Paper for Eurointelligence, May 2007

The Economic Consequences of Mr S.

Jean Pisani-Ferry

In the aftermath of Nicolas Sarkozy's resounding electoral victory, the three main questions are: Has he won a mandate for change? Which policies will he give priority to? And what will be the consequences for Europe?

The answer to the first question is a clear yes, and this is not only because French voters participated in the election en masse. Throughout his long march to power, Sarkozy consistently emphasised the need for a clear break with the policies of the last decades – a *rupture*, as he called it. And there is no doubt that the voters got the message. According to IPSOS exit polls, 77% of those who voted for him did it because they wanted him to be president (against 18% who wanted to prevent Ségolène Royal's election) – while only 55% of those who voted for Ségolène Royal had the same motivation. According to a recent TNS-Sofres poll, more than 60% of the voters expect his election to lead to change and to the speedy enactment of reforms. In short, Sarkozy has clearly spelled out his philosophy and his priorities and – barring a highly unlikely surprise in the parliamentary elections next month – he was elected to implement them.

It is hard to realise how new this situation is. In 2002, Chirac won because his opponent was Le Pen. In 1997, Jospin won a majority in parliament because Chirac had called a snap election without being able to explain why. In 1995, Chirac ran a left-leaning campaign (because this was the only way to eliminate Edouard Balladur, his former friend turned rival) before governing on the right. In 1988 Mitterrand won on the promise to unite the country. In all those cases, after the election the president or the prime minister found himself deprived of legitimacy as a result of campaigning on an explicit agenda. For the first time in more than two decades, a French president has amassed in the election the political capital he needs to implement his policies.

The answer to the second question is: labour market reform, tax cuts and the restructuring of state spending. Sarkozy's main economic theme has been the need to "rehabilitate the value of work". He wants to introduce tax incentives to work longer hours, to get rid of the duality between permanent and temporary labour contracts by introducing a single contract, and to merge various agencies dealing with unemployment insurance, job placement and training in order to improve matching of labour supply and labour demand. He has promised to cut (if not scrap) taxes on wealth and inheritance and to reduce the overall tax rate by 4 percentage points of GDP (though he later watered down that proposal after it was pointed out that it would result in a massive budget deficit). He intends to reduce the number of public employees by replacing only each second civil servant who leaves for retirement. And he has announced a reform the pension regime of public utilities employees.

Some of these measures (especially the merger of the various employment agencies and the reform of the labour contract) have long been advocated by economists. Some are disputable on efficiency grounds (why should the government go beyond a neutral stance as regards actual working time and give companies a massive incentive to hire less and let their employees work longer?) or on fairness grounds (why should the inheritance tax be eliminated?). But they do have consistency: Mr Sarkozy wants a more flexible labour market, a slimmer state and lower taxes – hardly an unusual combination.

Can they be implemented and succeed? While not radical by European or global standards, these reforms are very significant by French standards and implementing them is likely to be tough. Furthermore, for the labour market reforms to have a rapid effect on unemployment, they would have to be complemented by liberalisation of product markets, especially in rent-laden sectors such as retail trade and specific sectors where entry is restricted (taxis are an example all foreign visitors have noticed). They would also need to be complemented by financial market liberalisation (because of oligopoly behaviour and administrative regulations, credit constraints abound for small companies). However Mr Sarkozy, who could have taken as an example Romano Prodi's recent decisions in this field, has remained rather silent on those reforms. Is it because he intends to liberalise the labour market only, or because spelling out his goals would have risked costing him votes in his own camp? This remains to be seen.

What is unlikely to be a short-term priority is fiscal adjustment. True enough, Mr Sarkozy paid lip service to debt reduction but in the coming times, he has every reason to treat it as a second-order priority. First, he has entered into many specific commitments whose aggregate cost should exceed €50bn by the end of his term (this does not include the overall promise to lower taxes by 4 percentage points, only specific tax cut proposals). Yet unless growth accelerates beyond potential, total available resources for discretionary measures amount to about €25bn. Second, Sarkozy is unlikely to give priority to fiscal consolidation because he knows that some reforms are more likely to succeed with budgetary support, as argued in a recent book by his former adviser Jacques Delpla and Charles Wyplosz. Third, he may use the deficit strategically to justify cutting spending – the "starve the beast" strategy adopted by many conservative governments since first implemented by Ronald Reagan. France's choice after this election is thus likely to be different, and possibly opposite to that of the German grand coalition under Angela Merkel: more reforms, and less fiscal consolidation.

This leads to the third question: What will be the consequences for Europe? Sarkozy will certainly make the resolution of the constitutional crisis easier: unlike Ségolène Royal, he has expressed preference for a mini-treaty ratified in parliament. He will, as explained above, aim at ending French labour market exception. But at the time ministers in the euro area have committed themselves to budget balance by 2010, France is unlikely to follow suit. On the contrary, its government may well confront partners and the Commission with an uncomfortable question: do you want reforms or fiscal adjustment? As already made clear during the campaign, Mr Sarkozy is likely to insist on preventing an appreciation of the euro, including by a more accommodative monetary policy. And he does not seem to have any intention to scale down his attacks on the EU competition and trade policies. His first speech as president-elect was very clear in this respect: he summoned France's European partners "to hear the voice of the peoples who want to be protected".

The big question for Europe is whether this is mere tactics or an indication to be taken seriously. France's partners may be tempted to say that they have seen the same before – after all, Chirac and Jospin also started of with pledges to change Europe – and that like so many other European leaders, Mr Sarkozy will learn that his margin of manoeuvre is narrower than he thinks.

It is true that Mr Sarkozy is likely to realise quickly the strength of Ms Merkel's commitment to budget discipline and the depth of Germany's trust in an open trade policy – not to speak of the other main partners. However from a domestic standpoint, Mr Sarkozy can hardly afford to endorse a budget discipline / liberal reforms / free trade agenda. In a country in which 55% of voters rejected the EU constitution on economic grounds and more than 70% see globalisation as a threat, a sure recipe for losing support is to wear the clothes of Brussels-Frankfurt orthodoxy. The more Mr Sarkozy reforms, the more he will need to dissociate himself from the European orthodoxy. This will be a difficult game for him to play, as well as for his partners in Europe and the EU institutions.