

France: what reform plans?

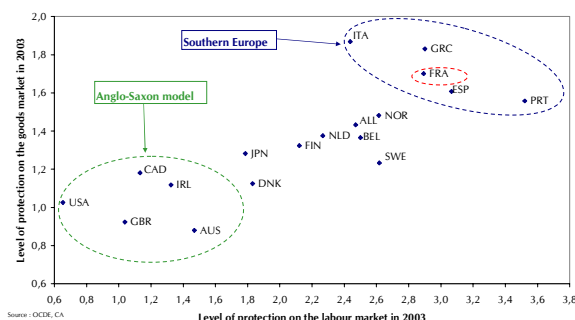
1- The overriding rationale

After the elections, the reforms. At stake is the central objective of 2.5% potential growth, which puts France in a better posture to tackle the effects of competition and an ageing population. The election period just ended opens up a period of major reforms announced to and endorsed by voters. Their combined objective is to boost France's potential output, obviously by cutting public spending (non-replacement of public sector workers, the LOLF public finance framework law, etc.), but more importantly by making labour and product markets more efficient. In the following pages, we will be analysing what we shall call the Sarkozy-Fillon Plan, with its most important measures, their limitations, and what we can expect of them.

The starting point: France lags behind

In 2006 and 2007, France posted lower economic growth than the European average. Its per capita GDP, which was 10% higher than the European average in 1990, is now scarcely above the average. Other countries, such as Spain, have been catching up with the leaders, which is only normal, but France is increasingly falling behind, which is not. **The phenomenon can be put down to a particular cause, namely the scale of protective measures on the labour and product markets (see graph, below), which is greater than among our main competitors, at a time when the world is increasingly liberalising trade.** In this more open world, with the growing importance of emerging economies and technological revolutions, carrying increasing costs and reduced flexibility has a sapping influence over time. French businesses are therefore less profitable in France and generate less growth. They are opting for more external growth. Being less profitable and presenting an increased risk of inflexibility, they invest and innovate relatively less at home, and it is easier to purchase the best of them.

Protections on the labour and goods markets in 2003



Game rule: competing on reforms

France is a European Union Member State and part of the eurozone. This is nothing new, but nevertheless changes things. As an EU Member State, it is part of the world's second-biggest economic area, with a special emphasis on

competitiveness in conjunction with the size of the markets. This comes from clear, long-standing commitments in terms of increasing trade and competition, keeping a watchful eye on concentrations, supporting research, and so on, in the framework of a liberal social model, ie, the Treaty of Rome.

The eurozone comprises those EU Member States who opted for the more exacting choice of a single currency. This involves restrictive policies in terms of budget deficits and public debt, designed to boost potential eurozone growth faster and further. A country belonging to the eurozone thus commits to reducing its deficit and debt on the basis of a multi-year programme, under the scrutiny of its peers.

Of a country's five "degrees of freedom" (devaluation, deficit and debt, inflation, unemployment, falls in asset values), a "eurozone country" only retains two – the most dangerous! It cannot devalue (it belongs to the single currency), nor allow its deficit to slide (peer scrutiny). If it accepts higher inflation, it will lose market share among its neighbours, which will no longer buy its products. And if it implements fewer reforms than the other members of the euroclub, it will see unemployment rise and its assets depreciate. This will trigger a crisis at home.

It is worth adding that a country which starts to reform before the others emerges a winner: there is such a thing as a "first reformer advantage". It will export more outside the eurozone as it has become more competitive. It will export more inside the zone, since the other countries are lagging behind on the reform front. It makes the task of reforming more difficult for them, and hence increases its lead. Some will find this game somewhat uncooperative, while others will point out that it serves to goad players into action and is actually a genuine form of cooperation!

