céline Antonin, Christophe Blot and Danielle Schweisguth

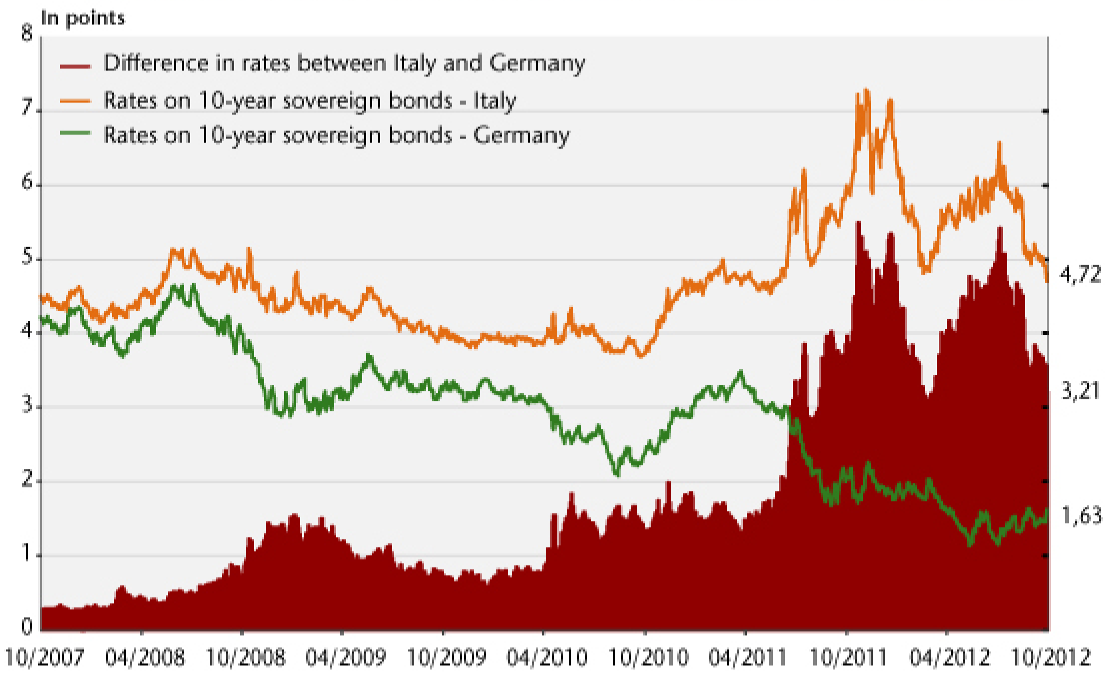
*This text summarizes the OFCE’s October 2012 forecasts for the economy of the euro zone.*

After more than two years of crisis in the euro zone, this time the meeting of the European Council, held on 18 and 19 October, had nothing of the atmosphere of yet another last-chance summit. Even though discussions on the future banking union [1] were a source of tension between France and Germany, there was no sword of Damocles hanging over the heads of the European heads of state. However, it would be premature to assume that the crisis is coming to an end. It is sufficient to recall that the GDP of the euro zone has still not regained its pre-crisis level, and in fact declined again by 0.2% in the second quarter of 2012. This decline is forecast to continue, as we expect GDP to fall by 0.5% in 2012 and by 0.1% in 2013. Consequently, the unemployment rate in the euro zone, which has already surpassed its previous historical record from April 1997, will rise further, reaching 12.1% by end 2013. What then are the reasons for the lull? Can the euro zone quickly resume its growth and hope to finally put an end to the social crisis?

