A Changing Europe Monitor

France’s labour reforms: not a game changer

The recently introduced labour reforms cannot be dismissed as “small” but, in our view, have not gone deep enough to either landmark a major change in business conditions or to satisfy the electorate’s hopes. The changes, by and large, have reduced the complexity of managing the labour force, but have not reduced the cost of labour, nor have they boosted flexibility in the way small and micro companies had hoped.

We expect the labour code changes to support an ongoing drop in the unemployment rate by a further 2p.p. by the end of 2020, bringing it back to the 2008 low point. This is proving sufficient for keeping wages stable and even rising mildly already. However, French wages are 6.5% above the EU average and the convergence process implies that average wages are likely to continue to fall in relative terms and, eventually, may also drop in absolute levels, in our view.

In this report, we compare the German and Italian labour reforms of the past 20 years with the recent French amendments, to get some perspective on the long-term impact on the economy and on the political outlook. We have also discussed the French changes with 30 companies in France to get a different perspective on this issue, and we present a summary of the feedback we gathered in this report. The labour reforms in Germany corresponded to a rise in potential growth, but did not prevent a decline in Italy. In our view, it should prove neutral for France. That said, both Germany and Italy amended the labour market rules four times – so more changes may be ahead in France too.

In order to boost the attractiveness of France as a place for business and to live, a bolder industrial strategy that puts a lot more emphasis on pushing micro companies to expand would be a more appropriate policy priority in our view, than labour market deregulation, *per se*. A healthy SME sector plays a subtle role in society: it can contribute to investment and productivity as well as providing a certain flexibility of lifestyle that some cherish. Changes to the SMEs thus influence not just the economy, but election results too.

In the aggregate, the French non-financial corporate sector balance sheet is the best in the Eurozone: it has hoarded over 3x GDP worth of financial assets, well in excess of its equally impressive debt burden. However, there are two problems that are well hidden behind such impressive results. First, we know from the turnover by company size data that the improvements have not trickled down to the micro-small companies. In our view, this process will continue and will curb job creation. Secondly, France has used the benefits of the low borrowing costs to the maximum. It is thus, in our view, vulnerable to a reversal of that trend.

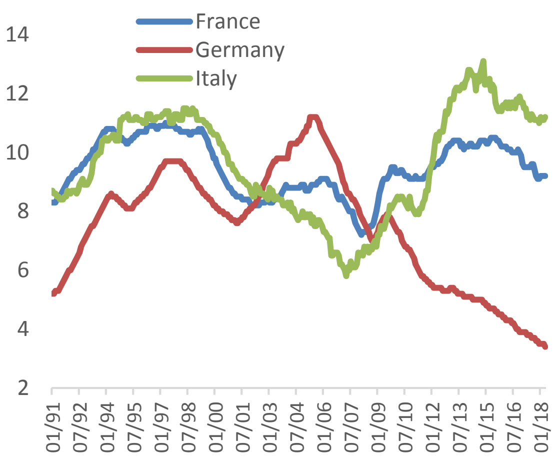
Labour reforms: not quite a game changer

One of President Emmanuel Macron's first measures, after taking office last year, was the introduction of important changes to the labour code. These changes largely simplify the process of hiring workers, negotiating their contracts and firing them. It sets a cap on compensation and a maximum of one year to challenge a dismissal in court. The labour code changes were also followed by a recently presented package to support SMEs and an increase of EUR 15bn to support work training and to monitor unemployment benefits deployment. More details of the reforms can be found from page 9 and a summary of the feedback we gathered on the ground can be found on page 13.

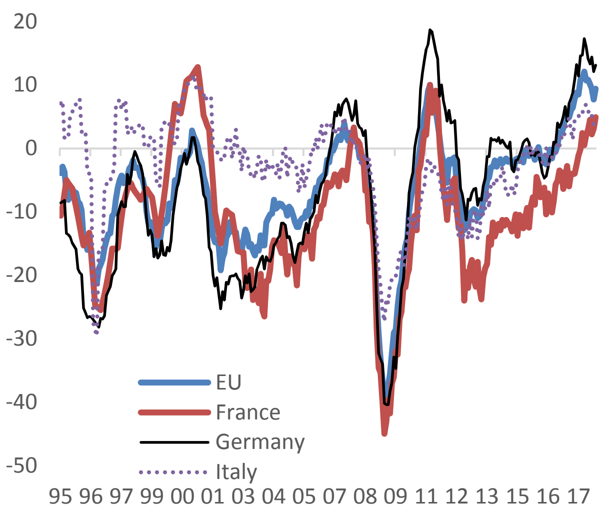
In order to assess the impact of the latest amendments by President Macron, we compare the changes introduced in Italy starting in the 1990s and the German Hartz reforms since 2002. The Italian and German reforms (taken together – in both cases: four "episodes"), in our view, were more radical than what France has introduced this time and thus yielded large drops in the unemployment rate over time. That said, labour market deregulation, *per se*, is no panacea for other challenges, especially not for developed economies with high average wages.

