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Bringing French Public Debt Down: The Options for Fiscal Consolidation

Balázs Égert

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by Balázs Égert

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ABSTRACT / RESUMÉ

Bringing French public debt down: the options for fiscal consolidation

France has a track record of persistent general government deficits, partly reflecting pro-cyclical fiscal policies in upswings. This has resulted in a quadrupling of its public debt-to-GDP ratio since the 1970s to above 80% of GDP. Reducing public debt is crucial because a high level of public debt may hamper long-term growth and may have a direct impact on fiscal sustainability if long-term interest rates rise. Bringing back public debt to 60% of GDP even by 2030 would require a fiscal effort of 4 to 5 percentage points of GDP (under the assumption of unchanged long-term rates), implying permanent primary general government surpluses, which is very ambitious in view of French fiscal history since 1970. The government's consolidation programme, which is aimed at reducing the general government deficit to 3% of GDP by 2013, represents around two-thirds of this effort. This study analyses how fiscal governance could be improved by the creation of a structural deficit rule and looks at ways the public deficit could be lowered. With France already having a very large public sector, most of the effort should be borne by holding down spending. Better control of the public wage bill, increasing public-sector efficiency and tackling age-related costs are the obvious candidates to contain expenditure. On the revenue side, there is significant potential for cutting tax expenditures. Furthermore, eliminating distortions in the tax base would encourage economic growth.

JEL Codes: H19, H21, H23, H24, H25, H51, H54, H55, H62, H63, H71, H72

Keywords: public debt, general government deficit, fiscal rule, structural deficit, fiscal council, government spending, tax revenues, local governments, pension system, healthcare, tax expenditure

This Working Paper relates to the 2011 OECD Economic Survey of *France* (www.oecd.org/eco/surveys/France).

Réduire la dette publique française : les options de l'assainissement budgétaire

Sous l'effet pour partie de politiques budgétaires pro-cycliques en phases hautes, la France enregistre des déficits récurrents des administrations publiques, qui ont entraîné un quadruplement du rapport de la dette publique au PIB depuis les années 1970, pour dépasser 80 %. Réduire la dette publique est indispensable car un niveau élevé d'endettement peut nuire à la croissance sur longue période et avoir une incidence directe sur la viabilité budgétaire si les taux longs augmentent. Ramener le rapport de la dette publique au PIB à 60 % même d'ici à 2030 exigerait un effort budgétaire de 4 à 5 % du PIB (dans l'hypothèse de taux à long terme inchangés), qui supposerait d'atteindre de façon permanente un excédent du solde financier primaire des administrations publiques, ce qui est très ambitieux au vu de l'histoire budgétaire française depuis 1970. Le programme d'assainissement, qui vise à ramener le déficit des administrations publiques à 3 % du PIB d'ici à 2013, représente environ deux tiers de cet effort. Cette étude analyse les améliorations pouvant être apportées à la gouvernance budgétaire par l'introduction d'une règle budgétaire de déficit structurel et passe en revue les moyens de réduire le déficit public. La France ayant déjà un secteur public très étendu, la majeure partie de l'effort devra porter sur la maîtrise des dépenses. Un meilleur contrôle de la masse salariale dans la fonction publique, une amélioration de l'efficacité du secteur public et la limitation des coûts liés au vieillissement sont à l'évidence les options à privilégier. Du côté des recettes, les possibilités de réduction des dépenses fiscales sont nombreuses. En outre, l'élimination de distorsions affectant la base d'imposition favoriserait la croissance économique.

Codes JEL : Q41 H19, H21, H23, H24, H25, H51, H54, H55, H62, H63, H71, H72

Mots-clés : dette publique, déficit des administrations publiques, règle budgétaire, déficit structurel, conseil budgétaire, dépenses publiques, recettes fiscales, collectivités locales, système des retraites, santé, niches fiscales, niches sociales

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BRINGING FRENCH PUBLIC DEBT DOWN: THE OPTIONS FOR FISCAL CONSOLIDATION

By Balázs Égert¹

France has a long track record of budget shortfalls...

The last time the general government budget recorded a surplus (+0.4% of GDP) was in 1974 (Figure 2.1, Panel A). As a result, public debt has been trending inexorably upward in relation to GDP (Figure 2.1, Panel B). The main source of budget imbalance is, nominally, the central government. However, deficits elsewhere have been merely hidden by inter-governmental transfers, although imbalances have started to appear recently in the social security system and local governments. Debt accumulation stems from fiscal policy being countercyclical during economic downturns but at best non-cyclical or even pro-cyclical during buoyant times. The implications are that debt accumulated in bad times is not offset in good times, resulting in a permanently higher level of debt in the longer run.

The global crisis led to record-high deficits in 2009-10...

The general government deficit peaked at over 7% of GDP in 2009 and 2010, driven mainly by the play of the automatic stabilisers, but also by discretionary measures taken to cope with the severe economic downturn. The French government reacted early to the economic crisis by launching a recovery plan in December 2008, broadly in line with the TTT (timely, targeted, temporary) principles: *i*) it came in good time; *ii*) it targeted public investment, the labour market, business cash flow and the most vulnerable population groups, so as to increase consumption; and *iii*) it bore costs for the budget only for 2009-10. According to official estimates, total fiscal stimulus amounted to EUR 38.3 billion in 2009 and EUR 9.6 billion in 2010, representing roughly 2.5% of GDP, of which only 1.4 percentage points showed up in the budget deficit, because a number of measures were cash-flow and financial operations having no impact on the general government balance in national accounts terms.

... in a context where the level of public spending remains high

Government expenditures as a share of GDP have been drifting upwards at a steady pace since the 1950s and by 2009 had almost doubled to 56% of GDP (Figure 2.2). Government revenues followed suit but have fallen short of the sometimes sharp expansion in outlays. Direct government spending (including government final consumption expenditure, other current payments by general government and net government investments) can explain much of the trend rise in aggregate spending.² While the social transfer component of public expenditures (composed of social security benefits and subsidies paid by the

¹ OECD Economics Department, email: balazs.egert@oecd.org. This paper was originally produced for the 2011 OECD Economic Survey of France, published in April 2011 under the authority of the Economic and Development Review Committee of the OECD. The author thanks Pablo Antolin, Hervé Boulhol, Francesca Colombo, Andrew Dean, Robert Ford, Peter Hoeller, Peter Jarrett, Josef Konvitz, Margit Molnár, Valérie Paris, Mark Pearson and experts from the French administration for helpful comments and suggestions. Many thanks go to Patrizio Sicari and Mee-Lan Frank for excellent technical assistance.

2. Government final consumption expenditure and other current payments increased steadily while net government investment declined as a share of GDP.

government) rose steadily until the end of the 1970s, it has been stable ever since. Nonetheless, social benefits are nearly 20% of GDP in France, one of the highest shares among OECD countries (Figure 2.3, Panel B). Similarly, France's direct government spending is high by an OECD-wide comparison (Panel A). A striking feature of the data is that direct government spending in France is considerably higher than in other countries with similar levels of social benefits.

Reducing public debt is crucial

Despite certain drawbacks, a number of studies tend to show that a high level of public debt may hurt long-term growth via an increase in long-term interest rates that crowds out private investment. Uncertainty about future corrective policies may further deter private investment. Reinhart and Rogoff (2010) find an increasingly negative correlation between the public debt-to-GDP ratio and real GDP growth. Debt in excess of 90% of GDP is associated with an average slowdown of GDP of 1 to 3 percentage points for developed countries and 0.5 percentage point for France. Kumar and Woo (2010) estimate that an increase in the debt-GDP ratio of 10 percentage points reduces growth by 0.15 percentage point. For Checherita and Rother (2010), the impact on potential growth is a loss of up to 1 percentage point beyond a debt threshold of 80% to 120% of GDP. France's public debt is fast approaching the 90% threshold, which could begin to hamper long-term growth.

Figure 2.1. **Government deficit and gross debt by sector**

1. Gross public debt for 1958-1969 is calculated using general government deficits; gross debt for central and local governments and for social security is derived using deficits for 1958-1977.

Source: INSEE; OECD, Economic Outlook 88 database.

In addition to the adverse effect on long-term growth, an increase in long-term interest rates has a direct impact on public finances. Typically, a one percentage point increase in the public debt-to-GDP ratio is estimated to raise nominal long-term interest rates by up to 10 basis points (OECD, 2010a). Yet history suggests that countries with increasing indebtedness may not face an immediate rise in long-term interest rates if their financial markets are developed and if their fiscal institutions have a solid reputation. This allows the build-up of substantial fiscal imbalances. Then, if market sentiment turns, interest rates may rise sharply, putting public-debt sustainability in danger. Indeed, like the effect on growth, long-term rates may react to an increase in the gross general government debt-to-GDP ratio only if public debt goes beyond a certain ceiling – approximately 75% of GDP, according to Egert (2010).³ From then on a 10 percentage

3. The threshold of 75% of GDP was estimated by applying a threshold model to a sample of six G7 countries (excluding Japan) covering the period from Q1 2007 to Q4 2009.

point rise in the debt ratio is associated with a 40 basis point increase in long-term rates relative to short-term rates.⁴ By way of illustration, and given the current level of public debt (a projected EUR 1 620 billion for end-2010 in the latest *OECD Economic Outlook*), a 40 basis point rise in all rates would add roughly EUR 6.5 billion (0.3% of GDP) to general government's long-term annual interest payments.

Figure 2.2. The evolution of general government receipts and expenditures

Source: OECD calculations.

Figure 2.3. Direct government spending and social benefits in OECD countries

Note: Direct government spending includes government final consumption expenditure, other current payments by general government and net government fixed capital formation. Social benefits include social security benefits paid by general government and government subsidies.

Source: OECD calculations.

The structure of France's public debt is fairly healthy compared with other OECD countries. First, the share of short-term debt (with maturity less than 1 year) in total central government debt was slightly

4. The spread on French 10-year government bond rates over corresponding German rates widened from zero at the start of the financial crisis to around 40 basis points since December 2010.

below the OECD average in 2009 (Figure 2.4, Panel A). Second, the average maturity of public debt was somewhat above the OECD average of 6.2 years that year. Nonetheless, the fact that non-resident investors hold two-thirds of France's public debt, well above the OECD average, and that short-term debt has risen to 20% of the total, twice as high as in other large European countries, may potentially pose some risk in rolling over debt in the case of a sudden and extreme turn in market sentiment.