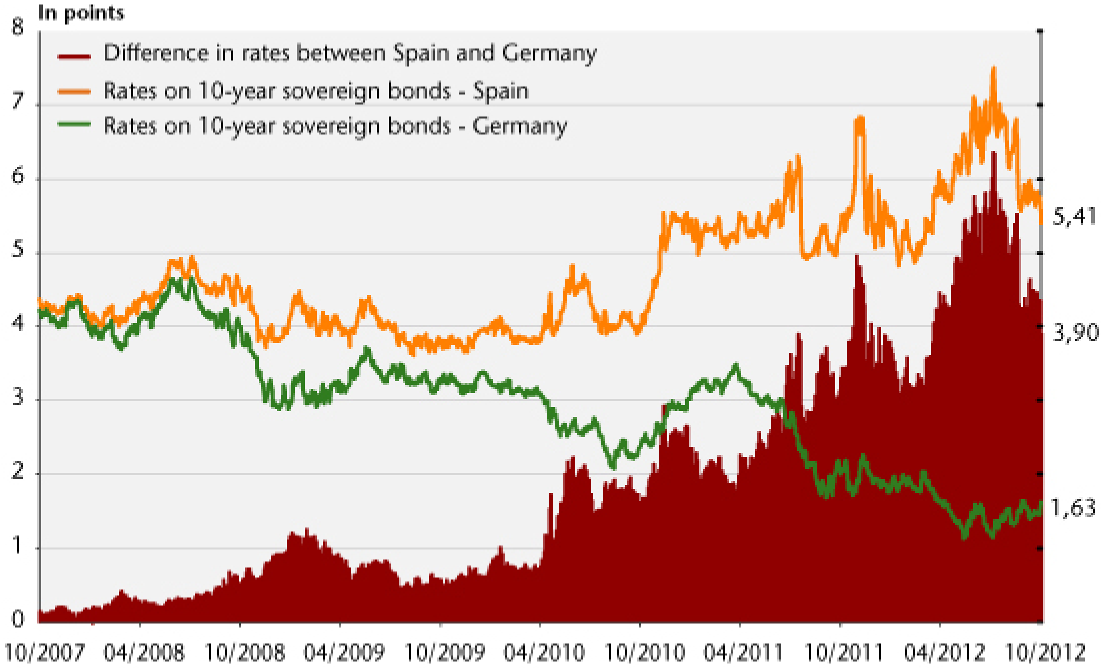
Since the end of 2011, Europe has adopted a new treaty (the Treaty on stability, coordination and governance, the TSCG) which is being ratified in the 25 signatory countries. The new law is specifically intended to strengthen both budgetary discipline – through the adoption of national golden rules – and solidarity through the creation of the European Stability Mechanism (ESM), in so far as the use of the ESM is conditional on ratification of the TSCG. On 6 September, the ECB unveiled the basic points of its new conditional purchase of sovereign debt (see here), which is aimed at reducing the interest rates of countries subject to the ESM. Thus, the risk premium, as measured by the difference between the Italian and Spanish sovereign interest rates and the German rate, after peaking on 24 July 2012, decreased respectively by 2.2 and 2.5 points (Figures 1 and 2). This is of course still far from normal, but this lull is nevertheless welcome and it shows that the spectre of a breakup of the euro zone has receded.

Could this new wave of optimism be a precursor to an upturn in the economy of the euro zone? The answer to this question is, unfortunately, negative. The fiscal policies of countries in the zone are still highly restrictive, a situation that has even intensified in 2012, pushing Italy and Spain back into recession and deepening the recession that was already hitting Portugal and Greece. For the euro zone as a whole, the fiscal stimulus will come to 1.7 percent of GDP in 2012 (table). The series of votes on national budgets confirms this strategy of a forced reduction of budget deficits for 2013, with the overall fiscal consolidation for the euro zone as a whole coming to 1.3%. There will be significant differences between the countries, since in Germany the fiscal stimulus will barely be negative (-0.2 point) while in Spain, Italy and Greece it will be more than -2 GDP points. However, the recessionary impact of this synchronized fiscal consolidation will be even greater given that the euro zone countries are still at the bottom of the economic cycle. In these conditions, the targets for budget deficit reduction will not be met, which will inevitably raise the question of the appropriateness of further budget cuts. More and more Member States thus risk being caught in a vicious circle where low growth calls for further fiscal adjustments that in turn deepen the economic and social crisis. It is essential that any decision about improving the governance of the European Union or the transmission of monetary policy restores confidence and creates the conditions for a return to growth. But this will be insufficient to escape the recession and should not obscure the impact of the fiscal strategy.

