

## Economic Survey of France, 2005

### Summary

France has high productivity per hour worked and a sophisticated social welfare system, but it also suffers from low labour force participation and high structural unemployment. This poor labour market performance contributes to a persistent budget deficit which is exacerbating, rather than alleviating, the fiscal pressures arising from ageing.

- Rising public debt threatens fiscal sustainability. It is partly a result of insufficient public expenditure control and insufficient public understanding of the need to meet long-run challenges as well as short-term targets.
- Aspects of the labour code designed to protect employees, and some aspects of the system of social transfers have had some unintended but perverse consequences leading to structurally high levels of unemployment and low participation rates.
- Dynamism and growth of activity and employment are held back by a lack of competition in a large number of service sectors.

### ***Focusing fiscal policy more on transparency and long-term needs***

Above all, long-term fiscal sustainability requires better control of public expenditures, including social expenditures and those of regional and local governments. It is important to reform the fiscal system, by reducing the number of organisms involved and simplifying the tax structure through eliminating those tax breaks that are

*This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of France. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

What are the main challenges?

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insufficiently justified. This would permit reduction in some high tax rates, which currently create economic distortions.

### ***Creating employment by improving the functioning of the labour market***

Employers can not provide the degree of social protection in the labour market that legislation attempts to impose. The high level of employment protection and a high minimum cost of labour raise the cost of employing many lower-skilled people above their productivity, despite reductions in social insurance contribution on low wages. France should substantially reduce the constraints of the standard employment contract, removing the need for a variety of special contracts which generate administrative complexity with little success in reducing unemployment. An improved public employment service, but also effective measures that condition benefit levels on active job search by the unemployed and their willingness to take jobs when offered, must be the counterpart of the high level of contribution with respect to social solidarity.

### ***Allowing competition to create new opportunities for growth and employment***

International experience suggests that still substantial public ownership, the only gradual market opening in network industries, protection of some service sector professions and the absence of competition in parts of retailing in France reduce the potential for growth, innovation and employment. Reforms should give greater weight to consumer welfare as against special interest groups. The whole economy would benefit from stronger competition in network industries, reduction in restrictions on entry to many professions and a deep reform of controls on retailing. ■

### **What are the main challenges?**

After a weak performance in 2000-03 output growth recovered in 2004, somewhat more strongly than in most euro zone countries. It reached 2¼ per cent but, as in the rest of the euro zone, weaker growth is likely in 2005-06, while unemployment remains stubbornly high, currently around 10%. The origins of poor labour market performance, a central challenge for French policymakers, lie in a combination of measures themselves designed to protect workers, notably a high minimum cost of labour and strict employment protection legislation, as well high tax wedges on labour;

a lack of competition in a number of service sectors further inhibits employment creation. There is also a strong link with another key challenge for the authorities, a persistently high budget deficit leading to rising public sector debt: low utilisation of labour potential has a direct impact on government revenues and expenditures, while at the same time generating pressure to use short-term fiscal intervention to increase employment.

Aware of these difficulties, the authorities have made efforts in the last two years to restore sustainable public finances with substantial reforms of pensions and the health system and putting in place strict control of central government expenditure. Furthermore, the authorities have worked to increase potential growth in improving labour market functioning, for example by relaxing the 35 hour week legislation, increasing competition on certain markets and making the fiscal and administrative environment more favourable to enterprise development. Even so, with a low utilisation of labour potential and a still difficult budgetary position, the French economy remains in a fragile situation from which to deal with the long term challenges from population ageing. ■

### **What should be done about the budget deficit?**

The public sector deficit was reduced from 4.2% of GDP in 2003 to 3.6% of GDP in 2004 and the French authorities' objective is to bring it below 3% in 2005. A large part of the likely fall in 2005 is due to a transfer from the public-owned electricity company EDF of some 0.5% of GDP, which will not generate a sustained improvement of public finances. The deficit may nevertheless remain over 3% of GDP this year and any reduction in 2006 is likely to be small. Current OECD projections suggest that the deficit will not be under 3% of GDP in 2006. Without further measures, the deficit is likely to diverge from the government's latest stability programme which was itself not very ambitious in its target for the debt ratio, now around 65% of GDP and unlikely to fall rapidly in the near future. France thus risks being inadequately prepared for the long-term pressures on health and pension spending that ageing will generate, despite important recent reforms. *To make room to deal with these spending pressures, it is essential that the ratio of public debt to GDP decline strongly in the medium term.*