Figure 2.4. **Structural of central government debt in OECD countries**

Source: OECD, Central government debt Statistical yearbook 2010.

A sizeable fiscal retrenchment is needed

The multi-annual budget bill for 2011-14, which aims to reduce the public debt-to-GDP ratio starting in 2012, is welcome. Bringing public debt back to below 60% of GDP will require a large fiscal consolidation effort. Stabilising public debt at its current level would require an immediate fiscal tightening of around 3% of GDP in terms of the primary balance (Table 2.1).⁵ If public debt is to be decreased to 60% of GDP by 2030 or 2020, additional consolidation measures of 1 to 2% of GDP are needed. Such a consolidation effort implies at least ten years of primary general government surpluses, unheard of in French fiscal history since 1970. Yet the government's consolidation programme aimed at reducing the general government deficit to 3% of GDP by 2013 is around two-thirds of what is needed to achieve a debt target of 60% of GDP by 2030. Assuming an effective interest rate of 3%, the primary deficit of roughly 0.3% of GDP implied by the total deficit of 3% would start to lower the debt ratio, and an additional consolidation of only 1.5% of GDP would be needed to bring debt down to 60% by 2030. The risk stemming from higher long-term interest rates is demonstrated in Table 2.1. For stabilising debt at the current level or decreasing it to 60% of GDP, a rise from 3% to 4% in the effective interest rate would in the long term imply an extra annual fiscal burden of around 0.7 percentage point of GDP.

Consolidation may hurt economic growth

Fiscal retrenchment is bound to impact negatively on economic growth through Keynesian multiplier effects. For France, a recent OECD report suggests that over a two-year time horizon, the multipliers for government investment, consumption and transfers to households are 1.0, 0.8 and 0.6, respectively, while they are -0.3 and -0.6 for indirect taxes and taxes on personal income (OECD, 2010a). However, the direct negative effect on aggregate demand can be potentially counterbalanced by a positive indirect impact,

5. Compared to the underlying primary deficit of 3.3% in 2010, corrected for cyclical effects and one-offs.

which can be large if public debt is high and if fiscal consolidation signals lower future public debt and taxes that in turn decrease precautionary savings (Röhn, 2010).

Table 2.1. **Simulations regarding consolidation needs for different public debt scenarios**

Per cent of GDP	Effective nominal Interest rate on public debt					
	3%	4%	6%	3%	4%	6%
	Starting point: 2010 deficit			Starting point: 2013 deficit		
	Scenario 1: debt stabilisation					
Primary balance	-0.6	0.2	1.8	-0.7	0.2	1.9
Total balance	-3.1	-3.2	-3.2	-3.4	-3.5	-3.5
	Scenario 2: debt at 60% by 2030					
Primary balance	0.6	1.3	2.7	1.2	1.9	3.4
Total balance in 2030	-1.2	-1.1	-0.9	-0.6	-0.5	-0.2
	Scenario 3: debt at 60% by 2020					
Primary balance	1.8	2.5	3.9	3.8	4.5	6.0
Total balance in 2020	0.0	0.1	0.3	2.0	2.1	2.4

Note: The scenarios assume average annual real GDP growth of 2% and 1.8% inflation. A negative (positive) figure indicates a deficit (surplus).

Source: OECD calculations.

The government intends a smooth path for fiscal consolidation in the coming few years

Against the background of a record-high general government deficit of 7.5% of GDP in 2009, and growing concerns about debt sustainability, the government set out a path of fiscal consolidation in the multi-annual budget framework law (*Loi de programmation des finances publiques pour les années 2011 à 2014*), according to which the budget shortfall as a share of GDP is to decrease to 3% in 2013 and 2% in 2014. These objectives are taken from France's stability programme submitted to the European Commission in early 2010. While the pace of the consolidation seems appropriate, the government should disclose quickly what measures it intends to take to achieve the budget targets beyond 2011.

At the heart of the 2011 budget (and the budget framework law 2011-14) is the intent to contain spending by central government, the social security system and to some extent local governments, as well as to increase revenues. As far as the central government budget is concerned, spending is capped by two different norms, of which the more constraining has to be fulfilled. The two spending norms are *i*) a zero real growth target for central government expenditure and *ii*) a zero nominal growth target excluding interest and civil servants' pension payments, both expected to rise rapidly. Another set of measures aims at stabilising the central government payroll by continuing the current policy of filling only every second position freed up by retiring staff, by moderating wage growth in central government (freezing the civil service point value in 2011) and by cutting employment (2 600 positions) in agencies of the central government (ODAC, *Organismes Divers d'Administration Centrale*). Furthermore, the government's operating costs are targeted to decline by 5% in 2011 and by 10% in 2013, thanks in particular to productivity gains triggered by the General Review of Public Policies (*RGPP*). Finally, agencies of the central government are not allowed to contract any loans with maturity beyond one year.

The spending growth target for the basic mandatory social security schemes is 3.4% for 2011 (and an average of 3% for 2012-14). The 3.4% target is supposed to be achieved via a spending norm of 2.9% imposed on health insurance-related spending (ONDAM) in 2011 (2.8% for 2012-14). As a result of the 2010 pension reform, and according to official estimates, the deficit of the pension system will be reduced only slightly in 2011 and 2012 compared with the unchanged-policies scenario, with full savings taking effect by 2018 (Sénat, 2010a).

The State can influence spending by sub-national governments only indirectly, given their constitutional autonomy in budgetary matters. Two key measures are budgeted for 2011: *i*) a nominal freeze on operating transfers from the central to local governments will restrain spending due to the balanced-budget requirement for current spending applying to local governments; and *ii*) a freeze on nationwide safety and other regulatory norms, the implementation of which can be very costly for local governments.

On the revenue side, the government decided to reduce tax expenditures⁶ by EUR 11 billion in 2011, and an additional EUR 3 billion per year for 2012-14, compared to an unchanged-policies scenario. In addition to cuts in tax expenditures, the highest marginal income tax rate was increased from 40 to 41%. Also, the flat rate tax on income and capital gains from securities was raised by one percentage point. And the capital gains tax on property was increased by three percentage points. Finally, the budget framework law for 2011-14 requires that any surplus revenues have to be used for deficit reduction.

Strengthening the fiscal framework by introducing a structural deficit target...

Besides the various fiscal rules imposed by EU membership, operational rules have been in place in France for some time: these include a spending rule for central government since the mid-2000s and for health care spending since the late 1990s, and a golden rule for local governments (Table 2.2). The inability of the spending rules to contain the budget deficit shows the weakness of such rules, which lack an unambiguous and stable link to the budget deficit and public debt sustainability. The beneficial effects of spending rules on the budget balance can be offset by tax cuts on the revenue side and by spending rules that are not consistent with budget deficit targets or are not respected (Joumard and André, 2009). Likewise, although Article 34 of the French constitution prescribes that the multi-year budgeting law guiding public finances should aim at a balanced budget for general government, it is still not very effective because the date by which balance should be reached is not specified.⁷ The history of fiscal deficits and a rising debt-GDP ratio, despite the rules in place, therefore calls for stricter rules in France's case.⁸

The general framework needs to be strengthened via enhanced consistency and transparency by introducing a stable and effective budget rule, in line with the outcome of ongoing European talks. To avoid pro-cyclicality and ensure a rapid decline in the debt-GDP ratio, a maximum structural deficit rule for general government would be desirable. The fact that the French central government does not directly control the budgets of local governments and certain social security bodies would, however, require supplementary measures (see below). To become more operational, the structural deficit rule could take the form of spending caps and revenue floors. The exact target to choose is a political issue and will vary with circumstances (notably the size of the national debt and future fiscal liabilities), but a balanced budget target would reduce the debt-GDP ratio to 40 or 50% in a reasonable time (say, 20 years or so) and leave a sufficiently large buffer to accommodate most negative shocks below the 60% Maastricht ceiling. The target could be adjusted, once debt is below a level that is judged sufficiently low and defined in the rule, to one that would stabilise the debt-GDP ratio. In this context, a "sufficiently low" debt would not necessarily mean zero, as a liquid government debt market would provide advantageous portfolio

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6. The term "tax expenditure" in this review is used to translate either *dépense fiscale* or *niche fiscale*, which are considered to be synonymous.
 7. In early 2010 the French president, Nicolas Sarkozy, announced his wish to modify the constitution in order to establish an enforceable budget rule. How to anchor a fiscal rule in the constitution was examined by a commission of experts and members of parliament, chaired by Michel Camdessus (Camdessus, 2010).
 8. Public debt reduction was particularly sizeable and long lasting in countries where budget balance and spending rules were implemented jointly (IMF, 2009)

diversification and a market yardstick for interest rates. Yet such a rule is necessary but not sufficient to increase fiscal discipline: strong political commitment to maintaining public debt sustainability is crucial for a well functioning fiscal rule.

Table 2.2. **Fiscal rules in the European Union, 2008 and updated**

Rules	Level of government				
	General	Central	Regional	Local	Social security
Debt rule					
Debt ceiling	GBR (prior to the crisis)				
Per cent of GDP	BGR, POL (60%) SVN (40%)				
Per cent revenues	EST		ESP, SVK	ESP, HUN, ROU, SVN	
New debt		LTU		DEU, LVA, PRT, SVK	
Debt growth		HUN			
Spending rule					
Real growth	DNK	FRA, HUN			BEL (4.5%), FRA
Real ceiling	NLD	FIN			
Nominal growth		DEU, FRA	DEU, ITA	ITA	
Nominal ceiling	BGR (40%)	CZE, IRL, SWE SVK, FRA			SWE
Revenue rule					
Revenue ceiling	DNK				
Windfall revenues	DNK, NLD	LTU, FRA			
Rainy day fund					FIN
Deficit rule					
Set in law		AUT	AUT	AUT	
Balance	EST		BEL	BEL, DEU, FIN, IRL LTU, PRT, ROU, SWE	BEL, ITA
Balance over the cycle	ESP				
Balance structural	DNK, SWE (1%), GBR	FIN (1%)			
Golden rule			FRA, ITA	FRA, ITA	
Surplus primary	HUN				
Surplus structural					
Deficit and spending	DNK, SWE	FIN	ITA	ITA	BEL
Time frame					
1 year			ESP, FRA, ITA PRT, SVK	BEL, DEU, ESP, FRA HUN, IRL, LTU, PRT LVA, ROU, SWE, SVN	
2 years					
3 years		CZE, HUN			ITA
4 years	NLD, SVN	AUT, FRA	AUT	AUT	BEL, FRA
5 years	GBR	DEU, IRL	BEL, DEU		

Source: European Commission.

