

# Lower taxation on business but higher on households

By [Mathieu Plane](#) and Raul Sampognaro

Following the delivery of the Gallois Report in November 2012, the government decided at the beginning of Francois Hollande's five-year term to give priority to reducing the tax burden on business. But since 2015, the President of the Republic seems to have entered a new phase of his term by pursuing the objective of reducing the tax burden on households. This was seen in the elimination of the lowest income tax bracket and the development of a new allowance mechanism that mitigates tax progressivity at the lower levels of income tax. But more broadly, what can be said about the evolution of the compulsory tax burden on households and businesses in 2015 and 2016, as well as over the longer term?

Based on data provided by the INSEE, we have broken down trends in the tax burden since 2001, distinguishing between levies on companies and those on households (Figure). While this is purely an accounting analysis and is not based on the final fiscal impact, it nonetheless gives a view of the breakdown of the tax burden[\[1\]](#). In particular, this exercise seeks to identify the tax burden by the nature of the direct payer, assuming constant wages and prices (excluding tax). This accounting breakdown does not therefore take into account macroeconomic feedback and does not address the distributional and intergenerational impacts [\[2\]](#) of taxation.

For the period from 2001 to 2014, the data is known and recorded. They are *ex post* and incorporate both the effects of the discretionary measures passed but also the impact of fiscal gains and shortfalls that are sensitive to the business cycle. However, for 2015 and 2016, the changes in the tax burden for households and businesses are *ex ante*, that is to

say, they are based solely on the discretionary measures that have an impact in 2015 and 2016 and calculated in the Social, Economic and Financial Report of the 2016 Finance Bill for 2016 [[Rapport économique social et financier du Projet de loi de finances pour 2016](#)]. They therefore do not, for both years, include [potential effects related to variations in tax elasticities that could modify the apparent tax burden rates](#). Furthermore, under the new accounting standards of the European System of Accounts (ESA) tax credits, such as the CICE, are considered here as reductions in the tax burden, and not as a public expenditure. Furthermore, the CICE tax credit is recognized at the tax burden level in terms of actual payments and not on an accrual basis.

Several major points emerge from this analysis of the recent period. First, tax rates rose sharply in the period 2010-2013, representing an increase of 3.7 percentage points of GDP, [with 2.4 points borne by consumers and 1.3 by business](#). Over this period, fiscal austerity was relatively balanced between households and business, with the two experiencing a tax increase that was more or less proportional to their respective weights in the tax burden [\[3\]](#).

However, from 2014 a decoupling arose between the trends in the tax burdens for households and for business, which is continuing in 2015 and 2016. Indeed, in 2014, due to the impact of the CICE tax credit (6.4 billion euros, or 0.3 percent of GDP), the tax burden on business began to decline (by 0.2 GDP point), while the burden on households continued to rise (by 0.4 GDP point), mainly because of the hike in VAT (5.4 billion), the increase in environmental taxes (0.3 billion with the introduction of the carbon tax) and the increase in the contribution to the public electricity service (CSPE) (1.1 billion), together with the increase in social contributions for households (2.4 billion), mainly due to the rise in contribution rates to the general and complementary social security scheme and the gradual alignment of rates for

civil servant with those for private-sector employees.

In 2015, the tax burden on business will fall by 9.7 billion euros (0.5 GDP point) with the implementation of the CICE tax credit (6 billion), the first Responsibility Pact measures (5.9 billion related to the first tranche of reductions in employer social security contributions, an allowance on the C3S tax base and a "*suramortissement*", an additional tax reduction, on investment), while other measures, such as those related to pension reform, are increasing corporate taxation (1.7 billion in total). Conversely, the tax burden on households should increase in 2015 by 4.5 billion (0.2 GDP point), despite the elimination of the lowest income tax bracket (-2.8 billion) and the reduction in self-employed contributions (-1 billion). The hike in the ecological tax (carbon tax and TICPE energy tax) and the CSPE together with the non-renewal in 2015 of the exceptional income tax reductions of 2014 represent an increase in taxation on households of, respectively, 3.7 and 1.3 billion. Other measures, such as those affecting the rates of contributions to general, supplemental and civil servant pension schemes (1.2 billion), along with local taxation (1.2 billion), including the modification of the DMT0 tax ceiling and measures affecting tourist and parking taxes, are also raising taxes on households.

**Table. Measures affecting household and corporate tax burdens - 2015 and 2016**

In billion euros

	2015	2016
<b>HOUSEHOLDS</b>		
Income tax cut for low-income households	-2,8	-2,0
Ecology taxes + TICPE + CSPE	3,7	2,7
Change in VAT	0,5	-0,2
Local taxes	1,3	1,1
Elimination of PPE working tax credit		2,0
Old-age and CSA community autonomy tax	0,5	0,8
Other changes to social security contributions	0,8	0,1
Other measures	1,9	0,2
Reduction in self-employed contributions (Responsibility Pact)	-1,0	
Fight against tax fraud and avoidance	-0,4	-0,6
<b>Total of measures affecting household tax burden</b>	<b>4,5</b>	<b>4,1</b>
<b>Total excluding fight against tax fraud and avoidance</b>	<b>4,9</b>	<b>4,7</b>
<b>BUSINESS</b>		
CICE tax credit	-6,0	-0,3
C3S allowance (Responsibility Pact)	-1,0	-1,0
Elimination of exceptional IS corporate income tax (Responsibility Pact)		-2,3
Tax reduction on investments	-4,5	-3,5
Other measures affecting social security contributions	-0,4	-0,2
Other social contributions measures	1,1	1,0
Other measures	0,9	0,9
Fight against tax fraud and avoidance	0,2	-0,5
<b>Total of measures affecting corporate tax burden</b>	<b>-9,7</b>	<b>-5,9</b>
<b>Total excluding fight against tax fraud and avoidance</b>	<b>-9,9</b>	<b>-5,4</b>

Sources: PLF (Finance Act) 2016; OFCE calculations.

In 2016, the tax burden on business will fall by 5.9 billion (0.3 GDP point), mainly due to the second phase of the Responsibility Pact. Reductions in employer social security contributions on wages lying between 1.6 and 3.5 times the SMIC minimum wage (3.1 billion), the elimination of the corporate income tax (IS) surcharge (2.3 billion), the second allowance on the C3S tax base (1 billion), the implementation of the CICE tax credit (0.3 billion) and the additional tax reduction on investment (0.2 billion) have been only partially offset by tax increases on business, mainly with the hike on pension contribution rates (0.6 billion). However, as in previous years, the tax burden on households will increase in 2016 by 4.1 billion (0.2 GDP point), despite a further reduction in income tax (2 billion). The main measures increasing household taxation are similar to those in 2015, including environmental taxation, with the hike in the carbon

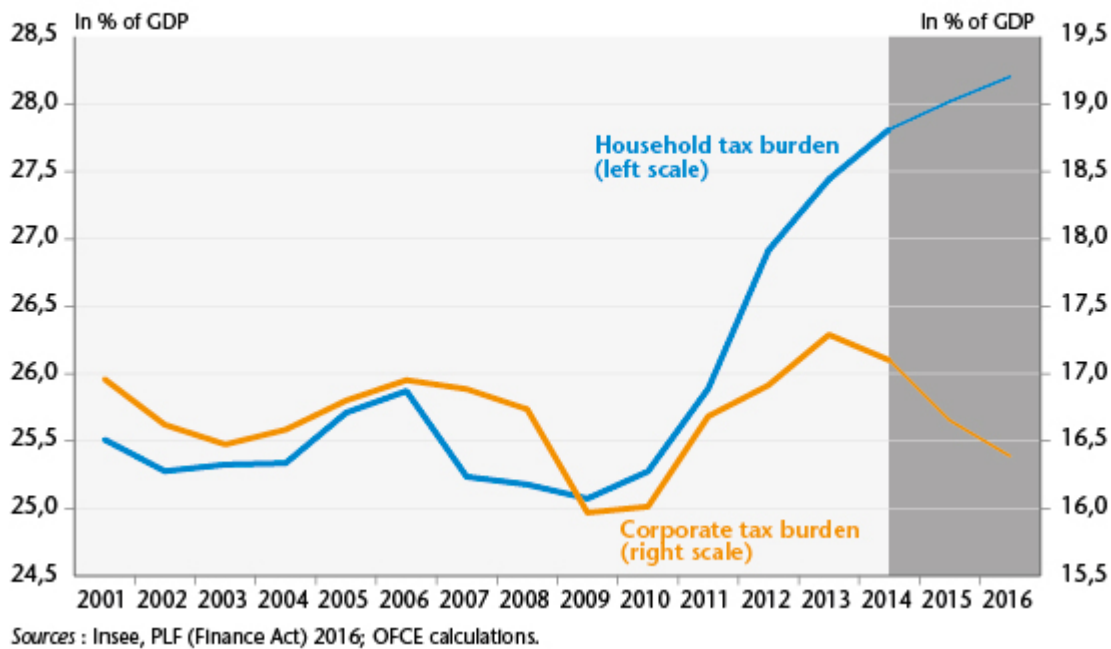
tax (1.7 billion) and the CSPE tax (1.1 billion), measures on financing pensions (0.8 billion), and the expected increase in local taxation (1.1 billion). Note that the elimination of the PPE working tax credit in 2016 will mechanically lead to an increase in the household tax burden of 2 billion<sup>[4]</sup>, but this will be offset by an equivalent amount for the new Prime d'activité working tax credit.