In 2004 the government introduced measures that it hopes will produce substantial savings in public expenditure, mostly as from 2006. These included a reform of the public health care insurance and delivery schemes, as well as certain measures to reduce public sector employment. In fact, although the health reform has the potential to improve overall health care, it is not clear that it will generate as many savings in public expenditure as expected, in the short-term; meanwhile, implementation of an earlier reform of the hospital system, also intended to control public expenditure and to improve efficiency, is turning out to be slower than planned. Following through on these is particularly important because, as the experience of other industrialised countries shows, strong upward pressure on health spending will continue in the long term. As for public sector employment, despite some first steps to reduce numbers, the government has not yet taken sufficient measures for a progressive reduction in employment levels in the medium term, and increases in public sector salaries decided recently limit the ability to control the wage bill. Given the growing pressure for age-related spending, *tight control of direct government expenditure, including cuts in employment that should take advantage of the large number of civil servants currently retiring, and restraint on wages and salaries, are needed.* ■

### What public spending reforms may make a difference?

The framework law on finance laws (*Loi organique relative aux lois de finances*, or LOLF) is to come into full effect in the finance law for 2006, whose preparation has already begun. The LOLF will allow improvements in the transparency of public sector accounts, improve the ability of the authorities to set spending priorities and increase the sense of responsibility among public managers by promoting a results-based outlook. Its implementation should reinforce control of central government expenditure. The health sector reform introduced measures aimed at reinforcing the sense of responsibility of patients and health sector workers, tools for promoting best practice, and a deep reform of management of access to health care. This reform, to be complemented by the forthcoming framework law on the financing of social insurance, includes provision for mid-year corrections if the early-warning committee (*Comité d'alerte*)

observes expenditure overruns; for this to work, the government *must be ready to impose unpopular cuts in the prices of health services and goods or in health service entitlements at short notice if increases in contributions are ultimately to be avoided.* The government will also have to ensure that the tighter control mechanism is not accompanied by a relaxation in the annual expenditure targets.

Central government expenditure has grown less than that of local and regional governments. This is only partly due to the government passing some responsibilities to lower levels, since there has also been underlying growth in local expenditure. Tight controls on borrowing by local government have not prevented this: some of the expenditure restraint that borrowing restrictions should generate has been undermined by the fact that central government has increasingly subsidised the apparent burden of local business taxation (the *taxe professionnelle*) by paying a substantial part of the notional tax to sub-national governments from central government revenues, with rates set by the local and regional governments themselves. *The reform of the taxe professionnelle must meet its objective of ensuring that the central government no longer pays local taxes on behalf of enterprises.*

Some transfers of spending responsibilities to sub-national government have in recent years been accompanied by the transfer of equivalent amounts of certain specific taxes, or parts of them. However, some programmes transferred have centrally-determined characteristics, such as using part of the petroleum tax to cover the cost of certain in-work benefits. These methods, although respecting a compensation principle which reasserts the financial autonomy of subnational government, run the risk of not creating an appropriate matching of resources to needs in the long run; *centrally mandated programmes whose administration, but not design, is decentralised should be financed by direct transfers financed out of general taxation.* As far as local and regional governments own spending programmes are concerned, local taxes provide the main share of their resources. The proposed reform of the *taxe professionnelle* should improve the distribution of the tax burden between firms and better reflect the impact of economic activity on local government costs. It should also ensure that central government no longer pays local taxes for and on behalf of companies, as it does at the moment. ■

## What tax reforms are needed?

The system of taxation in France is characterised by its high visible rates, the still large number of specific taxes, the number of institutions involved in calculating, collecting and allocating revenues, and the additional complexity engendered by the large number of exemptions and allowances for certain activities, sectors or agents. This also shows up in internationally high administrative costs even though they have diminished since the mid-90s. Some rationalisation and measures to reduce the burden on taxpayers have been undertaken in recent years, but a more fundamental reform of the entire system of taxation seems called for.