Targeting the structural balance purges the effects of the cycle and one-off spending or revenue items and thereby avoids pro-cyclicality and allows the automatic stabilisers to work. However, the implementation of cyclically adjusted balance targeting can be challenging, as it depends on a timely and accurate measure of the output gap (the deviation of the level of real GDP from its potential level) and of elasticities of government revenues and outlays to the output gap.⁸ It is essential that real-time deficit and output gap estimates do not diverge systematically from later revisions. Table 2.3 shows the absence of a major systematic bias for the revisions to France's structural deficit and output gap calculated by the OECD. In fact, the gap in absolute value between the first release of the cyclical deficit in Q1 $t+1$ for year t and the final figure is 1 percentage point of GDP, as observed for 2006, which is relatively low relative to the long-term effort required. Moreover, this difficulty should not be overstated in the case of France, as it

8. For the Swiss deficit rule, trend output rather than potential output is used to derive the output gap. For this purpose, trend output is obtained using a modified Hodrick-Prescott filter that accounts for the well known end-point problem by under-weighting the last observation (Bodmer, 2006).

is characterised by a rather stable economy, due to its size, a lower degree of specialisation than in many other countries and strong automatic stabilisers.

Table 2.3. **Revisions (in t+1 and t+2) compared to the first release (in t) in output gap estimates and underlying government balances in France (revision minus first release)**

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Average
Structural deficit	t+1	-0.5	-0.1	0.7	0.3	-0.2	-0.3	-0.1	0.0	0.1	0.0	-0.7	-0.7	0.5	-0.1
	t+2	-0.8	0.3	1.1	0.2	-0.5	-0.2	0.0	-0.3	0.3	-0.8	-1.0	-0.2	..	-0.2
Nominal deficit	t+1	-0.4	0.0	0.7	0.2	0.0	-0.1	-0.1	-0.1	0.0	-0.1	0.2	0.0	0.1	0.0
	t+2	-0.5	0.5	0.7	0.2	-0.1	-0.1	-0.1	-0.1	0.1	0.0	0.3	-0.1	..	0.1
Output gap	t+1	0.3	0.2	-0.5	-0.5	0.5	0.4	0.1	-0.1	0.3	-0.1	1.8	1.5	-0.8	0.2
	t+2	0.6	-0.4	-1.3	0.0	1.0	0.2	-0.2	0.5	0.2	1.4	2.7	0.4	..	0.4

Source: OECD Economic Outlook databases.

The calculation of the structural deficit should be fully transparent and harmonised at the European level following the work undertaken by the Output Gap Working Group, given that this indicator is the cornerstone of France's annual stability programme submitted to the European Commission. The German structural budget balance rule uses the cyclically adjusted budget balance provided by the European Commission.

To ensure some flexibility, the structural balance rule would need to be suspended temporarily in the case of exceptional circumstances relating to natural disasters, extraordinary recessions, international conflicts resulting in a significant rise in military and other spending or major structural reforms. Such exceptional circumstances should, however, be carefully circumscribed, since otherwise the escape clause may be used excessively to circumvent the restrictions imposed by the rule. This was the case under Germany's previous golden rule when the escape clause with reference to the veil of macroeconomic equilibrium was exploited on a regular basis (Mody and Stehn, 2009). If slippage occurs, either because of exceptional circumstances or bad execution, it is useful to have an explicit and enforceable mechanism to correct *ex post* deviations from the target. For instance, the fiscal rule in Germany requires not only past slippages to be recorded on a notional adjustment account and, if accumulated deficits reach 1.5% of GDP, to be corrected during years when the economy is expanding, but also extraordinary spending to be amortised over an (unspecified) medium-term horizon (Koske, 2010). Switzerland's fiscal framework is more explicit about the timing of correcting slippages. If the accumulated slippage exceeds 6% of spending of the previous year (roughly half a percentage point of GDP), the government has the obligation to reduce the excessive deficit over three years (Bodmer, 2006). In other countries, including Sweden, there are no formal adjustment mechanisms to deal with budgetary overruns (Boije and Fischer, 2007).

A multi-year budget in the spirit of the multi-annual budget framework law, but providing more details, would complement the rule and bolster its credibility by making clear, in concrete terms, how the deficit target is to be reached. Typically, such budgets run for three or more years. Camdessus (2010) recommended that a multi-year budget framework programme be voted by each new parliament, as in the case of the Dutch spending rule, where the new government lays down the fiscal programme in a very detailed manner in its coalition agreement. The annual budget bills, which would have to be consistent with the multi-year budget programme,⁹ would still be formulated and passed, as now, and could be used to adjust the multi-year framework to changing circumstances – for example to compensate for past slippages. Establishing a constitutional requirement that the government produce a multi-year budget that

9. France achieved considerable progress in improving the fiscal framework by introducing multi-year fiscal budgeting, initially in 2008 for 2009-12.

is consistent with the deficit rule (in effect, strengthening Article 34 of the current constitution) would bolster the credibility of the framework and would raise the political cost of deviating from the rule.

... and by creating an independent fiscal council

An independent fiscal council including high-profile fiscal policy experts would also strengthen the framework by assessing the official inputs at various stages of the budgeting process. The fiscal council would be mandated to verify the consistency of the multi-year budget programme and the annual budget bills with the structural balance rule. Expert review of official forecasts by a politically independent body and a systematic comparison with consensus forecasts would also increase credibility by eliminating politically motivated and overly optimistic macroeconomic and budgetary forecasts that tend to be associated with fiscal slippages because overestimating (potential) GDP growth or inflation is tantamount to *ex post* active expansionary fiscal policy (Hagemann, 2010; Lebrun, 2007). Indeed, the Task Force on Economic Governance in the European Union set up by the European Council, along with the OECD (2010d), recommend that euro area countries delegate the preparation of macroeconomic forecasts to an independent budget council at the national level. Official GDP growth forecasts have been almost systematically upwardly biased in France compared to forecasts by the European Commission, the OECD or the market consensus, and have therefore been even higher than *ex post* GDP growth. Table 2.4 shows that the nearly 0.3-point optimistic bias is significant and that it has remained fairly constant over time. In Austria, Belgium, Canada, the Netherlands and more recently the United Kingdom, the government does not produce its own forecasts but uses those published by independent research institutions (Austria), market forecasts (Canada) or fiscal councils (the other three countries).

Table 2.4. **Optimistic bias of official GDP growth rate forecasts relative to independent and market forecasts**

Difference relative to forecasts	Average for			Estimated bias
	1984-2011	1990-2011	2000-11	Entire period
OECD	0.29	0.32	0.35	0.32**
European Commission	0.31	0.32	0.36	0.28**
Consensus forecast		0.25	0.23	0.24**
Historical growth rate	0.51	0.81	0.86	0.51**

Note: The difference is calculated as the absolute difference between the French government forecasts and the reference forecasts. The estimated bias is obtained by regressing the difference on a constant. ** indicates that the bias is significantly different from zero at the 5% level.

Source: Jonung and Larch (2004, Improving fiscal policy in the EU: the case for independent forecasts, European Economy Economic Papers, No. 210) for the official forecasts, those of the European Commission and the market until 2004, updated through 2011 by the OECD.

A council would monitor the risk of slippages during execution in real time and would advocate prompt corrective action in a timely manner to limit large *ex post* deviations. Another task for an independent council would be to strengthen the existing spending rules by continuously monitoring loopholes used to circumvent spending targets via shifting spending and revenue items across sectors and via not respecting the pay-as-you-go principle to be applied to tax expenditures. Offsetting new tax expenditures can be achieved either through new revenue measures or through a decrease of the expenditure ceiling (Boije and Fischer, 2007). This principle was in fact reaffirmed in the budget framework law for 2011-14. Finally, the council would check whether the mandatory safety buffers are respected. Safety buffers are necessary to account for local governments, whose budgets are not fully controlled by the central government in France, or for unforeseen negative shocks and possible revenue shortfalls.

Still other roles could be assigned to the fiscal council and have been in other OECD countries. First, it could be mandated to provide a non-partisan analysis of the costs of new spending or revenue measures and the consequences of current and planned fiscal policies on long-term debt sustainability. The US Congressional Budget Office (CBO) is a typical example of a fiscal council that evaluates budget proposals using its own projections and conducts analysis on their costs. The Central Planning Bureau (CPB) of the Netherlands evaluates the fiscal implications of the electoral programmes of the major political parties and takes a position with regard to the impact of new coalition agreements. Second, it could also provide recommendations on fiscal policies and corrective actions to be implemented if needed. Sweden's Fiscal Policy Council takes a view on fiscal sustainability issues in addition to assessing compliance with the surplus target and the quality of government. The Economic Council of Denmark and Belgium's High Council of Finance are also mandated to issue recommendations if they judge it necessary (Debrun *et al.*, 2008; IMF, 2009).

Reducing budget deficits by cutting public expenditures

The public wage bill

Compliance with the central government's zero volume and zero value spending norms requires a stabilisation of the public payroll, given its weight of more than 30% in central government spending. While pension contributions paid by the State and directly linked to civil servant pensions can be tackled in the framework of the pension reform, described later in this study, government employment and wage policies have a direct impact on gross salaries, which represent 60% of the public payroll (including social contributions) and in turn drive non-pension overhead costs, another 10% of public payroll.

Gross salaries can be decomposed into base salary (79%), general benefits (6%) and ministry-specific special bonuses (15%). Salary increases depend on the change in an index reflecting the payment grid (*le point*) to which base salary and other components are linked not only in central government but also in local governments and hospitals. A 1% change in this index is estimated to cost around EUR 1 billion for central government and a total of roughly EUR 2 billion for the general government wage bill. This index, used to maintain the purchasing power of all civil servants until 2008, was disconnected from inflation in February 2008 by the introduction of an individual guarantee of purchasing power, which was intended to offset possible negative real salary changes. Other drivers of public wage increases are the annual uprating in the payment grid and special increases for particular occupations. Civil servants who were employed in two consecutive years benefit from all three components. The overall average nominal salary increases of 3.6% per annum from 1999 to 2009 were mitigated by the fact that civil servants leaving the public sector were replaced by persons entering the payment grid at lower levels, resulting in an annual average salary increase of only 2.2% per employee (Cour des Comptes, 2010d).