Graphique 1. Long-term sovereign interest rates in Italy and the Italy-Germany *Spread*



Graphique 2. Long-term sovereign interest rates in Spain and the Spain-Germany *Spread*




*Source* : Datastream.

Tableau. Fiscal stimulus in the euro zone countries

In GDP points

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| Germany | 0,7 | 1,5 | -0,9 | -0,5 | -0,2 |
| Autria | 0,4 | 0,6 | -1,6 | -0,1 | -0,9 |
| Belgium | 1,9 | -0,3 | -0,1 | -1,1 | -0,8 |
| Spain | 3,8 | -2,5 | -1,1 | -3,4 | -2,4 |
| Finland | 0,4 | 1,5 | -1,6 | -0,4 | -1,3 |
| France | 2,3 | -0,5 | -2,9 | -1,6 | -1,8 |
| Greece | 3,2 | -8,0 | -5,3 | -5,0 | -3,9 |
| Ireland | 2,2 | -4,4 | -1,5 | -2,4 | -1,8 |
| Italy | 0,8 | -0,4 | -1,2 | -3,2 | -2,1 |
| Netherlands | 4,0 | -1,1 | -0,2 | -1,0 | -1,2 |
| Portugal | 5,0 | -0,7 | -3,7 | -3,7 | -1,8 |
| Euro zone 11* | 1,8 | -0,3 | -1,3 | -1,7 | -1,3 |

* Excluding Cyprus, Luxembourg, Malta, Slovakia, Slovenia and Estonia.
*Note* : The fiscal stimulus is measured by the opposite of the variation in the cyclically adjusted primary balance, that is, excluding interest charges and exceptional revenue: it approximates the discretionary budget policy.
*Sources* : OFCE calculations and forecasts, October 2012.

tab

---

[1] See here for an analysis of the importance of the proposed banking union and the questions it raises.

# France: will the war of the 3% take place?

By Eric Heyer

*This text summarizes the OFCE's October 2012 forecasts for the French economy.*

The French economy is expected to see average annual growth of 0.1% in 2012 and 0.0% in 2013. This performance is particularly poor and far from the path that an economy recovering from a crisis would normally experience.

Four years after the onset of the crisis, the French economy has real potential for a rebound: this should lead to spontaneous average growth of about 3.0% per year in 2012 and 2013, making up some of the output gap built up since the start of the crisis. But this spontaneous recovery is being hampered, mainly by the establishment of budgetary savings plans in France and throughout Europe. The fiscal consolidation strategy imposed by the European Commission is likely to slice nearly 6 percentage points off GDP in France during 2012 and 2013.

**Table 1. The brakes on growth in France**

En points of GDP

| Rythm | ... quaterly | | ... annually | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| Spontaneous recovery | 0,8 | 0,8 | 2,1 | 3,1 |
| *Budget impact* | *-0,4* | *-0,4* | *-1,6* | *-1,7* |
| *Oil shock* | *-0,05* | *0,0* | *-0,2* | *0,0* |
| *External environment* | *-0,4* | *-0,3* | *-1,4* | *-1,2* |
| *Achievement* | | | *-1,0* | *-0,2* |
| Growth forecasts | -0,04 | 0,04 | 0,1 | 0,0 |

Sources : INSEE, OFCE calculations.

By setting a pace that is far from its potential, the expected growth will increase the output gap accumulated since 2008 and will lead to a further deterioration on the labour market. The unemployment rate will rise steadily and hit 11% by late 2013.

Moreover, the reduction of the budget deficit expected by the Government due to the implementation of its consolidation strategy – the target for the general government deficit is 3% of GDP in 2013 – will be partially undermined by the shortfall in tax revenue due to weak growth. The general government deficit will come to 3.5% in 2013.

Under these conditions, should the government do whatever it can to fulfil its commitment to a 3% deficit in 2013?

