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OECD Economic Surveys: France

Chapter 2

Making the fiscal system sustainable and more efficient

Over the past two decades public debt as a percentage of GDP has risen almost without pause, and the shares of public expenditure and revenues in GDP remain among the highest in OECD countries. Control of expenditure has been particularly difficult in the social and health insurance sector. The tax and social security contribution systems are rather complex creating high administrative costs and a number of distortions to incentives. This chapter recommends: i) *continuing efforts to control health and other expenditures, and reviewing the way in which some expenditure responsibilities and associated financial resources are decentralised;* ii) *simplifying the structure of personal income and other taxes;* iii) *consideration of a closer link between collection and calculation of personal income tax and collection of social security and CSG contributions;* iv) *the continuation of efforts to remove distortions in a number of areas, from high marginal tax rates on low incomes to the favouring of different sources of finance in capital taxation.*

Achieving fiscal sustainability

While reform of public expenditure management and of the structure of taxation is needed in order to improve economic efficiency, these issues have to be seen against the background of one of the main challenges for French fiscal policy, which is to halt and reverse the upward trend of public debt as a share of GDP. This needs to be done now in order to make room for the pressures stemming from the ageing of the population without jeopardising long-term sustainability.

It should be recalled that the roots of current fiscal problems were laid in the past. Indeed, over the past two decades general government budgets and also cyclically-adjusted budgets always remained in deficit. Significant consolidation efforts were made, however, after the mid-1990s which reduced the cyclically-adjusted deficit from around 5% between 1993 and 1995 to 1.5% in 1999. But this policy was abandoned in 2000 – despite the strengthening of the economy – and the cyclically-adjusted deficit increased to around 2% in 2000-01 and, after a further policy easing in 2002, to above 3% in 2002-03, according to OECD estimates. During this period of economic weakening cyclical effects added to the structural deficit so that the total deficit increased to over 4% of GDP in 2003. In 2004 the government started new consolidation efforts although the fiscal improvement remained moderate with the cyclically-adjusted deficit falling by only ¼ of a percentage point to 3% and the total deficit by 0.5 percentage point to 3.6%.

The main measure of the new consolidation strategy is holding real spending in the central government (State) budget constant over the medium-term, as it has been since 2002. With spending on health insurance rising on average by 2.1% and of local authorities by 1.8%, real general government spending is expected by the government to increase by 1.2% over the medium term. Assuming a growth rate of 2.5%, the government's stability programme projects that total public spending will then fall as a share of GDP from 54% in 2004 to 51.7% in 2008. Assuming also a more or less constant revenue share the deficit would then fall accordingly, to 0.9% in 2008 and the cyclically-adjusted deficit will be reduced every year by 0.5 percentage point to below 1% in 2008. Even with these projections, the ratio of debt to GDP, though declining, would remain over 60% in 2008.

However, there are some uncertainties about the stability programme projection. With more moderate assumptions about economic growth and – especially – the strictness of the spending constraint, the OECD Secretariat expects the deficit to decline less rapidly, remaining nearly 1 percentage point higher in the medium term than projected by the government. Both the government projections and the estimate by the OECD assume no major tax cuts in the near future although the political pressure for such cuts could rise with the presidential election in 2007.

It is difficult to assess the likelihood of future fiscal slippages. In the past, deficit overruns were the rule rather than the exception but this cannot simply be extrapolated into the future. Indeed, in 2004 the deficit outcome was close to the budget plan; spending

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increased faster than anticipated, but so did tax revenues, in particular from the corporate tax and the value added tax, preventing fiscal slippage. But fiscal consolidation can not depend on economic developments, it needs a firm government commitment. For example, the habit of treating revenue overruns as a jackpot (*cagnotte*) to be spent immediately, rather than to be taken into account in planning for the following year's budgetary planning, has led both to a tendency to miss targets for structural or cyclically adjusted fiscal deficits and to spending on one-off items not integrated into long-term planning. Under a new provision in the LOLF, however, the government is now required to say in advance what use it will make of any tax revenues overruns in relation to the finance bill. Implementing structural reforms in labour and product markets as suggested in the other chapters would enhance growth and employment and – together with strict spending controls – would make it more likely for the government to meet its fiscal target.

The structural fiscal deficit is relatively high and the relatively weak economy is posing additional stress on government budgets. Furthermore, future spending pressures on pensions and health costs are looming with population ageing raising the risk of ongoing fiscal imbalances and excessive burdens on future generations. Closing fiscal imbalances by raising taxes would be problematic as taxes are already relatively high and appear to have adverse effects on growth potential and employment. If anything, tax distortions should be reduced to make the economy more dynamic (see below). Reducing both fiscal imbalances and tax distortions requires very tight spending controls over the medium and longer-term and substantial structural reforms.

The government has taken various measures to limit spending. However, while spending appears to be better controlled at the central budgetary level, this is less the case for local authorities. Some of them complain that their higher spending is caused by a shift of spending obligations, under the heading of decentralisation, from central government budget onto their budgets, even though part of their higher spending is financed by the central government through transfers which, according to the authorities, have for some years complied with the principle, of constitutional import, which establishes an obligation of strict financial compensation. These transfers are partly recorded as a decrease in central governments receipts (in the case where the central government bears the costs of tax relief measures of other government levels) and are therefore not affected by the central government spending constraints. In order to improve spending controls it would therefore be better either to record all government transfers to other levels of government as spending, or to extend spending constraints to other government levels *e.g.,* through a national stability pact. In addition, the target for the structural fiscal balance should exclude one-off measures.

The share of public employment in total employment is high in France, reaching 22.8% in 2004, more than the average of OECD countries (14.4%) and efforts from the government to control this source of spending have been very limited up to now. The share of public employment kept growing until 1997. It decreased until 2001 as a result of strong economic growth that was favourable to private employment but has since stabilised. The upward trend of public employment since 1980 mainly comes from the increasing role of local administrations with the "decentralisation" process, while the share of public employment in social security has remained stable and that in central government has decreased. Since 2000, employment has been constant in the central government but has grown strongly in local governments and social security. Although it can be considered that the increase in employment in local governments was unavoidable because of the "decentralisation" process, it should have come in line with a corresponding decrease in employment in the central government, which has not been the case up to now. The increase in employment in social security mainly comes from the hospital sector and is thus difficult to avoid given the ageing of the population and changes in health practices. As a result, the government needs to concentrate its efforts on reducing employment in the central government, which still represents 50% of public employment. Efforts in this direction have been very weak up to now. The rule set by the government is the non-replacement of one civil servant getting retired upon two, but in practice, the rule is far from being followed. The budget law for 2005 foresees that most retirees will be replaced, which represents 7 188 job losses (out of a total of more than 2 million jobs in the central government).

The ageing of the population poses a continuing risk for fiscal sustainability. While France has a higher fertility rate than neighbouring countries, over the coming years the baby boomers who were born after World War II will retire; with an effective male retirement age of 59, which is among the lowest, and life expectancy at retirement among the highest in the OECD, the ratio between inactive and active persons will increase rapidly. Earlier work by the OECD has shown that in France the ageing of the population is likely to increase the combined expected funding shortfalls of the pension and healthcare systems by between 6.5 and 9% of GDP over the coming decades (before taking into account the pension reform and sickness insurance reforms adopted in 2003 and 2004). As deficits accumulate, so will interest payments, reinforcing the shortfall (see *OECD Economic Survey of France*, 2003 p. 43). It is obvious that policy makers had to take action to prevent such an outcome. Indeed, in 1993 and again in 2003 the government implemented major pension reforms and it is currently engaged in reforming the health care system. These reforms have the potential to significantly reduce the fiscal burden stemming from ageing populations but unless there is a significant increase in the employment rate, it is doubtful whether they will be sufficient.

Reforming pension systems

Since the 1990s France has implemented various reforms to ease the pressure of ageing on its public Pay-As-You-Go (PAYGO) pension system (see Table 2.1). Strong public opposition to reform has prevented steps being taken as quickly as would have been desirable from a long-term point of view. The first major step was the 1993 reform (*Réforme Balladur*) which affected, however, only pension systems of private employees while public sector pension schemes remained more generous. The reform reduced newly assessed pension benefits by changing their calculation and their indexation. The level of pensions was calculated on the basis of wages over the average of 25 years with the highest pay instead of 10 years as previously, while the minimum period of contribution required for receiving the full pension at age 60 was lengthened from 37½ to 40 years. Furthermore, pensions were indexed to prices instead of wages (which had been the case *de facto* since 1987). As a result the total net replacement rate (benefits as per cent of the last net wage) is expected to decline, for an average worker in the private sector with a full work career and who also receives a (compulsory) complementary pension from AGIRC or ARRCO schemes, from 84% in 2000 to 71% in 2020 and 67% in 2040. It was, however, explicitly mentioned that the government could take additional measures to raise benefits, for example in periods of strong economic growth.

In 2001 (based on the social security financing law of 1999) a pension reserve fund (*Fonds de Réserve pour les Retraites*) was created. The aim was not to set-up a fully-funded

Table 2.1. **Main changes in the French pension system introduced in 1993 and 2003 by scheme**

	General scheme (wage and salary earners in the private sector)			Public sector	
	Before the 1993 reform	Changes introduced by the 1993 reform	Changes introduced by the 2003 reform	Before the 2003 reform	Changes introduced by the 2003 reform
First age at which retirement is possible	60 since 1983	No change	56 in case of long career (55 if disabled) from 2004	55 or 60 according to categories	56 in case of long career after 2008
Mandatory age of retirement	60	60	65 except derogation	65 (55 or 60 in strenuous work)	No change
			65 except for derogation by agreement within a given profession		
Age or duration conditions for retirement at full rate	60 and 37.5 years of contribution or 65 without condition on contribution period	Duration condition raised progressively to 40 years in 2003	Contribution period increased by 2 quarters by year from 2008 to reach 41 years in 2012 and about 42 years in 2020[1]	55 or 60 years and 37.5 years of contribution	Contribution period increased by 2 quarters by year from 2004 to reach 40 years in 2008, 41 years in 2012 and about 42 years in 2020[1]
Pension level at full rate	50% of the average of wages over the 10 best years of ones' career (social security ceiling)	Idem but the average over the best years raising progressively to reach 25 years in 2008	No change	75% of the last monthly wage during the 6 last months	No change
Reduction for retirement before reaching the full rate	Prorating effect plus a reduction of 10% per missing year (5 years maximum)	No change	Prorating effect plus a reduction after 2004 to reach progressively 5% in 2014 per missing year (5 years maximum)	Prorating	Prorating effect and introduction in 2006 of a reduction that will reach 5% per missing year in 2020 (5 years maximum)
Increase for retirement after reaching the full rate	None	No change	3% from 2004 for each additional year of contribution	None	3% from 2004 for each additional year of contribution
Indexation	Price	Price	No change	Wages	Price

1. Linked to changes in life expectancy at age 60.

pension system but to create a reserve using social security surpluses and other ad hoc resources until 2020 so as to reduce the need to raise pension contribution rates or reduce the level of pensions between 2020 and 2040. However, the pension reserve fund, is included in the calculation of the public sector balance; furthermore, some revenues scheduled for this fund (from privatisation and surpluses of other funds) have not materialised. Other measures were taken to encourage personal savings, particularly by employees, with the help of tax exemptions. However, so far, savings in private pension funds have remained low, though they have been rising due to concerns over the decreasing level of state pension provisions.

Another major step was the 2003 reform (*Réforme Fillon*). This reform addressed two main issues, first the substantial inequalities between private and public pension systems and second, the large disincentives in the pension system for working longer. Inequality between the pension systems was reduced by basically extending the measures taken in 1993 for systems covering the private sector to public sector pensions. There remain, however, a number of exceptions as some public sector schemes continue to be more generous, such as those for employees of the national railroads, the electric and gas company (EDF-GDF) and Parisian public transport.

Concerning incentives to extend working lives the formula for calculating the pension was changed in two ways. First, the minimum contribution period for receiving a full pension period will be increased between 2009 and 2012 from 40 years by one quarter per year reaching 41 years by 2012. Thereafter, the minimum contribution period will rise further as needed to keep its ratio to the average payout (retirement) period constant, which implies de facto indexation of the minimum contribution period on average life expectancy. It is expected that this will increase the contribution period to 41.75 years by 2020, if the trend increase in life expectancy continues as at present. This measure will provide an incentive to continue working until the minimum contribution period has been reached as retiring earlier reduces the benefit replacement rate. The second measure to increase incentives to work longer was the introduction of benefit accruals for workers who continued working after the statutory age of 60 and beyond the contribution period required to obtain a full pension. Before the reform the replacement rate remained constant for these workers although they continued paying contributions, so that they lost net pension wealth by continuing to work. The reform introduced a 3% benefit accrual for each additional year of work beyond the statutory retirement age of 60 and the required contribution period.

At the same time, however, for those who retire before the minimum contribution period the rate by which benefits are cut has been harmonised between the main systems already reformed in 1993; it will be lowered from 10% for each missing year to 5% (to be progressively reached by 2013); an identical benefit reduction rate is soon to be introduced for public sector employees. While this measure facilitates earlier retirement it does bring the system closer to actuarial neutrality. Furthermore the 2003 reform also enables people who began working at a young age (between the age of 14 and 16) and who had worked for 40 years, to retire at age 56. Civil servants are also to benefit from this measure as of 2005. These measures will increase early retirement in the short-term and it is expected that between 2004 and 2008 this measure will enable about 500 000 persons to retire before the age of 60. Another measure of the 2003 reform which made the system more favourable for the low-paid was to raise the minimum pension for workers with a full working career earning the minimum wage, from 81% of the net minimum wage in 2003 to 85% by 2008.

Both the 1993 and the 2003 pension reforms aimed at achieving the solvency of the pension system without major increases in contributions, which are already relatively high. Nevertheless a small increase in the pension contribution rate by 0.2 percentage point (from the current 16.35%) was decided in 2003 to be made effective in 2006. It is expected that the combined effect of the measures will keep the PAYGO system solvent until 2020. According to estimates by the *Conseil d'Orientation des Retraites* the 2003 reform reduced the implicit debt of pension systems from 150% of GDP to about 100% of GDP which corresponds to a permanent reduction of the annual structural deficit of 1% of GDP (according to the authorities, the equivalent lasting reduction in the deficit could reach 1½% of GDP by also taking into account the favourable impact the reform is expected to have on participation rates). In order to keep the system solvent after 2020 it is envisaged to raise the pension contribution rate but at the same time reduce the contribution rate on unemployment insurance so that the total social security contribution rate will remain unchanged. This assumes that by that time unemployment will have declined sufficiently to enable a cut in unemployment insurance contributions.