Since 2003 the central government has been implementing a policy of replacing only one half of retiring civil servants. Since then employment in the central government has been declining (Figure 2.5), with the accumulated full-time-equivalent job reduction reaching 150 000, though part of that reflects transfers from central to local government in the decentralisation process. According to government policy, half of the gains from job cuts are recycled to compensate for the costs of reorganisation and overtime worked resulting from the non-replacement of retiring staff. Yet a recent report suggests that this so-called retrocession has considerably exceeded the stipulated share of 50% (Cour des Comptes, 2010d).

In the medium term, a nominal stabilisation of central government payroll could be achieved by a freeze on the pay grid, capping the occupational benefits and revising some of them that are not easily justified. In the longer run, introducing additional steps in the pay grid could slow down rises in salaries. A further reduction in the recycling of cost savings due to the partial replacement of retiring staff would also help moderate public payroll. Importantly, the RGPP may help identify room for further job reductions.

Figure 2.5. Total change in full-time equivalent central government employment

Source: Projet de loi de finances 2011.

Increasing public-sector efficiency

Beyond the stabilisation of public payroll, government spending could be curbed by improving public-sector efficiency. France has one of the OECD's largest public sectors in terms of general government expenditures expressed in relation to GDP and when measured as the share of general government employment in total labour force (Figure 2.6). Yet its perceived effectiveness, measured by the World Bank Worldwide Governance Indicator, is poor. Among major industrialised OECD countries, only Italy, Japan and the United States fare less well. Successive French governments, recognising the ample scope for bolstering public-sector efficiency, launched two major initiatives to remedy this problem: the organic law of public finances (*Loi organique relative aux lois de finances, LOLF*) and the RGPP.

Figure 2.6. The share of general government employment in the labour force in 2008

Source: World Bank Worldwide Governance Indicators 2010 and ILO.

By introducing performance measurements in the budgeting process...

The LOLF, passed in 2001 and first applied for the 2006 budget bill, represents a change in paradigm in the allocation of budget resources. Rather than allocating funds to government units and by types of

spending (current or capital), with no apparent link to policy objectives, it defines goals for public policy areas concerning, for instance, education, health care and defence (the so-called assignments or missions) and allocates the necessary money to the programmes, themselves composed of programmes and tasks. This increases transparency significantly by linking policy objectives to resources. Programme managers have flexibility to achieve the objectives by shifting funding across tasks. Whether the objectives, defined in annexes to the budget bill, are met is monitored via performance indicators measuring socio-economic outcomes, the quality of service and management performance, all published in annual performance reports. Before 2005, the parliament had limited power to change the budget proposed by the government and could vote only on new measures. By contrast, the new framework given by the LOLF makes it possible for the parliament to modify each mission, thus requiring the government to justify the level and not only the increase in spending. Finally, the Court of Audit has to certify the government's accounts following each fiscal year and assess the budgetary execution. In an extension of the LOLF, the organic law of public finances of social security (*LOLFSS*) came into force in 2006: among its aims was to make social security accounts more transparent, and it enabled the introduction of multi-year budget planning (Cour des comptes, 2010b).

While substantial progress has been made with regard to the implementation of performance budgeting, there are some areas where further improvements could be achieved. First, the information system underlying the evaluation and the full costs of programmes needs to be enhanced. Available information is not always reliable, and there are sometimes a large number of performance indicators, which may change over time, rendering *ex post* evaluations difficult. Second, performance indicators are not linked to budgetary execution and supervision. Finally, performance cannot always be analysed because some spending transits via tax expenditures and through State operators (public establishments and companies) that are outside the purview of the LOLF (Cour des Comptes, 2010e).

... by reviewing systematically the efficiency of public policies...

The RGPP, launched in 2007, aspired to review systematically all public policies in order to identify the least efficient and least useful spending categories. Unfortunately, the initial ambition of questioning the very existence of some policies was scaled back to one of achieving cost-efficiency gains via organisational restructuring. Cost savings identified in more than 300 areas were estimated by the government to result in almost EUR 3 billion per annum for the period 2009-11. Half of the estimated gains are related to the policy of replacing only every second position freed up by retirees, of which half is transferred back to public employees, as discussed earlier, reducing net gains to below EUR 7 billion. This may still be an overstatement, because in fact more than half has actually been given back, as mentioned above. A set of 150 new measures is to be implemented for 2011-13, reducing government spending by an estimated EUR 10 billion, which can be split into three major parts (RGPP, 2010). First, the central government's wage bill will be reduced by continuing the non-replacement policy (EUR 3 billion). Second, central government operating costs will be lowered by EUR 2 billion through three channels: *i*) the establishment in 2009 of a central procurement agency covering all ministries; *ii*) a decrease in real estate-related expenditures via reducing office space occupied by central government and capping rental prices that the government is prepared to pay; and *iii*) streamlining support functions. Third, so-called "intervention" expenditures (essentially subsidies) will be cut by 10% (EUR 5 billion) over that time frame. The global savings of around EUR 13 billion from 2009-13¹⁰ are not negligible but are lower than the potential spending cuts of around EUR 50 billion identified by independent analysts (as reported in OECD, 2010c).

10. The figure of EUR 13 billion is calculated as the sum of EUR 2 billion per year for 2009 and 2010, and EUR 3 billion per year for 2011 to 2013.

A remarkable achievement of the RGPP is to have cut red tape for formal administrative procedures. Simpler and faster public services increase quality and help free up resources in public administration. A key measure is the creation of a physical network of one-stop shops for tax declaration, job seekers and private enterprises, accompanied by an expansion of “e-government”: Internet services making feasible on-line completion of a large number of administrative procedures (OECD, 2010f). The waiting and processing times are to be diminished by one third in key public institutions including prefectures, courts, tax authorities, embassies and family benefits offices. Simultaneously, the government has decided to set up and regularly publish indicators concerning the quality of public services.

The RGPP in its present form could nevertheless be improved in several respects. A general criticism concerns the lack of transparency regarding the time horizon and the amount of savings achieved in specific areas. Official documents do not permit readers to link cost savings resulting from reforms due to RGPP to their impact on the overall budget (Cour des Comptes, 2010c). While the RGPP and LOLF should be complementary in seeking efficiency gains, they are not always fully consistent with each other, given that the RGPP is in some cases focused on government units rather than on missions (Cour des Comptes, 2010e). More generally, the gain would be greater if the coverage of the RGPP were extended beyond the government wage bill and operational costs, namely to social benefits and investment programmes. For instance, reducing social benefits deemed not useful or not meeting their policy objectives could result in much larger savings than any organisational restructuring of the administration of underlying social transfers could possibly bring about (OECD, 2010c; Cour des Comptes, 2009). The efficiency gains would be more substantial if reorganisation of government entities and the review of government policies were to be extended to social security and local governments as well, even though amendments to the constitution might be required for the latter.

... and by reorganising local governments

Having expanded strongly over the last 20 years, local government expenditures now amount to roughly 11% of GDP.¹¹ The sharp increase, driven to some extent by political and administrative decentralisation, did not translate into major budgetary shortfalls (Figure 2.1), given the existence of a golden rule that requires *ex ante* balanced operating budgets. Despite the absence of major imbalances, the expenses of local governments could be reduced by: *i*) simplifying the complexity of the multi-layered structure of local governments; *ii*) decreasing the number of municipalities; and *iii*) creating incentives for local governments to achieve cost savings.

The two main waves of decentralisation, launched in 1983 and 2003, resulted in the transfer of many tasks from the central government to the three levels of local government (regions, departments and communes). Among others, regions became responsible for managing upper secondary schools and vocational training of the unemployed. Departments were assigned the task of operating social and selected health-care programmes and lower secondary schools, while management of urban public transport, kindergartens, primary schools, libraries and museums was given to communes. Decentralisation is thought to have improved allocative efficiency via a better match between public-goods provision and local preferences, an increase in accountability and a reduction in supervision costs (Greffé, 2005). Realised efficiency gains hinge upon labour mobility across different levels of governments. In France, the imperfect reallocation of civil servants from the central to local governments raised the costs of decentralisation. Furthermore, decentralisation may have resulted in a loss of economies of scale. For instance, the assignment of secondary schools to regions and lower secondary schools to departments may have lowered quality or raised outlays if the two schools are located on the same geographical site, due to co-ordination problems between the region and the department. In a similar vein, the fact that the training

11. In 2008, communes, departments and regions accounted for respectively 56, 31 and 13% of total local government expenditures.

of unemployed people and those living on subsistence benefits (*minima sociaux*) on the one hand and that of employees on the other hand are assigned to different levels of local government may generate sub-optimal outcomes, as a result of coordination problems (de la Rochefoucauld and Colin, 2008). The partial overlap in policy tasks, generating redundant administrative capacities, coupled with the lack of any hierarchical structure among levels of local governments results in less transparency for citizens, leads to a dilution of responsibilities and inflates public spending (Council of European Municipalities and Regions, 2009). Doing away with one of the levels of local government would help clarify tasks and responsibilities and produce substantial cost savings (Commission pour la libération de la croissance française, 2008).

An important source of inefficiency is the very small size of French communes. France's nearly 37 000 municipalities, a heritage of history, account for 40% of the total number of municipalities within the EU-27. An average French commune has around 1 800 inhabitants: 32 000 have fewer than 2 000, while only 103 have more than 50 000. This contrasts sharply with the European average of 5 500 and the Danish average, post reform, of 55 000 inhabitants. In many European countries, mergers have reduced the number of municipalities by a factor of 2 to 10 since the 1950s. France has opted for inter-municipal co-operation: in 2007, roughly 2 600 inter-municipal co-operation structures (*intercommunalités*) covered 90% of communes and 80% of the population, achieved via financial incentives (Council of European Municipalities and Regions, 2009; OECD, 2010c). A new law on sub-national governments foresees that all communes should be part of such a structure by 2013. Inter-municipal groupings may help them to provide sewerage, water, transportation and waste-collection services more efficiently. Parallel administrative structures at the communal level induce important inefficiencies both in terms of staff and local representatives. But potential efficiency gains will depend largely on the number of shared services.

