The responsibility pact's obligation of a result

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

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

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

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

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

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

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

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

Important change of course at the Elysée Palace. Austerity is no longer the priority

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When he was elected François Hollande made fiscal discipline his main goal. The 2008 crisis was continuing to have an impact on the developed economies; in the face of a sovereign debt crisis, Europe's governments had been implementing austerity measures that were to cause a second recession, a "double dip", to use the language of economists. For example, when François Hollande came to power, the situation in France seemed disastrous: the public deficit was 5.2%, with a rise in the public debt of more than 600 billion euros since 2008 along with a 2-point rise in unemployment (to 9.6% of the workforce). The pressure was intense, and, the euro zone states were falling like dominos, with Spain and Italy in danger of following Greece, Portugal and Ireland. In this context, it seemed that only budgetary discipline could help Germany to support a faltering euro zone.

Yet the worst was still to come. By underestimating the magnitude of the fiscal multipliers (the impact of fiscal policy on activity), as was eventually recognized by the International Monetary Fund (IMF) and the European Commission, and as we had pointed out in July 2012, the consequences of generalizing this unprecedented fiscal effort throughout the European Union were dismissed.

What Francois Hollande had presumed would be a painful recovery preceding a rebound that would open up new possibilities proved instead to be a period of economic stagnation, where rising unemployment went in hand with bad fiscal news. When the fiscal multiplier is high, nothing works. The budget efforts were weighing down economic activity, and there was no real re-absorption of the government deficits. If this infamous multiplier had been low, François Hollande's strategy – and that of the euro zone as a whole – would have worked. But the multiplier is not at our beck and call; it was the result of an economic situation in which the balance sheets of agents were degraded, with the banks suffocating and expectations dire.

The second part of François Hollande's five-year term, which the press conference of 14 January 2014 was to launch, is now much more complicated than expected. Instead of a recovery in public finances, the debt has barely been stabilized despite an incredible effort. Instead of a strong recovery, what we have is, in the understated language of the INSEE, a "sluggish recovery", which really amounts to continuing recession, with unemployment rising relentlessly. Our businesses are anaemic, and to try to restore their margins, the tax credit for competitiveness and employment (the "CICE"), inspired by the Gallois report, has not really injected new blood.

To lower the cost of labour without increasing the deficit, households, though exhausted, have to be hit again. The fiscal multiplier is still high, and growth, along with a reversal in the trend in unemployment, is being postponed. Worse, the commitment to Brussels to reduce the public deficit (a structural effort of 0.8 GDP point by the end of the five-years, *i.e.* 50 billion euros in total) will postpone a reduction in unemployment until after 2017. The patient may well die from the cure, and at best it will be Hollande's successor in the 2017 elections, which he's lost in advance, who might hope to reap the benefits of a policy that prioritized deficit reduction at the worst possible time.

The responsibility pact now proposed by François Hollande is setting out a different path, a different choice. Instead of austerity, a reduction in the cost of labour is to be financed not by taxes but by fiscal spending (amounting to 1 GDP point). The bet is that the growth stimulated will bring in additional revenue to meet the commitments on the public deficit. A reduction in social charges of thirty billion euros was announced, replacing the current CICE (20 billion). This means an additional 10 billion euros that can be obtained by companies that are to engage in collective bargaining under the watchful eye of a bipartisan watchdog. While this does not simplify the complex CICE, it will promote social dialogue.

On the other hand, François Hollande confirmed that the target for cutting public expenditure remains, *i.e.* 16 billion euros in 2015 and 18 billion in 2016 and 2017, for a total of 50 billion, with no increase on previous announcements. The CICE was partially funded by an increase in VAT (6 billion euros from 2014) and environmental taxes (4 billion). Replacing the CICE with cuts in social charges gives room for finesse: if companies benefit from the lower labour costs to boost their profits, then taxes on these profits will reduce the bill for the state by 10 billion euros (one-third of 30 billion). If, however, they increase employment and wages or lower their prices or invest, then there will be an increase in activity and the financing will come through growth.

Compared with France's budget commitments to Brussels (an 0.8 point reduction in the structural deficit every year), there will be a 20 billion euro fiscal stimulus based on lowering labour costs by 2017. This GDP point could lead to the creation of 250,000 jobs by 2017 and allow a one-point drop in unemployment. This is a substantial change of course from the priority given up to now to deficit reduction. A choice has been made to focus on business and push companies to create new activity or jobs through a pact. This is a significant step, but there is still more to be done to put an end to austerity, to repair the social damage done and to take radical action to reduce unemployment.