To start with, it is necessary to continue efforts to reduce the number of agencies involved in calculating and collecting taxes and charges and to reduce administrative costs to taxpayers. The introduction of deduction at source for income tax would work in this direction though there would be short-term transition problems. Some otherwise useful reform measures may be prevented by the separation between social security finance and central government finance, even though this separation is not always strictly respected (the CSG is an income tax used for social security finance). In the long-term, nevertheless, merging the collection of social security contributions, the CSG and personal income tax could produce significant cost savings.

Reducing the use of tax expenditures would also produce cost savings, both directly for tax administration and indirectly through increased transparency of the system for tax payers. *The government should significantly reduce the use of tax expenditures, along the lines suggested by the Conseil des Impôts in 2003.* The government intends that tax expenditures be limited in time by using five-year sunset clauses. Further steps could be to restrict the introduction of such measures to finance laws, subject to the Constitutional Council's opinion, to improve initial estimates of their effects on revenues and behaviour and to ensure systematic *ex post* evaluation. *Special measures such as tax credits or deductions for specific types of company expenditure should be limited to areas where there is a strong and demonstrable benefit for society.* This is true for both the national corporate tax and for the local *taxe professionnelle*; eliminating such tax breaks would allow lower basic tax rates, stimulating entrepreneurial activity in general and reducing the need for companies (especially small ones) to devote resources to tax accounting in

order to minimise their liabilities. Tax distortions between different sources of financing can also constrain the expansion of newly-created enterprises who need to raise new capital; *notably, the remaining asymmetry between the treatment of dividend and interest payments in the interaction between the corporate and personal income tax systems should be reduced.* ■

## Why does unemployment remain so high and participation so low?

The unemployment rate is currently 10% and has not been below 8% for twenty years, even at the cyclical peak of the late 1990s. There is room for discussion about the precise quantitative effects of strict employment protection and the minimum wage. But these effects, combined with the uncertainty over the cost of dismissal to the employer, and the fact that the minimum cost of labour exceeds the potential productivity of a number of low-skilled workers, appear to be responsible for a large part of the high level of structural unemployment, especially among certain groups, such as youth and the long-term unemployed. These policies are intended to place part of the responsibility for income protection and security of employment on employers. Over the years the response of employers to these increases in labour costs has been to reduce the demand for labour even though reductions over the last decade in social insurance contributions for low paid workers have increased employment prospects for the low skilled. High employers' social insurance contributions have the same effect on the demand for labour at wage levels where these reductions no longer have an impact. On the other hand, the interaction of taxes, social security contributions and social benefits also leads to poor labour market performance by tending to reduce the supply of labour.

When comprehensive account is taken of all taxes on labour income (personal income tax, social security contributions including the supplementary social security taxes CSG and CRDS) and income-tested social benefits, it is seen that marginal effective tax rates on labour are very high in France. Measures have been taken to reduce these disincentives, targeted on low income earners, such as reductions in employers' social security contributions and the *prime pour l'emploi* (PPE), an income tax credit for people in low-paid jobs. Although the PPE has yet to be fully evaluated and would perhaps be more effective if

applied to the CSG, which is deducted at source, rather than to income tax which is paid in arrears, these policies have had some beneficial effects on the labour market *and should be maintained and if possible expanded*. But increases in the minimum wage, the SMIC, such as those that resulted from the reduction in working time, work directly against measures to improve labour demand through reducing costs, although the further reductions in employers' contributions offset the effect on labour costs, at the expense of public finances. *Future increases in the SMIC should be limited to those necessary to maintain its purchasing power, in order not to reduce employability among the low skilled.*