Ultimately, over the period 2010-2016, the household tax burden will increase by 66 billion euros (3.1 GDP points) and the burden on business by 8 billion (0.4 GDP point). The household tax burden will reach a historic high in 2016, at 28.2% of GDP. Conversely, the corporate tax burden in 2016 will amount to 16.4% of GDP, less than before the 2008 crisis. And in 2017, the last phase of the Responsibility Pact (with the complete elimination of the C3S tax and the reduction of IS corporate tax rates) and the expected CICE-related reimbursements should lead to cutting corporate taxation by about 10 billion euros, bringing the corporate tax burden down to the lowest point since the early 2000s.

The need to finance measures both to enhance corporate competitiveness and to reduce the structural deficit is placing the entire burden of the fiscal adjustment on households. Thus, the reduction in income tax in 2015 and 2016 will not offset the rise in other tax measures, most of which were approved in Finance Acts prior to 2015, and seems low in relation to the tax shock that has hit households since 2010. However, how these recent tax changes affect growth and the consequent impact on inequality will depend on the way business makes use of the new resources generated by the massive decline in its tax burden since 2014. These funds could lead to a rise in wages, employment, investment or lower prices or to higher dividends and a reduction in debt. Depending on the way business allocates these, the impact to be expected on the standard of living in France and on inequality will not of course be the same. An evaluation of

the impact of these changes on the tax burden will surely lead to future studies and debate.

**Figure: Changes in the tax burden on households and business**



[\[1\]](#) The tax burden on households includes direct taxes (CSG, CRDS, IRPP, housing tax, etc.), indirect taxes (VAT, TICPE, CSPE, excise taxes, etc.), tax on capital (ISF, DMTG, property tax, DMT0, etc.), and salaried and self-employed social security contributions. The corporate tax burden includes the various taxes on production (value-added tax and corporate property tax (ex-TP), property tax, C3S tax, etc.), taxes on wages and labour, corporate income tax and employer social security contributions.

[\[2\]](#) For example, employer social contributions for pensions are analyzed here as a tax burden on business and not as deferred wages for households or a transfer of income from assets to retirees.

[\[3\]](#) In 2013, 61% of the tax burden was on households and 39% on business. However, over the 2010-2013 period, tax increases

were borne 64% by households and 36% by business, which was more or less their respective weights in taxation.

[\[4\]](#) The PPE credit will be replaced by the Prime d'activité working tax credit, in an equivalent amount, which also encompasses the RSA activité tax credit; for accounting purposes the PPE is considered as a public expenditure. However, this new measure should not change household income macroeconomically, but only the nature of the transfer. Thus, excluding the elimination of the PPE, the tax burden on households would increase by 2.1 billion in 2016.

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# 2015-2017 forecasts for the French economy

By [Mathieu Plane](#), [Bruno Ducoudré](#), [Pierre Madec](#), Hervé Péléraux and Raul Sampognaro

This text summarizes the [OFCE's economic forecast for the French economy for 2015-2017](#)

After a hesitant upturn in the first half of 2015 (with growth rates of 0.7% and 0% respectively in the first and second quarter), the French economy grew slowly in the second half year, with GDP rising by an average of 1.1% for the year as a whole. With a GDP growth rate of 0.3% in the third quarter of 2015 and 0.4% in the fourth quarter, which was equal to the pace of potential growth, the unemployment rate stabilized at 10% at year end. Household consumption (+1.7% in 2015) was boosted by the recovery in purchasing power due in particular to lower oil prices, which will prop up growth in 2015, but

the situation of investment by households (-3.6%) and the public administration (-2.6%) will continue to hold back activity. In a context of sluggish growth and moderate fiscal consolidation, the government deficit will continue to fall slowly, to 3.7% of GDP in 2015.

With GDP growth in 2016 of 1.8%, the year will be marked by a recovery, in particular by rising corporate investment rates. Indeed, all the factors for a renewal of investment are coming together: first, a spectacular turnaround in margin rates since mid-2014 due to a fall in the cost of energy supplies and the impact of the CICE tax credit and France's Responsibility Pact; next, the historically low cost of capital, which has been helped by the ECB's unconventional monetary policy; and finally, an improvement in the economic outlook. These factors will lead to an acceleration of business investment in 2016, which will increase by 4% on average over the year. Household consumption should remain strong in 2016 (+1.6%), driven by job creation in the market sector and by a slight fall in the savings rate. Fuelled by the rise in housing starts and building permits, housing investment will pick up (+3%), after shrinking for four years in a row. Foreign trade will be boosted by the impact of the euro's depreciation and the government's competitiveness policies, and will make a positive contribution to growth (+0.2 GDP point in 2016, the same as in 2015). Once the impact of the downturn in oil prices has fed through, inflation should be positive in 2016, but still low (1% on an annual average, after two years of virtual stagnation), a rate that is close to underlying inflation. The pace of quarterly GDP growth in 2016 will be between 0.5% and 0.6%: this will trigger a gradual closing of the output gap and a slow fall in the unemployment rate, which will end the year at 9.8%. The public deficit will be cut by 0.5 GDP point, due to savings in public spending, notably through the contraction of public investment (-2.6%), low growth in government spending (+0.9%), and the impact of the rise in tax revenues as the economy



recovers.

Assuming that the macroeconomic environment remains favourable, the output gap is expected to continue to close in 2017. With GDP growth of 2%, the government deficit will fall further to 2.7% of GDP, passing below the 3% bar for the first time in 10 years. Under the impact of the government's employment policies and the absorption of the overstaffing by companies, the unemployment rate will continue to fall, to 9.4% of the active population by the end of 2017.

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## Greece: an agreement, again and again

By [Céline Antonin](#), Raul Sampognaro, [Xavier Timbeau](#), [Sébastien Villemot](#)

<i>... La même nuit que la nuit d'avant</i>	[...The same
night as the night before	
<i>Les mêmes endroits deux fois trop grands</i>	The same
places, twice too big	
<i>T'avances comme dans des couloirs</i>	You
walk through the corridors	
<i>Tu t'arranges pour éviter les miroirs</i>	You
try to avoid the mirrors	
<i>Mais ça continue encore et encore ...</i>	But it
just goes on and on...]	

[Francis Cabrel, \*Encore et encore\*, 1985.](#)

Just hours before an exceptional EU summit on Greece, an

agreement could be signed that would lead to a deal on the second bail-out package for Greece, releasing the final tranche of 7.2 billion euros. Greece could then meet its deadlines in late June with the IMF (1.6 billion euros) as well as those in July and August with the ECB (6.6 billion euros) and again with the IMF (0.45 billion euros). At the end of August, Greece's debt to the IMF could rise by almost 1.5 billion euros, as the IMF is contributing 3.5 billion euros to the 7.2 billion euro tranche.

Greece has to repay a total of 8.6 billion euros by September, and nearly 12 billion by the end of the year, which means funding needs that exceed the 7.2 billion euros covered by the negotiations with the Brussels Group (i.e. the ex-Troika). To deal with this, the Hellenic Financial Stability Fund (HFSF) could be used, to the tune of about 10 billion euros, but it will no longer be available for recapitalizing the banks.

