December 20, 2018

What is driving the yellow vest revolt in France?

Growing anger among the working and middle classes living outside the major cities at what is perceived as arrogance on the part of the ruling elite and an ever-rising tax burden has sparked a nationwide protest movement in France. While the protests appear to have subsided for now, the long term political damage has been done.

Not only does this have negative implications for French President Emmanuel Macron's domestic reform agenda, it also makes it all the more difficult for European Union members to agree on meaningful reforms, thus adding to the many challenges already facing the EU.

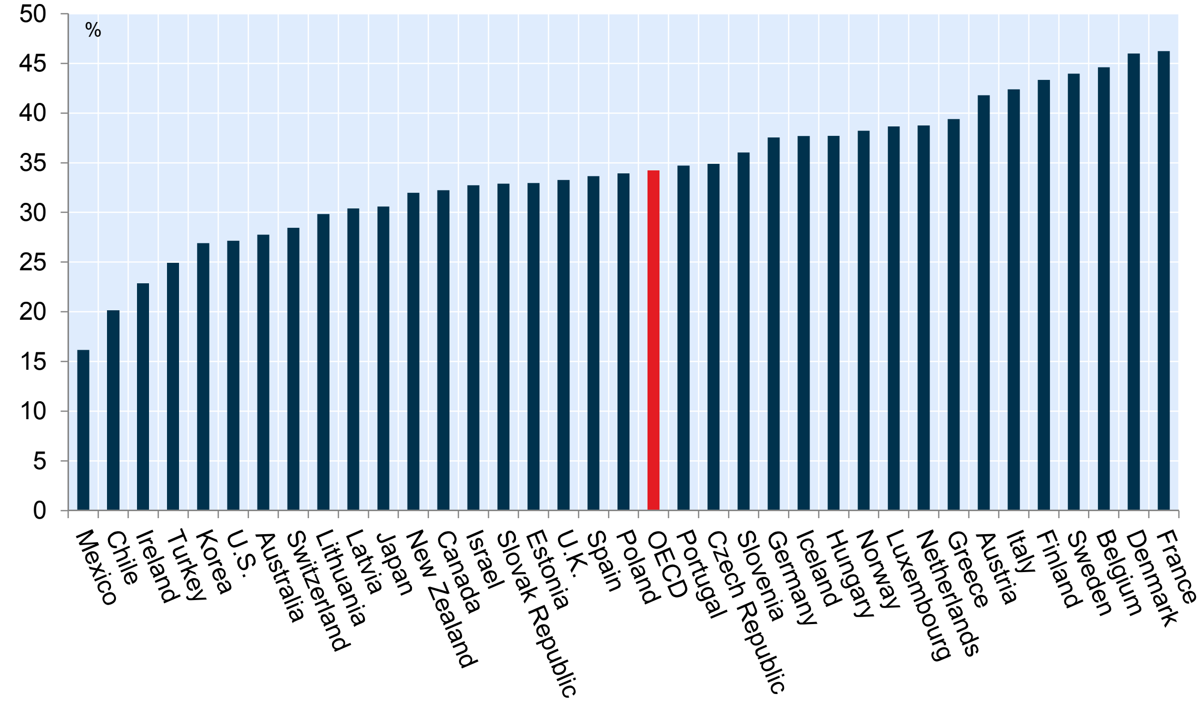
Why the proposed fuel tax hike became a tipping point

