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Research Report

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Economic Reforms in France

Bleak Macroeconomic Data Is Shaking Politics in Paris and Cementing France's Traditional Approach towards the Economic and Monetary Union

Paweł Tokarski

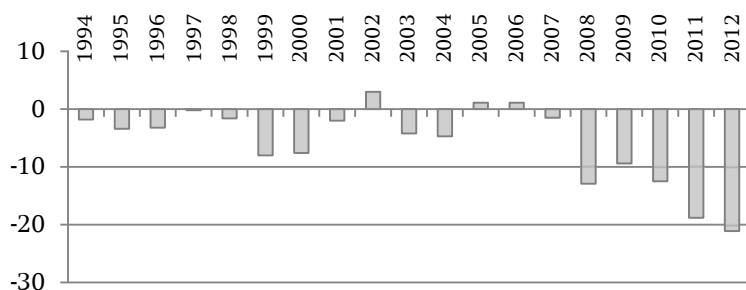
With the third government since his election in May 2012, President Hollande will soon enter the second half of his term of office. He came to power with promises of economic recovery. However, the implementation of a coherent economic program quickly became an uphill battle. French voters' persistent dissatisfaction resulted in two sound electoral defeats of the »Parti socialiste« and record support for the »Front National«. The difficulties of the second largest Eurozone economy are sooner or later likely to affect the Eurozone's stability. Why is it so hard to reform France? What does President Hollande expect from the Eurozone? And is there an acceptable way to assist French reforms?

The French economy has been severely hit by financial and economic turmoil. The widening of the current account deficit and recent deterioration of the net international investment position indicate a widening competitiveness gap between France and northern Eurozone countries. The problems with the French economy are numerous: an excessive and gradually increasing government spending level (one of the highest in relation to GDP in all OECD countries, and the highest in the Eurozone); rigidity of wages; high unit labor costs compared with other euro area countries; and red tape. All of this puts a heavy burden on the private sector, making French companies less profitable and more vulnerable to foreign acquisitions than their foreign competitors. In March 2014, in an in-depth review of the French economy, as part of the "Macroeco-

nomie Imbalance Procedure", the European Commission stated that France had been experiencing macroeconomic imbalances which should be properly addressed.

On June 2, in the framework of the European Semester, the European Commission delivered a slightly more optimistic picture than in 2013, but pointed out several structural problems and cast doubt over the deficit assumptions made by the government for 2014 and 2015. One of the main challenges for the current and future French governments is the growing level of general government gross debt, which reached 93.5% in relation to GDP in 2013 and is projected to reach 95.6% in 2015. A level of debt higher than 85% of GDP can be a significant drag to economic recovery. Although the costs of debt servicing decreased last year, in 2013 alone the French taxpayer had to

Figure 1
Net International Investment Position of France as % of GDP



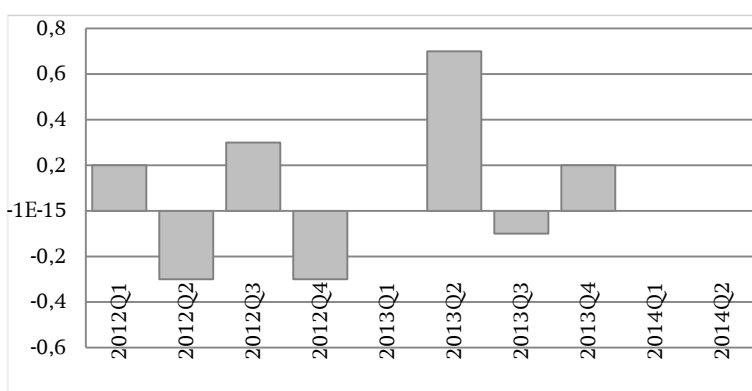
Source: Eurostat

cover €47.3 billion in interest, as 2.3% of the country's GDP (according to Eurostat).