If an agreement is reached, it will almost certainly be difficult to stick to it. First, Greece will have to face the current bank run (despite the apparent calm in front of the bank branches, more than 6 billion euros were withdrawn last week according to the *Financial Times*). Moreover, even if an agreement can put off for a time the scenario of a Greek exit from the euro zone, the prospect of exceptional taxes or a tax reform could deter the return of funds to the country's banks. Furthermore, the agreement is likely to include a primary surplus of 1% of GDP by the end of 2015. But the [information on the execution of the state budget](#) up to May 2015 (published 18 June 2015) showed that revenue continues to be below the initial forecast (- 1 billion euros), reflecting the country's very poor economic situation since the start of 2015. It is true that the lower tax revenues were more than offset by lower spending (down almost 2 billion). But this is cash basis accounting. The [monthly bulletin](#) for April 2015, published on 8 June 2015, shows that the central government payment arrears have increased by 1.1 billion euros since the beginning of

2015. It seems impossible that, even with an excellent tourist season, the Greek government could make up this lag in six months and generate a primary surplus of 1.8 billion euros calculated on an accrual basis.

A new round of fiscal tightening would penalize activity that is already at half-mast, and it could be even more inefficient in that this would create strong incentives to underreport taxes in a context where access to liquidity will be particularly difficult. The Greek government could try to play with tax collection, but introducing a new austerity plan would be suicidal politically and economically. Discussion needs to get started on a third aid package, including in particular negotiations on the reduction of Greece's debt and with the counterparties to this relief.

Any agreement reached in the coming days risks being very fragile. Reviving some growth in Greece would require that financing for the economy is functioning once again, and that some confidence was restored. It would also require addressing Greece's problems in depth and finding an agreement that was sustainable over several years, with short-term steps that need to be adapted to the country's current situation. In our study, "[Greece on the tightrope](http://www.ofce.sciences-po.fr/blog/greece-tightrope/) [in French, or the English-language post describing the study at <http://www.ofce.sciences-po.fr/blog/greece-tightrope/>]," we analysed the macroeconomic conditions for the sustainability of the Greek debt. More than ever before, Greece is on the tightrope. And the euro zone with it.

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# The spirit of the letter of the law ... to avoid a “Graccident”

Raul Sampognaro and [Xavier Timbeau](#)

The noose, in the words of Alexis Tsipras, is getting tighter and tighter around the Greek government. The last tranche of the aid program (7.2 billion euros) has still not been released as the Brussels Group (the ex-Troika) has not accepted the conditions on the aid plan. The Greek state is therefore on the brink of default. It might be thought that this is simply one more episode in the drama that Greece has been acting out with its creditors and that, once again, at the last moment the money needed will be found. But if Greece has managed to meet its deadlines up to now, it has been at the price of expedients that it is not at all certain can be used again.

While tax revenues since the start of the year have been almost one billion euros behind the anticipated targets, the expenses for wages and pensions still have to be paid each month. This time the wall is getting closer, and an agreement is needed if the game is to continue. In June, Greece must pay 1.6 billion euros to the IMF in four tranches (5, 12, 16 and 19 June). On 28 May an IMF spokesperson confirmed the existence of a rule that would make it possible to group these payments on the last day of the month (a rule last used by Zambia in the 1980s). Since it would then take six weeks for the IMF to consider Greece in default, the country could still gain a few days after 30 June before the deadline with the ECB (with 2 tranches for a total 3.5 billion euros by 20 July 2015).

Historically very few countries have failed to honour their

payments to the IMF (currently only Somalia, Sudan and Zimbabwe are in arrears to the IMF, for a few hundred million dollars). As the IMF is the last resort in case of a crisis in liquidity or the balance of payments, it has, as such, the status of preferred creditor, so defaulting on its debt may trigger cross defaults on other securities, in particular, in the Greek case, those held by the [European Financial Stability Facility](#) (EFSF). This could make them due immediately. A Greek default with the IMF could well jeopardize Greece's entire public debt and force the ECB to reject Greek bonds as collateral in the Emergency Liquidity Assistance (ELA) operations, the only firewall remaining against the collapse of the Greek banking system.

The legal consequences of such a default are difficult to grasp (which says a lot about the modern financial system). [An article published by the Bank for International Settlements, dated July 2013](#), whose author, Antonio Sainz de Vicuña, was then Director General of ECB Legal Services, is very informative about this issue in the context of the Monetary Union.

In presenting the legal framework, Sainz de Vicuña focuses on Article 123 of the [Treaty on the Functioning of the European Union \(TFEU\)](#), a pillar of the Monetary Union, which prohibits the ECB or the national central banks from financing government<sup>[1]</sup>. In a footnote, the author concedes that there are two exceptions to this rule:

- “Credit institutions controlled by the public sector, which may obtain central bank liquidity on terms identical to private credit institutions.” This exception appears explicitly in paragraph 2 of Article 123 of the TFEU<sup>[2]</sup>.

- “The financing of state obligations vis-à-vis the IMF.”

This second aspect has attracted our attention because it is little known to the general public, it does not appear explicitly in the Treaty and it could be a solution, at least in the short term, to avoid Greece being put in default by the IMF .

In searching the corpus of European law, this exception is defined more precisely in [Council Regulation no. 3603/93](#), which clarifies the terms of Article 123 of the TFEU, which it is authorized to do under paragraph 2 of Article 125 of the TFEU[3]. More specifically, in Article 7:

*The financing by the European Central Bank or the national central banks of obligations falling upon the public sector vis-à-vis the International Monetary Fund or resulting from the implementation of the medium-term financial assistance facility set up by Regulation (EEC) No 1969/88 (4) shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty*[4].

The justification for this article is that: during quota increases in the IMF, the financing by the central bank was accepted because it had as a counterpart an asset comparable to international reserves. In the spirit of the law, financing Greek borrowing from the IMF by a credit from the central bank (the ECB or the Bank of Greece) should not be permitted. The obligations falling upon the Greek state probably only concern, according to the spirit of the text, the contribution to the IMF quotas. Nevertheless, the spirit of the law is not the law, and the proper interpretation of the phrase “obligations falling upon the public sector vis-à-vis the International Monetary Fund” could open another door for Greece. Given the consequences of a default with the IMF – in particular the continuity of the ELA – invoking this could be justified as preserving the functioning of the Greek payment system, a role falling within the mission of the ECB.

Beyond the legal possibility of a central bank financing

Greece's debt to the IMF, which would certainly be challenged by some governments, this action would open up a political conflict. A MemberState could be accused of violating (the spirit of) the Treaties, even though that is not a reason to exclude it ([according to the ECB's Legal Services](#)). But is this really an obstacle in view of the importance a default on Greece's debt would have for the sustainability of the single currency?

Greece's cash flow problems are not new. Since January, the government has been financing its expenditure through [accounting transactions that allowed it to offset tax losses](#). In particular, on 12 May, the Greek government was able to repay an IMF loan tranche by drawing on an emergency fund that was essentially international reserves. The Eurosystem was able to use this exception to give Greece extra time in order to continue the negotiations and avoid the accident.

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[\[1\]](#) Paragraph 1 of the article stipulates that, "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

[\[2\]](#) Which stipulates that, "Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions."

[\[3\]](#) Which stipulates that, "The Council, on a proposal from

the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article.”

[4] Article 104 became Article 123 in the TFEU.

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## Greece on a tightrope

By [Céline Antonin](#), Raul Sampognaro, [Xavier Timbeau](#) and [Sébastien Villemot](#)

[\*This text summarizes the special study, “Greece on a tightrope”\*](#)

Since early 2015, Greece’s new government has been facing intense pressure. At the very time that it is negotiating to restructure its debt, it is also facing a series of repayment deadlines. On 12 May 2015, 750 million euros was paid to the IMF by drawing on the country’s international reserves, a sign that liquidity constraints are becoming more and more pressing, as is evidenced by [the letter](#) sent by Alex Tsipras to Christine Lagarde a few days before the deadline. The respite will be short: in June, the country has to make another payment to the IMF for 1.5 billion euros. These first two deadlines are only a prelude to the “wall of debt” that the government must deal with in the summer when it faces repayments of 6.5 billion euros to the ECB.

Up to now, Greece has made its payments despite its difficulties and the suspension of the bailout program negotiated with the “ex-Troika”. Thus, 7.2 billion euros in



remaining disbursements have been blocked since February 2015; Greece has to come to an agreement with the former Troika before June 30 if it is to benefit from this financial windfall, otherwise it will fail to meet its payment deadlines to the ECB and IMF and thus default.