The government must not increase unnecessarily the number of measures designed to tackle certain difficulties in the labour market, and must avoid their misuse. For example, plans to subsidise private sector employers to recruit the long-term unemployed through a "minimum activity income", the RMA, are worth implementing, but *the contrat d'avenir ("contract for the future", a parallel measure for employment in the public sector) must aim at improving employability among certain categories of the unemployed rather than to increase total public sector employment*. Furthermore, the RMA must be subject to a programme of realistic evaluation for cost-effectiveness, based on results achieved. One area where progress has been made is in reducing the incentive for people aged 55-60 to withdraw from the labour force. This progress needs to be maintained and *other programmes, such as disability benefits, should not be allowed to become substitutes for the early retirement provisions that have been abolished, as has happened in some other countries.* ■

### How can employment protection be counter-productive?

Employment protection legislation (EPL) makes dismissing workers on standard employment contracts relatively difficult and expensive in France. For many firms, most of the time, this is probably a minor inconvenience. But it causes significant extra costs for firms in difficulty or facing fluctuating market conditions and over time it has contributed to an unwillingness to hire, especially in uncertain times. The expansion of short term contracts, which represent about 13% of total employment, has allowed some increased flexibility, but conditions attached to these contracts mean that they do not often lead to long-term employment and may have encouraged a dual labour market to develop.

The government should work to change the counter-productive approach of placing the major part of the burden of protecting workers against economic fluctuation on employers, by relaxing EPL on the standard contract. Having a number of different types of contract, each designed to allow some flexibility but heavily circumscribed in their application, makes for costly complexity. The current situation is paradoxical: despite substantial assistance to the unemployed and strong apparent employment protection, employees feel great uncertainty over their future. A number of recent independent reports, as well as reform experience from some other countries, suggest that it is possible to reform EPL without jeopardising adequate job security. *One way to increase both flexibility and security of employment, while reducing the current complexity, would be to absorb the different contracts into a single standard contract with the degree of protection varying with length of service, while reinforcing measures to help the unemployed find new jobs*. Such a single contract would naturally have to be designed so as to maintain the gains in labour market flexibility that the development of fixed term contracts has permitted. Given the high degree of support for the unemployed in France, very strong employment protection should not be necessary if labour market institutions can adapt to help displaced workers find new jobs. Implementation of a major reform would need to deal with the problem of transition; people now employed in jobs with the current high level of employment protection would be fearful of losing out. This obstacle would make it difficult to move quickly without first developing a consensus that such a reform is needed. *The government should seek, to establish such a consensus; the recently created Conseil d'orientation pour l'Emploi should allow such a debate and thorough analysis of these questions.*

The public employment service already has plans to try to simplify procedures facing unemployed people as they seek new jobs. *The government should ensure that the proposed maisons d'emploi do not add another layer of administration to the already numerous agencies responsible for different aspects of labour market policy, and that they lead to one-stop shops for employment services, which should provide adequate cost-effective job-search support and offer the possibility of active labour market measures targeted on individual needs*. This may not be feasible without merging some of the main institutions, notably the ANPE, the national employment service, and the UNEDIC, responsible for managing unemployment insurance. The relatively generous level of social benefits

means, as mentioned earlier, that material incentives to take jobs at low pay can be quite small for an unemployed person. Therefore, to improve labour supply, *eligibility conditions for unemployment benefits should be tightened up for those who do not actively seek work or refuse jobs offered to them too often*. Provided such measures are not implemented in an arbitrary fashion, the objection that this involves an unacceptable degree of compulsion can be countered by the argument that the obligation to take up a job (otherwise losing transfer income) is the counterpart of the obligation on society to support them when they are without a job. Such policies are successful in a number of OECD countries. ■

### Why does competition matter?

Restrictions on competition, such as those found in France, not only reduce productivity growth but also hinder the development of employment. Productivity levels in terms of output per hour are high in France – they are probably higher than in the United States – but this has a lot to do with the fact that the labour market excludes many low-skilled people. Thus, despite a high ranking in terms of output per hour, GDP per capita is lower in France than in many other OECD countries. Reforms to increase competition through injecting some dynamism into some over-regulated areas would allow higher GDP per capita by increasing both productivity and employment.

