

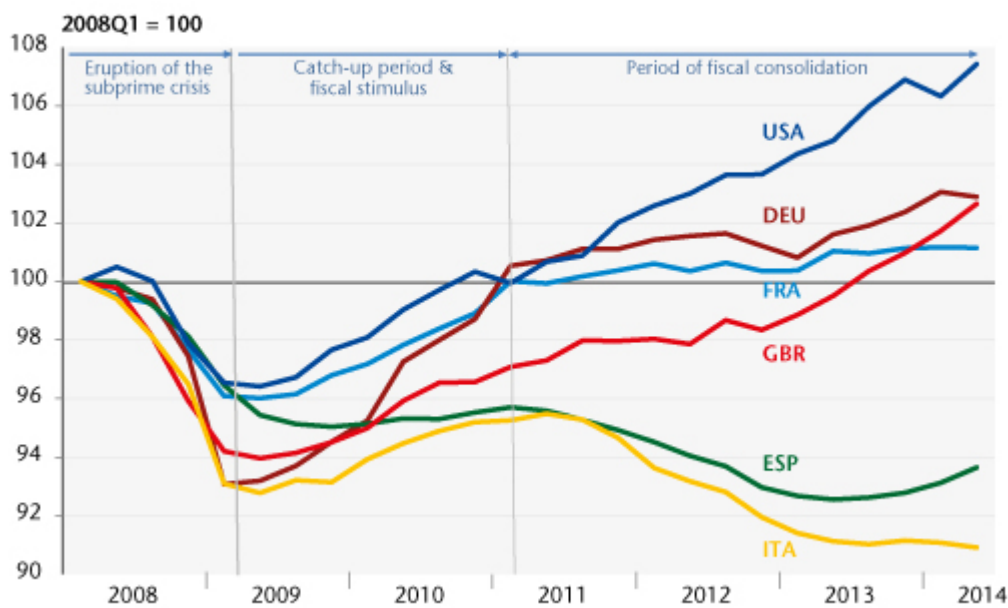
# France: duty-free growth

By [Bruno Ducoudré](#) , [Éric Heyer](#), Hervé Péléraux, [Mathieu Plane](#)

**This post summarizes the [2014-2015 outlook for the French economy](#)**

In early 2011, France was one of the few developed countries to have regained its pre-crisis level of GDP. Economic growth exceeded 2%, even reaching 3% yoy in the first quarter of 2011. Since then the situation has changed: the recovery was interrupted, and while the economy is experiencing positive growth, the rate is close to zero (Figure 1). Four types of shock explain why the post-recession recovery in 2011 died out. Growth was already being battered by austerity and by deteriorating credit conditions, and was then also hit by fluctuations in oil prices and by the impact of price competitiveness in 2012 as a result first of wage deflation in France's competitors and then in 2013 of the rise of the euro (Table 1).

**Figure 1. Comparative development of GDP in France and in its main partners**



Sources: National accounts.

In 2014, the improvement expected on the economic front did not occur: the stimulus due to the gradual easing of austerity is being offset by the powerful brake exerted by the significant appreciation of the euro that has taken place since mid-year as well as by the collapse in consumer investment in housing. As in the previous two years, growth is expected to come to 0.4%, which is not enough to reverse the rise in unemployment or to reduce the public deficit significantly. Worse, while the public deficit has been cut by over 3 GDP points since 2009, it is now expected to rise slightly once again, reaching 4.5% of GDP (Tables 1 and 2).