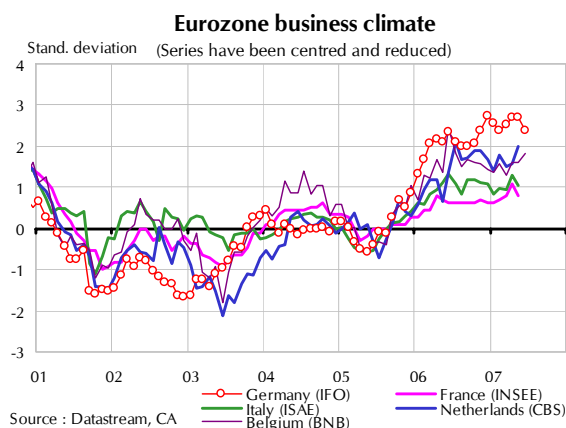
Germany is the best example of this rule, having been first mover. It is currently the world's second biggest exporting country after China and is achieving more external growth than internal.

Contribution to growth 2000-2006 (Annual average)			
	Domestic demand (excl.inv.) (a)	Net Exports (b)	Growth (a + b)
France	2.4	-0.4	2.0
Germany	0.5	0.9	1.4

Source: datastream, CA

But one can see how long it has taken to implement, as Germany experienced lower growth than its biggest neighbours for several years. When it comes to reform, you have to be able to stay the distance.

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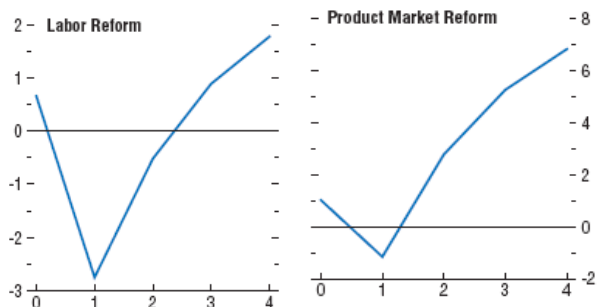


Catch-up policy: J-curves

The shape of the effects of reforms is effectively a J-curve, starting with a negative phase before positive effects override the negative. The negative effects are the social tensions and anxieties generated by any large-scale reform. They push up the savings rate and have an adverse impact on growth and employment. It is only subsequently that productivity gains become manifest and that activity picks up once more.

IMF research has show that reform J-curves are more pronounced in relation to product and labour markets – those very markets in which France lags furthest behind. The IMF calculated the accumulated impact of a reform policy on per capita GDP over time for a large number of countries. This amounted to an increase of one standard deviation in the indicator.

Labour and goods market reforms and per capita GDP

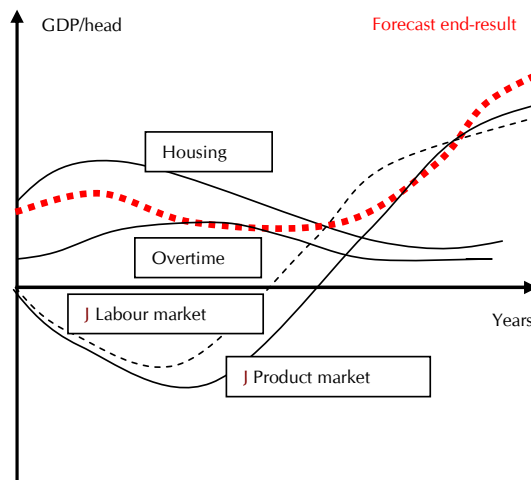


Source : IMF, *Advancing Structural Reforms*, April 2004

We can therefore see the economic risk (leaving social impacts to one side) of a programme that

combines these two reforms alone: a marked, long-drawn-out slowdown. This explains why the Sarkozy/Fillon Plan combines these types of measure with others, which increase revenues and boost (or sustain) wealth.

A representation of the Reform Plan



It is not, therefore, strictly speaking, a supply/demand sum, with supply impacting growth and demand pulling in the other direction to prop it up. Rather, the plan is an "inter-temporal" combination of measures, with the supply/demand effects. What is at issue here, therefore, is an in-depth reform plan concerning the two most important (and most stubborn) markets.

But the plan also takes timetable effects into account, to avoid a reform process that is too long drawn out with no visible upside (due to fears of reform fatigue) and also to avoid social and political tensions. With an improvement that should be visible three years on, it would thus help to nudge France's potential growth rate towards 2.5%, although with obvious uncertainties, notably budgetary. This is where the question of a social VAT will be posed (see last section of this document).