With these reforms France has made important steps to put the pension system on a sounder footing. Nevertheless some risks remain. The cost of the system remains relatively high, and will increase further after 15 years, unless further measures are taken. The incentive to continue working may have been increased, but the overall effect on participation rates near to the retirement age has yet to be confirmed; the 3% accrual rates may, perhaps, need to be raised. The cost of minimum pensions could rise further too, especially if increases in the minimum wage are not kept down. Finally, there are still alternative pathways into early retirement and the government has to ensure that these are not unwittingly subsidised by other policies such as disability schemes.

Reforming health care

Sharply rising health spending

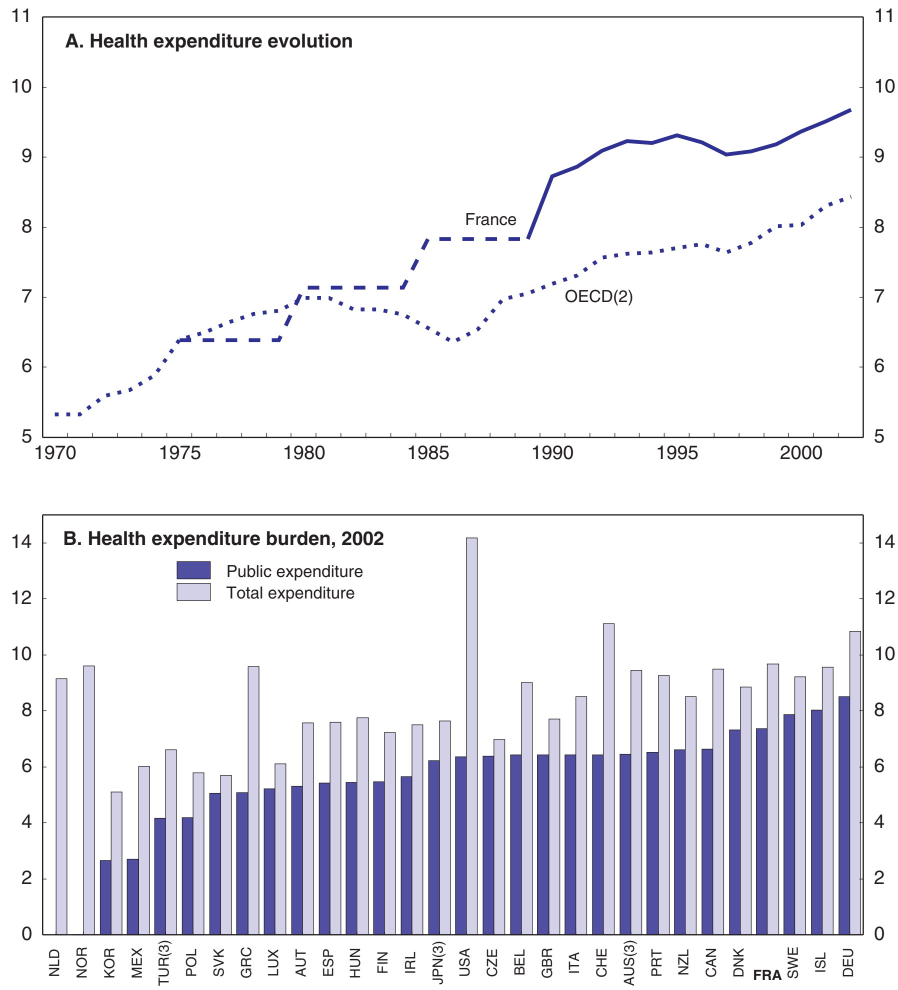
Since 1990, total (public and private) spending on health has been rising at over 4.5% per year on average and accounted in 2002 for 9.7% of potential GDP, more than in many other countries (Figure 2.1). This steep increase has weighed mainly on public expenditure, the share of financing by complementary insurance and by patients being relatively small (Figure 2.2). In 2002, more than 14% of public expenditure was on health. If such spending were to continue rising at its recent pace (7% in 2003), it would account for 10% of GDP in 2010, *i.e.,* 2 points more than in 2003. With the rate of increase in public healthcare spending having slowed somewhat in 2004, the sustainability of public finances depends on this expenditure being kept under lasting control.

Public health spending targets regularly exceeded

In 1996, in an effort to control the rise in public healthcare spending, the authorities introduced a national sickness insurance spending target (ONDAM – *objectif national des dépenses d'assurance maladie*), which restricts expenditure and reimbursements by all of the basic compulsory schemes. Since, however, the ONDAM does not represent a reimbursement ceiling, it is not binding and is therefore regularly exceeded (Figure 2.3).

Figure 2.1. **Health spending**

As a percentage of potential GDP(1)



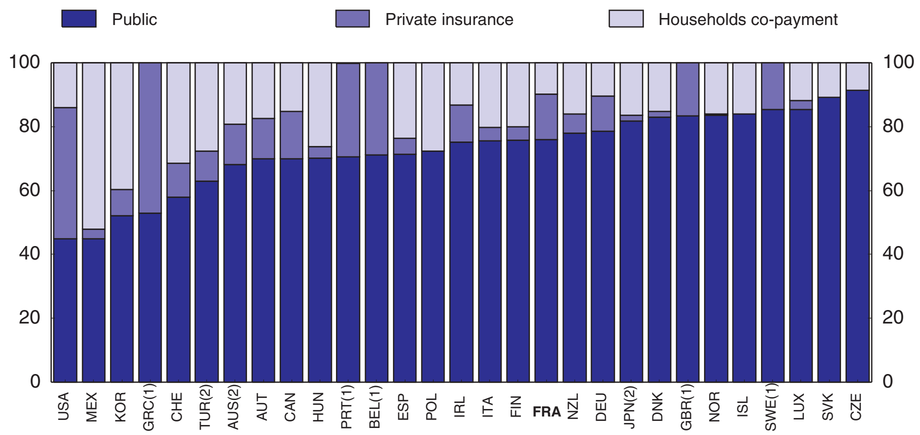
1. As a percentage of GDP for the Czech Republic, Hungary, Korea, Luxembourg, Mexico, Poland, the Slovak Republic and Turkey.
2. Unweighted average.
3. 2000 for Turkey and 2001 for Australia and Japan.

Source: OECD HEALTH DATA 2004, 3rd edition, *Economic Outlook*, No. 76.

The items responsible for ONDAM overspending are numerous. Mainly involved are the fees of certain health professions and spending on drugs. Daily allowances and medical transport have recently been another cause of the steep rise in healthcare spending, although daily allowances have come down since 2003. Lastly, expenditure by healthcare establishments accounted for one-third of overruns in 2003.

Figure 2.2. **Funding of health expenditure, 2002**

As a percentage of total expenditure

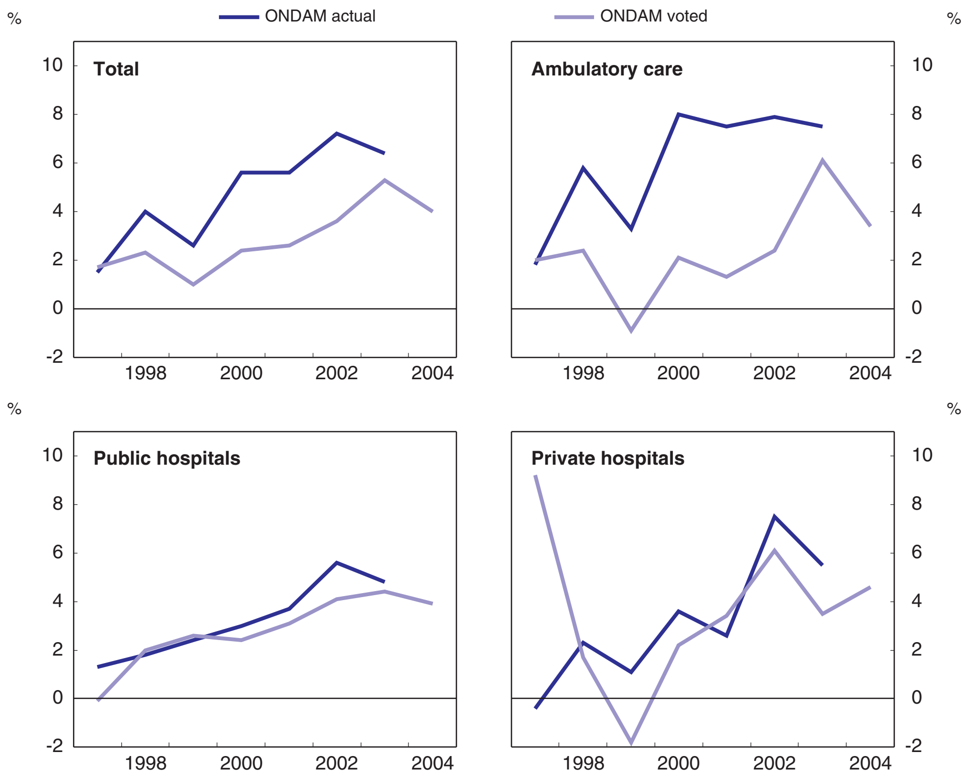


1. No data available on the share payable by households.
2. 2000 for Turkey and 2001 for Australia and Japan.

Source: OECD HEALTH DATA 2004, 3rd edition.

Figure 2.3. **Overruns on sickness insurance spending targets**

Annual growth rate



Source: Reports on ONDAM outturns, CNAM.

Health insurance is going to have to contend with rising expenditure

As in many other OCD countries, healthcare spending in France is increasing and will continue to do so for structural reasons such as demography, population ageing and technical progress. Technical progress in the healthcare field accounts for the bulk of the increase in health spending, especially in hospitals and on drugs, and this factor will continue to play an important role in the future. Existing studies conclude that the demographic impact of ageing, *i.e.*, the conjunction of the increased proportion of elderly people and the fact that health spending goes up with advancing years, is responsible for very little of the past increase in spending on health care (Annex 2.A1). Even so, the demographic effect is going to weigh heavily on health spending in the coming decades. This is because the number of deaths is bound to rise as the generations born immediately after World War II get older. Since health spending is high as death draws nearer, the increase in the number of deaths will prompt a rise in expenditure on health. Changes in practice, especially in terms of ambulatory care for persons well short of their life expectancy, would also play a very important role. So it is important to continue updating the incentives and to rationalise the healthcare system so as to achieve savings and cope with the increased demand.

The sustainability of health spending means controlling healthcare supply and demand

Apart from these characteristics which are shared with other countries, the French system is notable for having a very high reimbursement rate and, as a result, for offering few incentives to reduce healthcare demand:

- private complementary insurance usually reimburses the whole of the patient's contribution (co-payment) under the basic scheme, thereby neutralising its moderating effect;
- the cover provided by public schemes is extended to 100% for certain types of care and certain categories of patient (long-term disabling ailments, pregnancy, patients with disability pensions). These categories consume a very substantial proportion of health care because of the steep increase in the number of persons with long-term ailments;[1]
- in contrast with many other countries, access to specialists is not restricted.

The incentives to reduce the supply of ambulatory care are likewise inadequate. Care provided by doctors is on the basis of payment for treatment. While codes of good practices have been developed, there are few incentives to limit prescriptions for antibiotics, or to increase the share of generic drugs.

Little is done to stop people abusing the system. There are very few checks on patients when they are on sick leave. People with long-term ailments are often reimbursed in full for all the care they receive, whereas this should be the case only for treatment relating to their long-term complaint. Prior to the 2004 reform of sickness insurance (see below), doctors too were liable to very few checks on the prescriptions and medical certificates they issued when, in fact, their medical behaviour varies considerably.[2]

The way that medical establishments are currently organised does not ensure compliance with the ONDAM. This can be explained by the fact that the responsibilities of those in the system are not clearly defined (OECD, 2000). They are split between different actors (sickness insurance funds, representatives of health professionals and the State) who are all defending their own objectives which do not necessarily involve efficient management. The State deals solely with hospitalisation (public and private) and drugs, whereas the *Caisse nationale d'assurance maladie* (CNAM) is responsible for ambulatory care

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excluding drugs and has to keep the increase in the fees charged by doctors in private practice and by other paramedical professions within the budget voted by Parliament. The CNAM can propose corrective measures, but its role is actually limited in that it does not have responsibility for the whole of the system and the government often negotiates directly with doctors and other health professionals.

Reforms have been introduced to contain health spending

The authorities have tried on several occasions to control health spending by introducing more rationalisation in the system rather than by shifting a portion of public expenditure to private expenditure (OECD 2000 and Annex 2.A2). For the time being these reforms have not succeeded in containing expenditure for any length of time, no doubt because they did not deal comprehensively with the causes of the overruns and because they did not bring about any far-reaching changes in the incentives that determine microeconomic behaviour. Since these attempts at regulation, two reforms have recently been introduced with the object of producing in-depth changes in what governs behaviour: the Hospital 2007 plan, introduced in 2003, with the gradual implementation of activity-based payment in healthcare establishments and the 2004 reform of sickness insurance.[3]

The hospital reform should improve resource allocation…

Prior to the implementation of activity-based payment, the State exerted direct control over hospital expenditure by means of universal grants. While this method of funding did ensure that the ONDAM was respected in 1998 and 1999, it failed to eliminate big disparities in the budgets of hospitals with identical activities and did little to encourage efforts to improve efficiency and modernize, thus generating rents, resource allocation inefficiencies and the risk of increased spending in the long term.

Funding by universal grants does lend a certain predictability to hospital spending, but it does not ensure sustainability. The fact is that hospital spending has not stopped accelerating and there have been overruns since 2002, these being particularly high in 2003. These trends stem partly from wages, which account for 70% of hospital spending and are very much dependent on civil service pay trends. In addition, the recent sharp rise in hospital spending and part of the initial ONDAM overruns are due to the introduction of the legislation on the reduction in working hours (RTT) which was accompanied by a plan for the recruitment of hospital staff (53 000 jobs created between 2002 and 2005) and the application of the 1993 European Directive resulting in hospital doctors' on-call hours being incorporated in their weekly working hours.

All in all, any hospital reform which does not concern wage determination has little room for manoeuvre in terms of budgetary savings, especially in the short term. On the other hand, the introduction of funding tied to activity and the shift towards homogeneous financing of public and private hospitals should end the rent situation enjoyed by some establishments, cause costs to converge and prompt establishments to seek efficiency gains and contain costs. If it is to bring the expected benefits in terms of reorganisation, this change in the method of financing has to be coupled with the introduction of the instruments needed for reorganisation: an information system with appropriate accounting, critical assessments of resource utilisation, an improved purchasing policy (responsibility for which is in the hands of the *Mission d'Expertise et d'Audit Hospitalier-MEAH*), and enhanced decision-making powers for hospital directors. Also, the upturn in investment in health establishments, encouraged by the *Mission d'Appui à l'Investissement* which helps them to develop new technologies and to propose joining forces, ought to generate savings in the long term.