**Table 1. The brakes on French growth (2013 – 2015)**

In points of growth			
	2013	2014	2015
GDP growth	0,4	0,4	1,1
Impact on GDP of ....			
... changes in oil prices	-0.1	0.0	0.0
<i>Direct impact on the French economy</i>	-0.1	0.0	0.0
<i>Impact via addressed demand</i>	0.0	0.0	0.0
... price competitiveness	-0.1	-0.4	0.2
<i>Impact of change in euro exchange rate</i>	-0.1	-0.2	0.1
<i>Effect of Intra-euro zone competitiveness</i>	0.0	-0.2	0.1
... credit conditions	-0.1	-0.2	-0,1
<i>Direct impact on the French economy</i>	-0.1	-0.1	-0.1
<i>Impact via addressed demand</i>	0.0	-0.1	0.0
... austerity measures	-1.5	-1.2	-1.0
<i>Direct impact on the French economy</i>	-0.9	-0.8	-0.6
<i>Impact via addressed demand</i>	-0.6	-0.4	-0.4
Achievement	-0.1	0.3	0.1
Cumulative effect of shocks	-1.9	-1.6	-0.8
Other factors (housing investment, underestimation of accounts, declining potential, etc.)	-0.1	-0.4	-0.5
Spontaneous growth rate (excluding shocks)	2.4	2.4	2.4

Sources: INSEE, quarterly accounts; OFCE emod.fr forecast 2014-2015, made in October 2014.

In 2015, growth will pick up some, to +1.1%, due to the weakening of the negative factors that have stifled it since 2010, in particular credit conditions and austerity. Furthermore, the effect of price competitiveness, a factor that has played a very negative role in 2014, will be

reversed, due first to the depreciation of the euro, and second to the rising impact of the CICE tax credit, whose primary goal is to ensure lower export prices. But with GDP growth of 1.1% next year, the path towards expansion is still a long way from what can usually be seen during a post-crisis recovery (i.e. 2.4%). As the output gap is not closing, the anticipated growth cannot be deemed a recovery. Companies will benefit from this renewed pick-up to gradually restore their financial situation. This strategy is based primarily on increasing productivity, which will help to reduce surplus capacity and restore profit margins. The unemployment rate in metropolitan France will rise slightly to 9.9% in late 2015, and to 10.3% for France as a whole. The counterpart to loosening the austerity reins is a public deficit that is higher than what was originally programmed. It is expected to be 4.3% of GDP in 2015, departing significantly from its path back towards 3%.

**Table 2. Summary of forecast for 2014 and 2015**

%, annual average

	2010	2011	2012	2013	2014*	2015*
<b>GDP growth rate</b>	2.0	2.1	0.4	0.4	0.4	1.1
<b>Imports</b>	8.5	6.5	-1.2	1.9	2.4	1.2
<b>Household consumption</b>	1.7	0.3	-0.5	0.3	0.2	1.3
<b>Government consumption</b>	1.2	1.0	1.7	2.0	1.8	1.1
<b>Total investment</b>	1.9	2.1	0.3	-0.8	-2.2	-1.6
<b>Exports</b>	8.6	7.1	1.2	2.4	2.5	2.6
<i>Contribution to growth</i>						
<b>Domestic demand excl. inventory</b>	1.8	1.0	0.3	0.4	0.0	0.6
<b>Change in inventory</b>	0.3	1.1	-0.6	-0.2	0.4	0.1
<b>Trade balance</b>	-0.1	0.0	0.7	0.1	0.0	0.4
<b>Growth rate of euro zone GDP</b>	1.9	1.6	-0.6	-0.4	0.9	1.4
<i>Other indicators</i>						
<b>Inflation (consumption deflator)</b>	1.2	1.8	1.4	0.6	0.6	0.7
<b>Savings rate (% of GDI)</b>	15.8	15.7	15.3	15.1	15.5	15.2
<b>Unemployment rate</b>	8.9	8.8	9.4	9.9	9.7	9.8
<b>Public deficit (GDP points)</b>	-6.8	-5.1	-4.9	-4.1	-4.5	-4.3
<b>Public debt (GDP points)</b>	81.5	85.0	89.2	92.2	95.4	97.4
<b>GDP growth rate (year-on-year)</b>	2.2	1.5	0.0	0.8	0.4	1.4

\*OFCE e-mod.fr forecast for 2014 and 2015  
Sources: INSEE, quarterly accounts; OFCE.