Like any economic and political programme, it is therefore a second best. Some experts would no doubt have preferred to put the emphasis more (or only) on research, SMEs, or training, while others... But an economic programme is only possible if it has been voted for politically... The task now is to look in detail at the proposed rationale to assess its possible effects, the conditions required for success, and the limitations and methods of fine tuning.

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France: which reform plan?

2- Supply side

By supply side policy, we mean labour and product market reforms. This includes all structural reforms designed to minimise rigidities and inefficiencies in the French economy.

Although the supply-side policy is a central plank in the new French President's electoral programme, it is currently on the back burner, but has not disappeared – quite the contrary, if we are to believe the emphasis placed on the concepts of Reform and "Rupture" (breaking with the past) by the governing team.

The raft of measures currently being foregrounded by the new government to sustain demand is designed to enable future supply-side initiatives. Otherwise, we would be embarking on a Keynesian recovery! However, in a country with an external deficit and which is part of a monetary union, that would mean a guaranteed all-round crisis: a growth and employment crisis, a public finance crisis, and a European crisis. It is therefore essential to take into account the various components of this programme and their interdependence. It is this which makes it make sense, but starting with the central target: supply.

Labour market: towards a single employment contract?

The issues are plain: to bring unemployment down on a lasting basis, the idea is to stimulate employment and job supply by reforming the provisions of the employment contract.

Three factors to make the labour market more flexible:

- **A single employment contract.** Central to reforming the labour market is the need to make employment contracts more flexible. In particular, the aim is to bring in a new, single, employment contract for all, which would be a long-term contract. This would offer businesses greater flexibility and employees greater job security. The term used is "flexicurity". The idea is to make it less risky for businesses to hire new staff (the "flex" part), and to protect the employee, and not the job (the "security" part). The question of the progressive nature of employee rights depending on seniority in the business has not yet been broached. This is almost certainly the part of the reform that will be the biggest headache, especially as regards employees already in place.

- **A unified government employment department.** The single contract will go hand-in-hand with a makeover of the oversight, re-training and placement

of job-seekers by merging the ANPE (job centres) and Unedic (benefits) bodies to create a single government employment department. The new body would guarantee benefits amounting to 90% of the salary of a person made redundant with, if necessary, re-training leading to a job qualification.

- **A higher participation rate.** The idea is to increase the participation rate. The practical details have yet to be published. All we know is that the aim is to encourage higher employment rates for seniors (probably accompanied by more in-depth pensions reform, although for the time being, only the special retirement regimes are being mentioned) as well as for young people. Other measures will be designed to improve employability via a restructuring of occupational training.

A complex issue

Labour market reforms are the most difficult to implement. This probably explains the Government's caution in launching this particular project, especially in the run-up to a general election. We do, however, know that it intends to go ahead, as it has a mandate to do so.

- **Caution.** These reforms involve major risks. These are firstly social, with resistance from certain groups, and secondly economic, since they generate uncertainty, which impacts the savings behaviour of agents (as a result of fears about unemployment) and/or investment decisions, with an increase in business leader risk aversion.

This explains why the "working hours" component seems to have been sidelined, as it is out of the question to backtrack on the 35-hour week. At best, we are likely to see moves towards a degree of tweaking in certain sectors. The choice that seems to have been made for the time being consists in circumventing the law by encouraging people to work overtime, the mechanism of which is analysed below. We would also add that the "social VAT" presented at the end of this article is designed, to some extent, to stimulate employment.

- **Negotiations.** These reforms imply a period of sometimes lengthy negotiation with the social partners. The aim is to achieve consensus between employers and trade union representatives, but it is possible that political pressure could be strong enough for the talks to be wound up very quickly and for the House to decide.

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- **Explanation.** These reforms require a minimum of explanation if people are to be convinced of the need for them (especially for the workers who will feel most of the pain) and ensure that they are endorsed by society as a whole.

Contrasted effects on growth and employment

- **Initial problems.** In the short term, the reforms could stoke tensions and anxieties, undermine confidence levels and increase the savings ratio, with adverse effects on employment (reflected in the J-curve, see above).