… but doubts still remain

While the "Hospital 2007" plan is a move in the right direction, there are still a number of question marks and problems.

- The plan appears to be being implemented only rather slowly and progress on activity-based payment is proving very gradual. For 2005, the target is to achieve activity-related funding in public hospitals equal to just 25% of expenditure and, in early 2005, hospitals were still lacking information on what their budgets were for that year.
- The system of funding tied to activity was introduced in March in the private sector, having been somewhat delayed; ONDAM overruns in this sector have been high. Lastly, cost-coding will not apply to all public hospital activities, which is likely to mean that the different systems of payment in private and public hospitals will persist, whereas one of the aims of the reform was to set up a single funding/reimbursement system.
- Some of the difficulties facing public hospitals stem from the staff's civil servant status, which is responsible for cost rigidities and is holding up the modernisation of the system because staff mobility is very reduced. Hospital reform will not change the status of the staff, so that rigidities will persist. Nor will the reform ease the strains caused by the application of the 35-hour week and staff shortages.
- Some rigidities are also due to hospital governance which attaches considerable importance to political factors in decisions concerning hospitals. The impact on hospital governance of the changes scheduled by the reform of sickness insurance (see below) is uncertain.

The object of the reform of sickness insurance is to contain expenditure on ambulatory care

With only limited leeway for making savings on healthcare establishment spending in the short term, the authorities are for the time being focussing mainly on controlling ambulatory care expenditure. The four main features of the latest reform of sickness insurance are (see Annex 2.A2):

- The introduction of incentives which should prompt changes in behaviour on the part of both patients and doctors: increase in co-payment, introduction of the need to see a general practitioner to rationalise access to specialists, introduction in 2006 of personal medical files.
- The undertaking by doctors to control expenditure on drugs: reductions in prescriptions of antibiotics, certain drugs, sick leave certificates and medicalised transport, development of generic drugs and good healthcare practices and improved compliance with the regulations concerning non ALD-related expenditure.
- Increased monitoring and control of the use of the system by patients and doctors.
- Institutional reform (details of which are given in Annex 2.A2): creation of a warning committee responsible for preventing any excesses, improved participation by all sickness insurance actors in managing the ONDAM.

Moreover, a reform of the framework law on social security funding was also adopted in May 2005. It extends the scope of the social security financing law and gives it a multi-annual dimension. Parliament will vote the balance on the main sickness insurance systems and the impact of the ONDAM vote will be strengthened by virtue of a detailed discussion of its component parts. Like the LOLF, it introduces a "targets – results" approach and now prohibits repayment of the social security debt borne by the CADES being carried forward any further.

… but the impact of the reform is hard to assess

In the short term, the reform of sickness insurance is liable to generate a number of costs. The introduction of personal medical files, for example, promises to be relatively costly. Also, to have the reform accepted by doctors, the *Union Nationale des Caisses d'Assurance Maladie* had to agree to substantial increases in fees under the January 2005 agreement. While these mainly concerned specialists, general practitioners were also involved with the introduction of a fixed rate for doctors treating patients with long-term ailments. For specialists who apply fees in excess of the statutory rate, the possibility of choosing the co-ordination option, *i.e.,* of committing themselves to limiting their excess fees in exchange for a reduction in their social security contributions, is a fresh source of expenditure for the sickness insurance system. All in all, the reform contains a series of provisions designed to improve the quality and efficiency of health care, but it is difficult to say what savings can be expected in the short term.

In the medium to long term, the reform's success will depend on its ability to change people's behaviour. The success of the healthcare process is very much bound up with the behaviour of general practitioners, a large proportion of whom are at present against the reform. If the general practitioner is simply going to refer patients to specialists without reducing the number of visits, expenditure in terms of doctors' fees, which accounts for 20% of the ONDAM, is not going to be contained. It could even increase faster since fees have been increased under the new agreement put in place as part of the reform. The reform's success will also depend to a great degree on the effectiveness of the agreement on medicalised containment of spending trends, which itself rests on a commitment on the part of doctors. While the reform does allow for recourse to penalties, the key factor is whether doctors are going to agree to "play the game". Where patients are concerned, if demand for health care is to be reduced, co-payment will have to increase and this will depend on the behaviour of complementary insurance providers. If the complementary providers were to take responsibility for co-payment, the reform would indeed realize the savings generated by the fall in sickness insurance refunds, but it will not go any further than these savings, whereas a change in behaviour would. What is more, the result would be to switch part of public expenditure to private expenditure, which is not in the spirit of the reform. The authorities have made it clear that they do not want complementary providers to take any such responsibility for co-payment, even if they cannot intervene directly in this matter.

The "warning committee", which is independent of the authorities, is supposed to track trends in sickness insurance expenditure and sound the alarm when there are signs of probable overspending. In such cases, health system actors must take corrective measures such, for example, as cutting back on reimbursements or lowering tariffs. While setting up the committee is a useful measure, it is very difficult to know whether it will have any real practical impact. Similarly, while the reform of the framework law on social security funding is a step in the right direction, its impact is difficult to assess.

Finally there are other factors, also responsible for certain excesses, which are not in the reform. Payment per treatment is maintained, even though it encourages repeated visits. It might also be thought that an overall reform of the hospital system and ambulatory care would have been preferable to two separate reforms. Lastly, the question of health professionals' remuneration is not tackled, even though it accounts for nearly 50% of the ONDAM.

Simplifying the tax system and reducing its negative effects on the economy

The level of income tax and social insurance contributions is high in France and it is impossible to raise such amounts without having some effect on economic incentives. So long as the share of public spending in GDP remains high, average tax rates – and the corresponding effects on incentives – also have to be high as well. Careful design of the tax system is therefore required to minimise distortions, and this section considers how well the French tax system avoids such distortions, given the underlying need for large amounts of revenue.

One aspect of the French tax system is its complexity, in terms of the number of taxes, the number of exemptions and special allowances, the number of bodies involved in calculating and collecting taxes. This leads to questions about transparency and consistency, efficiency and administration costs. Another aspect of the system has been the trend over the past two or three decades to increase the share of income tax and social insurance contributions that is levied on labour, mainly as a result of the expansion of the largely payroll-tax-financed welfare system. This has led to concern about the impact on employment and inactivity traps, and is linked with the discussion of labour market issues in Chapter 3.

The challenge for French tax policies is to make the tax system less complex and more transparent and to reduce tax distortions where these are most pervasive, without putting fiscal sustainability at risk. After outlining the main trends in the overall structure of taxation, this section first examines some aspects of its complexity and the cost of tax collection. It then analyses the impact of labour and capital taxation on incentives and briefly discusses issues in the area of environmental taxation. The section ends with a discussion of some policy options to improve efficiency. The main characteristics of the French tax system and its development over time are described in Annex 2.A3.

The tax system is complex and administrative costs remain relatively high

The French tax system appears to be very complex, which gives rise to high costs, both for the tax administration and for tax payers. There are economic and political reasons why tax systems can be rather complex. One reason is that, apart from raising revenues, governments try to achieve many other goals which are thought socially or economically desirable. Sometimes measures are taken on an *ad hoc* basis without giving sufficient consideration to how they may interact with other parts of the tax system or with other policy objectives. Complexity may also arise from the existence of different levels of government and public institutions which are entitled to raise their own taxes with different tax bases. Finally, many small taxes may exist simply because they have been inherited from the past even though their net return for the government is low. These factors are all at work in France.

The main sources of government revenue in France are social security contributions, income taxes, value added and other indirect taxes. Although there are some variations in payroll taxes and in value added tax rates, the main taxes used for purposes such as redistribution or creating tax incentives, are those on personal and corporate income. Environmental taxes are at the other end of the scale, *i.e.,* the revenue they raise is largely incidental to their task.

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About two thirds of the revenue from taxation of personal income comes from a proportional tax first introduced in 1991 to supplement social security revenues; however, it is not referred to as an income tax but as a generalised social security contribution – the *contribution sociale généralisée* (CSG). Taxation of personal income is quite progressive, with a top marginal rate on dividends[4] of about 56% and 57% on earned income (including CSG, and the *contribution pour la reduction de la dette sociale* – contribution for the reduction of social insurance debt – CRDS). The personal income tax itself has a large number of exemptions and deductions, as can be inferred from the fact that the CSG, imposed at a flat rate of 7.7% (11%[5] on property income) and with no exemptions or deductions, raises more revenue than the personal income tax with a top rate of 48%. Only about half the population pays any income tax, though it is imposed at the entry rate of 6.8% where family income per head exceeds about € 4 000.[6] Although the rate structure is highly progressive, some other aspects are not, but upper limits are scheduled. In particular, the main reductions are due to allowances for dependants, whose value increases with income up to a ceiling (see Annex 2.A3). Other important taxes based on wage costs are the social security contributions, most of which are paid by the employer on top of the gross wage. Social security contributions are regressive, with lower rates at higher income levels, but there are now also reduced rates at low income levels.

In addition to the redistributive element of the personal income tax, and despite the relatively large number of people who do not pay any significant amount, this tax is quite frequently subject to modifications intended to influence behaviour. For example the employment premium (*Prime pour l'emploi*, PPE) is a non-wastable income tax credit for employees on low incomes that has both an employment and a social objective: conditional on employment, it improves incentives to work and thus helps people to get out of the poverty trap. Measures are also used to encourage various forms of saving. Other recent uses have included encouraging employers to link employee earnings to company results, encouraging home improvements, employment of home helps or encouraging property owners to rent to tenants on modest incomes. Sometimes particular measures can work in opposition, as for example in 2004 when, despite the panoply of tax subsidies to various kinds of saving, a tax credit was offered for people who took out consumption loans.[7] Other measures which could be thought paradoxical include a tax credit to encourage low-income people to take out complementary health insurance schemes, the result of which, for these people, is to neutralise the effect of a specific insurance tax to which these schemes are subject.

As far as company taxation is concerned, there is also a number of specific measures such as measures in favour of research and development expenditures (exemption for firms taking part in a research project in the future competitiveness centres, easing of the tax credit for research expenditure), measures to avoid delocalisation (with the creation of advantages for firms operating in areas in great difficulty or which relocate to France), and measures in favour of apprenticeship contracts.

Indirect taxation is also used for policy purposes to some extent, though with less frequent changes. The most important recent change was to charge the reduced rate for home improvements, partly in an effort to boost the construction effort, but also because this sector composes a significant part of the informal economy, this in turn being partly because of the high rate of value added tax imposed. This example has generated pressure to extend this treatment to hotels and restaurants, particularly as food consumed off these premises is charged at the lower rate.

While all countries use the tax system to modify behaviour to some extent, a report from the *Conseil des Impôts* suggests that the practice of introducing special exemptions that result in tax expenditures may be excessive in France (*Conseil des Impôts*, 2003). Partly this is because they are inadequately evaluated: of some 400 individual tax expenditures[8] the revenue impact is estimated only for about half of them, and in about half of these cases the estimates are based on inadequate information; even less are any of the measures which are intended to have specific impacts evaluated for cost-effectiveness. Many such measures are introduced as amendments to non-finance legislation, where an equivalent voting of funds would not have been possible. The *Conseil des Impôts* made a number of recommendations for reducing the extent of tax expenditures including providing better information, restricting the creation of tax expenditures to finance legislation, requiring such measures to have sunset clauses, suppress measures whose effect is very limited, require measures to be justified in terms of specific objectives. For the moment, few of these largely reasonable suggestions have been implemented.[9] The government recently pledged that tax expenditures would from now on be time-limited, lapsing automatically after five years.

In France, the number of taxes which are collected by or attributed to different levels of government also appears to be relatively high. Quantitative international comparisons are difficult because of institutional and definitional differences between countries, but it can be seen that New Zealand and the United Kingdom, for example, have a more simple allocation of type of tax to level of government than France, and that the number of different taxes that are allocated (or partly allocated) to social security finance in France is particularly high (Table 2.2). This does not necessarily mean that each tax is itself necessarily complicated for the taxpayer; it may mean that decisions over levels of individual taxes are more difficult, however.

Where taxes are shared between levels of government and each level can set its own rate, as for example local taxes, for which communes, departments, regions, and a number of specialised agencies set their own tax rates, there are some grounds to believe that there will be an upward bias in the overall level of taxation (Flochel and Madiès, 2002). On the other hand, competition between neighbouring districts may limit or offset this bias. There does indeed seem to be evidence that electoral competition (in the case of residence and property taxes, though not for local taxes on companies) does affect rate setting (Madiès and Rocaboy, 2005).

Tax administration is more fragmented than in most other countries. Within the Ministry of Finance there are by tradition significant organisational divisions between the different tax functions: calculating tax liabilities is mainly the task of the *Direction Générale des Impôts* (DGI), while tax collection is the responsibility of the *Direction Générale de la Comptabilité Publique* (DGCP). However, reforms were recently implemented with the object of reducing administrative costs and giving taxpayers a single department to liaise with. Thus, 2002 saw the creation of a specialist national agency for large firms, which deals with assessment and collection, while a similar mechanism came into being for small and medium-sized firms at local level in 2004. Social security contributions are collected and administered separately by a number of different agencies. Also, France is one of the few OECD countries which does not have a withholding tax system, or deduction at source, for the income tax on wages and salaries; social security contributions and the CSG are deducted at source, however. Since 2002, income tax payers can file and pay taxes online on the websites created to this end – a procedure which is enjoying real success. For those,

Table 2.2. **Tax revenues by sub-sectors of government**

2002

	Central Government					Local Government					Social Security Funds				
	France	Finland	Denmark	New Zealand	United Kingdom	France	Finland	Denmark	New Zealand	United Kingdom	France	Finland	Denmark	New Zealand	United Kingdom
Taxes on income															
Individuals	•	•	•	•	•		•	•			•				
Corporate	•	•	•	•	•		•	•			•				
Social Security Contributions															
Employees	•	•	•				•				•	•	•		•
Employers	•	•	•				•				•	•	•		•
Self-employed or non-employed											•	•			•
Taxes on property															
Recurrent taxes on immovable property	•				•	•	•	•	•	•					
Recurrent taxes on net wealth	•	•													
Estate, inheritance and gift taxes	•	•	•	•	•										
Taxes on financial and capital transactions	•	•	•	•	•	•									
Taxes on goods and services															
Taxes on production, sale, transfer, etc	•	•	•	•	•	•	•	•	•		•				
General taxes	•	•	•	•	•										
Taxes on specific goods and services	•	•	•	•	•	•	•	•	•		•				
Taxes on use of goods and perform activities	•	•	•	•	•	•	•		•		•				
Other taxes															
Paid solely by business	•		•			•					•				
Other	•	•													

Source: OECD Revenue Statistics.

however, who are unable or unwilling to use this new technology the procedure is more cumbersome. The self-assessment of wage income also leads to a significant time lag between income and tax payments. Some people who are newly unemployed can thus find themselves still having to pay income tax on the previous year's income; this delay also makes measures that make use of income tax incentives (such as the PPE) less likely to be effective, at least in the short run, and to increase the deadweight losses associated with them. Simplifying the tax system and rationalising tax collection would certainly help reduce administrative costs. Introducing a withholding system for the part of personal income that relates to wage income would probably meet some resistance from the business sector, since the information to be processed would probably be more complex than in the case of social security contributions and the CSG. Some wage-earners could also be reluctant because of the information that would have to be brought to the attention of their firms, although there are other countries where this does not seem to be a problem. Rectified tax returns would remain necessary in many cases.