Besides Greece's external repayments, the country must also meet its current expenses (civil servant salaries, retirement pensions). But the news on the fiscal front is not very encouraging (see [State Budget Execution Monthly Bulletin, March 2015](#)): for the first three months of the year, current revenue was nearly 600 million euros below projections. Only the use of its European holding funds, combined with an accounting reduction in expenditures (1.5 billion euros less than forecast) allowed the Greek government to generate a surplus of 1.7 billion euros and to meet its deadlines. So by using bookkeeping operations, the Greek government was able to transfer its debt either to public bodies or to its providers, thus confirming the tight liquidity constraints facing the State. Preliminary data at the end of April (to be taken with caution because they are neither definitive nor consolidated for all government departments) seem nevertheless to qualify this observation. [At end April](#), tax revenues had returned to their expected level; however, the government's ability to generate cash to avoid a payment default is due to its holding down public spending through the accounting operations described above. These accounting manipulations are simply emergency measures, and it is high time, six years after the onset of the Greek crisis, to put an end to this psychodrama and finally find a lasting solution to Greece's fiscal difficulties.

Our study, ["Greece on a tightrope"](#), considers what would be the best way to resolve the Greek debt crisis over the long term and the potential consequences of a Greek exit from the euro zone. We conclude that the most reasonable scenario would be to restructure the country's debt, with a significant

reduction in its present value (cutting it to 100% of Greek GDP). This is the only way to significantly reduce the likelihood of a Grexit, and is in the interest not only of Greece but also of the euro zone as a whole. Furthermore, this scenario would reduce the scale of the internal devaluation needed to stabilize Greece's external position.

If the Eurogroup were to refuse to restructure Greece's debt, a new assistance program would then be needed in order to deal with the current crisis of confidence and to ensure funding for the cash needs of the Greek State over the coming years. According to our calculations, this solution would require a third bailout plan of around 95 billion euros, and its success would depend on Greece being able to generate major primary budget surpluses (of around 4% to 5% of Greek GDP) over the coming decades. Historical experience shows that, due to political constraints, there is no guarantee of being able to run a surplus of this magnitude for such a long time, so this commitment is not very credible. A new assistance program would not therefore eliminate the risk that the Greek State would face yet another financial crisis in the coming years.

In other words, the full repayment of the Greek debt is based on the fiction of running a budget surplus for several decades. Accepting a Greek exit from the euro zone would imply a significant loss of claims that the world (mainly Europe) holds both on the Greek public sector (250 billion euros) and on the private sector (also on the order of 250 billion). To this easily quantifiable loss would be added the financial, economic, political and geopolitical impact of Greece's departure from the euro zone and possibly the European Union. This might look like an easy choice, since writing off 200 billion euros in loans to the Greek State would make it possible to end this psychodrama for once and for all. But the political situation is deadlocked, and it is difficult to give up 200 billion euros without very strong counterparties and without dealing with the issue of moral hazard, in particular

the possibility that this could induce other euro zone countries to demand large-scale restructurings of their own public debt.

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# The planetary alignment has not always been favourable to the euro zone countries

By [Eric Hoyer](#) and Raul Sampognaro

In 2015, the euro zone economies will benefit from a favourable [“planetary alignment”](#) (with the euro and oil prices down and financial constraints on the economy easing), which should trigger [a virtuous circle of growth](#). Over the previous four years (2011-2014), the “planetary alignment” that existed was in a diametrically opposite direction: the euro and oil prices were high, with financing conditions and the fiscal stance very tight.

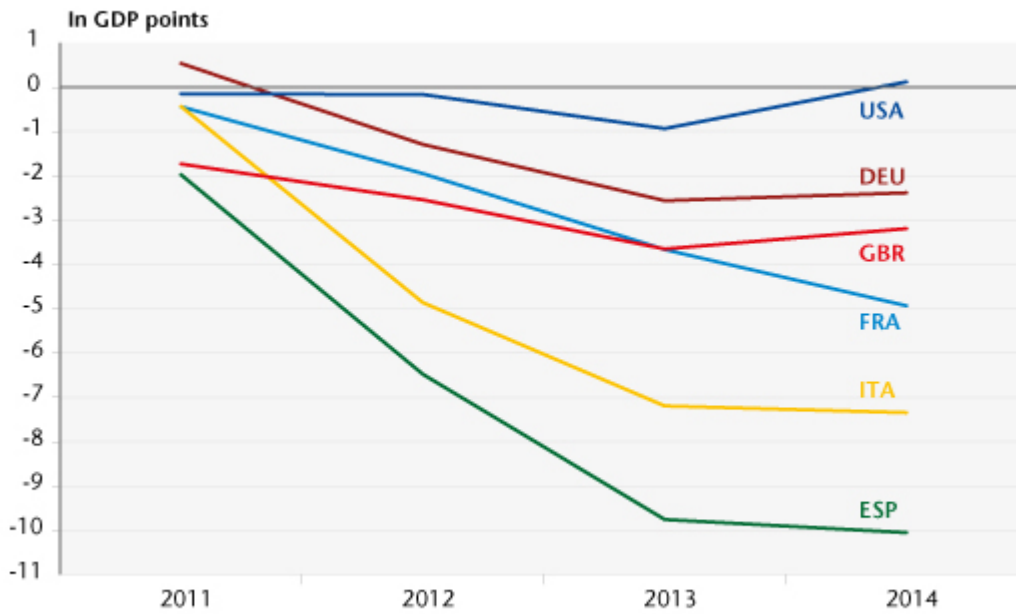
In [a recent article](#), we propose an evaluation of the impact of these four factors on the economic performance of six major developed countries since 2011 (France, Germany, Italy, Spain, the UK and USA).

It is clear from our analysis that the combination of these shocks explains a large part of the differences in growth recorded during the period 2011-2014 between the United States and the major European economies. A non-negligible part of this performance gap is explained in particular by the difference in the economic policies adopted, with a policy mix

that has been much more restrictive in the euro zone than in the case of the US. In particular, a very sharp fiscal adjustment took place in the countries experiencing pressure on their sovereign debt, such as Spain and Italy. In addition, the effects of the pressure on sovereign debt were multiplied by financial fragmentation, which can be seen in the deterioration of private sector financing terms, whereas the quantitative easing measures taken by the Fed and the Bank of England helped to prop up financing conditions in these countries. It was not until Mario Draghi's speech in July 2012 and [the announcement of the OMT programme](#) in September 2012 that the ECB's actions were sufficient [to reduce the financial pressure](#). While exchange rate trends tended to support activity in the euro zone throughout 2011-2014, the contribution of this factor depended on the way the various countries were integrated with global trade flows [\[1\]](#) and on the scale of wage disinflation, which was particularly pronounced in Spain. Finally, the rise in oil prices held back Europe's growth, while it had less impact in the United States, which [benefited from the exploitation of shale oil](#).

The cumulative loss in GDP was very significant in Spain (-10 points between 2011 and 2014), Italy (-7.5 points) and France (-5 points) and more moderate in the UK (-3 points) and Germany (-2.5 points). In contrast, the cumulative impact since 2011 on growth in the United States was zero, suggesting that real growth in the US was in line with spontaneous growth [\[2\]](#) (Figure 1).

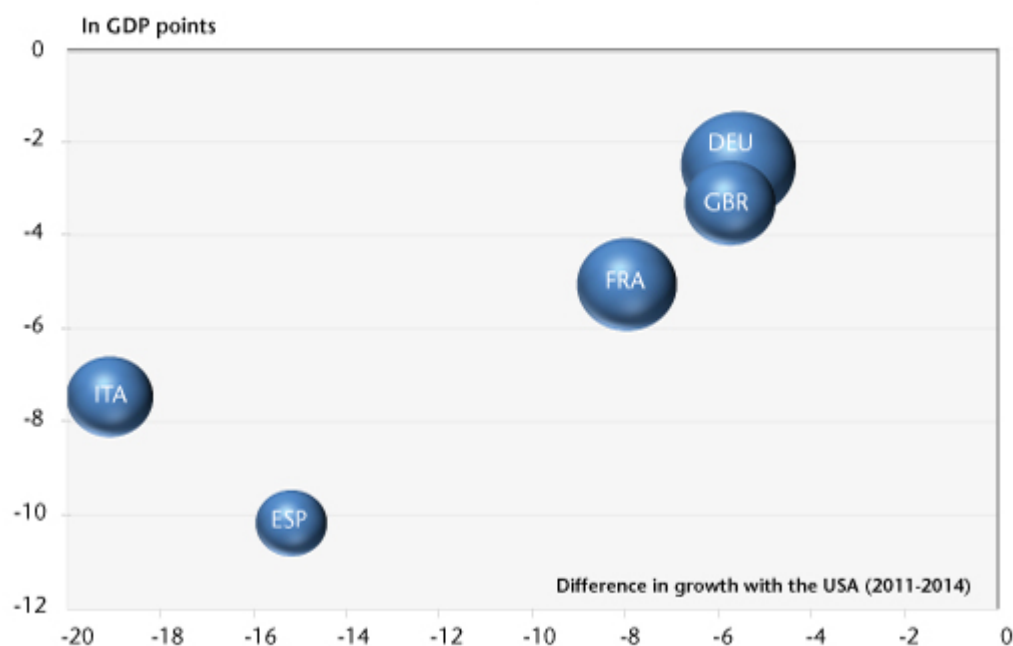
Figure 1. Cumulative impact on GDP of various shocks since 2011



Sources: National accounts, OFCE calculations.