The general legal framework for competition enforcement is good, and although there was a period in which it seemed that enforcement policy was not very active, this has improved since the late 1990s. Available indicators nevertheless point to relatively weak competitive pressures in a number of sectors, particularly in sheltered service industries. *Reforms in product markets should give more weight to general consumer welfare rather than protecting some relatively small vocal special interest groups*.

In merger control and in the operation of competition enforcement policy, there is room for greater transparency. *For merger control, France would do well to follow the example of most other OECD countries, which have given responsibility for control of implementation of merger policy to the competition authorities rather than the government*. France splits competition enforcement activity between two institutions, the *Conseil de la Concurrence* and the DGCCRF (a directorate of the French Ministry of Economy, Finance and Industry); unusually, the latter combines competition

enforcement with other kinds of market regulation and surveillance, including active enforcement of laws about unfair competition. *The competition framework should be strengthened either by fully transferring competition enforcement, and the necessary resources, to the Conseil de la Concurrence, or by a clearer separation of these functions and associated resources from responsibility for other market surveillance within the Ministry of Finance*. ■

### How can competition law work better for consumers?

The law contains general provisions against unfair competition, including predatory pricing, but in the retail sector extra layers have been added which impose detailed price-related regulation on some areas, preventing consumers from reaping the full benefits of competition among producers and adding to annual inflation. *The government has submitted a proposal for redefining the definition of selling below cost to parliament. While this goes in the right directions, a more fundamental reform should abolish the prohibition on selling below cost and increase competition by refocusing policies towards measures focussed on preventing harm to consumers*. Current legislation has its origin in a desire to regulate relations between producers and distributors and to protect small “traditional” retailers in town centres. If such protection is felt to be necessary *it should be through general zoning laws (without the current arrangements in which the representatives of current traders have a direct voice in granting planning permission for large retail outlets), or through direct and transparent subsidies from local government, but not at the cost of restriction on retail competition*. Other measures to strengthen competition would be to remove regulated monopolies and continue relaxing relatively strict television advertising rules.

The state retains quite large shareholdings in a number of companies. Continuing privatisation and “capital opening” is encouraging but the state still maintains its position as the dominant shareholder too often. As a consequence, competition is insufficient in many liberalised network industries because of the dominant position of publicly-owned companies. It is also important to improve corporate governance in public enterprises. “Capital opening” should be a prelude to full privatisation, not a means of raising capital to clean up the balance sheet or finance expansion. *Sector regulators in these industries need to have sufficient*

*powers and independence to secure non-discriminatory third-party access to promote competition and consumer interests. Public service obligations were previously mostly undertaken by state-owned monopolies. As these market are being liberalised, new measures to secure such obligations are being implemented. To ensure effective competition policy must continue to see that these measures define these obligations as systematically and as clearly as possible and where possible subject them to public tender, taking into account all associated costs and benefits.*

Many parts of the service sector are subject to specific regulations that have the effect of giving unnecessary protection from competition to existing service providers. For example, entry requirements to professions should be re-examined, and those that do not focus directly on consumer protection should be removed. The practices of professions which are self-regulating should be subject to

particular scrutiny. In France, as in many other European countries, services are fragmented and competition restricted by national regulations. *Policy in this area should give more weight to the interests of consumers of services, recognising that excessive protection of national providers or professional interest groups generally reduces efficiency in the service sector and increases costs for the rest of the economy.* ■

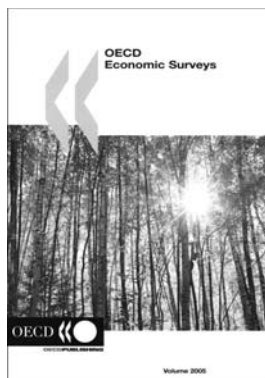
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