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MACRON RECALIBRATES BUT HOLDS FIRM ON REFORMS

Berenberg Macro Flash

Good news for the French economy – both over the short- and long-term: President Emmanuel Macron's plans to cut taxes for the middle class and accommodate a few demands of the yellow vests can help to further contain the protests, which have been gradually losing momentum since January anyway. In economic terms, the changes Macron outlined yesterday will support disposable incomes and private consumption at a time when the French economy faces a challenging external environment. Importantly, Macron will not roll back the pro-growth policies he has already implemented and seems committed to stick to his reform agenda for the remainder of his presidency. In combination with the ongoing reduction in corporate taxes, this should raise France's long-term growth potential. It could lay the ground for a golden decade of the French economy. Although the concessions will probably add to France's fiscal challenges, we expect stronger gains in employment and the tax base to more than offset any near-term fiscal damage over time.

In a press conference that lasted more-than-two-hours, Macron announced yesterday evening the following **tax and social measures**:

- Personal income taxes will fall for a "maximum number of citizens and especially those who are working" in the range of possibly 5bn euros, equivalent to 0.2% of French GDP.
- Bonuses up to 1000 euros will continue to be exempted from social contributions and taxes.
- Low pensions (below 2000 euros a month) will be re-linked to inflation. Middle and high pensions will also be linked to inflation starting in 2021.
- Single parents will get extra support.
- No school or hospital will be closed until 2022 unless the mayor of the municipality consents.

Holding firm on previous and planned measures: According to Macron, the tax cuts and higher government expenditures would be financed by closing (corporate tax) loopholes, reducing other public spending and having people work more and longer. An already announced public sector reform – to be passed by summer – is supposed to cut 120,000 of 5.5m civil servants by 2022 and end the "job-for-life" practice for top civil servants. While Macron stressed again that – in line with his campaign pledge – he would not raise the official retirement age of 62, he will introduce incentives to encourage later retirement. Macron reiterated that it was right to transform the wealth tax into a real-estate-only wealth tax. While that policy has been widely perceived as a gift to the wealthy, Macron argued the purpose was to attract investments and create wealth. As the tax system already corrects many social inequalities, Macron argued that France should focus more on investing heavily in early childhood education to deal with the "inequalities of origin, of destiny, of birth".

He also announced changes on **other issues**:

- More referenda will be possible, but mostly consultative and at the local level as France's representative democracy should be uphold.
- French democracy should get a (bigger) dose of proportional representation with 20% of MPs in both houses of parliament selected by popular vote for the MPs' parties.
- Public governance should be decentralised further from 2020 onwards by granting more power to local authorities.
- The National School of Administration (ENA) will be reformed, or even shut down, in an attempt to reform the way France selects its elites.

This time could be different and do the trick: It is not the first time that Macron has made some concessions to the yellow vests. When he cancelled a fuel tax hike planned for 2019 and announced a 10bn euros package on top late last year, the protests continued. While the number of people taking to the streets shrunk, the protests became more violent. This time, many yellow vests and some commentators will likely argue again that this is too little too late. Labour unions have called for a day of strikes on 9 May in response to his public sector reform. We take a different view. French reforms were always going to be a balancing act. By and large, Macron seems to have struck the right balance. We expect the number of protesters to fall further over time.

Major conflict with the EU unlikely: Macron's measures will not only support domestic demand, they will also likely raise the fiscal deficit. The offsetting measures which Macron alluded to will probably fail to raise sufficient revenues. While we expected France's 2019 deficit (3.2% of GDP) to already break the 3% Maastricht rule before Macron's announcement yesterday, we do not expect a potential modest further overshoot to be a major sticking point for the EU: 1) The 2018 deficit came in a bit better than expected at 2.5% instead of 2.7%. The same could happen in 2019. 2) Macron is implementing pro-growth structural reforms that will help to bring France's public finances in order in the long run. 3) Excluding the temporary impact of transforming the CICE tax credit into a permanent cut in employers' social security contributions, the deficit would be 2.3% instead of 3.2% in 2019. 4) Europe's fiscal situation has changed. The Eurozone's public deficit was down for a ninth consecutive year and reached a historical low of 0.5% in 2018. There is fiscal legroom and political willingness to give Macron flexibility to cut taxes and time to overhaul the French economy. In this sense, France differs from Italy where the government is pursuing policies that can curtail rather than augment the country's growth potential.

Macron's initial mistake: At the start of his presidency, Macron followed economic logic and cut corporate income and wealth taxes before touching personal income tax rates. Better incentives to invest in France help to boost the economy's potential. Tackling the supply side of the economy was the even more pressing issue than raising demand. Unlike the situation in other countries French wages and disposable income have grown fairly in line with productivity gains. Politically, however, this sequencing backfired and culminated in the start of the yellow vest protests five months ago. Some of Macron's initial measures were – and still are – perceived as a gift for the wealthy. On top of that, even though French employees enjoyed bigger pay gains in the past than in the Eurozone, these gains were still low relative to their long-term average as productivity growth has been low. And with unemployment so high in France (8.8% vs. 7.8% in the Eurozone), many did not participate in these (small) pay gains.

Sequencing of reforms as crucial for perception as their timing: We expect Macron to weather the yellow vest protests in the end. His experience with the yellow vests should not prevent political leaders elsewhere from implementing pro-growth reforms. Yes, such reforms are politically challenging to implement even for politicians who have run on a reform election platform and enjoy a parliamentary majority. Macron's experience highlights that reforms have to be perceived as sufficiently fair. For that purpose, the sequencing of the various steps may matter as much as the timing of the overall package.

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