- **Positive impact subsequently.** In the mid-term, the implementation of the single employment contract should help to minimise the two-sided nature of the labour market (protected/unprotected workers, skilled/ unskilled, male/female, juniors/seniors) and their accompanying lack of job security. It would help to spread a carrot and stick mindset and deliver a degree of career security. But it is obvious that these are early days and that the plethora of existing employment contracts, which creates a "flexibility à la française" situation, must be reformed.

- **To consolidate in the medium term** employment must be stimulated by a more efficient placement system for the unemployed. The increase in unemployment benefits will stabilise agents' incomes in the transitional period between jobs. It should also deliver an answer to the serious supply and demand mismatch on the French labour market. This is as true for unskilled and semi-skilled jobs in eg, catering or the construction industry, as it is for more highly-skilled jobs in IT, for example.

Products market: towards greater competition?

- **Greater retail flexibility?** A number of reforms will probably be put in train to ease a number of regulations on the products market, notably in the retail sector. These concern the unpicking of laws limiting the creation and extension of supermarkets (the Galland and Raffarin Acts). We are only at the start, but this will be necessary to make distribution systems less costly; it also involves very serious issues on upstream sectors and on jobs, however.

- **A reform of Sunday trading regulations?** This was announced by Mr Sarkozy. This reform could propose that all shops could open on Sunday in tourist areas. Elsewhere, waivers could be granted for,

say, ten Sundays a year, compared with the present five. This is the sort of reform that should stimulate household consumption. But it also involves agreements with the social partners, notably as regards the problem of additional compensation and time off in lieu. It will not be easy to implement as it will often be opposed by small and medium sized shopkeepers. This is also the backdrop against which it will be necessary to examine the provisions of the Services Directive.

- **To sum up, deploying labour and product market reforms will call for considerable dexterity.** The short-term negative impacts are likely to depress domestic demand. The example closest to home shows that while Germany may have successfully implemented structural labour and pensions reforms, it was at the cost of a sharp decline in household confidence and a drop in household consumption. It was in this context too that Germany was able to benefit from Asian and European outlets (and notably in the Accession States) to export. The first mover advantage (see above) thus operated to its benefit, but it is in the nature of the beast that it will not be able to benefit from subsequent changes! Income support measures for agents will therefore be necessary in order to stabilise savings rates during the transitional period for those who are currently boarding the reform train.

- **It is also easily understandable that a euro trading at around 1.20-1.25 to the dollar would provide additional support for reform policies in France.** One can also see that a joint policy with another country such as Italy could also prove positive in order to distribute the adjustment costs more evenly. But while the dollar is likely to start appreciating again, there is still a lack of sufficient intra-European cooperation. The dominant model of adjustments is that of peer pressure (name, shame, blame) on laggardly countries, rather than of more concerted, positive programmes. The Lisbon Agenda thus shows the shortcomings of the European approach to cooperation. Complementary talks on the Small Business Act, on European research programmes (with a greater role to be played by the Bank for International Settlements), on support for selected sectors or countries, and on the undervaluation of certain currencies such as the Yuan and the Yen are therefore necessary. Which also helps to explain the current debate about the Constitutional Treaty.

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France: what reform plans? 3- Demand side

The advantage of tax reforms is the speed at which the response comes. They will thus help to sustain demand while the difficult measures concerning the labour and goods markets are being prepared.

The draft tax law: what is at issue?

The first major draft law, presented to the Council of Ministers on 20 June, and which should be adopted this summer, is a tax reform concerning four main measures: exemption from social security charges and income tax on overtime; exoneration from inheritance tax for 90-95% of French citizens; a lowering of the "tax shield" from 60% to 50% of revenues; tax deductibility for mortgage interest. This "Fiscal package" will involve a massive tax cut of €12-15 billion a year, designed to seriously boost economic growth.

But this is more than "just" a support plan. True, the aim is to give the economy a severe jolt, by its sheer size and the fact that it acts on a number of different levers: cuts in tax and social security charges, an increase in the wage bill, a revaluation of personal wealth etc. Above all, though, it fits with the "J" curve (see above) and is designed to facilitate the adoption of painful reforms by stabilising the savings rate of economic agents.