An informative measure of the complexity of the tax system and its administration is the resource cost of collecting taxes. In international comparison France remains among the countries with relatively high costs per unit of collected revenues and also has relatively high tax arrears, even though the cost of tax collection has fallen appreciably since the mid-1990s. This is illustrated by the indicators shown in Table 2.3 although the numbers should be interpreted with considerable care as they are affected also by factors which are not related to the efficiency of tax administration. Administrative costs of tax collection appear to be particularly high for the income tax, the net wealth tax and local taxes, as those taxes are difficult to administer and have a relatively complex tax base.

Tax effects on economic performance

There has been a long debate among economists on the effects of taxes on the economy and its rate of growth and the question remains controversial. An overall assessment also requires consideration as to how tax revenues are spent. Nevertheless, it has become clear that taxes can affect the economy via different channels and some of these effects can be very significant. Furthermore, there is also a reverse causality as poor economic performance creates pressure to raise social security spending which triggers an increase in labour taxes which could cause a vicious circle with higher taxes and lower growth and employment.

While a comprehensive assessment of the effects of the French tax system and its changes on the domestic economy would go beyond the scope of this paper we focus on a few areas where such effects are, perhaps, important and where reforms may be needed. These are taxes on labour, parts of capital taxation and of environmental taxes.

The ratio of tax and social insurance contributions to GDP has been stabilized at a relatively high level

After rising rapidly during the 1970s and the first half of the 1980s, the ration of tax and social insurance contributions to GDP has remained broadly at a level of 44% over the last 20 years. France thus belongs to the group of OECD countries where the level of tax and social insurance contributions is relatively high. The longer-term increase in the overall tax ratio was mainly accounted for by the rise in tax and social insurance contributions on labour and capital while the tax burden on consumption declined somewhat (see Annex 2.A3) In recent years governments have implemented a number of measures to try to reduce some of the main difficulties that result from high average levels of taxation,

Table 2.3. **Indicators of administrative costs in tax revenue collection and tax arrears**

	Administrative costs as a % of collected revenue	Number of citizens per full-time staff	Number of labour force per full-time staff	Reported gross tax arrears as a % of net tax collections
	2002	2003	2003	2002
Australia	1.19	1 016	512	9.3
Austria	0.72	929	450	9.6
Belgium	1.00	476	207	14.6
Canada	1.20	810	425	8.4
Czech Republic	2.08	700	351	49.7
Denmark	0.73	651	348	4.9
Finland	0.67[1]	820	415	6.6
France	1.44	788	358	16.1
Germany		665	324	2.6
Hungary	1.35	768	309	
Ireland	0.95[1]	625	282	4.5
Italy		1 202	510	
Japan	1.62	2 260	1 199	
Korea	0.85	2 804	1 359	3.0
Netherlands	1.76[1]	629	320	
New Zealand	1.17	853	425	4.0
Norway	0.59[1]	716	374	4.0
Poland	1.32	751	339	8.6
Portugal	1.68	778	402	43.5
Slovak Republic	1.46	929	458	39.7
Spain	0.78	1 680	745	5.9 (2001)
Sweden	0.42[1]	985	494	1.9
UK	1.15[1, 2]	730[3]	360[3]	17.2[2]
USA	0.52[1]	2 261	1 445	16.1

1. Revenue base includes social contributions.
2. IRD.
3. IRD and C&E.

Source: Tax Administration in OECD countries: Comparative Information Series (2004), OECD Centre for Tax Policy and Administration.

notably in reducing labour taxes for low earners and bringing down the statutory rate of company tax in line with corporate tax reforms in many other countries.

Despite recent reductions effective tax rates on labour remain high and create inactivity traps

Taxes on labour are relatively high in France and yield around 55% of total revenues, including income tax and social security contributions (paid by employees, employers and self-employed), other payroll taxes (tax on salaries, tax for apprenticeship, tax for professional training) and (since 1991) the flat-rate tax on income, CSG (*Contribution Sociale Généralisée*) which is also levied on transfer income and capital income (which yield about a quarter of total CSG revenue). The contribution of the CSG has risen rapidly since its initial introduction. The rate of the CSG was raised various times in the past and its tax base was broadened, over a period in which health insurance contributions were reduced. The CSG is earmarked for social security finance and its revenues (together with those from certain related taxes) are now about one third higher than revenues from the personal income tax.[10]

The link between labour taxation and employment is complex and has been explored in many studies, including some by the OECD.[11] There is still some debate about the size of these effects - with some studies claiming that labour taxes have no significant impact on unemployment whereas others explain most of the rise in unemployment in Continental Europe by labour taxes.[12] Most theoretical and empirical work suggests, however, that labour taxes can have important adverse effects on labour markets although the effects largely depend on labour market institutions which determine the degree of tax-shifting into labour costs. Thus, tax-shifting and hence negative employment effects appear to be lower in countries where labour markets and product markets are more flexible and higher where they are less flexible. In a study for France, Cotis *et al.* (1996) found virtually full shifting forward of taxes. A study of OECD countries by Tyrväinen (1995) for the OECD Jobs Study found high shifting forward in Germany and Canada and low shifting-forward in the United States, the United Kingdom and Sweden. Daveri and Tabellini (2000) found that higher taxes lead to higher gross wages in continental Europe (but not in the United States or in the United Kingdom) while Arparai and Carone (2004) found only a relatively small effect of the labour tax wedge on real labour costs in the EU as a whole.

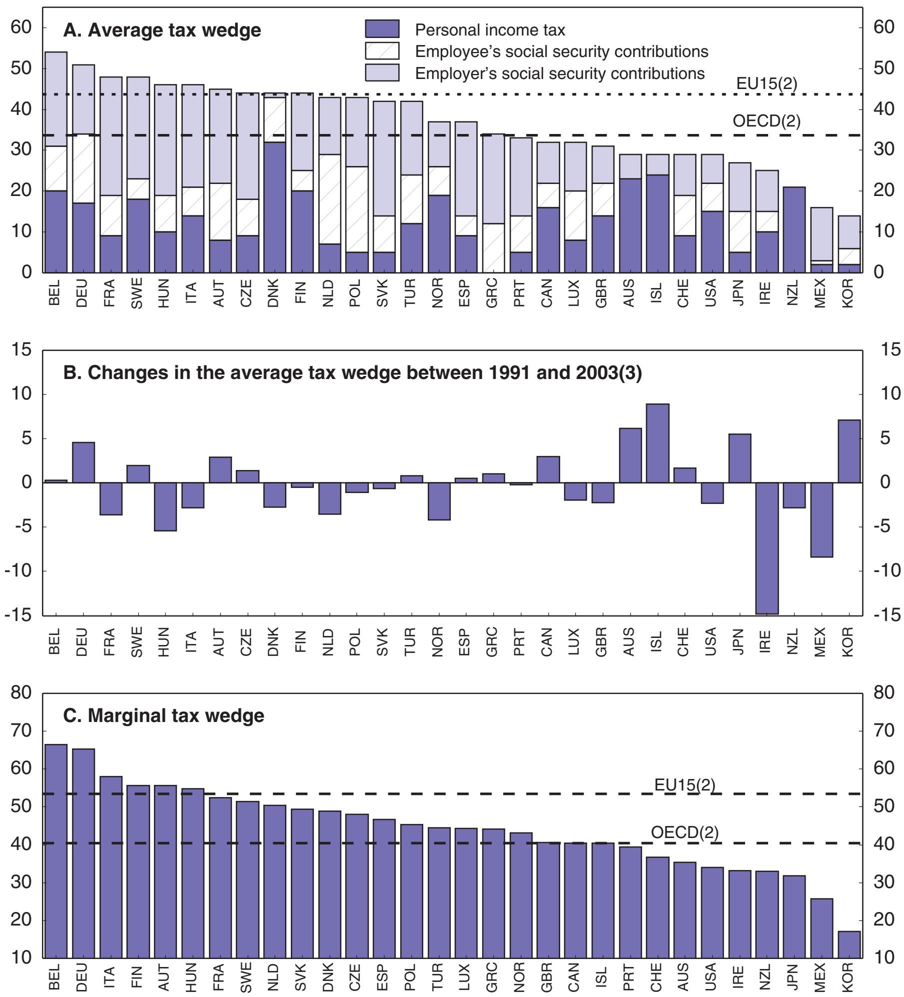
In France the average and marginal tax wedges (including social security contributions and income tax) of the average production worker are relatively high despite some reductions in recent years (Figure 2.4). The effects of labour taxes are compounded by income-related social benefits. The additional disposable income by entering employment or increasing work efforts is reduced by labour taxes and the (partial or full) withdrawal of social benefits. If the overall marginal effective tax rates (METR), as defined by the proportion of additional labour costs that is paid as tax, is very high, this leads to inactivity and poverty traps; these might be mitigated if people take a longer-term view and start working or work harder, despite limited short-term income gains, in the hope of escaping the poverty trap by moving up the income ladder and achieving higher lifetime income.

In France when taking-up a relatively low-paid job, high METRs used to arise from the withdrawal of the minimum social benefit (*revenu minimum d'insertion*, RMI) and the payment of labour taxes. The RMI was from the beginning subject to *intéressement*, meaning that a person could continue to receive the benefit for some time after taking a job, but the conditions for this were very restrictive in practice, until greatly relaxed in 1998. This relaxation reduced the METR on taking a job, spreading it through time as the *íntéressement* is phased out. A further step was the introduction in 2001 of the employment premium (*Prime pour l'emploi*, PPE), an in-work benefit paid as a non-wastable tax credit for low-income earners at a maximum basic rate of 4.6% of the gross wage.[13]

Rebates on employers' social security contributions for low-income employees also reduce METRs. As a result of these measures, the METR is below 100% for workers earning as little as half of the SMIC (part-time workers), but they are quite high nevertheless and increase quite steeply in the range of incomes over which the income-related benefits – PPE and employers' contribution rebates – are withdrawn (Figures 2.5 and 2.6). Other "spikes" in METRs are caused by the withdrawal of housing benefits and school benefits at incomes around 2 to 2.4 times the SMIC (if the person has children). Above this, METRs increase gradually because of the progressive income tax, although from the employers'

Figure 2.4. **Tax wedges on labour, international comparison**[1]

As per cent of gross labour costs, 2003



1. For a single individual without children at the income level of the average production worker on estimated wage levels of the average production worker.
2. Weighted average using 2000 GDP and Purchasing Power Activity.
3. 1991 or the earliest year available.

Source: OECD, *Taxing Wages*, 2003.

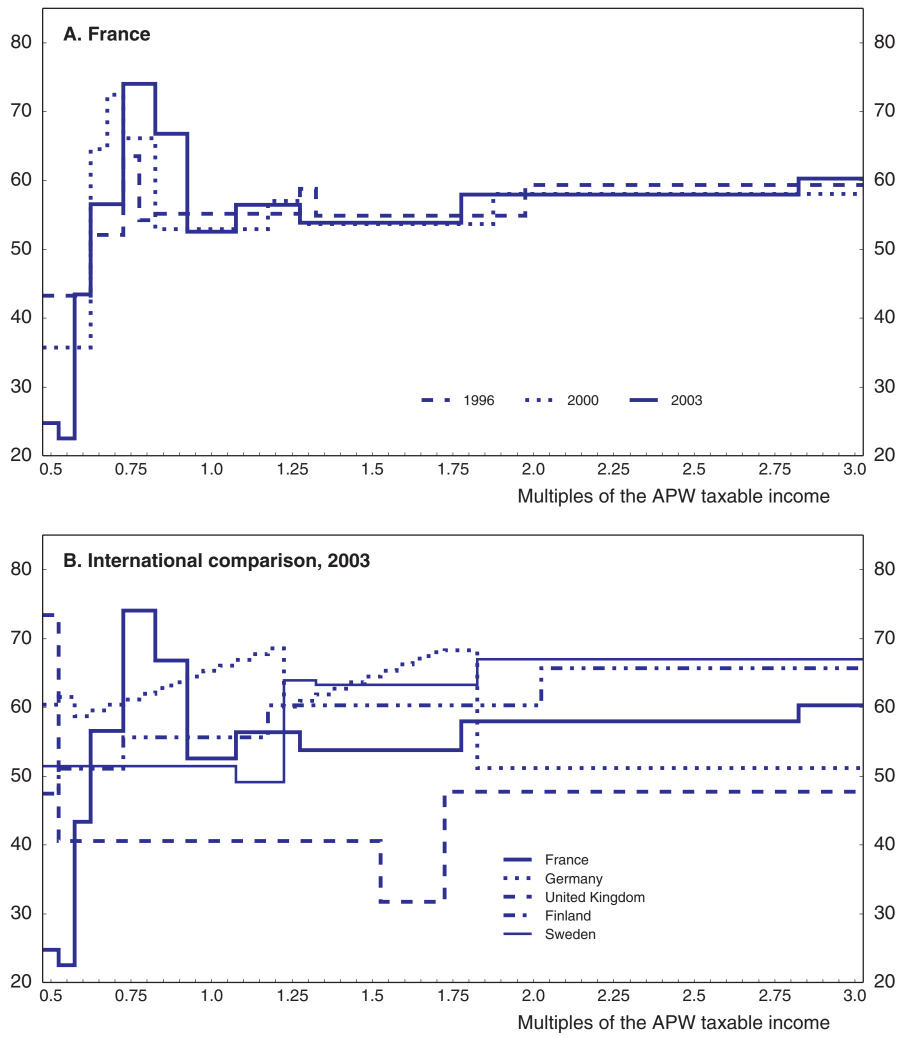
side there are offsets since employer contribution rates decrease somewhat at higher income levels.