Central government grants, representing roughly half of local government revenues, can give rise to the common pool problem: they reduce tax-raising efforts and inflate spending and deficits (Blöchliger and Petzold, 2009). In addition, they tend to amplify the pro-cyclical volatility of local government revenues (Blöchliger and Petzold, 2009). Another important source of revenue for local governments is earmarked central government tax receipts, which are used to cover the costs of tasks and responsibilities that have been transferred from the central government. The last component of revenues is own tax revenues. Local governments have little room for manoeuvre in setting the base and the rate of their own taxes, as the State tries to hinder tax competition among communes. The already limited tax autonomy of French local governments was further reduced by the reform of the *taxe professionnelle* in January 2010, especially for regions and departments (Carrez and Thénault, 2010). Things are particularly constraining for departments, as they also have limited autonomy on the spending side: 80% of their expenditures are mandated by national rules. This backs the case for merging departments with regions. Narrow tax autonomy and the lack of transparency with regard to the real tax burden on local electors due to the multitude (around 50) of local taxes reduces the accountability of local governments and thus provides little incentive for cost savings and tax restraint. Increasing tax autonomy would be a straightforward way to make local governments more accountable to their electors. Own taxes should have a greater weight in local government revenues, with more flexibility over the tax base and rates in the context of fewer and more visible taxes.

Insofar as they stem in part from exogenous factors, the increased per capita income disparity among local governments, induced by differences in tax potential and higher tax autonomy, could be limited by a horizontal equalisation mechanism that redistributes revenues across municipalities, rather than by central government subsidies. This is aimed at by the 2011 budget law, which endorses the creation of a national tax revenue equalisation fund for communes and intercommunal co-operation establishments (*établissements publics de coopération intercommunaux*, EPCIs) – and a separate equalisation mechanism for the Île-de-France region – by 2012. The revenue raised from communes and EPCIs whose per capita tax potential is 50% greater than the national average will be redistributed to communes and EPCIs whose

per capita tax potential is below the national average. The amounts collected annually should rise to 2% of the tax revenue of communes and EPCIs in 2015. Details on the implementation will be discussed in a report to parliament in 2011.

Incentives for cost savings could also come from the spending side. A largely involuntary constraint on local government spending occurs if earmarked taxes financing the transfer of competences grow less rapidly than the costs of the new tasks devolved to local governments. The freeze on government grants in nominal terms implemented from 2011 to 2014 is a more direct step in the direction of imposing efficiency gains. In the longer run, the government could consider introducing a more institutionalised framework to encourage cost savings. Following a thorough analysis of saving potential related, for instance, to deeper inter-communal cooperation, the government could set a predefined path of grants to local governments based on achievable productivity gains.

The ageing problem is a serious threat to France's public finances in the medium and long run

France's population is projected to age rapidly. The European Commission (2009) projects a near doubling of the number of elderly people and a 50% increase in very old persons by 2060, driven by the ageing of the baby boom generation of the 1950s and 1960s and extensions of life expectancy at birth. Population ageing is mitigated by comparatively high levels and modest increases in fertility rates since the mid-1990s, in sharp contrast with other OECD countries, where very low fertility rates are exacerbating the ageing problem.

Population ageing will put considerable strain on the public finances. The increasing number of elderly people triggers the need for more public spending via two main channels: *i*) age-related health and long-term care¹² and *ii*) public pension spending, mostly due to old-age pensions but also to survivors' pensions, early retirement and disability benefits. At the same time, some of the costs are offset by lower outlays on education and unemployment benefits. According to European Commission (2009) projections, population ageing will add an extra 2% of GDP to public spending in France between 2010 and 2060, much less than in other European countries (Figure 2.7). Nevertheless, France's starting point is higher as it spends considerably more public money on pensions and health care as a share of GDP than any other European country. Without policy actions to counterbalance the increasing burden of population ageing (including the positive impact of the 2010 pension reform discussed below), France's public debt would rise to very high levels in 2050 (European Commission, 2009).

12. Board and lodging costs in nursing homes, mostly borne by individuals, represent the main part of long-term care costs (OECD, 2011b).

Figure 2.7. Ageing-related public expenditures as a share of GDP

Source: European Commission (2009), Sustainability Report 2009, European Economy 9.

Health-care expenditures

Total health-care expenditures in France, at 11% of GDP, are the second highest in the OECD. France even occupies first place on the podium if only public funds spent on health care are considered. Health-care spending has been rising over the last 30 years and is projected to continue to do so in the future. The main reasons for the trend rise are constant technological progress that makes new and costly treatments available, population ageing, epidemiological factors (including more obese people), and a rise in per capita income coupled with at least a unitary income elasticity of demand for health care (CCSS, 2010). A case in point is cardiovascular disease: screening, early detection and more efficient treatments raise the number of long-term patients, around 2 million in France; treating them is extremely costly – EUR 18 billion in 2007 (CCSS, 2010). Studies comparing the efficiency and performance of health care in OECD countries generally find that the overall performance of the French health-care system in terms of results and efficiency is among the best in the OECD. Nevertheless, there exist areas where significant improvements could be obtained, which, given the high share of health-related public expenditures, could help resolve France's fiscal problems (Journard *et al.*, 2010; OECD, 2010c).

Strengthening the spending rule on health-care expenditures

A spending rule on health-care expenditures (*Objectif national de dépenses d'assurance maladie*, ONDAM), defined in terms of nominal growth rates, was introduced in 1996 in an attempt to keep spending under control.¹³ An early-alert council, created in 2004, issues a warning to the parliament, the government and the Union of National Health-Insurance Funds, which are required to take remedial action, if there is a risk of spending exceeding the objective by 0.75% or more. In 2005, transparency about the ONDAM was reinforced. The annual social security budget bill compares the outcome with the earlier plan, gives details on the components of spending and presents projections for outlays for the next four years in an annex.

In 2010, the ONDAM may have been fulfilled, for the first time since 1998. The main reasons for the systematic non-compliance are overly optimistic policy assumptions or unanticipated outlays that the

13. ONDAM also includes part of long-term care expenditures for old and disabled persons.

functioning of the early-alert system manages to correct only imperfectly over the course of the year. In fact, the alert has been activated only once since 2004, and even in that case, it could not prevent a major slippage. This is due *inter alia* to the long lag with which the first corrective measures are put in place. A first set of new information influencing ONDAM, namely accounting data on the previous year's execution, becomes available only in early April. The early-alert council does not systematically issue an opinion on the causes of the excess spending growth until 1 June. As the social security funds have one month to elaborate corrective measures and the council another month to analyse the impact of the proposed measures, adjustment measures can be implemented only for the last few months of the budget year (Cour des Comptes, 2010f). Hence, it seems necessary to lower the threshold for the alert and speed up the implementation of the corrective measures. The Briet commission (Rapport Briet, 2010) recommended automatically putting in reserve part of the annual budget at the beginning of the year in order to increase the resistance of ONDAM to slippages. Reserves were already set aside for the 2010 execution year, and the social security budget law for 2011 continues this practice in accordance with the multi-annual budget framework law for 2011-14, which requires such set-asides on a systematic basis. Also according to the recommendations of the Briet commission, the warning threshold will be lowered gradually to 0.5% by 2012-13. In addition, the role of the early-alert council has been expanded. From now on it will issue a prior opinion on the setting of ONDAM. It will also perform an ongoing monitoring function and by 15 April will present ministers with an initial opinion on achievement of the previous year's ONDAM.

Exploiting cost-saving options

Joumard *et al.* (2010) identify several sources of inefficiency in the French health-care system. Heavy administrative costs stem from the complex web and multitude of social security and supplementary insurance funds. Within compulsory health insurance, the ongoing consolidation of insurance funds and pool schemes, with regard to information-sharing in particular, should be pursued. Administrative costs are also boosted by an unusually high level of absenteeism among workers in the health-care sector and employees of the social security system (Cour des Comptes, 2010f). Absenteeism is higher in France than in other European countries, and sickness-related work stoppages are especially frequent in social security administration when compared with the private sector or other parts of the public administration.¹⁴

Hospitals

Another source of inefficiency relates to the frequency and length of stays in hospitals, which are especially high in international comparison (Joumard *et al.*, 2010). Recognising this, the government has been gradually changing tariffs paid to hospitals to encourage short-term stays and ambulatory treatments. This has increased the relative profitability of certain ambulatory treatments and triggered a rise in hospitals' ambulatory capacities relative to the number of hospital beds. Alongside this policy, the spread of home hospitalisation (HH), deemed less costly, has increased substantially in the past ten years and grown sharply since 2009 (with activity up by 119%). Although it accounts for less than 1% of hospital output (Inspection Générale des Affaires Sociales, 2010), the spread of HH is contributing to the quest for greater efficiency in delivering hospital care.

14. Sick leaves are concentrated strongly in the initial six-month period during which employees receive 100% of their salary but drop sharply with the later decline in compensation rates (Cour des Comptes, 2010f). The Court of Audit estimates that cutting full-salary compensation to the three months applied in central government would reduce absenteeism by the equivalent of 1 200 full-time employees per year. Bonuses conditional on the number of days worked per year and more stringent controls on the causes of sick leaves could reinforce this effect (Cour des Comptes, 2010f).

While costs decreased only slightly in 2010, extending incentive tariffs to all treatments may yield benefits in the longer run (CCSS, 2010). Public hospitals receive a flat fee per hospital stay. This fee also covers special treatments such as medical imaging and thus gives the right incentives to avoid unnecessary medical acts. By contrast, private hospitals can invoice those acts at the price of what a private practitioner would be allowed to charge to the social security, on top of the hospital stay. This disparity needs to be corrected. Also, the tariffs paid to private practitioners are excessive (Cour des Comptes, 2010f), and the Court of Audit recommends aligning tariffs with doctors' equipment costs.

User fees, doctor pay, generics and drug consumption

In France, patient user fees account for an average of only 7% of the final price of health-care services (OECD, 2010g), which may result in excessive demand. In principle, gatekeeping could reduce demand for specialist care, which has recorded a certain expansion in recent years. It is also possible that French GPs, since they are paid by the act, tend to prescribe the best possible and thus most expensive treatments to retain patients, unlike doctors whose incomes are less strongly linked to the number of consultations. This may be reflected in France's very high per capita prescription drug consumption (OECD, 2010c).¹⁵ Therefore, consideration should be given to greater use of capitation-based doctor compensation.