Deductibility of mortgage interest payments

How it works

For all buyers of a principal home (new or existing mortgages), during the first five years following the purchase, 20% of the interest paid on the mortgage can be deducted from income tax. The total amount of interest deductible is capped at 7,500 euros for a couple and 3,750 euros for a single person, with an additional 500 euros for every dependent. Tax exempt households (around 45% of all households) will receive a cheque from the French Treasury.

Impact on growth

- **A new lease of life for the housing market.** The residential market is showing increasingly marked signs of flagging and both sales and prices are beginning to stabilise. This measure should re-launch the market for a period of around two years. At present, for an "average" household, given the current market conditions (effective mortgage loan rate 4.7%, average length of loan 19 years, average purchase price 240,000 euros, average amount of

borrowing 175,000 euros), interest charges are around 7000-8000 euros a year over the first five years' loan repayments. The tax cut thus amounts to 1,500 euros a year. **Given the capping arrangements, the cut corresponds to a 2-3% increase in average household disposable income for home buyers.**

- **This measure will give a fillip to the housing market,** since it will improve solvency for buyers who are increasingly hesitant and selective when faced with prices that have become prohibitive. **In addition, measures concerning inheritances and settlements (see below) should help to increase personal down-payments.**

- **But this will gradually be offset by higher prices and interest rates.** In a structurally tight market, where demand is potentially high but inventories low, any recovery in sales is going to push prices higher. A few quarters down the road, the market will have returned to its present configuration (excessively high prices, fewer and choosier buyers, and buy-to-renters more hesitant) and the market will contract once more. If on top of this the cost of credit increases a tad, which is likely, given recent increases in long-term rates, the fiscal measure will do no more than partly offset the higher cost of credit. The deductibility of mortgage interest payments could therefore postpone the expected stabilisation of the property market by around two years.

- **Support for the value of personal assets and revenues**

During this two-year period, the positive effects on growth will be fairly marked in three areas, namely construction, consumption, and wealth effects:

- the revival in the property market will stimulate the construction sector (which has been languishing for several months), property services and employment in these same sectors;

- home owners who were already repaying loans will benefit from an increase in their disposable income totalling an annual 3 billion euros. The impact on consumption will, however, be slightly lower, since home-owning households have higher than average incomes and a greater propensity to save;

- for all home owners (57% of all households) the positive wealth effects will persist, as the value of their asset will continue to rise, which will sustain high levels of consumption.

High budgetary cost

There are about 600,000 new buyers (or at least those buyers taking out mortgages) of a principal residence (new build or old) each year. In the first year, the budgetary impact linked to these first-time home-buyers is forecast to be around €0.6 billion. It would subsequently rise to €3 billion over the next five years. For households that already own their own home, the annual budgetary cost in relation to these existing credits is forecast to be about €3 billion per year.

The total cost of this raft of measures should therefore be in the region of €4 billion in the first year and €6 billion at the end of the presidential mandate.

Exemptions on overtime

Tax exemptions on overtime will consist in exempting it from employer and employee social security contributions and also exempting it from income tax. In addition, all overtime will be legally remunerated at a 25% premium as opposed to the current 10% premium in companies with less than 20 employees.

How it works

This measure concerns all employees: for all public and private sector employees working either full time or part time (via additional hours); and for employees with managerial status. For those paid a fixed number of annual hours, any hours worked in excess of the basic number of hours will be remunerated as overtime at 25% more than the basic rate, will be exempt from tax and social security contributions and will not be taxed as income. For those people working a fixed number of days per year the tax and social security charge exemptions will only apply to days worked in excess of a ceiling of 218 days a year, in exchange for these employees' waiving their entitlement to rest days.

Exemptions from payroll taxes will be modulated according to company size (fewer than 20 staff or 20 staff and above). Small companies (ie, those with fewer than 20 staff) will be given higher exemptions to compensate them for the increase in the basic overtime premium from 10% to 25% likely to be effective from 1 October 2007, instead of 1 January 2009.

Three hoped-for effects

Three objectives are being jointly pursued.