Sluggish growth and uncertainty in the private sector have had consequences for the job market. The unemployment rate, although considerably lower than in Italy or Spain, remains relatively high, especially among youth (22.4% in June 2014). This is becoming a major predicament for the government and a personal one for President Hollande. During one of his first speeches after the elections he portrayed himself as the "president of the youth" and raised expectations among his youngest supporters by promising change in the job market situation.

The slow, ongoing recovery throughout the Eurozone is only modestly apparent in the general condition of the French economy. The most recent economic data announced in August 2014 were a serious

Figure 2
French GDP Volume – Percentage Change over Previous Quarter



Source: Eurostat.

blow to the government's promises, indicating a 0% rate of economic growth in the first two quarters of 2014. Excluding government expenses, these data show a contraction of the private sector, rendering the previous government's end-of-year growth forecast of 1% impossible.

Euro area economies are affected not only by the performance of other member countries but also by the general political situation. Although the so-called "phase three" economic sanctions on Russia will probably entail fewer costs for France than for other big economies of the Eurozone, the close economic relations between Paris and Moscow (especially in the financial and energy sectors) could be a source of risk if the political situation in eastern Ukraine deteriorates further.

All of these are worrying signs. The French economy – the second largest in the Eurozone – has close trade and financial ties with other Eurozone members. This raises concerns over the possible impact of economic problems in France on Eurozone stability, and over realistic options for the current or next government majority to address these issues.

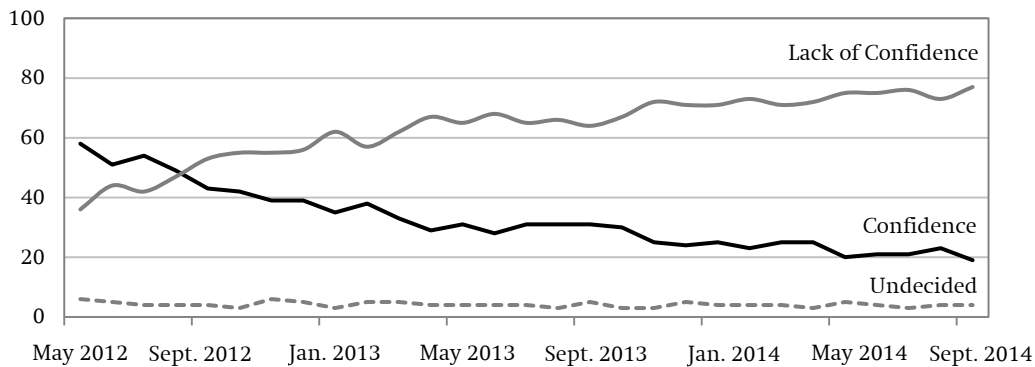
Limited scope of reforms

President Hollande won the presidential elections in May 2012, when the Eurozone crisis was still in full swing. He promised to change economic policy by reinforcing pro-growth policies, and to improve the situation of the French labor market.

These reform attempts were immediately hampered by a noisy battle over the 75% income tax rate for France's richest citizens, promised in the electoral campaign. The "tax on the rich" debate also failed to secure popular support for the government, which started rapidly decreasing as the general public demanded concrete steps to improve the economy.

Broader reform proposals have been presented on several occasions as "pacts", but these have not gone far enough to deliver a coherent, systemic solution to the

Figure 3
Confidence in President François Hollande, May 2012 – September 2014



Source: <http://www.sondages-en-france.fr/sondages/Popularite/Fran%C3%A7ois%20Hollande>

country’s structural problems. First, the “Pact for the Competitiveness of French Industry”, prepared by a working group led by Louis Gallois and published in November 2012, focused on French industry as the main factor of economic growth, and delivered a list of 22 rather diverse proposals to boost competitiveness and exports. Although President Hollande had distanced himself from the report even before its publication, some of these same ideas were included in the “National Pact for Growth, Competitiveness and Employment”, announced a day later on November 6, 2012 by then Prime Minister Jean-Marc Ayrault. The pact’s main goal was to reduce social charges for the business sector, facilitating access to capital for small and medium-sized enterprises and simplifying regulations for the business sector.