The costs of high drug consumption can be lowered by cutting use and by lowering the price of drugs. Excessive drug consumption could be reduced if the access to doctors is restricted by limiting the number of highly reimbursed consultations or raising patients' co-payments. Many countries rely on generics to reduce the prices of drugs. Yet, the saving potential in generic drugs remains under-exploited in France. In 2009, their market share in volume was 20% in France, compared to about 60% in Denmark, Germany, the Netherlands and the United Kingdom (OECD, 2010e). French policies to promote generics rely on allowing pharmacists to substitute generics for the brand name drug. The choice is made neutral by the alignment of the absolute margin of generics with that of branded drugs. Since 2003, some drugs are reimbursed on the basis of the cheapest generic drug, *i.e.* reference pricing. In 2009, the government launched a campaign to encourage GPs to prescribe a certain amount of generics: they receive a bonus if they fulfil an optional objective of generics use to which they may sign up contractually (CCSS, 2010). There are several ways to increase substitutability. First, the contract could be made obligatory for all GPs, as in other countries. Second, in France, substitutability is based on the same molecular content, whereas the same therapeutic value could be used as a criterion for substituting for generics. Third, a policy of fully reimbursing generics if the price difference with the branded drug is large enough would further encourage the shift towards generics. Fourth, reference prices could be used more systematically. Fifth, the health insurance fund should not pay higher prices for branded drugs after patent expiry than for their generic equivalents. Finally, and more generally, more guidance should be provided for doctors regarding appropriate prescription practises. While the doctors' main source of information is the pharmaceutical industry, the French National Authority for Health (*Haute autorité de santé*) could give more systematic guidance for prescribing the cheapest drug with the same therapeutic value.

The sustainability of the pension system

The government's pension reform proves commitment to future reforms

The imbalances of the French pension system can be tackled by changing its main parameters: *i)* raising pension contributions through a higher rate of pension contributions and/or higher participation and employment rates; *ii)* extending the effective retirement age; and *iii)* lowering the replacement rate.

15. The development of fixed remuneration must, however, factor in the fact that to pay doctors per act constitutes a useful incentive to activity, given the expected slowdown in medical demographics in the years ahead.

The estimates of the government's pension advisory board (*Conseil d'orientation des retraites*, COR), summarised in Table 2.5, indicate the enormous efforts needed to rebalance the system (COR, 2010). The pre-reform effective retirement age would need to be raised by five years if balance is to be re-established by 2020, and by ten years if the pension system's accounts are to be balanced in 2050. Similar large adjustments would be necessary to any of the other parameters, if all the adjustments were effected using just one. Increasing pension contribution rates, which are already relatively high, or reducing net replacement rates, which are slightly below average for the OECD countries, are not promising solutions (Figure 2.8). Higher pension contributions would be bound to hurt long-term economic growth by increasing labour costs, while lower pension benefits may face stiff political and social resistance. There is more room for manoeuvre for increasing the employment rate, which is below the OECD average and particularly low for those over 60 (OECD, 2011a, Chapter 1).¹⁶ The average age at which people stop working, which was slightly below 60 years, and the minimum legal retirement age prior to the recent reform, are among the lowest in the OECD, whereas life expectancy of French people at the time of exiting the labour market is higher than in any other OECD country.

Table 2.5. **Adjustments needed to rebalance the pension system**

	2020	2030	2050
Balance to be reached by using only one of the three measures listed below:			
Raising pension contributions by	5.2 p.p.	7.6 p.p.	9.8 p.p.
Lowering replacement rate by	22%	30%	36%
Extending the effective retirement age by (relative to the situation in 2008)	5 years	7½ years	10 years

Source: COR (2010), *Retraites : perspectives actualisées à moyen et long terme en vue du rendez-vous de 2010*.

The parliament passed a law on pension reform in autumn 2010 aimed at relieving pension spending obligations. At the heart of the reform is the progressive two-year increase in the minimum legal retirement age by 2018¹⁷ and the age criterion to receive a full pension. Once fully phased in, the legal retirement age will be 62 years. Under the 2003 Fillon reform, scheme participants who have not contributed long enough to have a full pension are to be penalised by 1.25% per missing quarter on the pension payment. However, whatever the number of years worked, everybody will receive a full pension when retiring at 67, without any penalty but still proportional to the contribution period. The minimum contribution period will rise gradually from 40.5 years for those born in 1950 to 41.5 years for those born in 1960, in accordance with the Fillon reform. Age criteria for early-retirement schemes related to physical disability or long working life have been raised the same as other age limits. Entitlement to early retirement for civil servants with three or more children has been abolished. To facilitate employing people close to retirement, a subsidy of up to 14% of gross salary is being offered for hiring unemployed persons who are older than 55 for a sustained amount of time. Lastly, there are forms of early retirement that persist, notably via the unemployment benefit scheme, most of which should be eliminated when the planned withdrawal of the job-search exemption takes effect in 2012.

16. Labour market reforms would help lower public debt in a sustainable way – see OECD (2011a), Chapter 1.

17. By four-month tranches for each birth-year cohort: the first cohort affected will be those born in 1951: the increase will be completed for those born in 1956.

Figure 2.8. Pension contribution and net replacement rates, 2007

Source: OECD (2009), Pensions at a Glance 2009: Retirement-Income Systems in OECD Countries; OECD Labour Statistics database.

On the revenue side, apart from the increased contributions collected as a result of the various measures to defer the receipt of pensions, new measures are likely to increase revenues by nearly EUR 8 billion in 2018. In 2018, virtually a third of this increase will come from a gradual hike in the contribution rate on civil servants' salaries from 7.85 to 10.55% spread over 10 years, which will not only raise revenues but will also be a step towards harmonising conditions for public- and private-sector employees. Over half of the revenue increases by 2018 is due to tax hikes: annualisation of the calculation of relief on social security contributions on low wages, increases of 1 percentage point in the highest marginal rate of the personal income tax and the tax on capital gains on sales of financial assets, 3 points in the capital gains tax on real estate sales, accompanied by higher special social contribution rates on stock options or purchases and shares given for free and on special management pensions, which in all would represent a total of EUR 4.4 billion in 2018. Furthermore, it is being assumed that unemployment should drop sharply by 2015. The outlays freed up from unemployment benefits would then be transferred to the pension system's accounts, bringing in EUR 1 billion in 2018. Finally, the pension reserve fund, which was supposed to be used only after 2020, will be depleted progressively to cushion the deficit of the system over the period during which it takes full effect.

The pension reform was crucial to maintaining long-term debt sustainability

Notwithstanding the numerous and ambitious reform attempts between 1993 and 2003, the French pension system, a defined-benefit, pay-as-you-go (PAYG) scheme, has been recording steadily widening deficits since 2004, when it was last in surplus. In 2010, prior to the pension reform adopted at year-end, the deficit reached EUR 15 billion (EUR 11 billion for all basic schemes and EUR 4.3 billion for the *Fonds de solidarité vieillesse*),¹⁸ nearly 1% of GDP (LFSS, 21011). The ongoing process of population ageing will put additional pressure on public pension-related expenditures. In 2008, these accounted for almost 13% of GDP, the third-highest in the OECD after Austria and Italy, and represented one quarter of general government expenditures. Without the 2010 reform, the number of pensioners would have

18. COR estimates that the overall deficit of all pension schemes was EUR 32.3 billion in 2010 before the reform. The roughly EUR 17 billion difference as compared to the EUR 15 billion deficit stated in the 2011 PLFSS stems primarily from the fact that the COR balance factors in the implicit employer contributions of the central government (EUR 15.6 billion in 2010), which ensure that the central government civil service pension scheme is in balance.

increased to 23 million in 2050 from 15 million in 2008, and, as a consequence, the number of working-age people per retiree would have declined from 3.5 in 2010 to 2 in 2050. The ratio of pension contributors to pensioners was only 1.8 in 2010 and would have dropped to 1.2 by 2050 (OECD, 2009a; COR, 2010). The additional pension spending that would have resulted was estimated at 0.6 to 1.2% of GDP by the European Commission. The *Conseil d'orientation des retraites* (COR, 2010) evaluates the pre-reform funding requirements of the pension system in 2050 at 1.7 to 3% of GDP, depending on whether the recent crisis will have a temporary or lasting effect on potential output and unemployment. This would suggest that, if left untreated, the cumulative funding requirements of the pension system in 2050 would have amounted to roughly 100 percentage points of GDP by 2050 (COR, 2010).

... but additional measures will be needed in the longer term

According to official projections, the reform set out above will re-balance the pension system by 2018. Nevertheless, there is a risk regarding maintaining the PAYG system on a sustainable path beyond 2018, or even earlier if the projections before 2018 turn out to be too optimistic,¹⁹ which could require additional long-term efforts. However, this has resulted in a decree accompanying the pension reform that calls for discussions to start in 2013 about the conditions under which a universal pension system based on a point system or with individual notional accounts could be put in place.

Germany, Italy and Sweden now have pension systems based on notional accounts or point systems.²⁰ In these systems, each person's pension contributions are reflected in accumulated points or units of account in the pension account balance, on the basis of which pension payments are calculated in an actuarially neutral way using a conversion coefficient, which accounts for life expectancy at the time of retirement, demographic projections and projected receipts and outlays of the pension system. The conversion coefficient is set in a way to balance, in a permanent scheme, outlays with receipts. In such a system, future pensioners can choose their own retirement age freely: either they retire at a young age with a low pension or they enjoy a higher pension after a longer working life.²¹ The simplification of the currently highly complex structure of the French pension system (with 38 compulsory schemes and numerous supplemental schemes with their different eligibility conditions and replacement rates) is a prerequisite to a shift towards a self-balancing system with points or notional accounts. Transparency would make reform easier because everyone would be able to see the individual impact of any reform, while now everybody thinks they lose more than most from any reform. Employees who change sectors and are covered by different regimes over their careers would gain from enhanced transparency with regard to their future pension payouts. Care should be taken, however, to ensure that a reform aiming to improve equity between pensioners not delay progress towards restoring financial balance to the pension system as a whole.

19. The 2010 reform called for creation of a Steering Committee (*Comité de pilotage*, Copilor) to assess annually “the financial position of pension schemes, conditions for restoring balance to the pension system by 2018 and the financial outlook beyond that date”.

20. In the German pension system, future pensioners accumulate pension points, while in Italy and Sweden, which implemented pension reforms in 1995 and 1998, respectively, future pension payments are determined as functions of pension wealth accumulated on notional pension accounts and life expectancy.

21. What really matters for future pensions is the pension contributions accumulated over one's career, rather than the age of retirement. Furthermore, the notion of a full pension loses its meaning.