- Increase the turnover and competitiveness of businesses via easier and cheaper recourse to overtime thanks to lower employer contributions. This measure will notably foster selected sectors such as the construction industry or catering, which are

finding it difficult to hire staff. According to a study by the DARES department, among business employing ten or more staff in the non-farm traded sector which declare overtime, it is in the construction sector that recourse is greatest. This can be checked against the number of full-time employees working overtime and an annual volume of hours per employee (see following table).

	Practical of overtime by sector in 2004*		Average annual volume by full-time employee who's making (in hours)**
	Share of the full-time employees making of declared overtime		
	In the whole of the businesses	In the businesses declaring	
Industry	41	49	46
Construction	50	71	82
Tertiary	34	49	56
All	37	50	55

Sources: Dares

*Average number overtime carried out by full-time employee who does at least one

**Businesses of 10 paid and more of the non-farm traded sector

- Boost employee purchasing power, via higher paid overtime, lower social security charges and income tax exemptions. The amount of overtime deductible from the taxable income will, however be capped, in order to observe the principle of equality of taxation.

- Encourage employees to work longer hours ("Work more to earn more"), and hence their pay, as a result of these different incentives.

In short, this measure would increase employee remuneration without affecting the competitiveness of businesses and at the same time circumvent the 35-hour week.

A limitation and a pernicious effect

- Limitation: the diversity and complexity of employment contracts. This measure could be limited partly due to the sheer diversity of employment contracts (managerial staff working a set number of days or hours annually, part-time workers, etc.), and partly due to the debate about additional hours...

- A potential pernicious effect: businesses could substitute overtime for new jobs. This effect could be especially powerful insofar as the measure will become effective at a time of economic recovery, hence at a time when businesses are still cautious as regards hiring decisions. In other words, in the short term, it will benefit those already in employment, the "insiders", whose purchasing power will improve. But one might point out that it will prompt the "outsiders" to start looking for work and training more actively, when they see that there is more demand and more income involved in employment. Over time, and as economic activity levels continue to improve, these effects should therefore be absorbed. At that point, the measure will prompt an upturn in the activity rate.

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Budgetary cost and effect on growth

The annual budgetary cost can be estimated at around €5-6 billion per year. These different measures should lead to an increase in corporate profits and more importantly in employee incomes. For most employees resorting to overtime there is a strong propensity to consume, which means that there will therefore be a large impact on consumption of around €4 billion, or an additional annual increase of 0.4 %. The impact on employment is uncertain.

Tax shield at 50%

From 2008, direct taxation will not be able to exceed 50% of a taxpayer's income. In addition, this will include the CSG and the CRDS taxes (11%). Compared with 2007 (the cap is set at 60%, CSG-CRDS not included), the "gain" is thus 21%. In addition, investments of up to €50,000 in SMEs will be deductible from the ISF wealth tax. These measures are mainly designed to lighten the burden of the wealth tax and discourage some taxpayers from becoming tax exiles, with the concomitant tax losses, notably in terms of VAT, which that assumes). **Cost: around €1 billion per year.**

Abolition of inheritance tax

Inheritance tax will be abolished for 95% of households, compared with the present 75%, via a series of tax exemption measures. In particular, the spouse's share of the estate will be completely exempted, and the allowance for each child will be increased from €50,000 to €150,000. With respect to donations, parents will be able to give their children €150,000 euros tax-free every six years. These measures will have a significant impact on consumption and will also foster investment in property. **Cost: around €2 billion a year.**

A marked global impact on growth

These measures, which combine reduced taxes and charges for individuals and an increase in wages, should boost household disposable income by around €12 billion in a full year. Some of this will go into savings, some will be used to buy housing, but most of it, around €9 billion, will be spent on consumption. This will apply mainly to 2008 and 2009 but will partly (about one-third) go on imported products due to the popularity of consumer electronics among households and the insufficient competitiveness of French products in many sectors.

From 2009, the impact is less clear. Measures to boost consumption often have a temporary impact and there is never any guarantee that a virtuous circle will ensue.

Other reform programmes, which depend more on the supply side policy, such as the single employment contract, the public employment service, the status of universities, and research and development, will get underway in the coming months. These questions will generally involve phases of negotiation and will be longer and harder to implement than this tax component. It is therefore logical to begin with the "fiscal package" which is no more than a first stage.