Statutory and effective tax rates on corporate income have declined

In France as in many other OECD countries, statutory corporate tax rates have been reduced in the past while the tax base has generally been broadened. These reforms aimed at improving framework conditions for firms in the light of lower economic growth and higher international capital mobility. The rate-cut-cum-base-broadening policies made tax

Figure 2.5. **Marginal tax wedge on labour**[1]

For a single person with no children, per cent



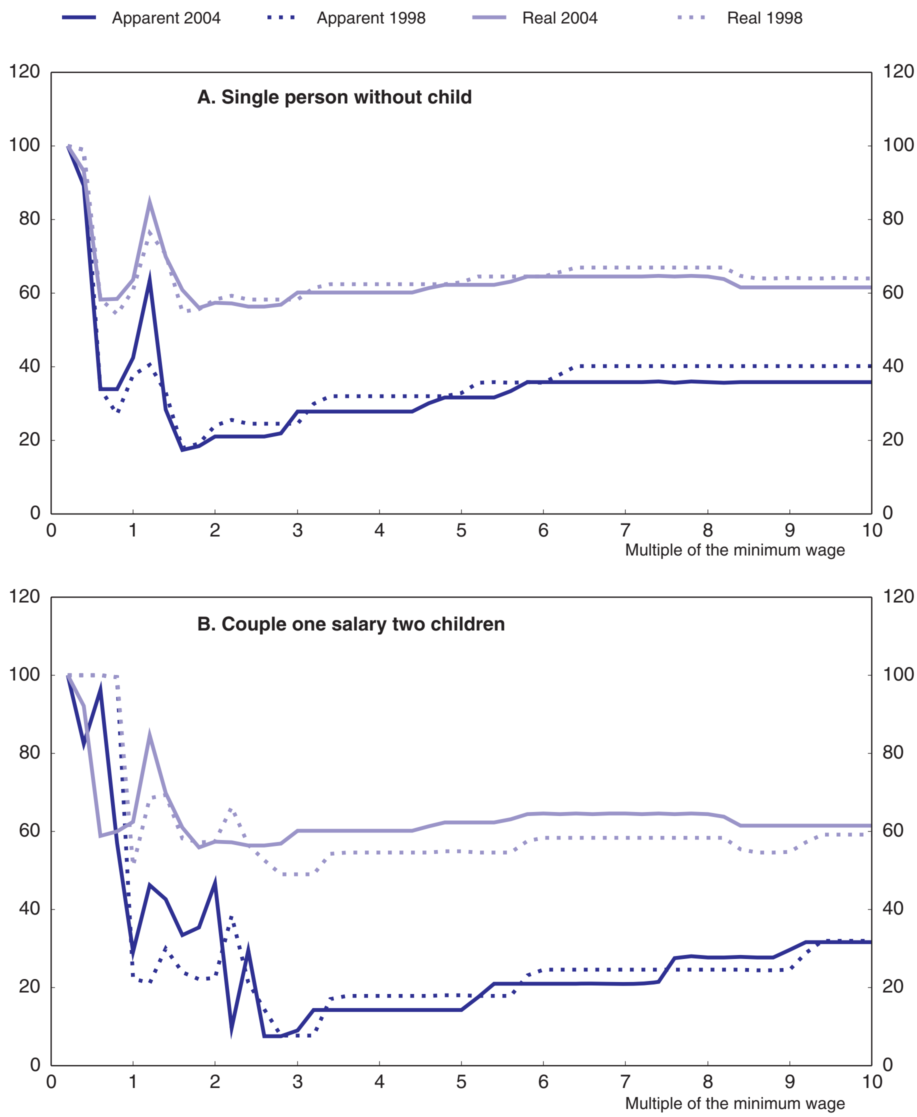
1. Tax wedges, between labour costs to the employer and the corresponding net take-home pay of the employee, are calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll tax, as a percentage of labour costs.

Source: OECD, *Taxing wages*, 2003.

systems more neutral by reducing distortions between different types of investment and sources of financing. In France the corporate tax rate remained at 50% (for retained profits) between 1965 and 1985 and was then reduced in various steps to 33.3% by 1993 (Figure 2.7). It rose again after a surcharge was imposed in the second half of the 1990s; this surcharge is in the process of being phased out, and the rate will return to 33.3% in 2006. Other countries have cut tax rates as much or more as France, and some of them are planning further cuts (see Annex 2.A3).

Figure 2.6. **Marginal effective tax and withdrawal rates**[1]

Per cent



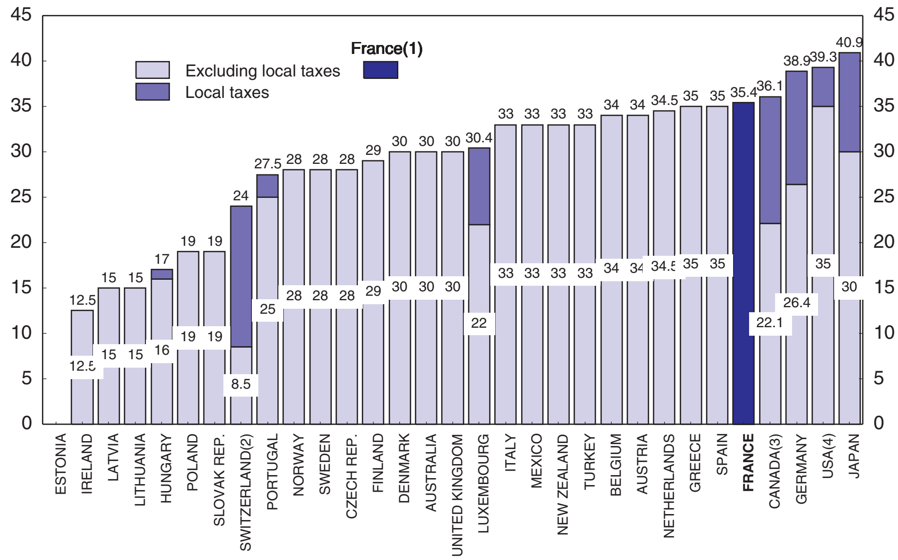
1. The "apparent" METR is calculated using marginal taxes and contributions paid by the employee, plus partial withdrawal of social benefits. The "real" rate is the apparent rate with the addition of the marginal impact on employers' contributions.

Source: Ministry of Finance.

The statutory corporate tax rate is, however, insufficient to assess the impact of corporate taxes on investment as the latter is also affected by the tax base. In the literature various indicators have been constructed to measure *effective corporate tax rates* as impact measures on business investment and it has been shown that in France as many other OECD countries effective marginal and average tax rates declined over the past two decades (Devereux, Griffith and Klemm, 2002).

Figure 2.7. **Statutory corporate income tax rates, 2004**

Per cent



1. Excluding local business tax (taxe professionnelle) but including the 3% surtax. The surtax will be eliminated in two steps in 2005 and 2006.
2. Zurich.
3. Ontario.
4. State of New York.

Source: OECD and German Ministry of Finance.

With the reduction of statutory corporate rates tax systems have become more neutral with respect to different sources of financing. However, in order to get a full picture of the impact of taxes on capital formation one also has to consider taxation at the level of savers (see King and Fullerton, 1984). In France the overall tax wedge (considering taxation both at the corporate and household level) for investment financed by new issues of shares is relatively high compared to other sources of investment financing (by debt or by retained earnings). According to simplified model calculations it also higher than in most other European countries (Eykmans, 2004).[14] This is so despite the fact that the tax relief on dividends *de facto* eliminates double taxation. The reason is that receivers of dividends are faced with relatively high marginal income tax rates (the top marginal tax rate on personal income being currently 48% and including the CSG around 58%). Most other countries either have lower top marginal income tax rates or have a flat tax on capital income, which is the case in France only for interest income (flat rate tax of 25% excluding CSG) but not for dividend income.[15]

From these considerations one could conclude that the French tax system may be a constraint for the development of newly-established firms which may wish to rely more on new equity financing than older firms. However, there are numerous tax-favoured saving (such as life insurances or other saving schemes including venture capital funds) which significantly reduce the effective tax burden on an investment financed by equity held in these schemes, below the level suggested above. A large proportion of personal equity wealth is in fact held through such schemes. Although they therefore reduce the effective tax rate they create significant transactions and information costs for investors, as well as introducing distortions of their own as individual savers and/or investors may benefit to a different degree from such schemes.

Corporate tax reforms also contributed to a decline of the tax burden on inward FDI. Work by OECD on the tax treatment of foreign direct investment found that in 2001 the French tax burden as measured by effective marginal and average tax rates was close to or even slightly below the OECD average (Kwang-Yeol Yoo, 2003). Tax reasons alone should thus not put too much pressure on companies to shift activity to other countries through outsourcing/off-shoring, even if some countries do attract FDI through even lower taxes. Nevertheless, as differences in statutory tax rates between countries, particularly in Europe, remain relatively large, multinational firms may still be tempted to shift profits by manipulating prices in intra-firm transactions (transfer-pricing) or financing arrangements with their subsidiaries in low-tax jurisdictions. While such behavior does not affect investment and employment it reduces domestic tax revenues. Although the OECD and the EU have designed measures to prevent the allocation of profits to low-tax countries through transfer pricing, preventing such practices remains a big challenge for tax administrations (Davies and Gresik, 2003).

The local business tax has been subject to a number of changes in recent decades

There is not space here to cover all aspects of sub-national taxation in France, though a number of changes have been made in recent years, especially in the decentralisation of a number of functions from the State to the regions. But the local business tax, *taxe professionnelle*, has caused difficulties over a number of years. The *taxe professionnelle* is an important source of revenue for local government along with residence and property taxes paid by individuals. It originated in 1975 as a tax based partly on the firm's physical assets (including machinery and equipment) and partly on the payroll, replacing an earlier tax based entirely on property. While local governments were initially free to set the rate they wished, restrictions were introduced whereby the rate could not be changed in any year by more than the local residence and property taxes were changed. These rules were recently relaxed to allow the *taxe professionnelle* to be changed by up to one and a half times the change in local household taxes. With effect from 1999, the payroll-related part of the tax was gradually removed and local government was compensated by transfers from central government funds, because it was felt that this penalised labour-intensive companies. In addition, a ceiling on the tax was introduced such that no firm would have to pay more than a ceiling of between 3.5 and 4% of its value added. By 2004, nearly 40% of the revenue from the *taxe professionnelle* derived from firms taxed on their value added and the whole of the payroll part of the tax was paid by central government. This means that the tax is now essentially an adjunct to the VAT as far as many firms are concerned, its effective structure being entirely different from its notional one.

Seeking to rationalise the tax, and to promote both employment and investment (a difficult task) and to avoid penalising industry, a commission was set up in 2004 to propose a new structure. The Fouquet commission recommended a structure that combines elements of all earlier versions of the tax. It would rest on a mixed base consisting of the rental value of the buildings and the gross value added deriving from the firm's accounts. Value added would be shared locally on the basis of the workforce and property rental values. The rate of the new tax would be fixed by each commune, department and region, but within a national framework. If adopted, a revised tax would probably be phased in over a number of years.

Environmental taxes may be under-utilised

Compared with a number of other European countries, France makes relatively little use of environment-related taxes. Their overall weight, as measured by their share in GDP or in total taxes, is lower than average for European countries but similar to that in Belgium and only a little below Germany. But the range of taxes is relatively low, being largely restricted to petroleum-related taxes, water and water treatment charges (which are earmarked directly for the regional water management agencies), certain nitrogen oxide and other emissions, and pesticides. Only petroleum taxes (*Taxe Intérieure sur les Produits Pétroliers*, TIPP) and water taxes and charges raise any significant amounts of revenue (although revenue raised is not a good measure of the effectiveness of an environmental tax). In general, environment-related taxes are not particularly well-aligned on known pollution externalities.

The TIPP remains an important source of revenue however, which is largely socially accepted and is now partly allocated to regional, departmental and local administrations; provided there is European Union agreement, regions are to be given some power to vary the rate charged. Water charges too have been related less to environmental costs than to the meet the financing needs of the water agencies (see Lenain and Vourc'h, 2001). The pesticides tax, however, is better designed to reflect differences in pollution damage of the products.

There is no carbon tax even though the French authorities have always placed a high priority on action against climate change. In 2000 it was planned to extend the general pollution tax (*Taxe générale sur les activités polluantes*, TGAP) to intermediate consumption of energy by industry. This tax groups together a number of the old special-purpose taxes formerly allocated to the *Agence de l'Environnement et de la Maîtrise de l'Énergie* (ADEME). As initially proposed, this was a fairly straightforward tax based on the carbon content of different fuels and the final legislation contained a large number of exemptions and rebates to reduce the burden on certain energy-intensive sectors. The constitutional council declared that the resulting law was inconsistent with the constitution and it was abandoned. One of the reasons for this was that what firms would have paid was not proportional to their CO_2 emissions, in the sense that heavy emitters could end up paying less tax than firms with lower emissions. This is potentially a problem for pollution taxes because what matters for their environmental efficiency is the tax paid on marginal emissions, not the average tax; legislators may want to limit the overall tax bill in order to avoid penalising past investment decisions that were made when the tax did not exist. The introduction in 2005 of a European market for CO_2 emissions permits for industry and energy production means that the advantages of this sort of tax are now more limited. The EU CO_2 emissions trading system will in fact have results that are in some respects similar to the abandoned TGAP, since heavy emitters who reduce their emissions below their allocated level will be able to sell them to other companies, the net cost or benefit to companies participating in trading will be related to changes in their emissions, but will have no direct link to their actual emissions.[16]

The constitutional principle of fairness in taxation will therefore have to be applied in a manner better adapted to environmental taxation which has developed internationally in a way that, implicitly, is willing to sacrifice some aspects of fairness in order to optimise the trade-off between overall abatement costs and environmental gains. In any event, it already takes into account the aim of the legislation, and differentiating between taxpayers is warranted on these grounds. The recent incorporation of an environmental charter into the constitution may facilitate this balance, though the notion of potential conflict and trade-offs between environmental, economic and social objectives is not very strongly presented.

Policy considerations for making the tax system less complex and more efficient

As pointed out earlier, relatively high marginal tax rates are inevitable given the high level of public spending to which successive French governments remain committed. The administration is rightly concerned to try to minimise disincentives to employment and investment, but there are few reforms available that achieve both these aims for the majority of taxpayers while at the same time maintaining the level of overall revenues: under such a constraint, tax reforms are to a considerable extent (though not entirely) a zero-sum game. It follows that governments should avoid pursuing reforms that benefit particular sectors or interests, since the burden of taxes in one area can only be relieved by moving it elsewhere.

There exist numerous measures which are not very effective in providing incentives but are relatively costly in terms of foregone revenues. Many such measures are discussed in the annual report of the *Conseil des Impôts* for 2003 and the recommendations of that report are a step in the direction of a more rational tax system. Eliminating many small measures in this way would simplify the system for taxpayers, reducing the need for them to spend resources looking for tax breaks, and reduce the government resources needed to design and police them. Removing some of the many exemptions for the main taxes would doubtless cause difficulties for some sectors, but broadening the tax bases in this way would contribute to establishing a level playing field and allow statutory rates to be reduced; it should be a medium-term aim.