In fact, in our view, what France actually needs to boost its potential growth is not really a labour reform, but a bolder industrial strategy (more aggressive than what can be seen in the SMEs bill). Aside from the structural considerations, in our view, French growth is growing dependent on low interest rates and, as such, a hawkish turn by the ECB may end up triggering more economic and political turmoil than what the fixed income and equity markets assume currently.

Unemployment rate, %



Industrial hiring appetite indices



Source: Macrobond, ADA Economics

Rising hiring appetite is good, but not good enough for many

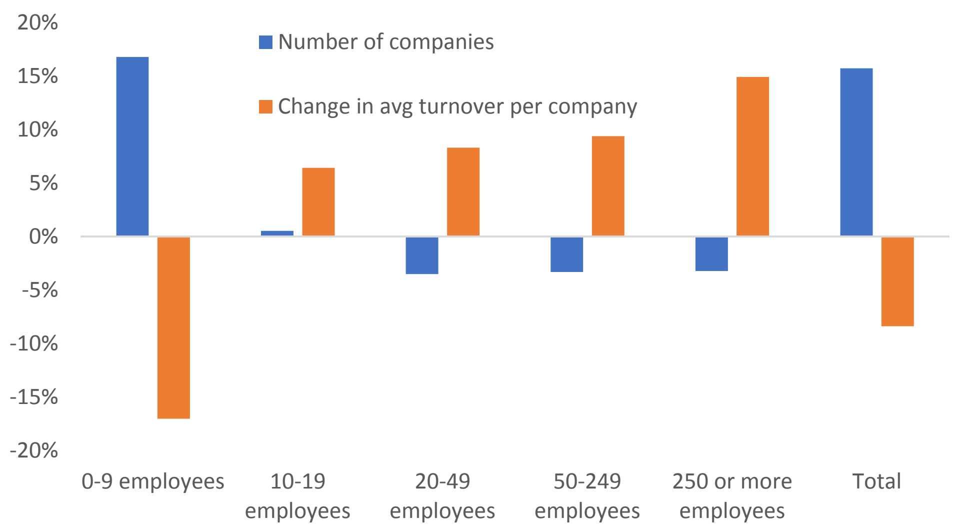
The benefits of the increased flexibility in the labour laws are probably showing already in the industrial sector hiring appetite, which is still holding up better than in the rest of the Eurozone. Given the current conditions, the trend in the hiring appetite surveys suggest that the unemployment rate, which remains fairly high so far at 8.9% in Q118 (in the domestic definition), should drop by 2ppts in the next two years, returning to the 2008 low by 2020E.

A pick up in employment opportunity is a welcome step forward, but do these changes go far enough to meet what voters' were probably hoping for when they voted for President Macron last year? In our view, no. Last spring, we ran a small data survey in France; that is, we sampled a relatively small number of people with different economic backgrounds and resident in different parts of the country (See France: This election is mostly about jobs, March 2017). The sample is too small to provide accurate statistics, but detailed enough to reveal a great deal about voters' strategy and what they hoped to see in future. We asked them to tell us their complaints and expectations for the next legislation. On the labour market, we came across three common desires: a broad call for greater flexibility in the labour code; lower taxes; and, ideally, the elimination of the 35-hour working week. The changes introduced by President Macron, in our view, address the flexibility demands partially, but they have not addressed the remaining issues.

The financial state of the business sector: a mixed bag

The business sector in France is, on the whole, very resilient from a balance sheet perspective: it is flushed with financial assets and while it is highly indebted, the net financial position records a huge surplus (180% of GDP as of Q118, 5 times that in Germany and well north of the 9% of GDP deficit in Italy). However, the overall numbers mask a serious divergence in performance between the micro/small companies and the large ones. According to Eurostat data (which is a bit less timely than the French national statistical office dataset, but allows cross country comparisons), in the five years to 2015 there were 15% more companies for a total of 2.9 mn in the business sector. However, essentially all the change took place in the micro segment: 397,000 more companies with 9 employees or less. Over the same time period, the total turnover of the business sector rose by 6%, but it fell slightly (3%) for the micro companies and when calculated as an average turnover per micro company the drop was a remarkable 17%. The chart below shows you the full breakdown of this data.