The most recent (and still ongoing) reform measures were unveiled as part of the “Responsibility Pact”, personally announced on January 14, 2014 by President Hollande. This pact aims to increase employment in the business sector by reducing labor costs, company taxes and red tape. The pact was supplemented in April by a social pillar aimed at reducing the tax burden for the poorest households. The flagship project which both pacts are related to is the CICE, *le crédit d’impôt pour la compétitivité et l’emploi* (competitiveness and

employment tax credit), the aim of which is to reduce social charges for companies by €20 billion within three years.

The appointment of Manuel Valls as Prime Minister in March 2014, after the shocking defeat of the *Parti socialiste* (PS) in regional elections, was intended to add fuel to the reform program. He announced further cuts of labor costs for the lowest-income employees and a reduction of the income tax surcharge for the largest companies. He achieved some initial successes when the National Assembly voted for €50 billion in budgetary cuts and simplified the country’s complex administrative structure by decreasing the number of regions.

However, the rather limited scope of the proposed measures and their slow implementation are unlikely to produce any major effect on the French economy, especially on the labor market, before the elections in 2017. More than half of the proposed spending cuts still need to be specified, which could trigger an angry reaction from trade unions. Therefore, the execution of the adopted fiscal consolidation program remains highly uncertain. Moreover, the outcome of the CICE flagship project, introduced at the beginning of 2013, is also questionable. Limiting tax reimbursement to employees earning up to 250% of the minimum legal wage has probably not benefited companies exporting for

international markets, as much as it has benefited large domestic firms employing low-qualified workers, such as large retail groups. Due to the long duration of the legislative process, several measures announced in the “Responsibility Pact”, such as corporate tax cuts, are unlikely to be introduced before the end of the current political term.

In addition, in August 2014 the constitutional court questioned the €2.5 billion reduction of social charges for the 7.4 million lowest-income employees, which was supposed to enter into force at the beginning of 2015 to further reduce labor costs. As a result, in September the government will be forced to propose compensatory measures or agree to forego some of the pact’s measures.

The general public in France has remained broadly skeptical towards the scope of the reform agenda and its pace of implementation. Statements by President Hollande have increasingly contradicted macroeconomic data. In September, 77% of the French public expressed their dissatisfaction with the measures taken by François Hollande. The private sector expressed its discontent as well. At the end of June, eight major employer organizations published a letter to the president and the prime minister in the *Journal de Dimanche*, calling for urgent implementation of the core measures of the Responsibility Pact (i.e. bringing down labor costs and the fiscal burden for the private sector, reducing red tape, and cutting public expenses).

The recent poor macroeconomic data for the first two quarters of 2014 sparked another wave of criticism of the president and the prime minister. This constituted a serious blow to the government majority just before the mid-term elections to the Senate in September. The opinion polls from September show that over 80% of voters distrust the government’s economic policy.

Why is reforming France an uphill battle?

History shows that skepticism regarding reform options in France is nothing new. Past attempts to unblock the French economy abound – some of them dating back to the early 1960s, like the report by the Rueff-Armand Committee which proposed reinforcing competition and limiting the number of restricted professions. There are also many other layers of resistance which explain the difficulties of reform processes.

Trade unions have traditionally played an important role in French politics, even if the rate of membership among employees in France (7.9%) is considerably lower than in Germany (18.6%) or in the UK (26.4%). Most trade union leaders have a rigid view of redistributive economic policy. They are politicized and ready for noisy confrontation, even with the socialist government if they think their interests are threatened. The culture of dialogue is clearly lacking compared to Germany, Denmark or Sweden. The most recent example of this could be seen on July 7 at the annual social conference. Three large trade union organizations, namely the FSU (*Fédération syndicale unitaire*), CGT (*Confédération générale du travail*) and FO (*Force ouvrière*), walked away from the negotiation table refusing to support the Responsibility Pact. They argued that budgetary cuts would have an adverse effect on the country’s economic growth. It seems therefore, that any ambitious structural changes in the economy will automatically incite conflict with the main employees’ organizations.