In order to meet its commitments on structural efforts and

nominal deficits, the government could decide to vote to make an additional effort of 8 billion euros. This would correspond to a 1.2 point hike in the standard rate of VAT. If that happens, GDP would grow no more than 0.8% next year, and the deficit would be reduced by only 0.2 GDP point, compared to our baseline scenario (Table 3).

**Table 3. Impact on the French economy of an 8 billion euro hike in VAT**

In %, difference from central accounts

Impact on ...	2015
... GDP	-0.3
... General government financing capacity (% GDP)	0.2
... Market sector employment (%)	-0.1
... Unemployment rate (percentage points)	0.1

Source: OFCE *emod.fr* forecast 2014-2015, made in October 2014.

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# The dilemma of competitiveness

By [Jean-Luc Gaffard](#)

The competitiveness of a country is a complex subject. Some people rebel against the very concept on the grounds that it can't be applied to a nation and is only meaningful for companies. It is true that if a company gains market share, this necessarily comes at the expense of a competitor. And it is no less true that when one country increases its exports to another, then the extra income earned by the first will, in part, fuel demand that then benefits the second. The benefits of one become a condition of benefits for the other. This back-and-forth justifies international trade, whose aim is a better use of resources by everyone, with the benefits being shared by all, on an equitable basis. This story makes sense. And it does indeed indicate that the competitiveness of a

nation is not comparable to that of a business.

However, there are global imbalances that result in longer-term surpluses or deficits that reflect differences in the competitiveness of the companies in the countries in question. These require appropriate policy responses to meet the challenge of making possible what some have called the return journey, that is to say, to set in motion the mechanisms through which the income earned by one country is converted into demand on the other.

This is the difficulty facing France today. The country has been building up trade deficits since 2002: it is facing a problem with the competitiveness of its companies on global markets, and is no longer able to use the exchange rate instrument. The persistent trade deficit is clearly of even greater concern than the public deficit, and its absorption should be a priority. This is why calls have been mounting for a competitiveness shock, that is to say, economic policy measures that are able to make companies more competitive by reducing their production costs.

That said, a competitiveness shock is not easy to implement. Of course, in a developed economy, business competitiveness primarily means non-cost competitiveness that is based on a company's ability to occupy a technological or market niche. But regaining this type of competitiveness requires investment and time. Furthermore, non-cost competitiveness is not independent of immediate price competitiveness. Quickly rebuilding business margins is a necessary, though probably not sufficient condition for a return to non-cost competitiveness. This requirement is all the more stringent today as obtaining captive markets through differentiation can often be very costly in terms of R&D and exploring customer prospects.

The difficulty facing the French economy is that the restoration of margins needed may come at the expense of household purchasing power and thus of domestic demand. Competitiveness gains could remain a dead letter if final

demand were to collapse. Moreover, there is nothing to say that restoring margins *per se* will result in a pick-up in investment if companies face just such a slowdown in demand, if not a fall.

It seems that what is needed is to grasp both ends of the chain: short-term price competitiveness and medium-term non-price competitiveness. Quickly restoring business margins requires transferring the financing of social protection to taxes on households. Enabling companies to re-establish their price competitiveness demands further improvements in the level of infrastructure and support for the establishment of productive ecosystems that combine good local relationships and the internationalization of production processes. In both cases, this involves the question of what fiscal and budget strategy should be implemented.

The difficulty comes from the prioritization of objectives. If priority is given to immediately restoring the public accounts, then adding another burden due to the transfer of charges onto the tax grabs already taken from households will definitely run the risk of a collapse in demand. This means either admitting that such a transfer is really possible only in conditions of relatively strong growth and thus postponing it, or making the improvement of the trade deficit a priority over the public accounts and thus not tying our hands with a budget target that is too tough.

The government has decided to stay the course of public deficit reduction, and has in fact postponed the competitiveness shock by proposing, after a year or more, business tax credits that are to be offset by hikes in the VAT rate in particular. The underlying rationale is clear. The search for a balanced budget is supposed to guarantee a return to growth, but care is being taken about further weighing down demand by adding to the tax increases already enacted to meet the target of a 3% government deficit by 2013. The prevailing idea is that, aided by a wise budget, a pick-up in activity

will take place within two years in line with the supposedly conventional economic cycle, which has the additional advantage of coinciding with the electoral cycle.