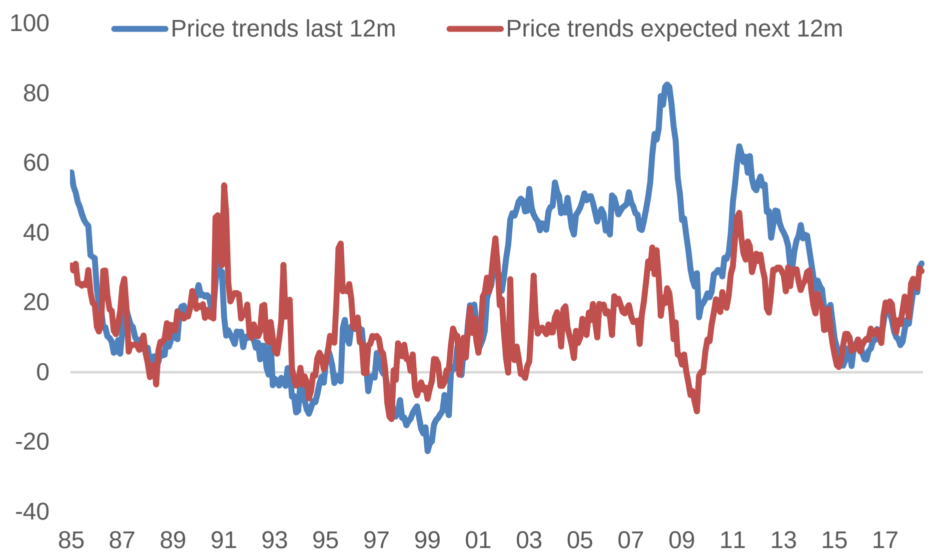
More and more tiny companies, but average turnover dropping (2015-10)



Source: Eurostat, ADA Economics

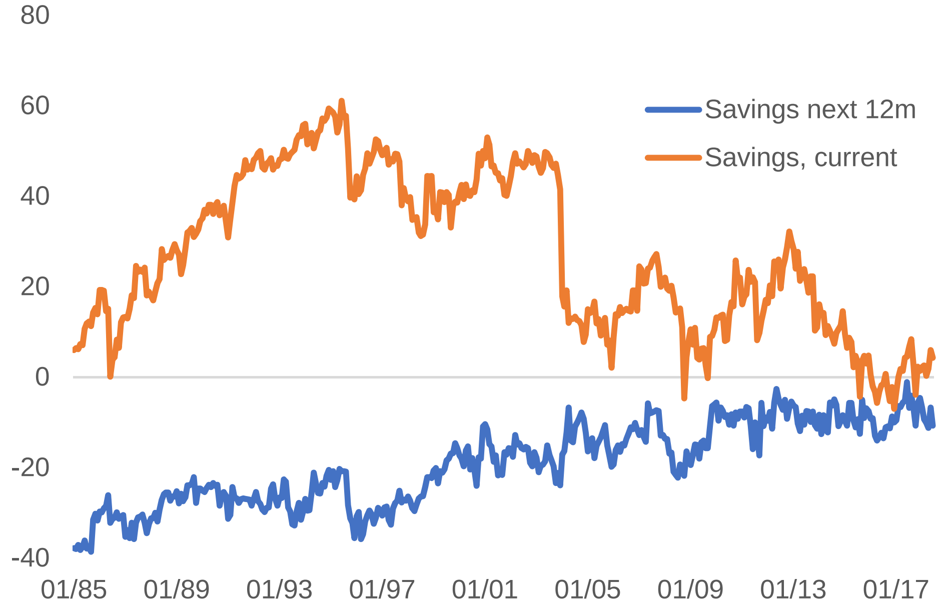
These industrial changes should be taken very seriously, in our view, as the micro companies are a critical part of a country's investment, employment and overall attractiveness. In our view, the changes in the labour code (and those in the SME plan) do not go far enough to address the challenges faced by the very small companies (a discussion on corporate inequality can be found in Balance sheet inequality: has it gone too far? March 2018). Indeed, our suspicion was confirmed in our conversations with 30 companies in France, conducted in June. The entrepreneurs of small businesses told us that they had not seen any relevant improvement in the regulatory environment, while they faced limited to no pricing power and thus must respond by reducing or limiting their hiring plans.

French household index on perceived inflation and expectations



Source: Macrobond, ADA Economics

French household index on perceived and planned savings



Source: Macrobond, ADA Economics

Starting a business is cheap in France, making it profitable it hard

France does stand out relative to its neighbours in terms of its very low and simple procedures to set up a business (both are likely to be further simplified soon). However, this is not quite what the country needs: it needs to allow new entrepreneurs to grow their companies in terms of turnover and staff size, and it will not benefit much if it keeps on creating a lot of companies that barely break even. Our best guess is that if the current conditions remain in place, France could easily see 200,000-300,000 fewer jobs within three years purely because of the ongoing compression of micro-companies' profits: that is not far off the 340,000 total jobs created in the year to Q118, and that will work against the benefits gained in the large company size segment of the business sector.