Lowering budget deficits by raising revenues

Eliminating distortions in the tax base

In France, recurrent taxes on property accounted for 2% of GDP and 5% of tax revenue in 2008, which is higher than in many European countries but less than what has been observed in other OECD countries such as the United States, the United Kingdom and Japan (Figure 2.9). This suggests some potential to raise taxes on property, which are widely acknowledged as the least distorting of major taxes. Doubling the share of those taxes in total government revenues, to reach levels observed for Japan and the United States, would yield extra receipts of around EUR 40 billion. The extra revenues generated by greater taxation of immovable property (widening the base or raising the rates of recurrent taxes on immovable property and inheritance taxes) could be used to reduce the taxes that are the most distortionary and least conducive to economic growth, including transactions taxes (such as transfer duties), which, by limiting transactions, hamper geographical mobility. At the same time, rateable values, which were last updated in 1970, should be aligned on market values and updated regularly in the future. The tax breaks arising from owner-occupancy should be scrapped (OECD, 2011a, Chapter 3).

Raising inheritance and gift taxes, not only on immovable property but on all net assets, could offer an alternative to the taxation of lifelong saving and can be considered a way of taxing, for example, income or capital gains that were tax-exempt during a person's lifetime. Such taxes have the advantage of generating less distortion than annual wealth taxes, because inheritance is less planned. Insofar as gifts can be used to escape inheritance tax, the taxation of gifts should be brought more closely in line with that of inheritance so as to limit possibilities for tax avoidance (Owens and Brys, 2011).

Broadening consumption taxes would also improve the tax structure. The effective tax rates on labour and capital (calculated as receipts over the base) in France are each among the highest in OECD countries (Figure 2.10, Panel A), while consumption is taxed (including VAT and excise tax) at or below the European average (arithmetic or weighted by the GDP of each country, which is 22% and 19.7% respectively). In relative terms, this implies that, as in Italy and Spain, the tax burden on capital and labour is twice as high as on consumption (Figure 2.10, Panel B).

Figure 2.9. The share of immovable property-related taxes in total fiscal revenues, 2008¹

1. 2007 for Australia, Greece, the Netherlands and Poland.

Source: OECD calculations based on OECD Revenue Statistics 2010.

Figure 2.10. Relative effective tax rates in Europe, 2000-08

Source: OECD calculations based on Eurostat data.

The effective rate of VAT, computed as the ratio of VAT revenues to net private consumption, which was roughly 14% in 2008, is well below the standard statutory rate of 19.6% but falls within the European average, at the same level as Germany and ahead of Spain, Italy and the United Kingdom (Figure 2.11, Panel A). The difference between the statutory and effective rates stems in part from the fact that not all private consumption is subject to VAT. Excluding services not subject to VAT, such as notional rent (owner-occupiers), financial intermediation, domestic services and non-market educational, health-care and social welfare services, which in 2008 accounted for between 14 and 16% of private consumption, the effective VAT rate increases from 14% to almost 17%. The residual difference between the statutory rate of 19.6% and the effective rate of 17% is due to the widespread use of reduced rates. The reduced rates on essential goods and services are sometimes justified on equity grounds, because low-income households' consumption falls to a larger extent on these items. Yet the effectiveness of reduced rates is debatable, because they are not often well targeted at the needy. Means-tested lump-sum payments or targeted transfers may reduce inequality at a lower cost (Koske, 2010). Reduced rates are also used to support employment in specific sectors such as hotels, restaurants or home repair work (in addition to other measures, such as reduced social contributions) or to cut back on undocumented labour. But in doing so, this generates distortions in the allocation of labour.

Figure 2.11. The effective VAT rate and the VAT revenue ratio, 1990-2008

Source: OECD calculations based on OECD Revenue statistics.

Replacing the reduced VAT rates by the standard rate would mechanically increase government receipts by roughly EUR 30 billion²² (all things being equal). An additional increase of one percentage point in the VAT rate would generate roughly EUR 9 billion in revenues, implying that raising the rate from 19.6% to 25% would result in additional revenues of about EUR 50 billion.²³ Thus, the revenue potential due to higher VAT rates is huge: even if a leakage of 50% is assumed,²⁴ roughly EUR 40 billion, representing 2% of GDP, could be raised in this way. This sum could be used to reduce the budget deficit or, in the spirit of the so-called “social VAT”, to improve the tax structure by reducing levies on labour and capital in a revenue-neutral way, even if accompanied by compensation for the regressive effects induced by a VAT rate increase.

In 2010, the French government cancelled the local business tax (*taxe professionnelle*) levied on firms and replaced it by a new tax, the *contribution économique territoriale*. The old tax base had rested on the rateable value of assets used by firms and subject to property tax (17%), their turnover (3%) and their capital stock (80%). The new tax is composed of two elements: *i*) a tax levied on the rateable value of assets used by firms and subject to property tax (the property levy on firms), and *ii*) a progressive tax on firms’ value added. In addition, a flat tax on network industries was introduced. The reform cut the overall tax burden of firms by 0.5% of GDP in 2010 and by 0.3% thereafter. This welcome measure is an important step towards rebalancing the tax structure to promote capital investment and activity (more property taxation and lower taxes on labour and capital).

22. This figure is obtained by multiplying OECD-projected private consumption for 2011 (EUR 1 171 billion), adjusted by VAT revenue and exempt services, by the difference between the statutory and effective rates.

23. Roughly EUR 10 billion in additional revenue is obtained for each 1-point rise in the VAT rate on the basis of OECD-projected private consumption for 2011, adjusted for exempt services and assuming total elimination of reduced rates. Thus an increase in the statutory rate from 19.6 to 25% would yield EUR 54 billion in additional revenue.

24. The 50% leakage rate factors in the aggregate tax revenue loss due to the contractionary impact of higher taxes. Adding to this effect is the increased risk of VAT fraud at higher rates.

The scope for increasing environmental taxes

In France, revenues from environmental taxes accounted for 2.2% of GDP in 2007, one of the lowest in Europe: only Belgium, Greece and Spain levied less environment-related tax as a percentage of GDP. Moreover, those revenues had fallen sharply between 1995 and 2007. This can be partly explained by the decline in energy-related tax revenues due to a major shift from petrol to diesel cars. The ensuing shift in consumption from highly taxed petrol to diesel that is taxed less than petrol is reflected in lower revenues (Callonnec, 2009).

As argued in OECD (2011a, Chapter 4), in France, negative local and global externalities are not fully incorporated in the prices of goods and services, the production and consumption of which inflict damage on the environment. Much could be done to equalise taxes on energy products and to tackle the sources of atmospheric and water pollution. At the same time, additional revenues from environmental taxes could contribute to the reduction of the budget deficit and/or the tax burden on labour and capital. As a matter of fact, the potential for levying higher environmental taxes is substantial: raising the share from 2.2% in 2007 to around 6%, as is the case in Denmark, would yield extra budgetary receipts of some EUR 70 billion, all things being equal. Even assuming a leakage of, say, 30% due to reduced consumption of environmentally harmful goods and services (quantity effect), counter-balancing the price effect, such a hike in the volume of these taxes would still result in revenue gains of around EUR 50 billion.

A large potential for reducing tax expenditures

Tax expenditures, which can take the form of tax allowances, exemptions, rate relief (reduced rates), deferrals and credits, play an important role in the French tax system. According to the 2011 budget bill, there are 504 tax expenditures, versus some 400 between 2000 and 2004, despite the government's withdrawal, between 1997 and 2010, of some 140 provisions from the official list of tax expenditures (Cour des comptes, 2010a). This is very high in an international comparison. As shown in the left-hand panel of Figure 2.12, Germany and the Netherlands had only a handful of such provisions (if such a comparison can be taken at face value). Across OECD countries the majority of tax expenditures generally concern income tax, though France is an exception. In terms of magnitude, the revenue cost of tax expenditures is estimated to be as high as 12% of GDP in the United Kingdom, whereas it barely accounted for 1% of GDP in Germany (Figure 2.12, Panel A). For France, government estimates suggest foregone revenue of 3.4% of GDP in 2008. In contrast to other countries, tax expenditures in France are less concentrated: the ten largest items account for only 40% of total tax expenditures.

According to a recent report of the Court of Audit (Cour des Comptes, 2010a), which is based on a broader definition of tax expenditure than the one currently used by the government, the "revenue shortfall" is twice as great. If the tax expenditures in the social security budget are added in, the overall figure comes to some 10% of GDP.²⁵ Moreover, this figure itself takes no account of the interaction between the basis for calculating taxes and social contributions, nor of the tax expenditures granted by sub-national governments. Germany and Japan are examples of countries that have tried to quantify the scope of local government tax expenditures (Cour des comptes, 2010b; CPO, 2010).

25. Another Court of Audit report (Cour des comptes, 2010b) estimates the amount of tax expenditures on social contributions at some EUR 67 billion for 2009, considerably higher than the estimate given by the government in the annex to the social security funding bill (EUR 41.1 billion) because of perimeter differences (the PLFSS annex is limited to tax expenditures relating to private-sector activity and disregards tax breaks offset by central government transfers).

Figure 2.12. Tax expenditures in selected OECD countries and in France¹

Note: The second chart is based on data from the Court of Audit, which uses a wider definition of tax expenditures for the central government budget.

1. 2008 for France, Spain and the United States; 2006-07 for the Great Britain; 2006 for Germany, Korea and the Netherlands; 2004 for Canada. The figures cannot be fully compared across countries due to cross-country differences in the definition of tax expenditures.
2. FRA1 refers to the French government's estimate in *Projet de loi de finances pour 2010 (Évaluation des voies et moyens, dépenses fiscales, tome no. 2)*; FRA2 is based on the estimate of the Court of Audit on tax and quasi-tax expenditures for central government and social security.

Source: OECD (2010), Tax expenditures in OECD countries; Cour des Comptes (2010), Rapport sur la situation et les perspectives des finances publiques.

The difference between the figures put forward by the government and the Court of Audit stems primarily from differing definitions of tax expenditures. The government excludes structural relief measures, which are considered technical aspects of tax calculation. Moreover, tax reliefs intended as incentives (such as the tax shield, which deploys a general principle of tax limitation), capital-gains exemptions and application of an international commitment (such as the tax exemption for aircraft fuel) are not classified as tax expenditures. The same holds true for measures having general scope and arising directly from a tax-redistribution approach (such as the tax brackets and the family tax-splitting quotient or certain reduced VAT rates intended to provide universal access to certain basic necessities such as food, medicine or books). In contrast, for the Court of Audit, "tax expenditures are [measures] derogating from a tax norm [...], the application of which results in a loss of public revenue, *i.e.* a tax cut for the beneficiaries" (Cour des comptes, 2010a). While the government's estimates seem too low, given the narrowness of the definition it has adopted, those of the Court of Audit are probably too high insofar as the net cost of the measures may be lower than their gross cost, which is computed mechanically, especially for extremely mobile tax bases and when tax expenditures lead to additional budget revenue elsewhere. Thus the actual magnitude of the revenue shortfall lies probably somewhere between these two estimates.