Social insurance and health benefits, in principle financed straightforwardly by employee and employer contributions based on earnings, are in reality now financed by a more complex system which adds a number of earmarked indirect taxes, a universal income tax (the CSG), and direct transfers from general taxation through the central government budget. At the same time, the central government has passed certain tasks to sub-national government, notably the implementation and finance of some aspects of social assistance and active labour market policy (the RMI, RMA and *contrats d'avenir*, for example (see Chapter 3), but the rights and obligations under these programmes are still determined by central government.

Tax administration costs remain relatively high in France. This is probably partly due to the complexity of the tax system, but also to the traditional separation of entities responsible for assessing and collecting (but often with insufficient co-ordination between these two functions). Certain reforms now under way do aim at simplification, notably by introducing the idea of a single agency to contact for tax purposes. Income tax and assessment in France has, however, become somewhat anachronistic, with nearly all countries deducting income tax at source, with annual assessments needed only for *ex post* adjustments, as opposed to self-assessment with payment in arrears in France. Switching to deduction at source would be feasible – it is already used for the CSG – and would probably improve overall efficiency, though transition arrangements would need to be devised. Certain obstacles, in particular the possible reluctance of employers and employees, could perhaps be overcome by drawing on other countries' experience in this area.

Ultimately, consideration could be given to merging the CSG and personal income tax. Concerns that the CSG, a relatively "good" tax, in the sense of having a very simple structure, low collection costs and high yield, being contaminated by the income tax (the exact opposite in all these dimensions) are not to be dismissed lightly, however. Even if there is no obvious economic justification, the objection that the two have to be kept separate in order to guarantee the separation of social insurance funding from funding of the state budget has some grounding in current constitutional arrangements (though this has not prevented transfers from the state budget to offset reductions in employers' contributions). The authorities find that the distinction between the two taxes to some extent maintains the system's political transparency in a context in which the said taxes correspond to different decision-making processes and budgetary appropriations. The income tax structure and system of collection should be reformed, however, even if it is decided to keep it separate from the CSG.

The efforts that have been made to remove inactivity traps and generally reduce marginal rates of tax and benefit-withdrawal at low income levels have been ingenious and appear to have had some success in making employment of low skilled people more attractive both to employers and to the low-skilled themselves. The set of measures that has been constructed over time increasingly resembles a negative income tax for those on incomes below a level somewhat above the minimum wage. It does not fully match a negative income tax because that would be prohibitively expensive given the high level of the SMIC. (It may be noted that the nearer the system gets to a negative income tax, the less the need for a high minimum wage, which puts part of the burden of poverty alleviation on firms.) Measures targeted more on those who are affected by the various inactivity and poverty traps, by reducing their marginal effective tax rates, are probably necessary given current budgetary constraints; but this very targeting is increasing the degree of complexity of the system, sometimes because measures with different purposes conflict with the general aim of increasing employment and participation rates. Better co-ordination of certain social policies, including a clear definition of their aims and how these may relate to labour market aims, is required, notably in the area of family policies.

Overall, given the level of ambition in supporting those on low-incomes, relatively high marginal effective tax rates will remain a fact of life. Part of the burden of improving labour market outcomes will have to be taken on by tightening requirements for taking up work and/or for participating in training programs. This system – known as Flexicurity (*en français:* Secuflex), meaning security plus flexibility – exists in Denmark and other countries (such as Germany) are also moving in this direction. This is discussed further in Chapter 3.

One possible radical reform, though not currently under consideration, is to switch financing of social insurance from an income base to an expenditure base. For this sort of reform to be favourable, however, the disinflationary effect of the reduction in social insurance contributions would have to outweigh the inflationary effect resulting from the rise in indirect taxation, which is not guaranteed in the case of France. Also, the authorities are afraid that such a far-reaching reform of the funding of welfare expenditure might result in less attention being paid to controlling this spending. Lastly, it is important to note that, while the share in

Box 2.1. **Summary of recommendations**

Ensuring fiscal sustainability

- Increase incentives for fiscal discipline at all budgetary levels and if this proves difficult extend spending controls through a national stability pact to regional and local authorities. The aim should be to halt and reverse the upward trend of public debt as a share of GDP in order to make room for pressures stemming from the ageing of the population without jeopardising long-term sustainability.

Continue with pension reform

- Carefully monitor the effects of recent reform measures on labour participation of older workers and, perhaps increase incentives to continue working by further raising pension accrual rates.
- Ensure that alternative pathways into early retirement are not subsidised by other policies, such as disability schemes.

Continue with health care reform

- Reduce excessive demand by higher co-payments or other measures aimed at making patients more responsible.
- Improve cost-efficiency in the hospital sector and improve hospital governance by reducing political influence on decisions.

Reforming the tax system

- Continue to reduce the costs of tax collection and, insofar as is possible, consider ultimately merging the main tax collection systems.
- Reduce labour tax distortions by further reductions in social security contributions for low paid workers and reduce the withdrawal rate for in-work benefits, financing these measures preferably through reductions in other public expenditure.
- Simplify the personal income tax, widen its base to permit lower top rates while increasing overall revenue, and switch it to a system of deduction at source.
- Reduce capital tax distortions by cutting the corporate tax rate and widening the tax base and reduce the number of special incentives for certain kinds of activity. Reduce the persisting bias against financing investment by new issues of shares rather than by borrowing.
- Increase the role of "green" taxes with a view to efficiency gains rather than significant sources of revenue, at the same time seeking to justify such measures so as to secure a favourable opinion from the *Conseil Constitutionnel* on questions of tax "equality".
- Ensure that tax reform measures together are revenue-neutral since in current circumstances medium term budgetary sustainability is in question - do not spend anticipated gains from reforms until they materialise.

GDP of the tax and social insurance contributions on labour intended to finance the social security (social insurance contributions, CSG) has increased since the 1970s, that of the taxation of personal incomes and corporate profits in GDP remains below the OECD average and that of indirect taxation higher than in some OECD countries. In the end all taxation is paid for out of incomes, whether collected directly on incomes or on expenditure, even if there may be a case for reconsidering the balance between the different types of taxation with the aim to reduce the impact of tax distortions on employment and growth.

By reducing the statutory tax rate and broadening the tax base past reforms have improved the allocation of capital. Compared with other European countries, the corporate tax rate is still relatively high (although lower than in the United States and Japan). It could be further reduced while at the same time broadening the tax base. Reducing the corporate tax rate would also reduce incentives for firms to shift taxable profits to low-tax countries by transfer-pricing or financing arrangements. Further rate-cut-cum-base-broadening would further improve the allocation of capital and would also make the system more neutral between capital and labour intensive sectors, by benefiting the latter.

Reducing the tax on dividend income would be an additional step towards making the system of capital taxation more neutral by reducing the tax wedge for investment financed by new issues of shares which is currently higher than in most other countries. The reason is that in France dividend income is taxed by the progressive income tax with a top marginal tax rate (including the CSG) of almost 60%. Most other countries have either lower marginal income tax rates or have a separate flat tax rate on dividend income which is lower than their top marginal income tax rate. If France would make its highly progressive income tax flatter this would automatically reduce the tax wedge on dividends and hence on new equity-financed investment. Otherwise a separate flat tax on dividends could be introduced which is already the case for interest income. Making the income tax flatter would make the tax system more neutral but would at the same time raise equity issues as the tax burden is redistributed towards the more affluent households. A third, radical, solution (and one which no country has yet adopted) would be to abolish corporate income tax altogether, integrating capital gains, interest and dividend income into the personal tax regime on the same basis.

Notes

1. Any person resident in France on a steady and regular basis for 3 months is guaranteed access to basic sickness insurance, whatever his contribution (universal health cover, or CMU de base). Depending on their means, households may be entitled to free complementary health cover (CMU complémentaire).
2. According to a CNAMTS study, the average prescription issued by the 10% of the most "economical" general practitioners was € 50, whereas in the case of the most "extravagent" practitioners it was € 105, after making adjustments for client-related differences.
3. See Annex 2.A2 for the details concerning these reforms.
4. The 56.3% divide up into 48.09% (income tax) plus tax and social insurance contributions, part of which is deductible. Taking account of corporation tax and the mechanism lessening double taxation in respect of dividends received up until 2004, the higher overall rate applying to dividends is 57.7%; on interest it is 33.2%, of which 25% income tax.
5. In fact this 11% is made up of four separate levies, not just the CSG.
6. The threshold for 2004 is € 4 334 per adult equivalent in a family where the first two children count as half an adult, and subsequent children as equivalent to an adult.

7. At the same time, the terms attached to company-based tax-exempt saving schemes were relaxed for a short period, to allow withdrawals without any tax penalty. Within a three month period, savings equivalent to about 0.4% of GDP were withdrawn from such schemes. In some cases it was possible to reinvest these withdrawals immediately, attracting an additional tax subsidy.
8. The notion of tax expenditure used in the report is taken literally and includes, for example, tax credits used to avoid double taxation of dividends.
9. In some cases this is for constitutional reasons. It is thought to be difficult to restrict the freedom of parliament to attach tax expenditure clauses to any legislation it wishes, for example.
10. In 2003 the CSG (with the "social tax", the "additional contribution" and the "contribution to reducing the social debt") yielded € 63.62 billion and the personal income tax € 47.28 billion.
11. See e.g. Leibfritz *et al.* (1997) and OECD (1999).
12. Nickel, S., (2003), "Labour market institutions and unemployment in OECD countries", CESifo DICE Report 2, 2003.
13. When first introduced the PPE was only 2.2%. Received in arrears, its initial incentive effect was probably not very great – the tax authorities wrote to about 2½ million people inviting them to apply for it; about half of them (90% of those who replied) received it. Since then the rate of subsidy has increased, its budgetary cost has quadrupled, and over 8 million households receive it.
14. It is assumed that dividend recipients are in the highest income bracket and therefore have to pay the top marginal income tax rate.
15. For example separate taxation of dividends exists in Germany, Belgium, Finland and Denmark and Greece, the Netherlands and Slovakia have eliminated individual taxes on dividends.
16. So that a company with relatively high emissions may be paying less, or even actually receiving net income from sales of permits, than one with lower (but increased) emissions. This kind of example was used by the constitutional council to explain why the TGAP extension was unconstitutional.

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ANNEX 2.A1

Ageing and healthcare expenditure – what connection?

More than half of all expenditure on ambulatory and hospital care derives from patients aged 55 and over, so it may be thought that increased life expectancy and the growing proportion of elderly people increase healthcare spending mechanically. The connection is not so simple, however, since ageing is both a cause and a consequence of the growth of healthcare expenditure, greater life expectancy being partly attributable to access to care and to preventive policies. Other more solid reasons for the rise in health spending that can be put forward include (according to CNAM, 2003) the following:

- Medical consumption increases as death draws closer, but consumption prior to death falls sharply when the age of death increases. So this effect tends rather to reduce healthcare expenditure in the present context of an average age at death which is rising.
- In the case of persons deceased between 1996 and 2002, the pattern of medical consumption at the end of their lives altered very little, which is also true of hospital consumption. Medical consumption prior to death is tending to increase slightly.
- It is apparent that, among persons not exposed to a vital health risk, the new generations consume more than their predecessors. This is no doubt partly due to technical progress.

These findings are completely consistent with the econometric analysis carried out by Dormont *et al.* (2005). The study in question uses different factors to explain the growth of health spending: the purely demographic effect (the increase in the proportion of elderly people, bearing in mind that health spending increases with advancing years), the change in morbidity (sickness rate) at a given age, and the change in practice at a given age and morbidity level. The authors show that the purely demographic effect has little impact on the growth of healthcare spending. Changes in morbidity give rise to a downward trend in the pattern of health spending, but this downward trend is more than offset by changes in practice which result in an increase in medical consumption.

ANNEX 2.A2

Recent reforms to the health care system

France has introduced a number of reforms to the health system aimed at improving quality of care while permitting better control of public spending. Sustained deficits in the social security system have led the government to introduce major changes in the way that the existing budget control mechanisms are organised and operated. A key feature is a clear desire to integrate all of the major actors in the decision making process to help avoid spending above established ceilings. In addition, a number of measures have been taken to attempt to counterbalance the costs of a system that remains largely marked by the incentives of fee-for-service payment arrangements and a tradition of extensive prescription of pharmaceutical drugs when compared with most other OECD countries.

Major reforms to the arrangement for controlling health care spending

The 1996 Juppé reforms put in place greater parliamentary oversight of the social security system, which up to then had been almost entirely governed by the social partners. A constitutional amendment gave Parliament legislative authority over health spending, *via* the law on the financing of the social security which is passed every year, like the budget. The social partners continue to be involved in the management of the system but the key decisions are now taken by Parliament and implemented by the government. Each year Parliament sets a national health spending target (ONDAM) based on revenue estimates and the national health goals defined by the National Health Conference. The fact that the national spending target is voted by Parliament means that the nation's elected representatives make the desired amount of healthcare spending explicit. However, the budget is indicative rather than binding. Initial attempts to introduce claw-back measures – largely in the ambulatory care sector – established in the original reforms were declared unconstitutional.

Since the ONDAM has been repeatedly exceeded, the authorities have reorganised, in the 2004 reform of the social security law, the way that the ONDAM is to be constructed by broadening the range and the role of stakeholders in the system. The key points of the changes area as follows:

- The health insurance system will participate in developing the ONDAM through the *Union national des caisses d'assurance maladie* (UNCAM)[1] that will regroup the three major social insurers: the CNAM, CANAM and the MSA.[2] Each of the three insurers will present a budget proposal by the middle of the preceding year and the measures to ensure that the budget balance of the multi-year budget framework set by Parliament will be met.[3]

- A greater consultative role is given to new organisations regrouping health-care professionals (*Union national des professionals de santé*, UNPS) and private insurance and *mutuelles* providing complementary insurance (Union des organismes de protection sociale complémentaire). These will give their views on the decisions of the UNCAM as regards the reimbursement rates and the care covered by the insurers.
- An "Early-Warning" committee (Comité d'alerte) has been established that will follow spending developments and will warn the Parliament, the government and the social insurers when spending exceeds the ONDAM by 0.75%. In this case, the social insurers will be required to propose corrective measures and the *Comité* will assess whether the measures appear sufficient within the following two weeks. The authorities foresee that these adjustment measures will essentially take the form of reductions in reimbursement rates.