President Macron has also put forward a gradual reduction of the corporate income tax from 33% currently, to 31% next year and continuing to fall steadily to 25% by 2022. These changes do not affect the changes taking place between small and large companies described above for two key reasons: first the drop in the tax rate is slow, so it will make little difference to the segment of the business sector that is already today under profit pressure nor it will make France stand out in the European context given that Eastern Europe is well ahead in the race to the bottom on corporate tax rates. Secondly the drop in the corporate tax will inevitably benefit more those that have a large balance sheet as the magnitude of the savings are larger in absolute amounts and therefore can be deployed to achieve bigger and faster business strategy changes (to put it bluntly: on an annual profit of EUR100,000 – a reasonable assumption for a good performance of one of the 2.7mn micro companies in France, a 5p,p, drop in the corporate tax yields EUR5,000 of savings by 2020. What can you buy these days in France for EUR5,000? Not much.).

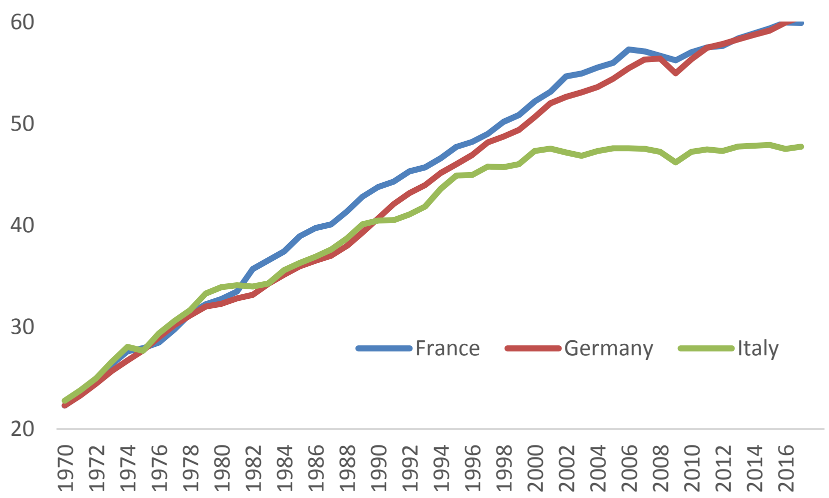
French labour code changes not as radical as the German/Italian reforms

In order to benchmark the latest labour code changes implemented by France, we looked in detail at the various labour market reforms introduced by Germany and Italy in the past two decades. Perhaps the most striking difference is the cost element: Germany and Italy introduced contracts that were enormously cheaper for companies compared with permanent contracts. In France, short-term contracts already existed and do offer some advantages relative to the permanent option, but the latest changes did not change the cost of labour dramatically: it simplified the procedures for managing the labour force and it will make it easier for companies to impose their preferences on working conditions compared with the past. However, by and large, French labour overall (from blue collars to highly skilled) remains expensive relative to most of the EU.

…German/Italian labour deregulation did not pay off immediately…

Both Germany and Italy experienced approximately a 40% drop in the unemployment rate after 10 years of the initial labour code amendments, but the unemployment rate began to drop steadily only three-to-four years after the amendments. In terms of real potential GDP growth, Germany experienced an acceleration in the following 10 years after the first Hartz changes. In Italy, potential real GDP growth fell from 1999 until 2012, and its recent recovery probably did benefit from the Jobs Act, as well as a long period of balance sheet restructuring. In our view, the labour deregulations in both countries were partly responsible for the changes in potential growth, but were not the only factor in play. In Germany, the accession of Central and Eastern European countries in 2004 was most likely a critical element in boosting the competitiveness of the German manufacturing sector and the size of exports increasing steadily since 2003-04.