- For many years, the French and other EU governments encouraged the use of diesel fuel via lower taxes on the mistaken assumption that diesel was less harmful for the environment. As a result, more than 60% of cars in France today run on diesel.[1] The government has now reversed its position on diesel cars and announced measures, including higher fuel taxes and outright bans on older diesel models entering certain cities, to discourage their use. The consequences for owners of diesel cars are twofold: Rising fuel taxes, and a substantial decline in the resale value of their vehicles.
- While many people living in France's biggest cities are well-served by public transportation, this is not usually the case for those living outside major urban centres. Because of the high cost of housing in the major metropolitan areas, many people have been forced to live tens of kilometres away where public transit options are often limited, leaving them little choice but to drive to work. Indeed, it is estimated that four-fifths of commuters drive to work and that one-third of them travel more than 30 kilometres each way.[2]
- One of Macrons' earliest decisions was to eliminate the wealth tax that applied to many assets of France's richest households and replace it with one that applied only to real estate holdings. While the objective was to stimulate investment and encourage high-net-worth individuals to keep their assets in the country, this angered many in the working class who have labelled him the president of the rich. Certain comments by Macron have only reinforced this perception. In one widely publicized outing last September, he told an unemployed landscaper: "If you're willing and motivated, in hotels, cafes and restaurants, construction, there's not a single place I go where they don't say they're looking for people." In retrospect, it would have been more politically astute to combine the elimination of the wealth tax with tax cuts for ordinary households. Instead, pensioners and the working class were hit by a package of tax increases and austerity measures that have now been partially reversed (more on this later).
- Even though diesel and gasoline prices are comparable to those in other European countries, any fuel tax increase must be viewed against the fact that France is the most taxed country in the developed world.

[1] "Macron's Retreat Shouldn't Mean Surrender," Bloomberg, December 5, 2018
[2] "French 'gilets jaunes' show pain of Macron's tax policy," Financial Times, December 4, 2018

OECD: Perspective on taxation

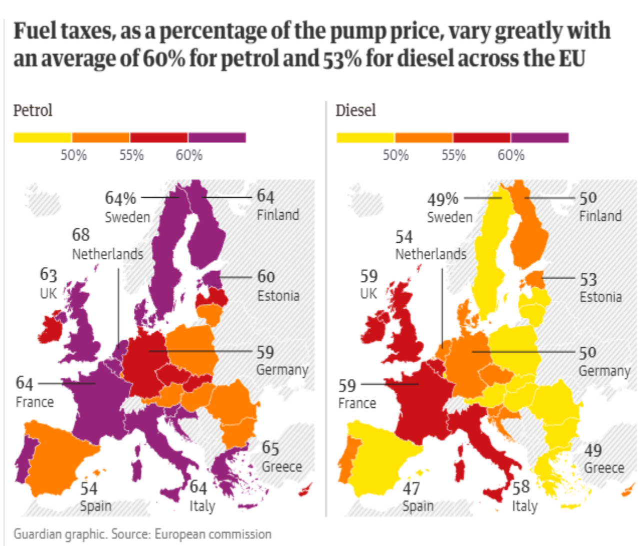
Tax revenue as a percentage of GDP, 2017



*2016 data for Japan and Australia

NBF Economics and Strategy (data via OECD)

As part of its push for cleaner cars, the French government this year raised the carbon tax 7.6% per liter on diesel and 3.9% on petrol. The decision to impose an additional increase of 6.5% on diesel and of 2.9% on petrol effective January 1, 2019, was seen as the final straw.[3] Experts say the best way to avoid a political backlash when imposing a carbon tax is to make it revenue neutral, i.e., what you pay out in higher taxes you get back in lower taxes elsewhere. France, in contrast, had planned to use most of the proceeds of the carbon fuel tax to reduce the deficit.



Source: "Are the French hit especially hard by fuel taxes?" The Guardian, December 3, 2018

[3] "France fuel protests: Macron holds urgent security meeting," BBC, December 2, 2018

On top of the controversy surrounding higher gasoline taxes, electricity prices look set to rise as well