Thus, in the absence of these shocks, Europe's spontaneous growth could have exceeded the rate of potential growth, as in the United States (Figure 2). This would have led in the euro zone countries in particular to a long-term convergence of GDP with its potential level, to a reduction in imbalances on the labour market, to the normalization of capacity utilization, and to a recovery in the public accounts.

**Figure 2. Difference in growth and the cumulative impact on GDP of various shocks for countries over the period 2011-2014**



Sources: OECD eo96 for the output gap, national accounts, OFCE calculations for the impact of the shocks.

[Go to the full version of our study.](#)

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[1] The impact of these competitiveness shocks differs across countries because of differences in the elasticity of foreign trade, but also due to variations in the countries' degree of exposure to trade and to intra / extra euro zone competition. For more on this, see [Ducoudré and Heyer \(2014\)](#).

[2] An economy's spontaneous growth results from its long-term potential growth (which depends on structural factors that determine in particular changes in the global productivity of the factors and the labour force) and the rate of closing the output gap, which was deepened in most countries by the 2008-2009 crisis and which depends on an economy's capacity to absorb the shocks that hit it.

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# France: Recovery ... at last!

By [Mathieu Plane](#), [Bruno Ducoudré](#), [Pierre Madec](#), Hervé Péléraux and Raul Sampognaro

**[The OFCE's forecast for the French economy in 2015-2016 is now available.](#)**

Not since the beginning of the subprime crisis has the French economy been in such a favourable situation for a recovery. The fall in oil prices, the ECB's proactive and innovative policy, the easing of fiscal consolidation in France and the euro zone, the gathering impact of the CICE tax and the implementation of the Responsibility Pact (representing a tax transfer to business of 23 billion euros in 2015 and nearly 33 billion in 2016) all point in the same direction. The main obstacles that have held back French activity over the last four years (over-calibrated fiscal austerity, a strong euro, tight financial conditions, and high oil prices) should all be out of the way in 2015 and 2016, with pent-up growth finally released. The supply policy being pushed by the government, whose impact on business is still pending, will be all the more effective thanks to the positive demand shock from foreign trade, which will allow the economic rebalancing that was lacking up to now.

French GDP will grow by 1.4% in 2015, with the pace accelerating in the course of the year (to 2% yoy). The second half of 2015 will mark the turning point in the recovery, with the corporate investment rate picking up and the unemployment rate beginning to fall, ending the year at 9.8% (after 10% in late 2014). 2016 will then be the year of recovery, with GDP growth of 2.1%, a 4% increase in productive investment and the creation of nearly 200,000 private sector jobs, pushing the

unemployment rate down to 9.5% by end 2016. In this positive context, the public deficit will fall significantly, and is expected to be 3.1% of GDP in 2016 (after 3.7% in 2015).

Obviously this virtuous cycle will only take effect if the macroeconomic environment remains favourable (low oil prices, a competitive euro, no new financial tensions in the euro zone, etc.) and if the government limits itself to the budget savings already announced.

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## **Flexibility versus the new fiscal effort – the last word has not been spoken**

By Raul Sampognaro

On 13 January, the [Juncker Commission clarified its position on the flexibility](#) that the Member States have in implementing the Stability and Growth Pact (SGP). The new reading of the SGP should result in reining in the fiscal consolidation required for certain countries<sup>[1]</sup>. Henceforth, the Commission can apply the “structural reform clause” to a country in the corrective arm of the Pact<sup>[2]</sup>, whereas previously this was only possible for countries in the Pact’s preventive arm<sup>[3]</sup>. This clause will allow a Member State to deviate temporarily from its prior commitments and postpone them to a time when the fruits of reform would make adjustment easier. In order for the Commission to agree to activate the clause, certain conditions must be met:



- The reform plan submitted by the Member State must be major and detailed, and approved by the Government or the National Parliament; its timetable for implementation must be explicit and credible;
- The plan must have a favourable impact on potential growth and / or the public finances in the medium-term. The quantification of the impact should be carried out transparently and the Member State must submit the relevant documentation to the Commission;
- The Member State must make a structural budget improvement of at least 0.5 GDP point.

In this new context, France has reforms it can point to, such as the regional reform and the law on growth and activity, the so-called Macron law. [According to OECD calculations from October 2014](#), the reforms already underway or being adopted [\[4\]](#) could boost GDP by 1.6 points over the next 5 years while improving the structural budget balance by 0.8 GDP point [\[5\]](#) (the details of the impacts estimated by the OECD are shown in Table 1).

**Table 1. Impact on GDP of the reforms underway or announced**

In points

Reforms	Impact on GDP at 5 years	Impact on GDP at 10 years
<b>Reforms underway</b>	1.2	3.0
Greater competition (administrative simplification shock and first measures on regulated professions)	0.2	0.3
Labour market reform	0.6	1.3
– including CICE tax credit and Responsibility Pact	0.5	1.1
– others (unemployment insurance reform, active policies)	0.1	0.2
Modification of tax system	0.1	0.4
Creation of “metropolises” (Paris and Aix-Marseille)	0.3	1.0
<b>Reforms announced</b>	0.4	0.7
Increase in competition in electricity and gas and reform of the regulated professions (reform a little broader than the Macron law)	0.4	0.7

Source: OCDE (2014), “France. Structural reforms: impact on growth and options for the future”. October 2014.

In March, the Commission will decide whether France’s 2015 Finance Act complies with the rules of the SGP. To benefit from the structural reform clause, France must then meet certain conditions:

1) The outline of the reforms needs to be clarified: [at end December 2014, the Commission felt that there were still many lingering uncertainties](#) concerning the regional reform and the content of the Macron law, uncertainties that will be resolved in the course of the parliamentary process.

2) The Ministry of Finance at Bercy must produce credible assessments of the impact of the Macron law, while the Commission will carry out its own evaluation. The Commission has already noted that the OECD's calculations will constitute the upper bound of the impact.

The evaluation of the 2015 Finance Act may result in the imposition of financial sanctions on France, unless the government decides to go for a greater fiscal adjustment. [The Commission warned in late November that further steps would be needed to ensure that the 2015 budget complies with the SGP.](#) Indeed, the Commission found that the adjustment was only 0.3 GDP point, while in June 2013 France had committed to an annual structural adjustment of 0.8 point in 2015 to bring its deficit below 3% in 2015[\[6\]](#).

While the Commission approves the positive effects expected from the reforms, there is a problem with the application of the "structural reform clause": the structural budgetary adjustment is still below 0.5 GDP point, which prevents the application of the new clause. France therefore still faces the threat of sanctions, despite the new doctrine.

While this analysis of the [document published on January 13](#) shows that the Commission has given the Pact greater flexibility, it also shows that the Commission expects France to make a larger fiscal adjustment. This would be on the order of 4 billion euros (0.2 percent of French GDP) instead of the 8 billion (0.4 percent of GDP) that would have been expected back in October (the impact of a strict reading of the Pact has been analyzed [here](#)).

The Government's refrain is that it does not wish to go any further with fiscal adjustment, that this is not desirable in the current economic climate: 2015 could be a year for recovery provided that the risk of deflation is taken seriously. There is a lot of support for economic activity, including lower prices for oil and the euro, an expansionary monetary policy and the Juncker plan, even if the latter needed to go much further. However, France's fiscal policy is continuing to be a drag, and just how much so will remain uncertain until March. From now till then, with the terms of the debate clearly spelled out, everyone will need to take the risk of deflation seriously.