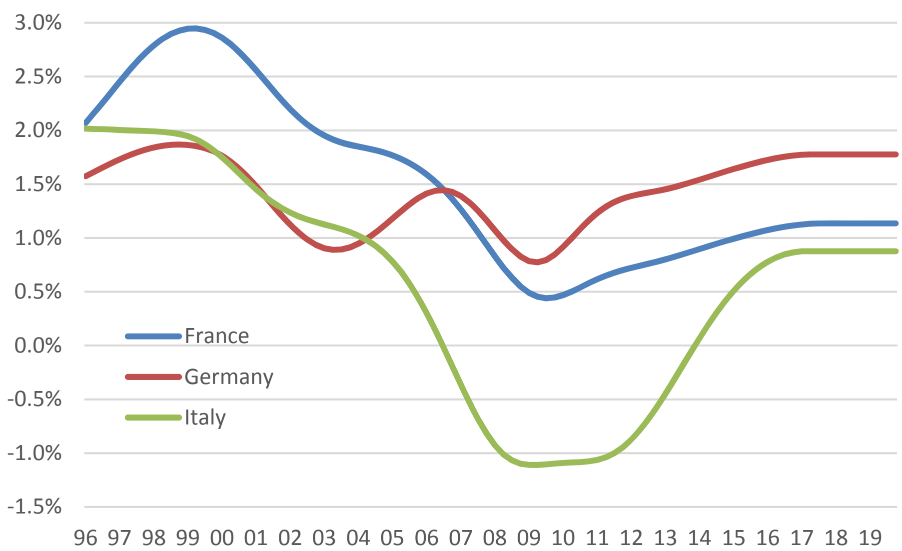
Labour productivity developments since the 1970s



Source: OECD, GDP per worker in USD PPP terms, ADA Economics

In Italy, the deregulation of a segment of the labour market probably added to other factors that has kept labour productivity stagnant since the late 1990s. The other prominent factors were, in our view: the ageing profile of entrepreneurs; excessive investment in construction; and a painful delay in adapting to the benefits and threats of the growing penetration of the internet. That said, the reduction in labour costs that was permitted with the Treu reform, together with the drop in borrowing costs due to the introduction of the Euro, gave sufficient balance sheet space to allow companies that should have been restructured to stay afloat for an extra decade, until the global crisis in 2008 erupted (the details of the labour reforms can be found below, on page 9-10).

Real potential growth GDP estimates



Source: Real GDP filtered with HP as a proxy for real potential growth, ADA Economics

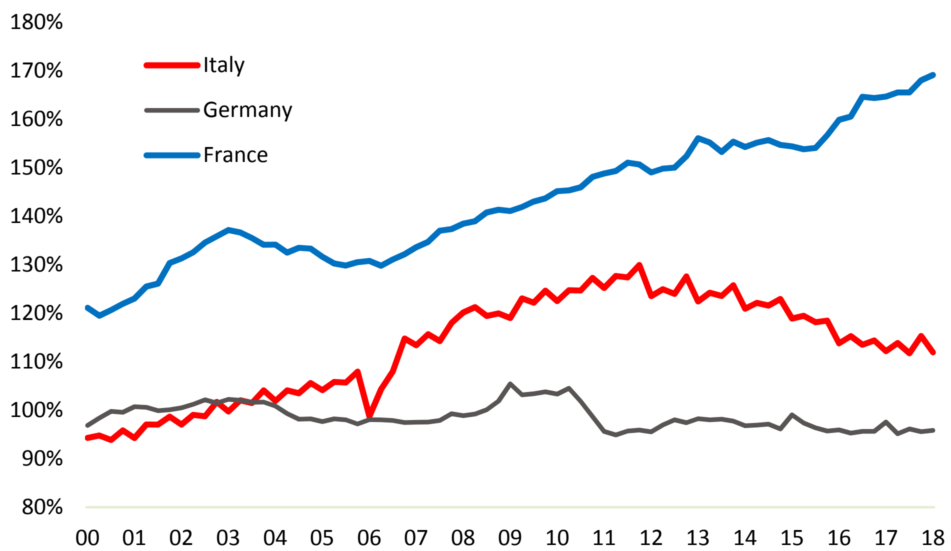
All in all: much changed, but not quite enough. Watch out for higher interest rates!

In the aggregate, the non-financial corporate sector in France is seemingly the best in Europe. The total financial assets of the non-financial corporate sector stood at 349% of GDP as of 1Q18; this compares with 132% of GDP in Germany and 102% in Italy. By any measure, the non-financial corporate sector is enormous. Among its assets: there are 21% of GDP worth of deposits (compared with Germany's 16% of GDP and Italy's 19%); 209% of GDP worth of equities (27% of GDP are quoted).

Total debt (excluding equities liabilities) was 168% of GDP in France in 1Q18, 96% of GDP in Germany and 111% of GDP in Italy. Given how large the financial assets are, the debt burden of French companies is not excessive, but it is very high on an international comparison. So, is the business sector solid or not? In our view, these numbers imply that France took full advantage of the low interest rates post the creation of the Euro and after the 2008 crisis, and used leverage to boost balance sheets and accumulate financial assets. That is a good thing, *per se*, but we know from the turnover data that the benefits of this strategy are probably concentrated in the large companies and are not trickling down to the micro/small ones.