In a context of financial uncertainty, being the only State not to keep its promise of fiscal consolidation is a risk, *i.e.* of being punished immediately by an increase in the financial terms on the repayment of its debt. This risk is real, but limited. The current situation is that of a “liquidity trap” and abundant savings. The result is a “flight to quality” phenomenon on the part of investors seeking safe investments. But among these are both German and French government bonds. Under these conditions, reducing the government deficit by 1 GDP point instead of 1.5 point would have very little impact on French bond rates.

However, maintaining a target of a 3% deficit in 2013 could have a dramatic impact on economic activity and employment in France. We simulated a scenario in which the French government maintains its budgetary commitment regardless of the costs and the economic situation. If this were to occur, it would require the adoption of a new programme of budget cuts in the coming months in the amount of 22 billion euros.

This strategy would cut economic activity in the country by 1.2% in 2013. It would lead to a further increase in the unemployment rate, which would reach 11.7% at year end, nearly 12%. As for employment, this obstinacy would intensify job losses, costing nearly 200,000 jobs in total.

A darker scenario is also possible: according to our forecasts, and taking into account the draft budget bills known and approved, no major European country would meet its deficit reduction commitments in 2013. By underestimating the difficulty of reaching inaccessible targets, there is a high risk of seeing the euro zone countries locked into a spiral where the nervousness of the financial markets would become the engine driving ever greater austerity. To illustrate this risk, we simulated a scenario in which the major euro zone countries (Germany, France, Italy and Spain) implement new austerity measures to meet their deficit targets in 2013. Adopting such a strategy would result in a strong negative shock to economic activity in these countries. For the French economy, it would lead to additional austerity that either at the national level or coming from its euro zone partner countries would cause a severe recession in 2013. French GDP would fall by more than 4.0%, resulting in a further increase in the unemployment rate, which would approach 14%.

**Table 2. Illustrative scenarios of risks to French growth**

In %

| | 2011 | 2012* | 2013* |
|---|---|---|---|
| **Central scenario** | | | |
| GDP | 1,4 | 0,1 | 0,0 |
| Gov't deficit *(in GDP points)* | -7,1 | -4,4 | -3,5 |
| Unemployment rate | 9,4 | 10,2 | 11,0 |
| Market employment | 104 | -95 | -166 |
| **Scenario where France alone meets its budget commitments** | | | |
| GDP | | | -1,2 |
| Gov't deficit (in GDP points) | | | -3,0 |
| Unemployment rate | | | 11,7 |
| Market employment *(in 1000s)* | | | |
| Change | | | -361 |
| Deviation from central scenario | | | -195 |
| **Scénario where euro zone countries meet their budget commitments** | | | |
| GDP | | | -4,6 |
| Gov't deficit *(in GDP points)* | | | -3,0 |
| Unemployment rate | | | 18,8 |
| Market employment *(in 1000s)* | | | |
| Change | | | -910 |
| Déviation from central scenario | | | -744 |

* OFCE forecast October 2012

*Sources :* INSEE ; OFCE calculations *e-mod.fr.*

---

# The governance of public finances: from the Fiscal pact to France's Organic law

by Henri Sterdyniak

So the French government has had Parliament enact an "Organic law relating to the planning and governance of public finances" (*loi organique relative à la programmation et à la* *gouvernance des finances publiques)*, which translates into French law the European Fiscal pact (the Treaty on stability, coordination and governance) that France had made a commitment to ratify. This Law can be assessed from two points of view: from the perspective of how well it conforms to the Treaty or from the viewpoint of its own relevance, *i.e.* will it improve France's fiscal policy?

In fact, the government has chosen – as the Constitutional Council had provided it with the possibility of so doing – a minimalist approach to taking into account the Treaty. The new budgetary procedure is not incorporated into the Constitution, and as we shall see, the Treaty provides for certain automatic binding procedures that the Organic law tempers or does not mention.

The Organic Law has three sections, dealing respectively with the budget plan (*loi de programmation des finances publiques – LPFP*), the High Council on the Public Finances (*Haut Conseil des finances publiques*), and a correction mechanism.

