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# Crisis and Growth: A Strategy for France

Report by Philippe Aghion, Gilbert Cette, Élie Cohen and Mathilde Lemoine

## EDITORIAL

*The report that follows, which is in line with the CAE's 2007 'Increasing France's Growth Potential', offers an inventory of the challenges to be overcome before outlining a growth strategy incorporating the dual crisis, global and European.*

*The authors propose a growth strategy for France that targets, in particular, the 'supply' aspect. A strategy that combines 'horizontal' interventions by the government, likely to affect all sectors (innovation, R&D, education, goods market, labour market, etc.) and 'vertical' interventions, impacting certain priority or strategic sectors. This latter dimension leads to the recommendation of a new industrial policy favouring, for example, green innovation as well as more decentralised sector aid targeted at more competitive sectors. There are also proposals for using taxation to serve growth.*

**Christian de Boissieu**
*Executive Chairman of the CAE*

*In this report, the authors raise the question of the choice of economic measures that are favourable to medium/long-term French growth which take into account the constraints, notably budget constraints, that the recent crisis has increased. In this respect, this document is in line with a previous report of the Conseil d'analyse économique (CAE) published by Philippe Aghion, Gilbert Cette, Élie Cohen and Jean Pisani-Ferry (2007), which dealt with the growth levers and, differently from this one, insofar as the monetary, financial and economic crisis has altered the relevance of the decisions to be made. It develops questions relating to the quality of the productive supply and France's competitiveness.*

*The authors advocate a policy of investment in higher education and R&D, flexibility in the goods and labour markets, security as regards professional development, as well as sector-based support for innovation. Given the budget constraints that have emerged following the recent crisis, they suggest that it is important to proceed not with a net increase in expenditure but a shift in expenditure so as to ensure the conditions for the necessary fiscal consolidation. This is why they highlight, in particular, savings that could be achieved by reducing, or even removing, certain fiscal niches, and this despite the inevitable discontent that such measures would cause. Their viewpoint is therefore to refuse any extreme position – ultra-Keynesianism on the one hand, whereby an increase in public spending ignoring budget constraints would be the essential impetus to boost the macro economy, and monetarist on the other hand, whereby the drastic cleaning up of the public finances would be an inevitable prerequisite without any notable recessive effect. The authors favour a third route, that of targeted intervention internalising the budget constraint.*

*This report was discussed in the presence of the Secretary of State to the Minister of the Economy, Finance and Industry, responsible for foreign trade, on 24 June 2011. This letter, published under the responsibility of the permanent team, covers the main conclusions.*

## Inventory

In order to provide recommendations in terms of economic policies, an inventory of budget constraints, as well as the main weaknesses of the French productive system is necessary. Initially, the authors examine economic literature which offers quantifications of the expected medium-term impact of the current crisis. The various studies, based on diverse approaches and methodologies, are far from being convergent. As a precaution, they adopt a point of relative consensus: the current crisis should not have a durable effect on the economy's growth rate, but is likely to have generated a level of GDP loss that will probably not be recovered subsequently.

### *Deteriorated public finances and external competitiveness*

The authors' first observation is that French public debt, as a proportion of GDP, has increased substantially recently. Admittedly, France enjoys relatively low interest rates, but if they were to rise, in the event of France's rating being lowered, could necessitate a considerable budgetary effort. Secondly, they underline the specific role played by Germany within Europe. They reiterate that Germany's foreign trade surplus is the result of competitiveness acquired at the expense of a strict wage policy imposed over the last fifteen years or so. It is difficult to generalise this experience to all European countries, precisely because German growth has been fuelled primarily by external demand, notably European.

The authors envisage various possible scenarios, according to whether Germany draws closer to other economies by stimulating its own demand, the eurozone finishes by no longer being able to contain the growing imbalances, or European economies follow the German example of a strict wage policy. The most probable trajectory appears to be an alignment, even if only partial, of economies such as France, to Germany. The report provides a detailed analysis of France's loss of competitiveness vis-à-vis Germany (appendix C). At the very least, it appears that France has limited room for manoeuvre and a recovery in export market share would be welcome. The recovery could arise from action aimed at slowing the rise in production costs, amongst other things through less taxation on labour costs. It could also be activated through ambitious industrial policies, which are discussed in the remainder of the report.