So where do we go from here? In the 2000 and 2008 crises, financial assets of non-financial corporations dropped by around 70% of GDP respectively. Nothing smaller is likely to materialise when the next global recession strikes – in our view 2020 looks like a good candidate for that. However, post 2000 and 2008, the ECB eased monetary policy aggressively and French households were less indebted than what they are today – so they could partially smooth the hit. This time around, the ECB is unlikely to have much space on interest rates and French household debt has risen further to 66% of GDP as of Q118: 6p.p. higher than what it was at the end of 2008 and 21p.p. of GDP relative to the end of 2000.

Debt to GDP of the non-financial corporate sector



Source: Macrobond data, ADA Economics. Beware there are various estimates of balance sheets, we used the data from Macrobond, which is consistent with what is on the Bank of France website: http://webstat.banque-france.fr/en/browseTable.do?node=5385192&STO=LE&INSTR_ASSET=F&INSTR_ASSET=F2&REF_SECTOR=S11&CONSOLIDATION=N

Taking this problem further: if our reasoning is correct on the French balance sheets, France has an "inbuilt" incentive to keep the Eurozone interest rates as low as possible, but Germany is almost at the opposite end of the spectrum: the drop in indebtedness in recent years and the social discontent that is building around rising price levels (please see our report "Germany: A lingering feeling of unhappiness" September 2017) makes Germany far less accommodating, in our view, of another 10 years of very low interest rates.

All-in-all – we find it laudable that President Macron is attempting to implement a comprehensive strategy for growth, one that includes a greater focus on SMEs. That said, his efforts so far have been half-hearted and, thus, his likely gains will be underwhelming, in our view, both in terms of the benefits for potential growth, as well as the benefits for his own approval rating. However, there will be implications for the ongoing negotiations about the next EU budget 2021-2027 and overall the growth strategy of the European Union. More on this in upcoming publications…

Raffaella Tenconi & Shubhra Singh, July 2018

-Appendices below-

Details of the changes

We describe the changes introduced by France, Germany and Italy briefly below. To simplify the comparison, we have paid attention to what we see as the four critical areas usually targeted in labour reforms:

1. The hiring process is cumbersome and the firing process is lengthy, complex and costly.
2. The cost of labour is high because social contributions are high (the “tax wedge”) and/or because actual wages are high.
3. There is limited ability of companies to fine tune contracts directly with their own workers, as details are negotiated primarily at the country/sector level.
4. Unemployment benefits or other safety nets are perceived as too generous, impairing the willingness of workers made redundant to find a new job.

The table below shows how France, Germany and Italy compare today on seven key metrics that influence the labour market. The first item relates to the cost of setting up a business, where all three countries have seen a sharp drop since 2004 on speed and cost, but France remains the easiest and cheapest destination. The second time relates to how easy and for how long can a company use temporary staff, on this front Germany stands out as being the most flexible; also note that in Italy there has been a growing trend in recent years to try to make temporary work contracts more expensive and limited in duration.

France; Germany and Italy as of 2018 compared on key labour market regulations

France	Germany	Italy
	Time and cost to set up a business	
5 procedures, the equivalent of 3.5 days of work for a cost of 0.7% income per capita*. The equivalent paramenters were 5;7; 1.1% of income in 2008 and respectively 8, 41 and 1.4% in 2004	9 procedures, the equivalent of 10.5 days of work for a cost of 1.9% income per capita*. The equivalent paramenters were 9;18; 5.8% of income in 2008 and respectively 9, 45 and 6.1% in 2004	6 procedures, the equivalent of 6.5 days of work for a cost of 13.7% income per capita*. The equivalent paramenters were 9;13; 18.7% of income in 2008 and respectively 9, 23 and 22.1% in 2004
	Fixed tems contracts max length	
Permissible for permanent tasks, but max length allowed 18 months	Not permitted for permanent tasks, but no time limit on use of these contracts	Not permitted for permanent tasks but max length allowed 36 months*
	Minimum wage	
Euro1498.47/monthly	EUR8.8per hour (EUR1,498 per month)	No min wage*
	Social security contributions, employer share	
45**	19.4**	30**
	Unemployment benefits level	
Based on your previous wage, min 57% payout	60% of the net average daily income in the	Under NASpl75% of the monthly reference
	Max length on benefits	
24 months for those up to 52 yrs old	24 months	At most 2 years under Naspl, extendable by 6max under ASDI
	Active labour policies	
Current under review and will be much more linked to actively looking for jobs and job offers must be accepted	Very strict rules and under Hartz IV euro jobs were introduced: paid EUR1 per hour to do work of public interest while in benefits	Increasingly used, but not hugely effective yet

Source:Time & Costs to set up a business from the Doing Business Report, Minimum wage from Eurostat, unemployment benefits from the European Commission website, max length of benefits from various local sources.