**The Budget Plan**

Article 1 of the Organic Law stipulates: "In accordance with the objective of balanced government accounts as set out in Article 34 of the Constitution, the LPFP sets the medium-term targets of the government administrations referred to in Article 3 of the TSCG."

Article 34 of the Constitution, adopted on 31 July 2008, set out only a medium-term non-binding target. It has had little influence on the fiscal policy adopted since then. In times of crisis, the multi-year guidelines quickly cease to have an influence. This was the case, for example, in 2009. The 2009 deficit, which was set at 0.9% of GDP by the four-year budget plan passed in January 2008, and 3.9% of GDP according to the January 2009 plan, ultimately amounted to 7.5%. Should we give up this flexibility?

Moreover, how can the budget plan “set a target” when the target flows from Article 3 of the Treaty, which clearly states that the target should be a structural deficit of less than 0.5% of GDP and that a path for an adjustment to ensure a rapid convergence toward equilibrium will be proposed by the European Commission?

Doesn’t the ambiguity of this article actually reflect an attempt to reconcile the irreconcilable: the sovereignty of Parliament in budgetary matters with France’s commitment to follow the recommendations of the Commission?

Article 1 of the Organic Law continues: “The budget plan (LPFP) determines the trajectory of the successive annual actual balances and structural balances… The structural balance is the cyclically-adjusted balance net of one-off and temporary measures.” Article 3 states that the period covered is at least three years.

Thus, the Law takes no account of the experience of the Stability and Growth Pact (SGP): it is impossible to fix a trajectory for the public finances, in terms of the structural and actual deficit, for a period of three years. In January 2008, France was committed to having a balanced budget in 2012. It won’t even get close. Should commitments be made that are impossible to keep?

This is impossible for two reasons. First, unpredictable economic fluctuations make it necessary to constantly adapt economic policy. In case of a deep crisis, as since 2009, it is necessary to make use of both economic stabilizers and discretionary measures (which increase what is called the structural deficit). If taken seriously, the Treaty prohibits any policy to boost activity during a downturn in activity. In the autumn of 2008, according to the Commission France had a structural deficit of 3.2% of GDP. If the Treaty had been in force, it would have had to reduce this quickly to 2.5% in 2009. In fact, France has moved to a structural deficit of 6%

of GDP, according to the Commission’s assessment, in other words, 3.5 percentage points higher. Is the government wrong to have promoted activity, or to have come to the rescue of the banks? Should it have embarked on a tough austerity policy to offset the fall in tax revenue?

The text is, of course, ambiguous. On the one hand, it sets out that the structural deficit does not include “one-off and temporary” measures. Assistance to banks is undoubtedly a one-off, but why not all the 2009 stimulus measures, or in the opposite direction, the 75% income tax assessment which is scheduled for 2 years? Who decides? On the other hand, the Treaty recognizes that a country may deviate from its target or its adjustment path in the event of “exceptional circumstances” which, since the revision of the Growth and Stability Pact, can be interpreted as negative growth or a large output gap. However, the Commission refuses to recognize that most euro zone countries have actually been in this situation since 2009, and it is insisting on imposing rapid deficit reduction policies on them.

On the other hand, a State has no economic reason to set itself a standard for balancing the public purse. According to the true “golden rule of public finance”, which was stated by the economist Paul Leroy-Beaulieu in the late nineteenth century, it is legitimate to finance public investment through debt. In the case of France, a structural deficit of around 2.4% of GDP is legitimate.

As in the Treaty, Article 1 of the Organic Law refers to the structural balance, the balance that would exist if France were at its potential output, the maximum output consistent with stable inflation. But the size of this potential output, which cannot simply be observed, is a subject of debate among economists. Different methods produce different results, which are subject to sharp revisions. France’s structural balance in 2012 is 3.6% according to the French government, 3% according to the European Commission, 2.8% according to the OECD, and according to us 0.5%, since the crisis has caused us to lose 8% of GDP compared to our growth trend. The Treaty requires the use of the Commission's method. Is this scientifically legitimate? Can France call into question this assessment?