Rationalising health care supply and demand in the ambulatory sector

Against this background of changed institutional arrangements, the authorities have also put in place a number of additional reforms that are intended, partly, to limit the increase in public spending on health care:

- The introduction of an electronic personal medical dossier or file is aimed at improving the quality of care. According to the authorities, doctors should have – *via* this mechanism – a better overview of the health problems of the patient, reduce the risk of redundant care and permit treatments to be better tailored to patient needs. This is expected to reduce costs, but the key emphasis is on an expected improvement in the quality of care.[4] This will be introduced by mid 2007.
- With 15% of the population with chronic diseases representing roughly half of spending on health care of the social security system, greater attention will be paid to:
  - Establishing up to date treatment protocols based on evidence-based medicine for these groups (largely heart and circulatory disease, diabetes, cancer and mental disorders) by the newly established Superior Health Council (la Haute Autorité de santé, HAS, see below).
  - Identification of fraud and abuse of the system for those with chronic conditions and on sick leave.
  - Improving the regional management of health risks, illness patterns and care needs at all levels through agencies made up of the regional services of the UNCAM and the ARH, the goal being to adapt national policies to local conditions.
  - Better control of patient trajectories in the ambulatory sector. The reforms establish a family doctor (médecin traitant) to oversee the trajectory of the individual through the care system and ensure the co-ordination of care. The family doctor will receive a basic amount for a person with chronic disease who chooses the doctor (€ 40 per year).[5] While freedom of choice of doctor will be maintained, individuals not accessing a specialist through the family doctor will face lower reimbursement levels that will not be picked up by complementary insurance. Greater attention will be placed on ensuring that the specialists inform the generalists. Specialists are encouraged to provide specialist diagnosis and treatment – through a fee of paid € 40 – while the family doctor will be in charge of the follow-up.

– Greater incentives to prescribe generic drugs through the system of "tarif forfaitaire de responsabilité" (TFR), a reference price arrangement. This system, established in 2003, will be extended with drugs being reimbursed on the basis of the TFR, which is fixed near the price of generics in that group.
– Improving the oversight of doctors' prescribing and practice behaviour using a number of indicators. For example, doctors who over-prescribe without any obvious reason will be informed of the risk of sanctions – for example through the suspension of the right to over bill patients or a refusal to pay part of their social security contributions that would normally be picked up by the State.
– Increasing cost sharing through a Patient contribution for each care episode (*e.g.*, generalist or specialist consultation, biology test, etc.) of € 1 up to a limit of € 50 per year. Pregnant women, children under 18 and those covered by the CMU are exempted.

The responsibilities of the Haute autorité de santé (HAS)

In an effort to consolidate the existing arrangements and to give further impetus to the drive towards higher quality, the 2004 reform of the social security law also establish the HAS. This is an independent public body of a scientific nature governed by 8 "wise men". Its main operational ambit covers:

- The periodic evaluation of the service provided by health goods (pharmaceutical drugs, medical apparatus) and treatment and the impact on health outcomes;
- Establishing protocols of care and recommendations for high-quality care;
- Assessment of the quality of care of practitioners and the certification of health-care establishments;
- Implementation of the evaluation and accreditation of practitioners.

The HAS will take over the role of a number of existing institutions: the *Agence nationale d'accréditation et d'évaluation en santé* (ANAES) (which essentially undertook accreditation of hospital providers); *la Commission de transparence*; and, *la Commission d'évaluation des produits et des prestations* (CEPP) which evaluated the effectiveness of new medicines and medical apparatus.

The HAS will therefore have a considerable power over pharmaceutical drugs and, while the prices will continue to be set by the *Comité Economique des Produits de Santé* (CEPS), they will be strongly influenced by the opinions of the HAS concerning the services they render. The authorities expect that the consolidation of quality issues in one body will enhance its impact on the system and improve policy coordination

The reform of the hospital system

The French hospital system comprises a public hospital system which is financed through capped budgets (*Dotation globale annuelle*) and a system of private hospitals (often referred to as clinics) which are paid for on a fee for service basis but subject to overall constraints on the value of the services they can provide (*Objectif quantifié national* OQN). The system of capped budgets in the public sector has not provided incentives to improve the efficiency of the health care system (and may have actively hindered it), while the relative prices for private clinics proved not to be uniform over the country as a whole and do not necessarily reflect the costs of the activities performed.

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Public hospitals have also been constrained by excessive regulation and red tape. (For example, the appointment of a hospital doctor required the signature of the minister.) The incentives in the system have led the private hospitals to specialise in those treatment areas where the difference between the fee schedule and costs are the widest. This system has also contributed to sharp differences in the apparent efficiency between the two sectors. While the populations typically treated in the two sectors are not the same (with selection effects), the private clinics have been more nimble in providing elective care to low-risk individuals and have taken a large part of this market even though the costs to the patient can often face supplementary expenditures. Public hospitals have a larger share of "social" cases and patients with multiple pathologies and chronic conditions that tend to be high cost. Costs in the hospitals are estimated to be 30 to 40% higher than in the private sector. A large part of this difference in cost comes from differences in staff density.

At the end of 2002, the Ministry of Health introduced a reform of the hospital sector (*Le plan Hôpital* 2007. This programme proposed a number of measures aimed at rectifying a number these problems in the hospital sector. The key reforms are:

- Additional investment funds have been provided to counter the progressive run-down of existing physical plant and materials in the hospital sector. These total € 6 billion over the period 2002 to 2007. The investment of these funds are organised/overseen by a national agency (*Mission d'Appui à l'Investissement*).
- The progressive introduction of a new financing method for public and private hospitals to bring them closer in line with each other.
- The public hospital sector[6] will move from a capped budget system towards pricing based on activity (*Tarification à l'activité* or T2A). The rates of payment are built upon the existing cost-based information system (PMSI) used to assess the activity levels in individual hospitals.[7] The French system will allow for greater refinements in the price to allow, for example, for greater severity in certain cases. For the public system, over 60% of the budget will be paid for on this basis, the rest will take the form of grants related to a number of identified "public services" such as training (university hospitals) emergency wards or certain activities which continue to be financed by grants (psychiatry, follow-up care and re-education).
- In contrast to current arrangements (fee-for-service arrangements accompanied by a total cost ceiling (OQN), the private sector will only be paid on the basis of this prospective payment system on the basis of activity.

The authorities hope to achieve a harmonised system of payment for the public and the private sectors by 2012. However, there are already delays in the introduction of the new system in the private sector and the current expectation is that no more than 50% of total hospital costs will be activity based.

- The system of hospital planning through the Regional planning frameworks (*Schéma regionale d'Organisation Sanitaire* or SROS) will permit greater local flexibility in planning (*e.g.*, local needs will no longer be constrained by national targets). The authorisations for different types of medical buildings and equipment will be fixed every 5 years (in line with the lifetime of the SROS). The SROS will be overseen by the Regional Hospitalisation Agencies (*Agences Regionales de Hospitalisation* or ARH) and the need for ministerial authorisations will be reduced.

- Greater efforts will be directed towards: the establishment of alternatives to hospitalisation, improved care for the mentally ill and palliative care. Currently the establishment for new centres (*e.g.*, for outpatient surgery) needs to be balanced by a significant reduction in hospital beds which has in the past reduced incentives to provide new types of services. A separate plan for psychiatry will be established in the SROS and greater attention will be paid to establishing centres for palliative care.
- The law will also permit greater co-ordination and collaboration between different providers through co-operation agreements (*Groupements de coopération sanitaire*) between hospitals, clinics and providers in the ambulatory sector.
- Rules for purchasing will be made more flexible, in the first instance by aligning current rules on those in the EU.
- Finally, the governance of individual hospitals is being modified such that greater powers are given to the hospital director *vis-à-vis* the governing board, whose role will be limited to establishing the overall orientation of policies. Within the hospital, individual services (general medicine, opthamology, etc.) will be replaced by "centres of activity" and there will be a greater role for internal contracting in governing internal management of the individual hospital.

Notes

1. Union Nationale des Caisses d'Assurance Maladie.
2. CNAM: caisse nationale d'assurance maladie; CANAM: Caisse nationale d'assurance maladie des professions indépendantes ; MSA : protection sociale du monde agricole et rural.
3. The UNCNAM will propose a list of treatments that are covered, sets the reimbursement levels and negociates the contractual arrangements with the medical professionals. The reforms of the social security law also redefines the role of the governing bodies of the social insurers and strengthens their role with regard to the price setting for drugs and other medical goods and a new council overseeing developments in the hospital sector (see the description of the hospital reforms).
4. For example it has been reported that studies of heavy or atypical consumers of medical drugs had treatments that were inappropriate in just over 60% of the cases. (CNAM (2004), Rapport sur l'exécution de l'ONDAM, 2003).
5. All individuals aged more than 16 will need to choose their family doctor. The family doctor can be a specialist but is more likely to be a generalist.
6. In fact the public hospitals plus private hospitals having a public sector role.
7. This will only cover the services of Medicine, Surgery and Obseretics). Financing of, for example, psychiatry will follow existing arrangements. And local hospitals will temporarily be excluded from the the new financing system.

ANNEX 2.A3

Main characteristics and developments of the French tax system[1]

The tax-to-GDP ratio has been stabilised at a relatively high level

With a ratio of tax and social insurance contributions to GDP of around 44% over the last 20 years, France belongs to the group of OECD countries with relatively high tax levels. A number of other European countries (Austria, Finland, Norway, Belgium and Italy) also have tax levels at a similar order of magnitude (between around 42 and 46% of GDP) and only Sweden and Denmark have significantly higher tax levels (around 50% of GDP). The high tax burden in these countries is mainly caused by the scope of their welfare systems, in particular the financing of a good part of old-age pensions and health care services within the government sector (for a description of government spending in France see OECD(2003a)) (Figure 2.A3.1).

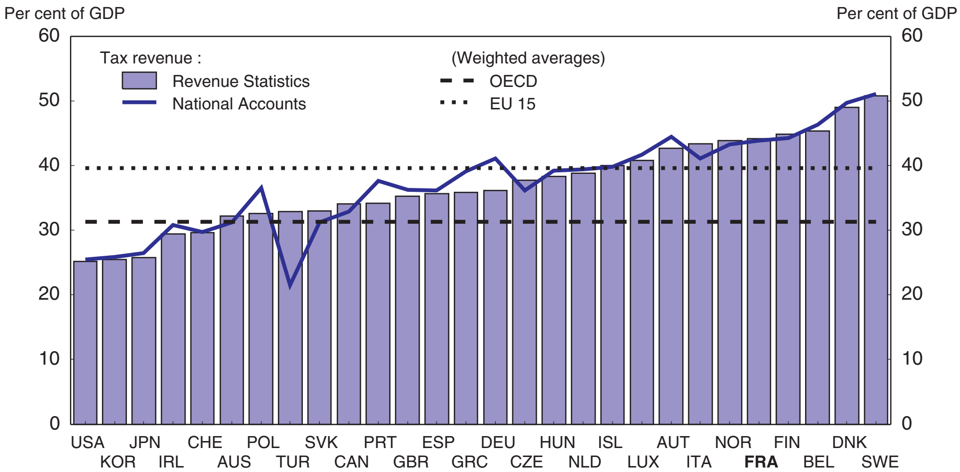
Despite relatively high level of taxation government revenues have never been sufficient to fully cover spending. As a result the level of public debt increased from 31% of GDP in 1985 to 65% now (on a Maastricht definition). Government deficits were particularly high between 1993 and 1995 when they reached around 5½ to 6% of GDP and on a cyclically-adjusted basis around 5%. After a short period with declining spending levels (as a percent of GDP) and buoyant revenues the deficit declined to 1½-1¾ per cent in 1999-2001 and the cyclically-adjusted deficit to 1½ per cent in 1999. Since then, public spending increased again while taxes were reduced at the same time. Perhaps the temporally high output elasticity of taxes of above 2 during the economic recovery in 1999 and 2000 (OECD, 2001) had created an illusion of a permanently high tax elasticity although according to recent OECD estimates the long-term output elasticity of total taxes is only 1 (Girouard and André, 2005). As a result the deficit increased to above 3% between 2002 and 2004 (both with and without cyclical adjustment) and therefore exceeded the 3% ceiling of the treaty of Maastricht The fiscal deterioration over the recent past now limits the room for further major tax cuts in the near future (Figure 2.A3.2).

The tax burden has shifted more onto labour and capital and away from consumption

The increase in the ratio of tax and social insurance contributions to GDP until the mid-1980s was mainly caused by the rise in social security contributions although taxes excluding social security contributions also increased somewhat. Since the mid-1980s the share of social security contributions in GDP declined somewhat while the share of other taxes continued to increase until 2000 and declined slightly since then. Among taxes

Figure 2.A3.1. **Tax to GDP ratio in OECD countries**

2003



1. Tax revenues from OECD National Accounts are not fully comparable with the information found in OECD Revenue Statistics. The divergences are due to a variety of general and country specific factors. The most important are the following: *i)* differences in accounting periods and methods; *ii)* voluntary social security contributions, which are fairly large for some countries (including Germany), are included as tax revenues in the National Accounts but not in the Revenue Statistics; so are the employer social security contributions for government employees; *iii)* imputed government contributions are not included in the Revenue Statistics; *iv)* inheritance and gift taxes are not considered as taxes in the National Accounts while they are included in the Revenue Statistics; *v)* for EU countries, VAT and customs revenues are shown net of the amounts transferred to the European Commission in the National Accounts while the Revenue Statistics show gross data.