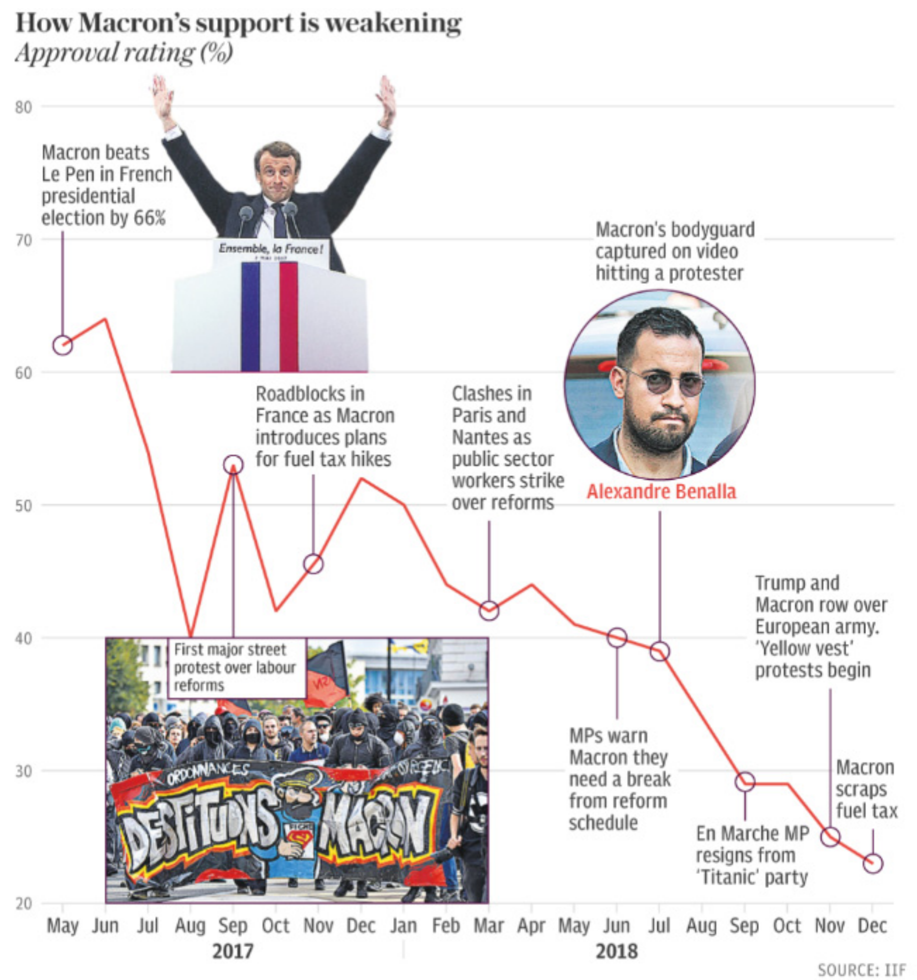
Macron has promised to reduce nuclear power's share of electricity output from 75% today to 50% by 2035 (pushed back from an initial deadline of 2025) in favour of greater reliance on renewable energy. If he follows through, 14 of 58 nuclear reactors in the country could be shut down 2035.[4]

EFD, the state-owned utility company, has estimated the cost of decommissioning its nuclear fleet at 350 million euros per reactor, which is far lower than the 900 million to 1.3 billion euros per reactor estimated by other European countries.[5]

A cheaper option could be to extend the 40-year lifespan of some of France's reactors by 10 to 20 years. The plants are over 30 years old on average, with 15 of 58 over 35.[6]

Building new reactors to replace aging ones has proven also to be a very expensive proposition. The cost of constructing one in Normandy has exploded from an initially budgeted 3 billion euros to 10.9 billion. The plant was originally scheduled for completion in 2012 but is now projected to be finished in 2019.[7]

Current polls show Macron's popularity has plunged to an all-time low



Source: "France's 'yellow-vest' protests have halved economic growth, central bank warns," The Telegraph, December 8, 2018

[4] "France grapples with its nuclear power dilemma," Financial Times, November 28, 2018
[5] "France's lower-cost decommissioning plan rests on Chooz A reactor learning," Nuclear Energy Insider, February 2017
[6] "France could close 'up to 17' nuclear reactors by 2025," France24, July 2017
[7] "More cost overruns, delays at French Flamanville-3 nuclear unit: EDF," S&P Global, July 2018

In an attempt to calm public anger, Macron has reversed course on many fronts:

- The 2019 carbon tax on motor vehicle fuels has been cancelled.
- Planned increases in gas and electricity prices have been withdrawn, and more stringent rules for motor vehicle emissions have been postponed.
- Minimum wages will be raised 100 euros per month effective January.
- Overtime hours will no longer be subject to a payroll tax, and a recent tax hike on retirees will be scrapped for those earning 2,000 euros a month or less.