Article 5 states that the potential growth assumptions should be presented in an appendix, but the definition of potential growth is even more questionable than that of potential output. For example, the latest budget bill (*projet de loi de finances – PLF*) expects potential growth of 1.5% per year up to 2017 for France, thus abandoning forever the expectation of making up the 8 points of activity lost to the crisis.

The Organic Law simply forgets Article 4 of the Treaty (which requires a country with a debt of over 60% of GDP to reduce the gap by one-twentieth per year). It also ignores Article 5, which states that a country subject to an Excessive Deficit Procedure (EDP) is to be placed under supervision, and has to submit to the EU Council and Commission annual budget plans and a list of the structural reforms that it will implement in order to make a sustainable correction to its deficit. It is this article that obliges France, like many other EU countries, to do all it can to get down to a 3% deficit by 2013, regardless of the economic situation, since, in case of an EDP, the constraint pertains to the actual balance and not the structural balance. It forgets Article 7, which states that, in this context, the decisions of the Commission are obligatory (member countries can oppose it only with a qualified majority, with the country concerned not voting).

The LPFP will cover a period of four to five years, but will be voted upon again each year, so that the constraint thus introduced can be changed by a vote on a new budget plan. This has been the case in France for as long as the Fiscal Pact has existed. Thus, the LPFP does not introduce any supplementary constraint itself, other than what is already required by European legislation.

**The High Council of Public Finance**

The Organic Law sets up a High Council of Public Finance, which will advise on the macroeconomic forecasts underlying the budget bill (LPF), the bill financing social security, the adjustment budget bills, the stability program that France must provide to the European authorities, and the budget plan (LPFP). It will assess whether France has been meeting its European commitments, and verify that the LPF (budget bill) is consistent with the trajectory announced in the budget plan (LPFP). It will give its opinion on any evocation of "exceptional circumstances".

Chaired by the President of France's Court of Audit (Cour des comptes), the High Council consists of four members from the Court of Audit and four members appointed for their expertise in public finance by the Presidents of the National Assembly, the Senate and the two finance commissions. This predominance of the Court of Audit is problematic. The judicial officers from the Court of Audit are not *a priori* experts in macroeconomics, and they are often, based on their function, more concerned with balancing the public finances than with growth and employment. For instance, the latest reports from the Court of Audit underestimate the output gap, support the thesis that the fiscal multiplier is close to zero, and believe that it is better to reduce public spending than to increase taxes. We would like to be certain that the composition of the High Council and its work and reports reflect the diversity of opinion that exists on fiscal policy.

More fundamentally, it is questionable whether the High Council has room for flexibility in its assessments. Will it have the right to conclude that the path of adjustment is too restrictive, and that the medium-term objective is not realistic? What strategy will be advocated by the High Council in the event of an economic slowdown: an expansionary policy to support growth or an austerity policy to restore the public finances?

Assume, for example, that the government has a budget for 2013 based on growth of 1.2%, resulting in a deficit of 3%. The High Council believes that growth will instead be only 0.6%, causing a decline in tax revenues, and thus a deficit of 3.3%. It will advocate doing whatever is necessary to achieve a 3% deficit. Assuming that the fiscal multiplier is 1, it will be necessary to come up with 12 billion in tax increases (or spending cuts), or 0.6% of GDP, to have an *ex post* deficit of 3%, but no growth. There is thus a great risk that this will lead to pro-cyclical policies. This will of course be mitigated when France is longer be subject to an EDP, as the High Council can then reason in terms of the structural deficit, but this will persist because everything will then depend on evaluating the structural deficit.

Lastly, there is the question of what legitimacy the High Council will have. The choice of fiscal policy must be subject to democratic procedures. The assessment of economic policy is part of a scientific, democratic debate. Should it be entrusted to a High Council, composed mainly of judicial experts, rather than economists on the one hand and representatives of the nation on the other?