### *Poorly directed productive investment and low innovation expenditure*

The inventory continues with a detailed presentation of the investment of non-financial companies in France. At the macroeconomic level, the French investment rate is very comparable to that of developed economies such as Germany or the United States. However, this general observation conceals a considerable diversity according to the size of company. In the case in point, it appears that modest-sized companies tend to invest significantly less than in Germany, which could be explained by more difficult access to credit. In sectoral terms, investment appears to be relatively low for intermediate goods, consumer goods, as well as equipment goods. Lastly, the information technology content of new investments made in France, embodying the diffusion of innovative technologies, is much lower than what it is worth in the United States or the United Kingdom. Domestic spending on French R&D is also lagging; the relatively weak propensity to take out French patents testifies to the inadequacy of innovation production.

This inventory is supplemented by a specific analysis of the financial situation of French companies. Companies' savings and self-financing rates have been declining significantly since the end of the 1990s. The rate of return for French companies has also dropped sharply, albeit more recently. This related trend in the savings rate and rate of return is, in all probability, the symptom of real financial fragility. Meanwhile, the debt rate for French companies appears to be midway between the high levels in Spain and the UK on the one hand, and the lower levels in Germany and the US on the other hand. The cost of credit for modest-sized companies is also appreciably higher than for the largest companies, with the difference being more than 1%.

## How to boost growth and consolidate the public finances?

The 'third route' backed by the authors, in terms of economic policy, consists in favouring policies that have a strong medium/long-term impact, without however neglecting the issue of how they are to be financed. The policies adopted, situated on the supply side, can be divided into horizontal and vertical policies:

- vertical policies, or a modern version of industrial policy, aim to support the development of dynamic sectors such as the health and cleantech sectors;
- horizontal policies are designed to boost the production of knowledge, develop flexi-security in the labour market and further liberalise the goods market.

### *A new industrial policy*

It is necessary to rethink industrial policy for the following reasons:

- in a crisis s ituation, governments protect certain industrial sectors considered to be critical, such as the auto sector;
- European economies must be capable of exporting in order to balance their current account. Deindustrialisation and specialisation in non-exchangeable services activities in Spain or Greece are at the origin of huge foreign deficits for these countries, while Germany is accumulating surpluses. The markets doubt both the ability of some eurozone Member States to honour their sovereign debt repayments and the eurozone to protect these States against specific attacks. The risk premiums associated with Greek sovereign debt clearly illustrate this situation;
- R&D is primarily carried out in the industrial sector (85%);
- European policies for dismantling dominant national positions have demonstrated their effectiveness, but common policies based on cooperation (R&D, currency, and especially competition) which are expected to take over are now being called into question;
- the industrial policies implemented after the Second World War, and based on the protection of certain sectors, combined with national preference in the case of public orders, have proved very effective (Japan, South Korea). Even if we subsequently criticised these policies for making it possible to arbitrarily choose which 'national champions' would be supported, it would be unrealistic to think that economic policy can be entirely neutral regarding the sectoral organisation of the productive system.

In order to offer a fruitful approach to industrial policy, the authors refer to several recent empirical studies which have produced the following results:

- the transfer to a green economy requires subsidies for 'clean' sectors: the cumulative phenomenon of 'path dependency' renders the transfer to green technologies even less likely since companies have accumulated skills in pollutant sectors; government aid in order to redirect them is therefore necessary;
- sectoral aid is particularly useful for a sector's exports when companies' access to bank lending and market financing is difficult;
- sectoral aid is particularly effective (in terms of export market share) when it is decided at a decentralised level, which militates in favour of the constitution of clusters;
- sector aid appears to be particularly effective when the targeted sector is more competitive;
- lastly, and this result is not very intuitive, within the same sector, the aid has even more impact since it is not concentrated, i.e. it is spread over a wide group of companies. However, this is only valid for large markets, such as China, the United States, or Europe.