One can, nevertheless, regret that measures to reduce taxes and charges for businesses, and for SMEs in particular, (company income tax, employer social security contributions, etc.) do not feature in the "tax package". These would have been a more appropriate response to the key issue in Mr Sarkozy's economic programme, which is to make the productive system more dynamic, efficient and competitive.

Beware public deficits

The total cost of these different measures can be estimated at €11 billion in 2008 and €15 billion by the end of the Presidential mandate. The hoped-for upturn in consumption will provide additional VAT receipts, which will reduce the net budgetary cost of the plan somewhat. But the cost will still be very high. How, then, will it be possible to meet public deficit (2.5% in 2006) and public debt (63.9% in 2006) reduction targets?

Spending cuts are accordingly being considered. These include the non-replacement of one in two public sector workers retiring, cuts in healthcare spending, a reform of special retirement regimes, and a rationalisation of State spending. All that can only be phased in gradually and may not be enough. The possible introduction of a "social VAT", which is still being researched, is unlikely to happen before 2009, and its workings, and hence its impact on financing deficits, are uncertain. By 2008-2009, even if GDP growth picks up somewhat, the public deficit and debt ratios could accordingly increase somewhat.

All in all, this fiscal package will provide substantial support for growth, and, more gradually, for employment, although it comes with a risk of widening deficits.

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France: which reform plan? 4- Towards a social VAT?

The idea of implementing a "social VAT" in France has again become a focus of public debate. It seems to have played an important role between the two rounds of the recent general election. That is just one more reason for spelling out the terms of the debate. The measure is designed to cut the cost of labour and to increase the (cost) competitiveness of French companies, which will stimulate growth and employment. It is necessary, however, to look closely at the provisions and the issues.

The facts

VAT netted slightly more than € 127 billion in 2006, almost half of the receipts of the State's general budget (see table).

Tax receipts in the general budget			
	2006*	2007**	2006
	(€ bn)	(€ bn)	(% of total)
Personal income tax	58,2	57,1	22,1
Company income tax***	43,7	46,1	16,6
Internal tax on oil products	19,3	18,8	7,3
Value-added tax***	127,4	133,5	48,5
Other tax receipts	14,3	11,7	5,4
Net tax receipts	262,8	267,2	

* : revised 2006 budget. ** : 2007 draft finance bill.

*** : net proceeds from payments and refunds .

Source : Ministry of the Economy, Finance and Industry

Three VAT rates are applicable in continental France: a normal rate of 19.6% applied to most goods and services sold; a reduced rate of 5.5% that mainly concerns necessities and everyday consumer items (food and cultural products such as books); and a super-reduced rate of 2.1% applied, for example, to the press and to drugs reimbursed by Social Security.

The principle of social VAT

The idea is to transfer a proportion of the social security contributions paid by employers over to VAT. At the same time, companies will strive to lower their ex-VAT prices by a similar amount in order to remain competitive. The impact in this case is neutral for consumers. We can illustrate the case of social VAT using an example. Let's assume an increase in the normal rate of 5.4 points, taking it from 19.6% to 25%.

5-point increase in normal VAT rate to 25%			
Before measure		After measure	
Ex-vat price	100	Ex-vat price	95
VAT	20	VAT	25
VAT-inclus. price	120	VAT-inclus. price	120

Source: Authors' calculation

Since reduced VAT rates are tax measures targeting selected sectors, an increase in the normal rate is the most likely hypothesis.

In fact, such an increase in the normal VAT rate would net around € 30 billion in additional receipts (see table below). It remains to be seen whether the money would be entirely spent on cutting charges, or whether part of it would go on financing new spending.

Consequence of an increase in the VAT rate			
Rate	Tax base* (€ bn)	Receipts (€ bn)	Effects of a 1-point increase in the normal rate (€bn)
19,6	572,9	112,3	5,7
5,5	228,7	12,6	2,3
2,1	44,9	0,9	0,4

Source: Crédit Agricole S.A. estimates

*Estimate based on sales of goods and services in 2006

Two expected (theoretical) positive results

- **Social VAT cuts the cost of labour.** Unit labour costs are reduced by lower employer social security contributions. This may encourage businesses to substitute labour for capital and in so doing stimulate employment. Ex-VAT prices could in this case be cut more than expected, while VAT-inclusive prices could be cut slightly and employment increase. This will benefit labour-intensive sectors in particular.