The High Council will of course only give advice, which neither the government nor parliament are obliged to follow, but the risk is great that these opinions will affect the financial markets and the Commission and that it would be risky for the government to ignore them.

**The correction mechanism**

To ensure that countries do indeed follow the adjustment path, the Treaty requires countries to provide an automatic correction mechanism if deviations are observed with respect to this path. In the minds of the negotiators of the North European countries and members of the Commission, this mechanism should provide that if a deviation of 1% of GDP is seen in year N, the Constitution provides that, automatically, a certain tax (*e.g.* VAT) would be raised by 0.5 GDP point and certain expenditures (*e.g.* social benefits) would be reduced by 0.5 GDP point.

In fact, Chapter 3 of France's Organic Law provides that the High Council is to report such a gap, the government is to set out the reasons for this discrepancy and then take it into account in drawing up the next budget bill. Parliament's rights are respected, but fortunately the character of being automatic is not guaranteed.

**Conclusion**

In the spirit of its founders, the fiscal treaty must put an end to the possibility of autonomous national fiscal policies. Fiscal policies should become automatic. The goal of fiscal policy should be balancing the budget, just as the goal of monetary policy should be fighting inflation; growth and employment are to be sought by means of free market structural reforms.

The Organic Law seems to be an ambiguous compromise. France is ratifying the Treaty, but implementing it only reluctantly. It's a safe bet that, as with the Stability Pact, there will be great tension in the euro zone between purists who demand the strict application of the Treaty and those who do not want to sacrifice growth to it.

---

# The situation on the labour market in France*

By Eric Heyer

The French economy is facing a number of imbalances, with the two main ones being:

– a public deficit that at end 2012 is likely to come to about 4.5 GDP points, or close to 100 billion euros;

– a lack of jobs, which is leading to mass unemployment.

While the first point is the object of great attention, and while it has been and remains the main or even the sole concern of every EU summit over the last three years and is at the heart of the European strategy on the crisis, it must be acknowledged that this is not unfortunately the case for the second point. However, it is not unreasonable to ask whether the priority in a country as rich as France should actually be to reduce the deficit at all costs even if this may worsen the plight of society's most vulnerable and make it more difficult for them to access the labour market.

Since the beginning of the crisis in early 2008, the French economy has destroyed more than 300,000 jobs, and the number of unemployed as defined by the International Labour Office has increased by 755,000. More than 2,700,000 French are now without jobs, i.e. 9.6% of the active population.

And this figure undoubtedly underestimates the real situation. The French economy is currently creating only mini part-time jobs that don't last long; in the last quarter, 4.5 million job contracts were signed: 3 out of 4 of these were contracts lasting less than one month (mostly 1 day to 1 week). Someone who signed one of these contracts and is looking for a job at the end of the same month is not counted as unemployed. Their inclusion would increase the jobless numbers and push the French economy a little further into mass unemployment.

Moreover, and this is more disturbing, the unemployed are getting older while remaining jobless – the number of long-term unemployed is continuing to shoot upwards – and thereby lose out in terms of both job skills and financially as they shift from unemployment benefits onto the social minima; in a study we conducted at OFCE for the National Observatory on Poverty and Social Exclusion (ONPES), we estimated that in France 100 additional unemployed during this crisis will lead to 45 more people in poverty in 2012. Thus, even stabilizing unemployment would not lead to halting the deterioration of people's situation – on the contrary.

It is therefore urgent to reverse current trends with respect to employment and unemployment.

The surest way to do this is to put the French economy onto a trajectory of dynamic growth: recall that low but positive growth is not enough for the French economy to create jobs again, as, given gains in productivity, the country's economy needs to grow by more than 1% in order to unleash a spiral of job creation. Moreover, given the continuation of demographic growth and the postponement of the retirement age, the labour force is increasing by 150,000 people every year. It is thus necessary to create more than 150,000 jobs in France before unemployment will begin to fall, which corresponds to growth of over 1.5%.

However, in light of the austerity policies being implemented in France and by our European partners, this level of growth seems unthinkable in 2012 and 2013.