The third item is the minimum wage: here France and Germany are essentially equivalent, while Italy does not have a minimum wage level at the moment but it is one of the policy priorities of the new government.

In terms of “generosity” of the unemployment benefit buffer, all three countries have curbed this type of safety net and the lowest level in our view is currently in Italy – both in terms of available amounts and length of coverage. Active labour policies are by now linked to the deployment of unemployment benefits and on this front Italy is tightening its rules, but it is not yet as aggressive as the German case. In France the public statements released by the President suggest there will be tighter rules between active search for a job and disbursement of the unemployment benefits in future.

France: key changes in the labour code and proposals for the new SMEs law (PACTE)

The labour code introduced a reduction in the maximum time permitted to appeal against dismissals to one year for all types of dismissals. The maximum compensation that can be awarded in the case of unfair dismissal is 20 months of salary for employees with a length of service of 30+ years. The statutory severance pay was raised to 25% of monthly salary per year of service, compared to 20% earlier, for up to 10 years; after 10 years, it is at 33% of the monthly salary per year.

The union representation requirements were loosened for companies with under 50 employees. In addition, the possibility of a referendum called by the employer to validate a company agreement was introduced (before, only employees could start a referendum).

The will be an aggregation of the various employee representative bodies: staff representatives (DP), works council (EC), and health, safety and working conditions committee (CHSCT) to form a new "social and economic committee" as of 2020. A commission responsible for health and safety will remain for companies with over 300 employees, but it will be compulsory only for sectors with a high healthcare hazard. By agreement, it will be possible to integrate the trade union delegates (DS), and thus the bargaining power, into a single body called a "company council". Its approval will be necessary on certain subjects.

Working from home has become an automatic right for all employees, a company that refuses to grant this option must justify its refusal.

The cost of setting up a business will be reduced further to a mere EUR 250 and a one-stop-shop electronic portal. The costs associated with starting a business, such as the compulsory “stage” or mandatory certification of accounts, will be scrapped for micro companies.

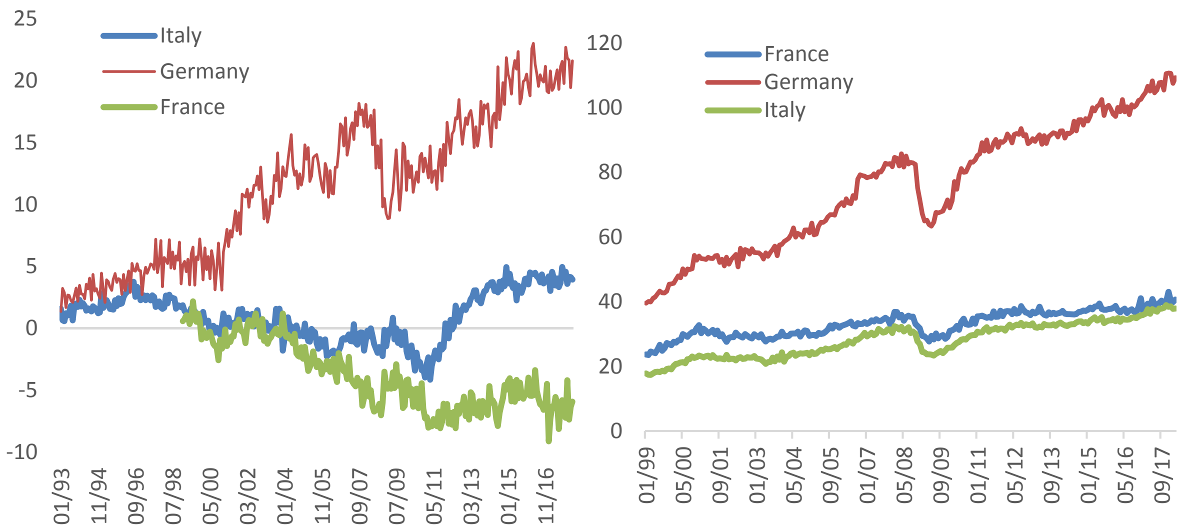
The liquidation procedures and costs will be reduced, and transfers of ownership will also become less expensive for micro companies.

Those that resign to set up their own business or those that liquidate a very small business are likely to be able to claim unemployment benefits for a period of two years to support the transition.