The main problem, however, lies in the French political class, both left and right. The majority of public opinion still seems to be locked into the view of an omnipotent role of the state. Thus, while there have been numerous proposals to boost economic growth through public investments, the need for a major revision of the role and size of the government sector seems to be the primary challenge. This narrows the options in designing economic policy. For example, instead of adopting systemic

measures, such as permanent reduction and simplification of taxes, temporary measures such as the CICE are put in place, adding complexity to the regulatory framework. The French labor code, at almost 3,500 pages long and consisting of 10,000 articles, remains a telling symbol of the complexity of French legislation. Another example is the housing market. France ranks 149th out of 189 economies in registering property, which does not help to decrease the rigidity of the overvalued housing market. Against this background, EU fiscal rules or the European Central Bank's (ECB) monetary policy are often presented in domestic discussions as a major obstacle to growth. The benefits of European integration, especially in relation to the EU single market, are rarely mentioned in public debates. This creates very fertile ground for Euroskeptic arguments that Brussels or Frankfurt-driven economic policies are hampering French economic growth.

Cracks inside the ruling party do not facilitate the reform task either. The country's poor macroeconomic performance will boost Hollande's opponents within the *Parti socialiste*. This opposition group emerged inside the PS over the vote on the €50 billion program of cuts for 2014–2017. Further tensions within the PS seem inevitable, increasing the risk for the government of losing its majority in the National Assembly. In addition, the upcoming presidential elections are likely to cause tensions between François Hollande, Manuel Valls and Arnaud Montebourg (the latter of whom is the former Minister of the Economy, who came third in the PS primary presidential elections in 2011 and represents the left-wing of the PS). All are considered potential presidential candidates of the left, and are therefore seeking support among the party members. Montebourg's open criticism forced Hollande to reshuffle the government for a second time, in a desperate attempt to regain political initiative. The opposition is calling for the dissolution of the National Assembly. However, this is

unlikely to happen any time soon, as low support for President Hollande would force him to face *cohabitation*. The unpopularity of Hollande and growing opposition inside the PS will reduce the effectiveness of the French executive, with possible further government reshuffles in the future. An ambitious Manuel Valls might decide not to risk his future political career by working for a president with a record low approval rating. It would seem, then, that increasingly unstable domestic politics in France offer little room for any major reforms before the next presidential and parliamentary elections.

The main problem with traditional French political forces is their low credibility. In his electoral campaign in 2012 Hollande raised high hopes among the French, to a level that his political force was unable to deliver on. He then used up the remainder of his support by announcing recovery in 2013 and 2014, only to be confronted by economic indicators showing the opposite. Yet a change of the ruling majority would not offer any viable alternative.

The position of the *Union pour un mouvement populaire* (UMP) is even worse. The socialists' archrival has found itself in a profound crisis, trapped by political scandals and financial problems, barely escaping bankruptcy. The weeks before the next UMP congress at the end of November will be marked by an internal power struggle. Aside from vocally criticizing the PS, none of the potential UMP candidates have proposed any comprehensive economic program.

The weak macroeconomic data are used extensively by the *Front National* (FN), which positions itself as an alternative to traditional parties. Marine Le Pen censures both the PS and the UMP, calling them "UMPS" and claiming that they have failed to address the country's economic problems. The FN itself offers a mixture of statist and anti-EU discourse, blaming the "Eurozone economic policy" and the euro currency for the stagnation of the French economy and its

continued deindustrialization. Their plans to introduce economic protectionism, increase state ownership, and return to a national currency would be disastrous from an economic and political perspective both for France and the rest of the EU. However, this program, being coherent and simple, has found numerous supporters (including among younger voters), and strong support for the FN creates a risk that some elements of its economic program may be assimilated into those of other parties. Recent polls indicate that a second round of presidential voting in 2017 would be a duel between Marine Le Pen and the UMP candidate. If Nicolas Sarkozy declared his participation, Le Pen would win the first round with 27% of votes to 26% for Sarkozy. However, Marine Le Pen is viewed very negatively by French society at large, which for now makes her unlikely to win the second round. Both Hollande and Valls are predicted to receive 17% of votes each. Liberal (centrist) candidate, François Bayrou, who seems to offer the most credible answers to the country's economic problems, is unlikely to play a major role during the presidential and parliamentary elections.