- **Foreign products will become more expensive when French product prices can remain unchanged overall. This is because foreign firms have to pay the same rate of VAT but do not gain the benefit of the cut in prices.** This should make French products more resilient to foreign competition and slow imports. Similarly, lower ex-VAT prices will improve our export competitiveness.

Three factors to build in

- **No implementation problems: an increase in VAT should not cause problems with respect to EU law, but it will be the last.** The European Parliament has capped the rate at 25% in EU countries. This is therefore a one-shot measure, since setting the VAT rate at the 25% ceiling excludes all other depreciation attempts. Then again, if our European neighbours imitate us, all that remains will be the uncertain competitiveness effects in relation to the rest of the world and to pursue conventional means of catching up with our neighbours.

- **Above all a local tax:** the competitiveness gap between France and some other countries, notably

emerging countries, is such that the measure will change very little to their advantage. **Conversely, however, in countries with comparable cost structures to France's, such as the United States and the rest of Europe, the measure will favour French production all else being equal. An increase in our domestic prices would, however, cancel out the competitiveness gains achieved.**

• **Comparison not reason enough. The beneficial effects of social VAT in Denmark and Germany mask realities that differ from France's.**

- **Denmark** increased its VAT rate by three points between 1987 and 1989, to 25%. It is, however, very difficult to say whether the strong performance of the Danish economy (lower unemployment, budget surplus, etc.) is the outcome solely of the positive effects of social VAT. What may be noted, however, was the fact that the inflationary impact was relatively limited.

- **Germany** increased its normal rate of VAT by three points, to 19%, on 1 January 2007, so far with no major impact on inflation. It should, however, be pointed out that the German mechanism is not entirely a social VAT: only one-third of the receipts generated has been earmarked for cutting employer social security contributions, the rest being destined for cutting deficits. We have very little room so far to analyse the impact on competitiveness. It will, in fact, be difficult to establish, as German businesses are already highly competitive, notably due to the efforts to improve competitiveness accepted by German workers since the start of the present decade (see above). We could add that German business margins are comfortable enough for firms to absorb a part of the VAT increase. What's more, weak domestic consumption leaves them scant margin for passing the shock on to end-consumers.

Two conditions for success

• **Price stability. Social VAT could boost inflation.** For one thing, in sectors where the French offering is weak compared with that from abroad (textiles, consumer electronics, information and communica-

tion technology, etc.), the impact will be very limited on output and significant on retail prices. Secondly, there is no guarantee that French firms will pass all reduced social security charges on to ex-VAT prices. Some may be tempted to rebuild their margins, especially as these have been eroded by higher commodity prices in recent years. In this case, VAT-inclusive prices will rise. All things being equal, if the lower charges are not passed on, a 5-point increase in the normal VAT rate will result in a 4-point spike in French inflation.

• **Wage stability. The positive effects of social VAT will be limited in the event of an increase in wages.** Such an increase would be triggered in the short term by the reduction in charges or by the additional inflation linked to the increase in VAT. In that case, the cost of labour will not fall. The hoped-for effects in terms of lower prices and increased employment will not materialise. Even assuming that the measure does benefit employment, the medium-term reduction in the unemployment rate will lead to wage increases, limiting its scope.

Overall, the effects of a social VAT could be limited:

- **it will affect our eurozone trade partners more than those elsewhere**, where wage costs are lower;

- **crucially, it assumes that inflation will not take off again**, and hence that the social partners (firms and employee trade unions) have properly understood and share the objective of moderate prices and stable wages. With VAT at 25%, there is a risk of seeing the grey economy develop further;

- **it is not strictly speaking a competitive devaluation**, because it is taking place within a monetary union. **It is a positive sum game if, and only if, it involves new relationships within businesses and between producers and distributors;**

- in the French case, the scope for higher VAT is restricted by EU rules. At the current maximum rate of 25%, it will be the last increase possible. **France will not get a second shot.**

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