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[1] The Commission permits subtracting investments made under the Juncker Commission Plan from the deficit calculation; it clarifies the applicability of the "structural reform clause" and moderates the speed of convergence towards the medium term objectives (MT0) for countries in the preventive arm of the Pact based on their position in the business cycle.

[2] *Grosso modo* this means countries with a deficit of more than 3%.

[3] *Grosso modo* this means countries with a deficit of less than 3%.

[4] Which goes beyond the Macron law alone and includes the CICE tax credit and the Responsibility Pact.

[5] The OECD data were used by the Prime Minister in his [October 27 letter to the Commission](#).

[6] In its 2014 autumn forecast, the Commission quantified the adjustment at 0.1 GDP point, but this figure is not directly comparable with the commitment of 0.8 point from June 2013.

Once the changes in national accounting standards and the unpredictable changes in certain variables are taken into account, the corrected adjustment is 0.3 GDP point. This figure is the calculation basis for the excessive deficit procedure.

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## Devaluation through wages in the euro zone: a lose-lose adjustment

by Sabine Le Bayon, [Mathieu Plane](#), Christine Riffart and Raul Sampognaro

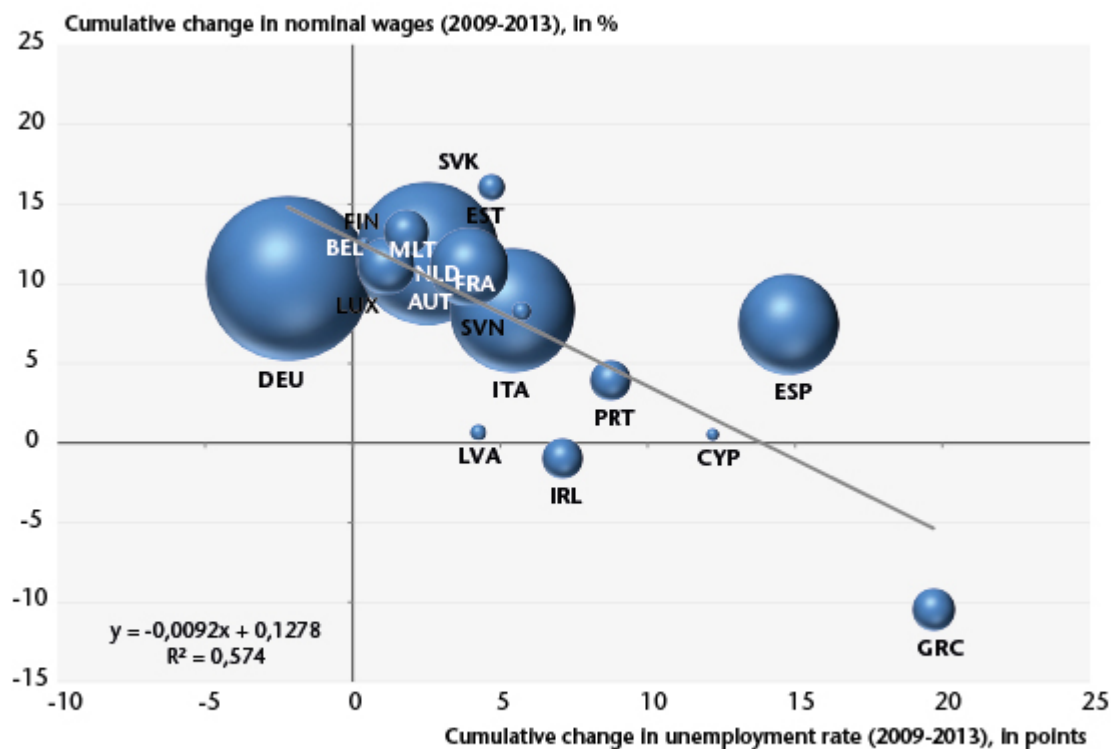
Since the outbreak of the financial crisis in 2008 and the sovereign debt crisis in 2010-2011, the euro zone countries have developed adjustment strategies aimed at restoring market confidence and putting their economies back on the path to growth. The countries hit hardest by the crisis are those that depended heavily on the financial markets and had very high current account deficits (Spain, Italy, but also Ireland, Portugal and Greece). Although the deficits have now been largely resolved, the euro zone is still wallowing in sluggish growth, with deflationary tendencies that could intensify if no changes are made. Without an adjustment in exchange rates, the adjustment is taking place through jobs and wages. The consequences of this devaluation through wages, which we summarize here, are described in greater depth in [the special study published in the dossier on the OFCE's forecasts \(Revue de l'OFCE, no. 136, November 2014\)](#).

## **An adjustment driven by moderation in wage increases ...**

Faced with falling demand, companies have adapted by making heavy cutbacks in employment in order to cut costs, which has led to a steep rise in unemployment. The number of jobless in the euro zone was 7 million higher in September 2014 than in March 2008. The situation is especially glum in countries like Greece, where the unemployment rate is 26.9%, Spain (24.2%), Portugal (13.8%) and Italy (12.5%). Only Germany has experienced a reduction in unemployment, with a rate of 5.0% of the active population.

As is suggested by the Phillips curve, runaway unemployment has eventually affected the conditions governing wage increases, especially in the most crisis-ridden countries (Figure 1). While between 2000 and 2009 wage growth was more dynamic in the peripheral countries (3.8% annually) than in the countries in the euro zone core (+2.3%) [\[1\]](#), the situation reversed after 2010. Nominal wage growth slowed in the peripheral countries (0.8%), but stayed close to the pre-crisis rate (+2.6%) in the core countries. This heterogeneity is due to differences in how much unemployment has worsened in the different countries. According to Buti and Turrini (2012) [\[2\]](#) from the European Commission, reversing the trend in wage dynamics will be a major factor driving the rebalancing of current account positions in the euro zone.

**Figure 1. Changes in unemployment rates and nominal compensation per employee**



*Note:* The size of the bubble is proportional to the GDP of each country in the euro zone.  
*Sources :* Eurostat, OFCE calculations.

Furthermore, an analysis at the macroeconomic data level masks the extent of the ongoing wage moderation, as the effects of the crisis are concentrated on the most vulnerable populations (young, non-graduate employees) earning the lowest wages. The deformation of the structure of employment in favour of more skilled and more experienced workers ([see the OFCE post: On the difficulty of carrying out structural reforms in a context of high unemployment](#)) is also pushing up mid-level wages. As can be seen in a number of studies based on an analysis of the macroeconomic data [3], wage growth after correcting for these composition effects is below the increase in the average salary.

**... that compresses domestic demand and is not very effective in terms of competitiveness**

Underlying this policy of deflationary adjustment through wages, what is important for companies is to improve

competitiveness and regain market share. Thus, compared with the beginning of 2008, unit labour costs (ULC) [\[4\]](#) fell in the countries deepest in crisis (Spain, Portugal and Ireland), slowed in Italy and continued their upward progression in the countries in the euro zone core, *i.e.* those facing the least financial pressure (Germany, France, Belgium and the Netherlands).

The most significant adjustment took place in Spain. Deflated by inflation, its ULC has fallen by 14% since 2008, 13 points of which are explained by the recovery in productivity, which was achieved at the expense of massive cuts in employment. Real wages increased only 1% over the period. Conversely, in Italy, the adjustment has focused on wages, whose purchasing power has fallen by 5%. However, this decline was not sufficient to offset the fall in productivity, and thus to prevent an increase in the real ULC. In Germany, after the real ULC rose in 2008, real wages continued to rise, but less than gains in productivity. In France, real wages and productivity have risen in tandem at a moderate pace. The ULC, deflated by inflation, has thus been stable since 2009 but has still worsened compared to 2008.