The path being chosen is narrow and, quite frankly, dangerous. Fiscal austerity measures are still subjecting domestic demand to heavy pressure. The restoration of business margins has been put off. Would it not be better to stagger the recovery of the public accounts more and ensure more immediate gains in competitiveness by using the appropriate fiscal tools?

The result to be expected from either of these strategies is of course highly dependent on the choices being made at the European level. Persevering on the path of widespread austerity will mean nothing good will happen for anyone.

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## **Some precautions for reading the results of macroeconomic simulations: The case of social VAT**

By [Eric Heyer](#)

In September 2007, the OFCE conducted simulations of the macroeconomic consequences of instituting a social value-added tax (VAT) using its emod.fr macroeconomic model. These simulations were discussed and published as an appendix to the Besson report on the subject. Nearly five years later, the

government has decided to introduce a social VAT, so we asked Mathieu Plane and Xavier Timbeau to perform another round of simulations using the same model. The initial results were presented and discussed at a one-day workshop on the topic of taxation that took place at the Sciences-Politique Institute in Paris on 15 February. Why did we conduct new simulations, and how do they compare?

## 1. The measures simulated are different

There are a number of differences between the measure simulated in 2007 and the 2012 measure:

### *a. The shocks are on a different scale*

In 2007, the measure simulated involved a rise of 3.4 points in the nominal VAT rate, which was offset by an *ex ante* reduction in employer contributions of the same amount. The measure proposed by the government in 2012 represents a 1.6 point increase in the standard VAT, which corresponds to a 1.1 point increase in the effective rate (10.6 billion euros) and an increase in the CSG tax on capital income from 8.2% to 10.2%, which amounts to 2.6 billion. The additional 13.2 billion euros in revenue will fund the elimination of employers' "family" social security contributions. Comparing the results requires at a minimum calibrating the shocks so that they are on the same scale. As our model is linear, a simple rule of three can then reassess the impact of the measure in 2007 and compare it with that of 2012. As is shown in the Table summarizing the results of this recalibration, the impacts on employment of the two versions are very similar.

Impact on employment at 5 years of a "pure" social VAT:  
Shock of 2007 calibrated to the same scale as that of 2012

2007	Version (Besson report)	2012 Version
Employment effect	51 000	48 000

### *b. The shocks are not the same type*



Unlike the simulations in 2007, besides the fact that there is a dose of CSG in its funding, the reduction in the cuts in contributions proposed by the government in 2012 is not uniform. It is targeted in particular at companies with employees who are paid at 1.5 to 2.1 times the minimum wage (SMIC), which has different sectoral impacts depending on the wage structure and on the impact on the relative cost of unskilled / skilled labour. The fact that it is focused on skilled workers whose labour cost is less elastic reduces the expected impact on employment of lowering labour costs. This effect will also be reduced by the potential substitution of unskilled labor by skilled more productive labour. While this kind of effect is well documented in the literature, our econometric macro model does not yet enable us to take this into account. Our model is in the process of being enhanced, which will at some point make it possible to refine our results.

## **2. The model used (*emod.fr*) evolves in the course of re-estimations**

Finally, it is necessary to keep in mind that macroeconomic models incorporate a certain number of estimated parameters, which can influence the results. This is the case in the simulation we are interested in of the elasticities of exports and imports to their prices and the elasticity of the substitution between capital and labor. However, the estimated value of these parameters is updated regularly to keep as close as possible to reality as captured by the national accounts. Thus, for example, the price elasticity of exports has changed considerably in recent years, from 0.57 to 0.31 between the version of the model used in 2007 and the 2012 model, meaning that any decline in price was less creative of activity and therefore of jobs.

In the next issue of the *Revue de l'OFCE* we will present all the results of our simulations in detail. We will also indicate the impact of a change in the value of the key

elasticities on our assessments so that readers can better understand our revisions of the impacts.