Germany: Hartz I – IV

The first chapter of the German labour reform started in 2002, with Hartz I. Hartz I introduced employment agencies all over the country, which aimed to place the unemployed back in the labour market and changed the benefits rules, such that job seekers had a very high incentive to take any job offer or explain why they were turning it down. With Hartz II the following year, mini- and midi-jobs were introduced, which were short-term contracts that were a lot cheaper for an employer than regular contracts. Under Hartz III, unemployment benefits would be reduced by 30% if a person refuses to take up offer for work and the criteria to classify for unemployment benefits were increased. In the latest change that came in 2005 with Hartz IV, unemployment and welfare benefits were merged into one, the penalties from refusing to take up a job offer were further increased and a new programme was introduced to get unemployed workers to conduct public works (one-euro jobs), for a nominal compensation of EUR1 per hour in addition to the benefit payment.

Evolution of the trade balance and exports (EUR bn)



Source: Macrobond data, ADA Economics

Statutory national minimum wage was introduced in 2015 at EUR 8.50/hour and raised to EUR8.8/hour in 2017.

Italy: Treu, Biagi, Fornero & the Jobs Act

Labour regulations and social safety nets in Italy (in the form of the Cassa d'Integrazione, CdI) have been very rigid and generous historically and thought to be a bottleneck for labour productivity. There were four attempts (broadly speaking, as there have been many more attempts to fine tune the incentives and regulations) to address these challenges: starting with a proposal from the Dini government in 1995 to introduce the possibility of temporary work contracts, which was implemented formally two years later and known as the Treu package and with the latest 2014 Jobs Act by former PM Renzi (technically a further amendment is being presented to parliament, known as the *Dignity* proposal). The biggest change introduced initially was the creation of new forms of contracts, which provide full flexibility in hiring and firing, and are much cheaper than the alternative permanent, full-time contract, negotiated at the sector/country level.

The first two reforms, however, did not address the problem of the expensive and lengthy process that companies faced when an employee disputed their dismissal on unfair grounds, they did not touch the permanent contracts, nor did they aim to reduce the length of benefits under the CdI. The 2012 Fornero law and the 2014 Jobs Act addressed all these features by reducing the maximum eligibility of unemployment benefits significantly, capping the severance pay for dismissals for any situation, and reducing the disparity in costs between short-term employment (in whatever form) and permanent contracts. In addition, it is important to highlight that the government introduced large fiscal incentives in 2015-17 to favour the switch from short-term contracts to permanent ones, and large fiscal incentives to boost investments; together, these two measures helped to re-start employment growth at a brisk pace.

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A view from the ground: timid moves

We discussed the latest labour changes, as well as the direction and substance of the Macron reforms, with 30 companies of different sizes, operating in various sectors, to get a different perspective on the likely impact of these changes. The most common responses we gathered indicate that there is no downward pressure on wages at this stage, nor there is a big perceived gain by the small companies from these changes or the tax changes introduced more broadly this year. Below, we present the common feedback we gathered, broken down into questions.

- Are you satisfied with the changes in the labour code; what more would you like to see?

We found that companies with over 200 employees were satisfied with the changes, but small and micro entrepreneurs did not see any benefits.

- How is the business environment?

On average, companies noted the improvement in the economy but, essentially, across sectors and company size, we noted that significant competitive pressures were stressed; in some areas, companies flagged early signs of moderating domestic demand.

- Is the minimum wage appropriate, in your view?

To our surprise, most people either stated that the minimum wage was fair, or even too low, given living costs. There were very few comments suggesting that it was too high.

- Is there a repricing of labour taking place, up or down?

We came across no significant evidence, after the labour changes, of a push by managers to attempt to reduce labour costs; in fact, wages appear to be stagnant, or even up mildly. However, small entrepreneurs made it clear that the high cost and low flexibility simply made them less keen to hire workers, even young ones, even if they could potentially allow them to boost their turnover.

- What other reforms do you think are needed?

We asked people to think broadly about the State services, and we found an almost universal concern about the public healthcare system, which is seen as being severely under strain and underfunded. Education was also an area perceived to be under pressure, with virtually no positive feedback for the education reform under review. Public administration overall also appears to be under pressure, with too few resources to retain highly skilled labour. The pension reform – as well as the increase in the tax burden on pensioners introduced this year – instead, was seen as a necessary evil by most.

- Is the exchange rate an important factor for you?

Perhaps it should not come as a surprise to see that almost none of the companies we talked to thought the Euro as an important variable of their business. Large companies were comfortable with their hedging strategy; while small domestically-orientated companies did not see it as an important variable. Admittedly, France has a relatively modest export to GDP ratio (23% of GDP, vs. 32% in Italy and 50% in Germany). However, in our view, there are some symptoms resembling those of a country experiencing an overvalued currency and our profit model for the aggregate business sector shows a significant and fairly sizeable impact the fluctuations in the euro-dollar level.

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