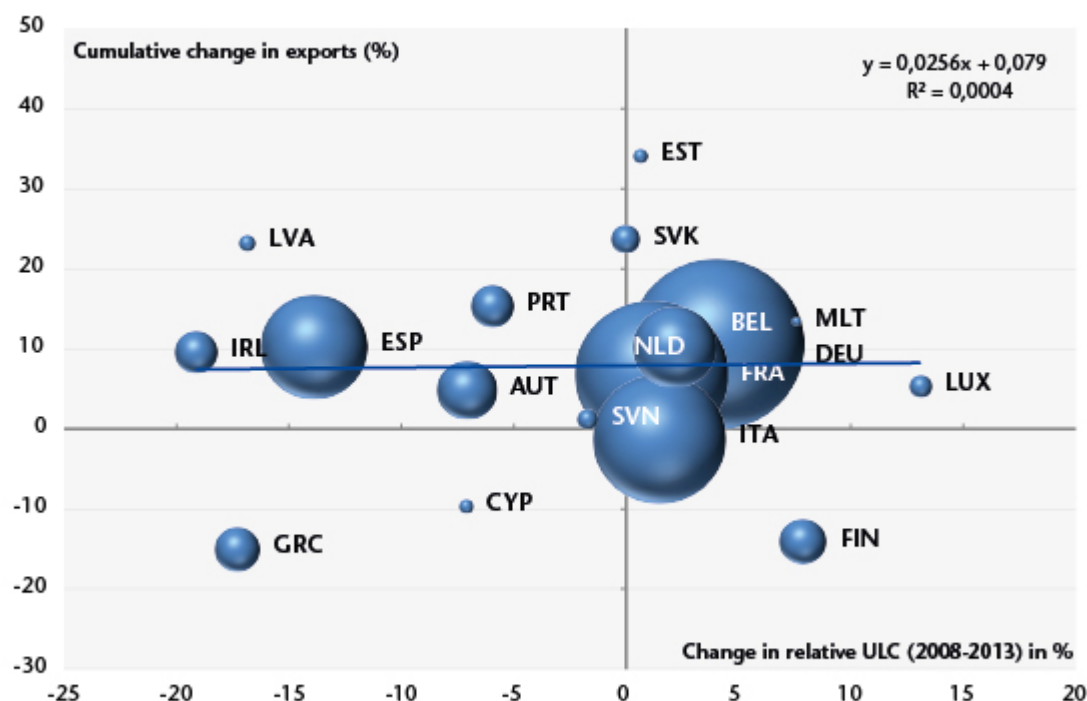
Even though this deflationary strategy is intended to restore business competitiveness, it is a double loser. First, as the strategy is being implemented jointly in all the countries in the euro zone, these efforts wind up neutralizing each other. Ultimately, it is the countries that carry the strategy furthest that win the “bonus”. Thus, among the euro zone’s larger economies, only Spain can really benefit due to the sharp reduction in its ULC, which reflects not only its own efforts but also some continued wage growth among its key partners. France and Italy are not experiencing any gain, and Germany has seen a deterioration in its ULC of about 3% between 2008 and 2013. Moreover, while the wage devaluation might have helped to boost activity, this will have been accomplished through a rebound in exports. But it is difficult

to find any correlation between exports and wage adjustments during the crisis (Figure 2). These results have already been pointed out by [Gaulier and Vicard \(2012\)](#). Even if the countries facing the deepest crisis (Spain, Greece, Portugal) might gain market share, the volumes exported by each of them are in the short/medium term not very sensitive to changes in labour costs. This might be explained by companies' preference to rebuild their margins rather than to lower export prices. Even in countries where the relative ULC fell sharply, the prices of exports rose significantly (6.2% in Greece, 3.2% in Ireland since 2008, etc.).

Finally, in an effort to improve their cost competitiveness, companies reduced their payroll by cutting employment and / or wages. This strategy of competitive disinflation results in pressure on household incomes and thus on their demand for goods, which slows the growth of imports. Indeed, in contrast to what is observed for exports, there is a close and positive relationship between changes in the relative ULC and in import volumes over the period 2008-2009 (Figure 3). In other words, the greater the adjustment effort in the ULC with respect to competitor countries, the slower the growth in import volumes.



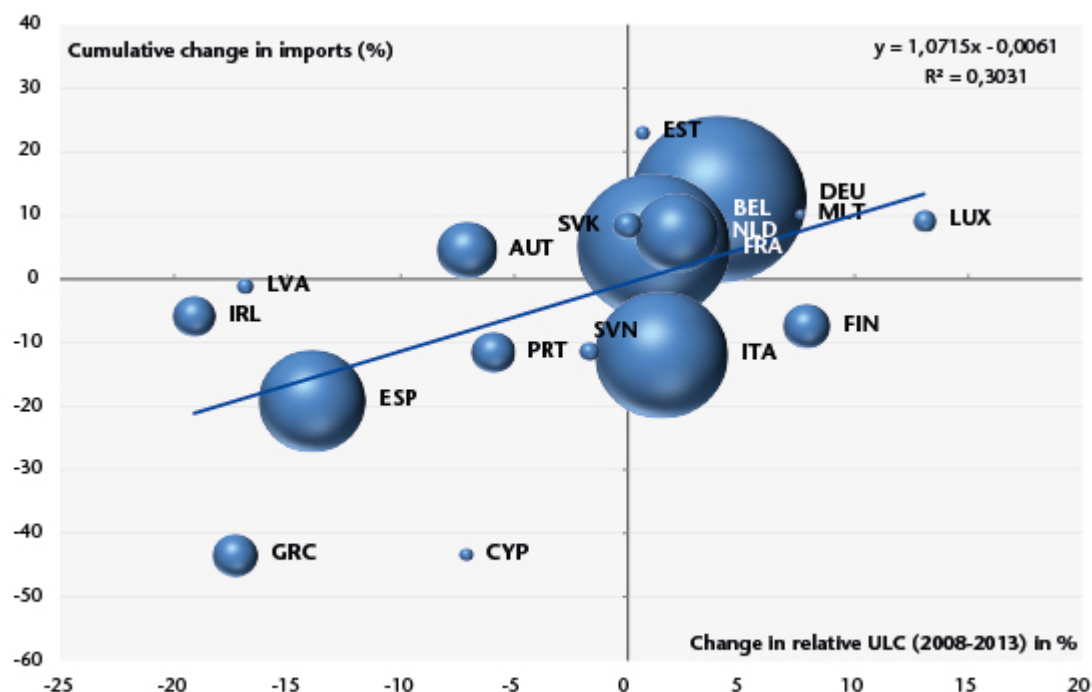
**Figure 2 : Change in relative ULC and exports, in volume**



*Note:* The size of the bubble is proportional to the GDP of each country in the euro zone.

*Sources :* Eurostat, OFCE calculations.

**Figure 3. Change in relative ULC and imports, in volume**



*Note:* The size of the bubble is proportional to the GDP of each country in the euro zone.

*Sources :* Eurostat, OFCE calculations.

This non-cooperative strategy to rebalance the current account can permanently affect an economic recovery in a context where reducing the debt of both private and public agents will become even more difficult if deflationary pressures are felt in an ongoing way (due to increases in real terms in debt and interest rates). The imbalances in the current accounts of the various euro zone countries will thus be dealt with *mainly* by a contraction of imports. The correction of such imbalances by means of a wage devaluation, as was the case in 2010-2011, is therefore doubly expensive: a low impact on competitiveness, relative to competitors, due to the simultaneous implementation of the strategy in the various euro zone countries, and an increased risk of deflation, making it more difficult to shed debt, thereby fuelling the possibility of a scenario of prolonged stagnation in the euro zone.

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[1] Germany, France, Belgium and the Netherlands. The peripheral countries include Spain, Italy, Portugal and Greece.

[2] Buti and Turrini (2012), "[Slow but steady? Achievements and shortcomings of competitive disinflation within the Euro Area](#)".

[3] For a comparison of a number of euro zone countries at the start of the crisis, see ECB (2012), "[Euro Area Labor Markets and the Crisis](#)". For the case of Spain, see Puente and Galan (2014), "[Un analisis de los efectos composición sobre la evolución de los salarios](#)". Finally, for the French case, see Verdugo (2013) "[Les salaires réels ont-ils été affectés par les évolutions du chômage en France avant et pendant la crise?](#)" and Audenaert, Bardaji, Lardeux, Orand and Sicsic (2014), "[Wage resilience in France since the Great Recession](#)".

[4] The unit labour cost is defined as the cost of labour per

unit produced. This is calculated as the ratio between compensation per capita and average labour productivity.