The sectoral policy desired by the authors focuses on activities that have not yet completely migrated to emerging countries –health, clean energies, digital. It gains from being based on competitiveness clusters, and must be implemented at different levels –European, national or local– according to the tool used to promote the sectoral policy.

### *A horizontal growth policy*

Six main lines relating to horizontal policies are highlighted by the authors and, for the most part, reiterate the recommendations of the CAE report published by Philippe Aghion, Gilbert Cette, Élie Cohen and Jean Pisani-Ferry (2007):

- investment in higher education must be continued. The LRU law, designed to allow the emergence of more effective universities in terms of both research and the integration of young people into the job market, is just starting to bear fruit. However, these efforts must not be allowed to conceal the weaknesses of primary and secondary education, as testified by the worrying results of the OECD's most recent PISA survey. A recent study by the Centre d'analyse stratégique (CAS) highlights the fact that in France the supervision of students by teachers is relatively weak: the issue of resources and the effective use of existing resources therefore deserve a discussion;
- support to promote competitiveness involves primarily fiscal measures (transfer of some of the social security contributions) and the development of green taxation which are broached in the remainder of the report;
- it is important to devise appropriate incentives to raise labour market participation rates: work-study combination incentives for young people, extension of flexible conditions enabling the continuation of a professional activity beyond the age of 65. As for those with low qualifications, the authors note that the SMIC (minimum wage) has undergone substantial increases, thus harming the employment prospects of the least qualified. The moderation of the SMIC, combined with an increase in the resources deployed to combat poverty through the RSA active solidarity income, would appear to be desirable;

• the goods and labour markets are too rigid. In the goods market, entry barriers for numerous professions (taxi drivers, solicitors, etc.) should be relaxed, except for the medical professions, while avoiding despoiling the professionals who have had to pay for their licences. Moreover, some sectors (transport, retail, electricity, etc.) are characterised by anti-competition regulations that need to be relaxed. For example, authorisations to install hypermarkets should be based solely on competitive considerations. Quantitative evaluations suggest that substantial relaxation in the goods market would boost GDP growth by half a point, which is considerable. As regards the labour market, the security aspect of flexi-security is very inadequate in its current state. In particular, training rights are still difficult to transfer and remain attached to jobs and not to workers. In addition, ongoing training is too specific, whereas it should be general to allow workers to adapt to a new job. A bonus-malus system for unemployment insurance contributions, according to the proportion of employees on courses leading to a qualification, would be an incentive for employers. Lastly, acquired rights should not be dependent on length of service in a company in particular, but should be accumulated in individual accounts;

• a temporary effort, in response to the crisis, to further encourage investment, should be undertaken through various routes: reduced tax on reinvested profits as well as maintaining and recalibrating the R&D tax credit which, despite the fiscal optimisation strategies it has generated, clearly enhances France's attractiveness;

• the large EUR 35 billion loan '*Grand emprunt*' is an original and key initiative around which the intelligence investment effort will be deployed. While it is legitimate to nourish ambitious hopes, it is also important to note the pitfalls to be avoided. Firstly, if the aid is spread too thinly and widely it is likely to prevent the emergence of universities of excellence. Secondly, the selection of certain projects is likely to substitute for declining budget spending with short-term objectives, instead of supplementing it with long-term aims. Lastly, the non-consumable nature of a considerable portion of the budget and the weakness of bond yields make the interface with private financing more than necessary.

### A fiscal reform serving growth

The proposed fiscal reform is designed not only to provide the resources necessary for the expenditure set out previously (expenditure on knowledge, boosting competitiveness), but also to remedy the main flaws in the current fiscal system. Among these, the authors have identified the following: too heavy social security costs burdening salaried employment, the too modest progressiveness of taxes, and insufficient recourse to taxes that are not distortive, such as inheritance tax.