France and the EMU: old wine in a new bottle?

Lack of success in economic policy on the national level forces Paris to step up its usual pressure on Berlin and Brussels. Already during his electoral campaign Hollande questioned the policy of austerity and promised to renegotiate the “Fiscal Compact” adopted in March 2012. However, he had to content himself with the “Compact for Growth and Jobs”, which was put together in two weeks, mostly relying on renaming existing EU measures, and which failed to have any measurable impact on the economy.

During Hollande's term of office France has failed to deliver any new narrative regarding the Economic and Monetary Union (EMU), sticking to its traditional, ambiguous approach. It supported the idea of “eco-

nomie government” of the Eurozone, but on the other hand it has shown reservations towards common fiscal rules. France has continued its pressure on the ECB to take measures such as asset purchases, has warned of inflationary risks, and has demanded that Germany increase its public spending. In June, Hollande presented to the European Council his “Agenda for Growth and Change in Europe”, which was an attempt to influence the new EU political cycle. The measures proposed, which focused on strengthening redistribution mechanisms at the EU level, were similar to those of the Compact for Growth and Jobs and earlier socialist concepts of the late 1990s. Hollande called for the creation a €1.2 billion program of public investment in the Eurozone, combining public and private sources with the Eurozone budget. France also insisted on increasing the budget for the “Youth Guarantee” to mitigate youth unemployment. According to Paris, the reinforced coordination of economic policies should focus first on social and fiscal convergence. French calls for the creation of “common social rights”, or the creation of a minimum wage in the EU, are not new and are unlikely to raise enthusiasm in other EU capitals. As such, these should be interpreted as being aimed at domestic supporters of the PS, rather than a viable project aimed at increasing Eurozone stability.

The introduction of the new EU political agenda in autumn 2014 is likely to be dominated by further tensions concerning fiscal policy. In early September, French Finance Minister Michel Sapin, confronted by weak macroeconomic data showing the contraction of the economy in the second quarter of 2014, confirmed that France would not meet the already extended deadline of 2015 to correct the deficit. Poor GDP growth data, high levels of unemployment, lack of time, and domestic obstacles to structural reforms are likely to increase pressure from France and Italy on Germany to make the interpretation of deficit rules more flexible. France and Italy used enigmatic wording to

interpret the European Council's June 26–27 conclusions, announcing that the deficit rules would be treated more flexibly. To increase leverage on Brussels, Hollande mobilized socialist leaders from Europe, who met twice this summer in Paris before the European Council meetings; however the political significance of this group has proved limited.

Their primary demand is to exclude “pro-growth” investments from the deficit calculation. Accepting this practice would be problematical, not only due to unpredictable market reactions, but also due to the lack of a precise definition of “pro-growth” investments. In any case, a softening of the deficit rules would not address the main problem of France and southern Eurozone states, namely their inefficient, overgrown public sectors. On the contrary, it would discourage policy makers from applying painful cuts to the government sector, which are so crucial in France's case. Furthermore, a softening of fiscal rules could be difficult to accept, not only in Berlin but also in countries like Poland, which has already sacrificed its private pension scheme to comply with deficit rules.

Recently, PS spokesman Olivier Faure demanded that French military spending, due to involvement in operations abroad, should be taken into account in the deficit calculation. This demand was already put forward by the Raffarin government in 2004.

Attempts to soften EU fiscal rules are nothing new, as all French governments have contested them since the Stability and Growth Pact (SGP) was signed. The breach of the SGP general government deficit threshold in 2003 by Portugal, Germany and France led to a significant watering down of the rules in 2005. However, unlike Germany, France did not use that opportunity to reform its labor market. This time France cannot count on German support.