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# **On the difficulty of carrying out structural reforms in a period of high unemployment**

By Sabine Le Bayon, [Mathieu Plane](#), Christine Rifflart and Raul Sampognaro

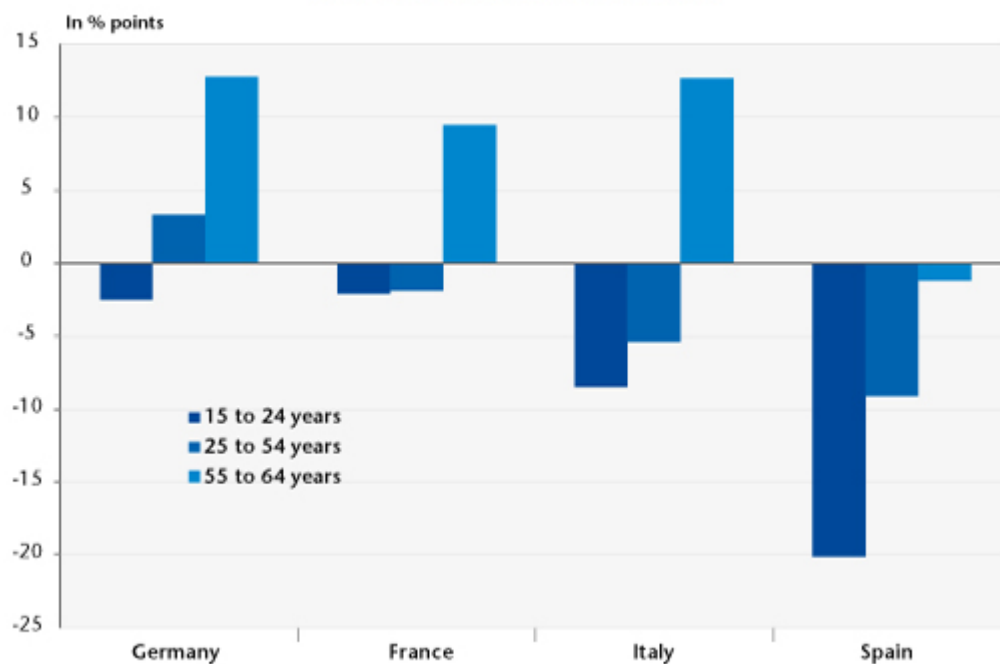
Structural reforms aimed at developing a more flexible labour market are often attributed all the virtues of fighting against mass unemployment and limiting the segmentation of the labour market between “insiders” on stable contracts and “outsiders” who are unemployed or on precarious contracts. When the economy is growing, these measures can facilitate job creation for the benefit of the outsiders, but the results are likely to be more uncertain in a context of mass unemployment and sluggish growth. Structural reforms can indeed reduce the labour market duality arising from regulatory measures but they cannot combat the duality of the labour market inherent in human capital, which is exacerbated during periods of mass unemployment: given the same qualifications it is experience that makes the difference, and given equal experience it is qualifications that make the difference. High unemployment therefore strengthens the phenomenon of “queuing” to access more stable jobs. Structural reforms aimed at streamlining the labour market will thus primarily affect employees who have less qualifications and experience without however enabling outsiders to gain access to more stable employment. This means

that inequality between workers is likely to rise, with no positive impact on employment due to the sluggishness of the economy. Only macroeconomic management that takes on board the goal of returning to full employment could lead to successful structural reform.

As we show in a special study, [“La dévaluation par les salaires dans la zone euro: un ajustement perdant-perdant” \[Devaluation through wages in the euro zone: a lose-lose adjustment\] \(Revue de l’OFCE, no. 136, November 2014\)](#), labour market segmentation has increased during the crisis despite the implementation of structural reforms in the euro zone countries. Since 2008, the employment rate [\[1\]](#) of seniors and of the better qualified has fared better than for other population groups in the four largest countries in the euro zone (Figures 1 and 2).

The sharp decline in the youth employment rate since 2008 is general – including in Germany, where the labour market has remained dynamic – and contrasts with the increase in the employment rate of older workers (or the small decline in Spain). The difference between these two categories is between 12 percentage points in France and 21 points in Italy (15 points in Germany and 19 in Spain). The adjustment in the employment rate of the 25-54 age group lies in an intermediate position. The resistance of the employment rate of older workers to the crisis is probably due to a combination of two factors: the introduction of pension system reforms in recent years (lengthening contribution periods and / or raising the legal retirement age) and the relatively higher cost of dismissing senior citizens, who more often occupy higher positions in the job hierarchy. In a crisis, it is likely that this has led to a substitution effect with the employment of older workers coming at the expense of the young.

Figure 1 : Changes in employment rate by age group between 2008 (Q1) and 2014 (Q2)

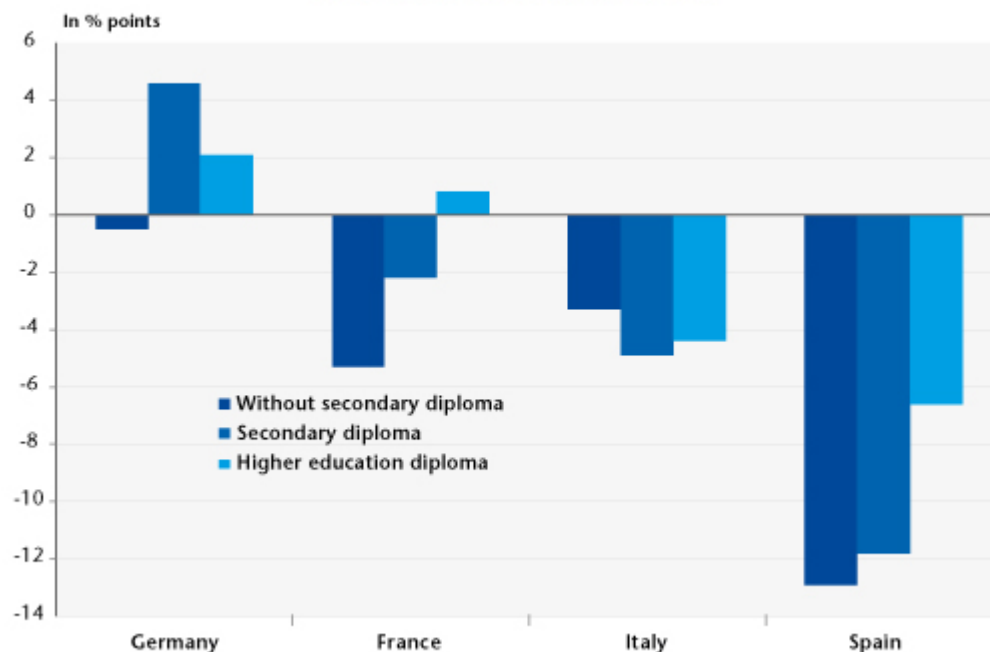


Sources : Eurostat, OFCE calculations.

The adjustments in employment rates were also more striking for people without a high school diploma, with the exception of Italy, where the diploma does not seem to provide protection from unemployment or inactivity. In France, the adjustment in the employment rate clearly decreased with the type of degree. In Germany, the employment rate for those with less education has declined during the crisis while it has increased for the other categories. In Spain, the employment rate of university graduates has withstood the crisis better than the rate of other population groups. In addition to these developments in employment rates by educational category, wage income in Italy, Spain and France has fallen for the initial income deciles. This adjustment in the wage incomes of the lower deciles is probably due to a reduction in total working hours over the year (part-time work, shorter temporary contracts or longer periods of unemployment between contracts, reducing average compensation over the year). Thus, in the countries hit hardest by the crisis, the most vulnerable populations, with the least human capital, have found themselves more exposed to a deteriorating labour market, whether this has been felt through falling employment rates or

a reduction in annual wage earnings.

Figure 2 : Changes in employment rate by level of diploma  
between 2008 (Q1) and 2014 (Q2)



Sources : Eurostat, OFCE calculations.

In the context of a deteriorating labour market, by accepting a slight downgrade the most qualified unemployed workers would be the first to find jobs, chasing out those who might otherwise have gotten it, who would themselves do the same thing at a lower level. This could explain why, at the end of the queue, it is the least skilled who are, regardless of labour legislation, the victims of unemployment and precarious employment.

The existence of a “spontaneous” segmentation in the labour market and the phenomenon of “queuing” may thus limit the success of a strategy of structural reforms and wage devaluation. In such a case, a more flexible labour market combined with a reduction in social welfare could increase inequalities between groups in the workforce without increasing the creation of full-time equivalent jobs.

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[\[1\]](#) This is the ratio of the employed to the working-age population.