With the consolidation of expenditure requiring decisions to be made, even though painful, the authors propose reducing the most costly fiscal niches and whose impact on employment is least evident, for example, the reduction in VAT for the restaurant and building trade, as well as tax-free overtime which, according to studies cited by the authors, has not had the expected effect in terms of job creation. A re-examination of other niches would also be conceivable. The authors admit that these are essentially illustrations, and that a more detailed study would be needed, in order to clearly make the difficult trade-off.

A second proposal consists in a transfer of social security contributions financing non-contributive expenditures (health insurance excluding daily allowances and family allowances) to the CSG general social contribution. In addition to the fact that nothing can justify allowances that are independent of employment income being financed exclusively by this same income, the transfer to the CSG would broaden the base considerably and include capital income. In that way, with unchanged allowances, it is possible to envisage a contribution decline of up to 6 points. However, this transfer raises technical difficulties and would obviously need time.

Meanwhile, the restoration of an additional dose of progressiveness would have the dual advantage of bringing in extra revenues and making measures requiring efforts by everybody, such as wage moderation, more easily acceptable. The authors suggest, amongst other things, besides the removal of the tax shield, the creation of an additional income tax tranche and the lowering of tax credit ceilings. Some of the resources could be deployed to extending the RSA to young people under 25 years old. Lastly, inheritance tax, which represents a mere 0.4% of GDP, could be increased, since this deduction creates little distortion. That said, the authors are not in favour of merging income tax and the CSG. Such a merger would offer no specific advantage (in other words, everything that it is supposed to be able to achieve could be without the merger) and it would be characterised by numerous technical difficulties and economic drawbacks developed in the report.

Lastly, corporate tax could also be amended. In particular, the total deductibility of loan interest reduces French companies' taxable base accordingly. A restricted deduction similar to that existing in Germany would produce around EUR 11 billion in revenues in three years.

### Accounting for the costs and gains expected

The assessment of the cost of the expenditure envisaged is consistent with the assessment in the CAE report published by Aghion, Cette, Cohen and Pisani-Ferry (2007), namely one point of GDP, divided here into 0.7 points for R&D expenditure and education, and 0.3 points for horizontal policies (support for the unemployed, greater flexibility in the goods and labour markets). The financing could be partially or even totally provided by the removal of fiscal niches.

The positive effects on growth are assessed here by comparing performances in terms of the growth of different groups of countries: Anglo-Saxon, Scandinavian and countries through which the Rhine flows. A cautious assessment amounts to believing that these reforms would halve the gap between France and the Scandinavian countries in terms of access to higher education, and would align its average degree of rigidity in the goods and labour markets to these same countries. The gain in growth rate would therefore amount to three-quarters of a point, which is quite considerable. However, it is important to note that the gain would only be gradual and that part of it is likely to disappear in the long-run, due to diffusion effects.

## Comments

***Jean-Philippe Cotis*** commented that in the United States, the crisis could have a persistent harmful effect on the growth rate, but that this is unlikely to be the case in Europe. That said, in France, the question of support for growth is particularly acute since, during the years preceding the crisis, productivity growth was relatively weak. The measures recommended by the authors evoke those of the OECD.

***Jean-Hervé Lorenzi*** noted that this report is both ambitious and topical. He added his contribution to the debate by suggesting that it would also be important to take into account the issues of an ageing population –which has an impact on both the labour and goods markets– as well as long-run savings –whose stimulation through fiscal incentives is essential to a massive investment policy.

***Jean-Pierre Vesperini*** commented that the current crisis has seen its scale considerably reduced through the recourse to modern Keynesian policies. He pointed out that the euro's high value against the dollar has damaged external demand –whose role must not be underestimated–, and that a depreciation of the euro would be welcome. He emphasised the importance of increasing the employment rate in France. Lastly, he believes the budget constraint requires, in addition to the re-examination of certain fiscal niches, a decline in public spending, notably general services expenditure.

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113 rue de Grenelle 75007 PARIS [France] Ph.: (33-0)1 42 75 53 00 – Fax: (33-0)1 42 75 51 27
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