A clash over SGP fiscal rules is likely to dominate the first half of the EU's current political cycle. Nevertheless, EU leaders should be careful not to fuel this conflict, which could serve as a useful game for

domestic purposes in Paris and Rome, undermining the Eurozone's credibility. Low yields of government bonds do not necessarily signal an increase of confidence in the Eurozone, but rather investors' mistrust of economic growth perspectives. The market's patience will soon be tested in November, when the ECB announces bank balance sheets results, so it is important not to send too many negative signals to financial markets.

French economic problems have had two major consequences for Germany and the process of Eurozone reconstruction. First is the lack of a partner, which Berlin requires on the road to further Eurozone reforms. Since France and its economy are part of a problem to deal with, it is unlikely to be part of a constructive solution. Secondly, France's poor economic prospects and mistrust by its citizens of the ruling majority have had a considerable impact. According to the European Commission's 'blueprint' from November 2012, sooner or later treaty changes will be necessary to allow stricter budgetary and economic surveillance, and reinforced coordination of tax and labor policies. A lack of domestic support for President Hollande puts at risk any possible revisions of the EU's treaties aiming for deeper integration, simplification, or increased efficiency of EMU architecture, as a referendum in France would likely produce a 'no' vote. Any such revisions should be reconsidered.

Limited options for Brussels and Berlin

It seems that the sustainability of the Eurozone will largely depend on the ability of its largest economies, including France and Italy, to successfully apply major structural changes. The French economy is of systemic importance for the process of Eurozone stabilization. EU leaders cannot ignore the economic situation in France and simply wait for the improvement of economic conditions or a change of the ruling majority. However, there is no single, easy way of

dealing with French problems at the European level, as most of the economic policy instruments are in the hands of domestic decision-makers.

There is a need for continuous pressure at the governmental level from Berlin and other European capitals, making it clear that a further extension of the deficit deadline should only be possible on condition that promised reforms go ahead. Otherwise, the willingness of other Eurozone countries to stick to deficit targets may fade, with all the consequences that would entail. However, German politicians should avoid open criticism of France, which could render the language of the French left even more confrontational.

The French government, with its very low level of support among the public, has nothing to lose. Economic reforms could still be successful if focused on small steps, such as reducing red tape or taming budgetary spending. Paris and Rome in particular seem unwilling to go along with the latest proposals from Brussels on their economic policies, which puts a question mark over the feasibility of planned reforms contracts to be managed by the European Commission. Thus, other incentives for reforms at the national level could be helpful. One of the latest polls indicates that 70% of French voters consider the fight against unemployment to be the most important goal in the government's economic policy. Therefore, an extension of existing EU mechanisms in employment policy should be considered. This could be applied to youth unemployment, especially among low-skilled workers and recent graduates. The budget for the Youth Guarantee scheme should be increased, as demanded by François Hollande at the European Council in June. This instrument could also play a broader role as an EU tool for supporting continuous professional education and requalification in Eurozone countries with high youth unemployment, particularly among low-skilled workers, whose votes are increasingly sought after by populist forces, including the FN in France. This measure

could be faster to implement and more effective than the EU investment plan of €300 billion currently being considered, which would probably be largely based on renaming existing EU expenses.

EU leaders often overlook strong potential for reform in the incomplete single market. Paradoxically, the EU is the only entity which can be successful in forcing the southern economies to introduce some market-oriented reforms through the 'back door'. In the past, despite strong domestic resistance, several sectors in France (including transport, energy and telecommunications) have been gradually opened up for competition in the framework of single market liberalization. This has benefited the economy and customers. Recent structural changes to the state railway system in France, to comply with single market rules, have shown that this can be less politically costly than a home-grown reform process. Therefore – in addition to the “Digital Agenda for Europe” – a new, broader single market liberalization package in the service sector should be considered in the current EU institutional cycle. The main task, however, is to convince the French left (which considers fiscal and social harmonization to be the primary objective) that the elimination of more barriers, for example in the EU labor market, would be beneficial for the unemployed.

Even if all of the above measures were introduced, they would only support the action plan in Paris and not replace it. France's primary problem – its overgrown general government sector – urgently requires systemic solutions on the national level and decisive leadership in the Élysée Palace.

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