In all, these package of measures will add an estimated 15 billion euros (roughly equal 0.8% of GDP) annually to the government’s tab.

Despite his troubles, Macron is at very low risk of being ousted from power. His party holds an overwhelming majority in France’s legislature, which means he does not have to face national elections again before 2022.

However, plans to reduce the size of the French state, reduce government spending, and generate stronger economic growth via further reforms will be much more difficult to realize going forward.

Moreover, the upcoming May 2019 European Parliament elections could serve as a warning to Macron. An IFOP poll published in early November showed Macron’s *Republique En Marche* party grabbing 19% of voting intentions, down from 20% in the previous poll at the end of August, while support for far-right leader Marine Le Pen’s *Assemblement National* rose from 17% to 21%.

Macron’s original political error

Macron mistook his May 2017 presidential election victory for an endorsement of market reforms and further EU integration whereas the outcome was largely due to the misfortunes of the other mainstream candidates and desire to keep the populist *Front National* party out of power. However, it is important to note that Le Pen garnered nearly twice as much of the vote as her party did in 2002, when it last made it to the second round of the presidential election (34% vs. 18%).

The recent major backlash from a broad segment of the population against Macron’s reforms is another case in point. In fact, politicians who enact reforms (which can take a few years before their impact is felt) are often not the ones to benefit from them politically. In Germany, for instance, Chancellor Gerhard Schroeder implemented several key labour reforms from 2003 to 2005 before losing the national election to Angela Merkel in May 2005.

France’s slowing economy and rising deficits…

After growing only about 1% a year from 2013 to 2016, France’s GDP expanded 2.3% in 2017. However, the economy is expected to grow only 1.6% this year. Unemployment is down from 10.1% in 2016 but remains uncomfortably high at 9%. Youth unemployment (15-24 year-olds) is over 20%.

The country’s finances are also worrisome. The debt-to-GDP ratio is almost 100%, and the budget deficit is projected to be 2.6% of GDP (just below the 3% limit imposed on Eurozone members). However, Macron’s recent spending measures to buy political peace could, according to some estimates, widen the deficit to 3.4% in 2019 if no spending cuts or tax hikes are implemented.

…exacerbate tensions within EU

Ironically, France’s growing deficit comes at a time when President Macron has recently expressed strong opposition to Italy’s plans to stimulate its economy through greater state spending. This turn of events has exposed him to charges of hypocrisy. **Italian Deputy Prime Minister Luigi Di Maio stated that France should be penalized for breaching the EU’s deficit limits just as Rome was being sanctioned for doing the same in an emergency situation.**

"History will probably show that if (Macron) had focused more on the French and less on Salvini and Italy, he would have a few less problems today," quipped Matteo Salvini, Italy’s other Deputy Prime Minister, during a recent media interview (Reuters).

Conclusion

Macron will end the year with the French economy slowing down, unemployment stubbornly high, and his approval ratings in freefall. He also risks becoming the latest in a long line of French presidents to abandon reforms in the face of street protests.

On the EU front, Macron's goal of greater EU integration has run into major roadblocks. The decision by both Italy and now France to increase deficit spending makes it near impossible for the likes of Germany, Austria, Finland, and the Netherlands to support the creation of a Eurozone finance ministry and/or Euro bonds. A decade of economic crises has left these countries highly suspicious of anything resembling a transfer union that would see their citizens permanently subsidizing social spending in other poorer EU nations. Where France is concerned, many countries will wonder how it can continue to spearhead efforts for further EU integration when it cannot get its own finances and politics in order.

Finally, the unrest in France is just one more challenge in an already long list facing Europe. These include uncertainty surrounding Brexit, increasing global trade tensions, populist governments in Italy and Eastern Europe, Germany's political fragmentation, and winding down of the European Central Bank's QE program at a time when Europe could be on the cusp of another economic slowdown.

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