Figure 2.12 (Panel B) shows that tax expenditures for central government increased by more than two percentage points of GDP from 2004 to 2010, probably related to the strict spending norm of zero real growth introduced in 2005 (Cour des Comptes, 2010). Recognising the ramping up of tax expenditures, the government sought to contain their evolution in the budget framework law 2009-12 through three measures: *i*) introducing a guarantee that the costs of new or extended tax expenditures be offset by changes in other tax expenditures; *ii*) limiting the duration of new and extended tax expenditures to four years; and *iii*) setting annual goals for changes in the costs of tax expenditures (CPO, 2010). For the Court of Audit (Cour des comptes, 2010a, 2010b and 2010c), the guarantee to offset new measures was not respected by the government even in 2009, given that the compensation from the costs arising from the new measures were spread over a multi-year period rather than focused on the year when the extra costs were incurred. Even if the government interprets the guarantee rule over the entire lifetime of new tax

expenditures, the fact that they are not offset immediately contributes inevitably to the worsening of the budget deficit in the short term. The budget framework law 2011-14 did not renew the two first measures, partly because it set explicit net revenue targets for savings on tax expenditures for 2011-14. However, an important problem is that the budget framework law has the same legal status as the budget law and the social security budget law and does not apply to the other budget-related laws.

Even if it is difficult to quantify precisely the shortfall for general government, tax expenditures could be reduced substantially. The many changes in and the high number of tax expenditures induce instability and render the tax system very complex. Fully understanding and exploiting the benefits of the system requires extensive expertise and resources. Hence, small enterprises and less well-off households may be handicapped *vis-à-vis* large firms and high-income households. Beyond the inequality induced by complexity and the fact that high-income taxpayers are more likely to benefit, multiple objectives assigned to some tax expenditures may contradict one another (OECD, 2010b). A case in point is, for instance, the reduced VAT rate for fertilisers, which is in contradiction with the goal to reduce fertiliser-induced environmental pollution. Moreover, the effectiveness of a number of measures in achieving the policy objectives is questionable in many cases. For example, encouraging overtime work through tax incentives does not seem to have yielded a significant increase in the number of hours worked and may have prompted fraudulent reporting in order to exploit the measure's benefits (Cahuc and Carcillo, 2010). In addition, green growth-related tax expenditures probably induce abatement costs for CO₂ emissions that are far higher than the price of carbon proposed by the Quinet report (see OECD, 2011a, Chapter 4). Furthermore, while the R&D tax credit is a good measure in theory, its rising cost to public finances due to its 2008 extension warrants a thorough evaluation of its effectiveness.

But even if the policy objectives are achieved, they can cause distortions in the economy, as illustrated by the following example. A recent Senate report (Sénat, 2010b) concludes that reducing VAT rates for specific sectors (hotels, restaurants, renovation works and personal aid services) achieved the objectives of lowering prices, increasing turnover and creating new low-skilled jobs. However, this measure creates distortions in consumption and investment behaviour. It would be preferable to achieve these objectives through measures that are neutral to the whole economy (*e.g.* via an additional general decrease in social levies targeting low salaries). In order to scale back inefficient tax expenditures or those that create the most distortion, items No. 1, 2, 4, 6, 13 and 16 from the budget bill and No. 2 and 8 from the social security budget bill in Table 2.6, amounting to an annual total of EUR 20 billion, are candidates for abolition or at least a thorough reconsideration.

Eliminating costly and inefficient tax expenditures would help increase government revenues. The government has committed to a EUR 11 billion cut in tax expenditures for 2011 and annual cuts of EUR 3 billion for 2012-14. It will prepare a thorough evaluation of tax expenditures annexed to the budget bill by mid-2011. This should be translated into more reductions.

The information provided by the government on tax expenditures has improved considerably since 2003 when an organic law first required detailed information annexed to the budget bill. Currently, the government produces total cost estimates for tax expenditures and indicates the reliability of the estimates for individual tax expenditures. Tax expenditures are classified in accordance with spending programmes, the type of tax and the type of taxpayer. The annex gives details on new, extended, cancelled and reduced tax expenditures compared to the previous year's budget and on those withdrawn since 2007 that still bear costs for the budget. Since 2008, the government has also quantified tax expenditures on social contributions in an annex to the social security budget bill (CPO, 2010).

Table 2.6. The largest 'official' tax expenditures cited in the budget bill and the social security budget bill for 2011

	Budget Bill	EUR billion	Social Security Budget Bill	EUR billion
1	Reduced VAT rate for repair works in housing	5.05	Reduction in employers' social contributions	21.18
2	Reduced VAT rate for restaurants	3.13	Exemption of overtime work	3.23
3	Employment allowance for low-income taxpayers in work (<i>prime pour l'emploi</i>)	2.98	Firms and independent entrepreneurs in overseas departments	1.07
4	10% rebate on pensions	2.70	Exemption on apprenticeship contracts	0.95
5	Tax credit for R&D	2.10	Exemption for home help for and paid by fragile persons	0.86
6	Tax credit for equipment for renewable energy in primary residence	1.95	Employment assistance contract	0.78
7	Tax credit on interest payments related to housing loans for the principal residence ¹	1.90	Exemption for home help for fragile persons paid by an association or firm	0.76
8	Tax credit on home work (cleaning, babysitting) for professionally active and unemployed persons	1.75	Exemption for seasonal workers in agriculture	0.41
9	Tax exoneration for personal aid	1.60	Exemption for unemployed persons starting or taking over a firm	0.33
10	Income-splitting half-share (<i>demi part de quotient</i>) for single parents	1.44	Exemption for self-employed persons	0.25
11	Exemption on profits, profit-sharing and revenue on company-aided savings received by employees	1.40	Exemption for job creation in "zones franches urbaines"	0.19
12	Exemption for elderly, handicapped or low-income persons	1.38		
13	Tax exemption for overtime work	1.36		
14	Tax reduction for employment at home	1.30		
15	Reduced VAT rate on refundable drugs	1.17		
16	Reduced excise tax on heating oil used as fuel	1.10		
17	Extra reduced VAT rates for overseas departments	1.09		

1. This provision was rescinded in the initial 2011 budget bill.

Source: Projet de loi de finances 2011 et Projet de loi de financement de la sécurité sociale 2011.

Yet, further progress is needed to have a clear view on the extent of tax expenditures, including those on social contributions, and their ability to meet policy objectives. First, the gross and net costs generated by tax expenditures should be quantified, and not only for central government and social security, but for local governments as well. Second, a concomitant and long-term guarantee for revenue offsets should be implemented when introducing new or extending existing tax expenditures to ensure that spending rules cannot be circumvented. Finally, a systematic and regular *ex ante* and *ex post* assessment of the effectiveness of existing and new tax expenditures needs to be undertaken by an independent body of experts, and the results should be translated into concrete policy action. More specifically, measures that do not bring the intended goals or do so at a high cost compared to alternative policy instruments, should be abolished. It is in this spirit that *ex ante* evaluation of any new tax provisions, by means of impact studies to be submitted systematically to parliament, is recommended. With regard to *ex post* evaluation, Article 12 of the budget framework law of 9 February 2009 stipulates that a report evaluating all tax expenditures be submitted to parliament by 30 June 2011.

Box 2.1. Recommendations to improve the sustainability of the public finances

Fiscal framework

- Create a stable general fiscal rule to strengthen the existing fiscal framework. Define the new fiscal rule in terms of a structural deficit for general government which could take the form of expenditure ceilings and revenue floors. The calculation of the structural deficit should be transparent and harmonised at the European level.
- Introduce a multi-annual fiscal framework along the lines of the budget framework law for 2011-14, but more detailed, that is consistent with and implements the rule, and a constitutional requirement that the government adhere to the framework.
- Create an independent fiscal council that would assess the macroeconomic projections used in the budgeting process, evaluate the multi-year fiscal framework's compatibility with the fiscal rule, identify loopholes that might be used to circumvent spending rules and monitor slippages during execution.

Public-sector efficiency

- Facilitate *ex post* evaluations of budgetary programmes in accordance with the LOLF by defining a narrow set of performance indicators that do not change over time. Budgetary execution and supervision should be linked explicitly to these performance indicators.
- Extend the coverage of the RGPP to social benefits and investment programmes and to social security and local governments as well. Use the RGPP to reconsider public policies that are not efficient or useful. Make the RGPP and LOLF more mutually consistent.
- Seek economies of scale in local governments by merging municipalities and by reducing the three levels of sub-national government to two. Increase regional and functional mobility of civil servants to reap the benefits of decentralisation.
- Increase incentives for local governments to reduce spending. Granting more fiscal autonomy would make them more responsible and accountable for their spending programmes. Introduce an incentive element into central government grants by setting efficiency targets for local governments and rewarding those outperforming the target.
- Lower the retrocession of gains from partial replacement of retiring staff in central government.
- Cut administrative costs in social security by simplifying the complex web of health insurance and pension funds.

Health care

- Decrease the threshold for ONDAM's early warning and shorten the lag necessary to correct slippages during execution.
- Continue policies aimed at shortening hospital stays. Raise user costs for medical care deemed non-essential by the French health authorities. Facilitate wider use of capitation payments for doctors.
- Continue efforts to shift drug consumption towards (cheaper) generic drugs.

Public pension system

- Link effectively the contribution period to changes in life expectancy in a continuous and automatic way.
- Reduce the complexity of the pension system by harmonising the multitude of retirement schemes.
- Continue eliminating all forms of early retirement, including those using the unemployment benefit system.
- Start considering the introduction of a notional accounts or point-based pension system, in which adjustment can be smooth and offset emerging deficits.

Tax structure

- Broaden the tax base by reducing tax expenditures. Introduce a long-term pay-as-you-go guarantee for revenue offsets when introducing new or extending existing tax expenditures. Assess the effectiveness of new and existing tax expenditures, including social security, *ex ante* and *ex post* on a systematic and regular basis. Expand the scope of the evaluation of revenue losses to tax expenditures granted by local governments.
- Lower the distortion for taxes on labour and capital by increasing consumption taxes, through narrowing the applicability of reduced VAT rates and raising the standard VAT while taking care to neutralise the regressive effects of such a shift. Increase property taxes and put more emphasis on environmental taxes that fully internalise global and local externalities.

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