So how can a further explosion of unemployment be stopped in the near future?

The first step would be to change Europe's strategy by establishing, among other things, a “more moderate” austerity.

The second step would be to adopt the strategy Germany is using for the crisis, that is to say, to reduce working time by massively resorting to part-time work and to partial unemployment schemes. Remember that 35% of German employees are hired part-time, as against 17% in France. Furthermore, during the crisis 1.6 million Germans have been on a partial unemployment programme, compared with 235,000 in France. All this has helped Germany to keep unemployment down during the crisis.

The last solution is to use what in France is called the "social treatment of unemployment". As the private sector is still destroying jobs, the public sector would offset part of this by creating subsidized jobs.

The government seems to be taking this last path: 100,000 "jobs for the future" will be created in 2013 and 50,000 in 2014.

In the short term, given the economic situation, this strategy seems to be the most effective and the least expensive. However, in the medium term, it cannot replace a policy of growth.

---

* This text is taken from a series of reports by Eric Heyer for the programme "Les carnets de l'économie" on France Culture radio. It is possible to listen to the series on France Culture.

# Rent control: What is the expected impact?

Sabine Le Bayon, Pierre Madec and Christine Rifflart

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

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

The decree aims to significantly lower market rents [2], which are being driven up by rents at the time of re-letting, *i.e.* during a change of tenant. Unlike rent during the lease period or upon renewal of a lease, which are indexed to the IRL rental benchmark, until 31 July 2012 rents for new tenants were set freely. In 2010, this applied to nearly 50% of re-lettings in the Paris area (60% in Paris). Now, in the absence of major renovations, these will be subject to control. Only rents for new housing that is being let for the first time or renovated properties (where the renovation represents more than one year's rent) will remain uncontrolled (Table 1).

Table 1. The method of setting rent under current law

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

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

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

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

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

Can this measure encourage mobility and restore household purchasing power? In the short term, it will certainly benefit the most mobile households by limiting the increase in the share of their budget spent on housing [3]. But these are the households facing the least constraints on income, that is to say, those with high incomes or a relatively low share of income spent on housing. It will also benefit households that are forced to move or those who are running up against the limits on their finances. For all these households, the increase in the share of income on housing will be lower than it would have been without the decree. In contrast, for low-income households whose share is already high [4], the decree won't change anything, because they can ill afford the additional cost of re-letting.

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

| | Rents noted letting on 31/12/2006 | Rents after re-letting on 01/01/2007 | Change in 2007 | Rents on 31/12/2009 after indexing to IRL and before re-letting | Rents on 01/01/2010 after letting | Change in 2010 | Gap between observed and simulated rents upon re-letting in 2010 |
|---|---|---|---|---|---|---|---|
| PARIS | | 19 €/m² | 2.2 % | 20.1 €/m² | 20.1 €/m² | 0 % | -12.4 % |
| Actual | 18.6 €/m² | (20.1 €/m²) | (+ 8.3 %) | (20,9 €/m²) | ( 22,6 €/m²) | (+8,3 %) | |
| PARIS REGION | | 15.4 | 1.3% | 16 €/m² | 15.9 €/m² | -0.6 % | -10.7 % |
| Actual | 15.2 €/m² | (16.2 €/m²) | (+ 6.4) | (16.9 €/m²) | ( 17.8 €/m²) | (+5.7 %) | |

**What are the risks?**

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

Likewise, the realization of improvements in line with the Grenelle 2 environmental consultation or simply maintenance work could wind up being abandoned due to the lengthening of the amortization period for landlords compared with the previous situation. Conversely, some owners might be encouraged to carry out major renovations (in excess of one year's rent) and "to upgrade the dwelling" in order to be able to freely determine the rent. This would give the landlord a margin of safety to offset any subsequent shortfall. These increases, if they occurred, would penalize less creditworthy tenants and would promote the process of gentrification already at work in the areas under greatest pressure. We could then see increasing differences between the market for “rundown housing” and that for renovated housing.

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

---

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

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

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

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

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

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