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.

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[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.

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[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.