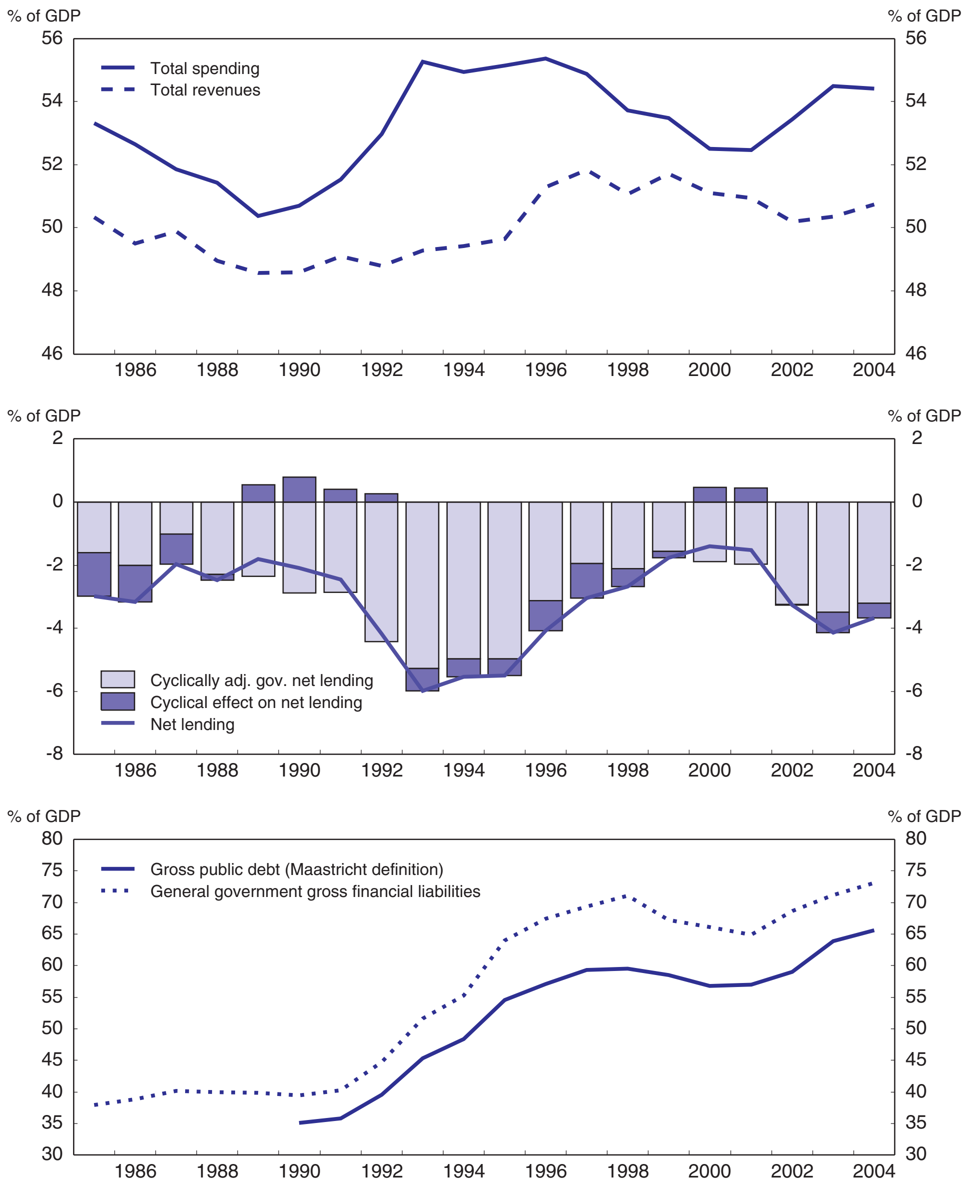
Source: *OECD National Accounts*; *OECD Revenue Statistics*, 1965-2003.

excluding social security contributions, taxes on goods and services became somewhat less important which was in contrast to the development in other countries. Instead the shares of taxes on personal income, including the CSG, on corporate income and on property increased both in GDP and in total taxes (Figure 2.A3.3, Tables 2.A3.1 and 2.A3.2).

The trend of shifting the tax burden more on labour and to shield consumption can also be seen if tax revenues are grouped according to economic criteria and expressed as a percentage of the relevant macroeconomic tax bases, resulting in implicit tax rates (ITR). In France the implicit tax rate of labour increased significantly over the past 25 years, and the ITR on capital also increased while the ITR on consumption has marginally declined. The trend of a rising implicit tax rate on labour and capital was also observed in the OECD area as a whole but was less pronounced than in France while the ITR on consumption did not decline in the OECD like in France but increased slightly (Carey and Rabesona, 2004). The government has taken various measures to limit the tax burden both on workers and firms. More recently, in France the trend of rising implicit tax rates on labour has been brought to a halt while the increase in the ITR on capital has continued and also the trend of a moderately declining tax rate on consumption. The implicit tax rates on labour and capital remain somewhat higher in France than on average in the EU 15 and the implicit tax rate on consumption remains somewhat lower (Table 2.A3.3).

The size and development of the implicit tax rate on capital contrasts with the average effective corporate tax rate as mentioned in the main text above. There are a number of reasons why these indicators differ. While the implicit tax rate on capital is based on actual

Figure 2.A3.2. **General government spending, revenues, financial balances and debt levels**

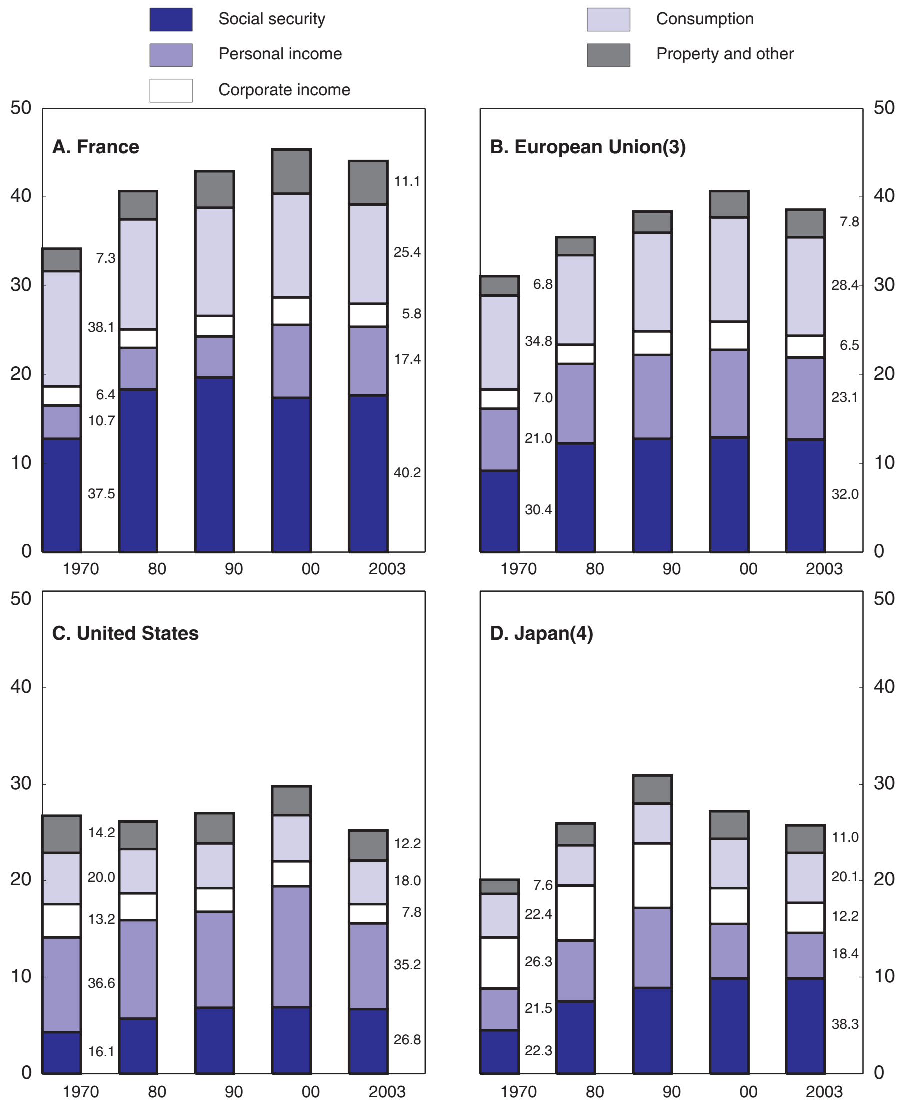


Source: OECD, *Economic Outlook*, No. 77.

tax payments which are affected by the history of profits and other factors which have affected past annual tax payments, the effective corporate tax rate relates to the corporate tax only and is based on tax parameters which affect investment decisions of a hypothetical firm. It is thus forward-looking and probably better suited as an impact measure for investment decisions. Furthermore the denominator of the implicit tax rate is estimated from National Accounts Statistics while for the effective tax rate it is based on model assumptions. In any case, care is needed with the interpretation of both indicators as they are unable to show the final incidence of capital taxes on the economy with mobile capital.

Figure 2.A3.3. **The evolution of the tax mix**[1]

Per cent of GDP[2]



1. The breakdown of income tax into personal and corporate tax is not comparable across countries.
2. Data along the bars are shares in total revenues.
3. Weighted average.
4. Last year available: 2002.

Source: OECD, Revenue Statistics database.

Social security taxes are high and have been supplemented by a social tax on total income

A large part of the French welfare system (such as health insurance, old-age pensions, unemployment insurance and family allowances) are funded *via* earmarked social security taxes. These amount to above 20% of GDP and to almost half of total taxes. Social security contributions are paid by both employers, employees and self-employed of which the lion's share (around 70%) is paid by employers. Given the financial constraints contribution rates

Table 2.A3.1. **Structure of tax revenues as % of GDP**

	1970	1980	1985	1990	1995	2000	2002
Total tax revenue							
France	34.1	40.6	43.8	43.0	43.9	45.2	44.0
EU 15	30.5	36.0	38.8	39.4	40.3	41.8	40.6
OECD	28.3	32.0	33.6	34.8	35.9	37.2	36.3
Social security contributions							
France	12.4	17.4	19.0	18.9	18.6	16.2	16.3
EU 15	7.1	10.3	11.1	11.1	11.8	11.5	11.4
OECD	5.5	7.4	7.9	8.2	9.3	9.3	9.3
Total tax excluding social security contributions							
France	21.7	23.3	24.8	24.0	25.3	29.0	27.7
EU 15	23.4	25.8	25.7	28.3	28.5	30.3	29.2
OECD	22.8	24.5	27.8	26.7	26.6	27.9	27.0
Taxes on personal income							
France	3.7	4.7	5.0	4.6	5.0	8.1	7.6
EU 15	8.5	11.0	11.3	11.0	10.8	10.9	10.8
OECD	8.3	10.4	10.4	10.6	10.0	10.0	9.8
Taxes on corporate income							
France	2.1	2.1	1.9	2.3	2.1	3.1	2.9
EU 15	2.1	2.1	2.6	2.6	2.7	3.8	3.4
OECD	2.3	2.4	2.7	2.7	2.8	3.7	3.4
Taxes on property							
France	1.6	2.0	2.5	2.7	3.4	3.3	3.3
EU 15	1.7	1.5	1.5	1.7	1.8	2.1	1.9
OECD	1.9	1.6	1.7	1.9	1.9	2.0	1.9
Taxes on goods and services							
France	13.0	12.4	13.0	12.2	12.0	11.6	11.2
EU 15	10.9	11.0	12.0	12.2	12.3	12.4	12.3
OECD	10.0	10.0	10.8	10.8	11.4	11.6	11.4

Source: OECD Revenue Statistics.

have been raised in the past (particularly for unemployment insurance) and income ceilings for the assessment of contributions have been abolished. At the same time, contribution rates have been reduced for low wage earners. Furthermore, new kinds of contributions have been introduced to broaden the base of financing. In 1991 a flat-rate income tax earmarked for social security, known as CSG (*Contribution Sociale Généralisée*) was introduced and in 1996 another levy, known as CRDS (*Contribution au Remboursement de la Dette Sociale*). Revenues from these new flat rate taxes are now larger than revenues from the personal income tax.

The personal income tax is highly progressive but has a narrow base

The personal income tax applies to income of persons (individually or jointly) including those enterprises which are not liable to corporate income tax. The personal income tax has been particularly affected by redistributive objectives. The rate structure is highly progressive. The earned income threshold where there is payable income tax is relatively high and the bottom marginal tax rate is relatively low (6.8% and including earmarked social taxes 14.6%) while the top marginal rate is relatively high (48.09% and including social taxes 55.9% for taxable earned income up from around € 48 000 in 2004).

Table 2.A3.2. **Structure of tax revenues as % of total tax revenues**

	1970	1980	1985	1990	1995	2000	2002
Social security contributions	36.3	42.7	43.3	44.1	42.4	35.9	37.0
France	24.2	29.2	28.9	28.4	29.5	27.7	28.1
EU 15	19.4	22.4	22.2	22.4	24.8	24.6	25.4
OECD							
Employee's social security contributions							
France	6.9	11.1	11.8	13.2	13.2	8.9	9.3
EU 15	8.0	8.9	9.3	9.4	10.2	9.1	9.1
OECD	6.2	7.1	7.5	7.8	8.4	8.0	8.3
Employer's social security contributions							
France	26.6	28.4	28.0	27.2	26.1	24.7	25.3
EU 15	13.8	18.6	17.2	16.7	16.4	15.9	16.3
OECD	11.0	14.0	13.3	13.2	14.3	14.3	14.6
Taxes on personal income							
France	10.7	11.6	11.5	10.7	11.3	17.9	17.3
EU 15	25.2	28.8	22.7	27.0	26.0	25.4	25.8
OECD	27.8	31.2	29.7	29.4	27.0	26.0	26.0
Taxes on corporate income							
France	6.3	5.1	4.5	5.3	4.8	6.9	6.6
EU 15	6.8	5.8	6.4	6.7	6.8	9.2	8.6
OECD	8.7	7.6	8.0	8.0	8.0	10.0	9.3
Taxes on property							
France	4.8	4.8	5.8	6.3	7.8	7.3	7.5
EU 15	5.8	4.2	3.9	4.4	4.6	5.1	4.9
OECD	7.1	5.3	5.2	5.7	5.5	5.5	5.5
Taxes on goods and services							
France	38.1	30.4	29.7	28.4	27.3	25.7	25.4
EU 15	36.4	31.1	31.6	31.5	31.0	30.1	30.8
OECD	35.8	32.4	33.7	32.0	32.4	31.7	31.9

Source: OECD Revenue Statistics.

Among OECD countries only Denmark has a higher rate top marginal tax rate (59%) while Sweden has a similar rate (including local taxes 56.5% for taxable income up from around € 48 000). In addition, in France large tax allowances prevail for families with children. Those benefit in particular from family income splitting ("*quotient familial*") which reduces tax liability for married couples with unequal income and for families with children.[2]

As a consequence the income tax base has been eroded and half of potential tax payers don't pay income tax and the shares of personal income tax revenues in GDP and in total tax revenues is relatively low. It yields less than 7% of total taxes and around 3% of GDP which is lower than in most other developed OECD countries. Tax brackets are adjusted for inflation, a measure which has become less important than in the past as inflation has come down. In contrast to other OECD countries and unlike social security contributions and the CSG, the personal income tax is not collected as a withholding tax for employed persons. It is instead collected in three installments in the year after the income is earned.[3] An option exists, however, for monthly payments in the current year, assessed on income earned in the past year with an adjustment at the end of the year to consider differences in income. About 45% of taxpayers use this option.

Capital gains are in some cases included in taxable income (either wholly or partially) and in other cases subject to a separate flat tax rate. The rate of tax on capital gains

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Table 2.A3.3. **Implicit tax rates (ITR) on labour, capital and consumption**

Revenues as a % of the relevant tax bases

	Average 1995-2002	Change between 1995 and 2002 in percentage points
ITR on consumption		
France	18.1	–0.8
EU 15 base weighted	19.6	0.0
arithmetic average	22.3	0.8
ITR on labour		
France	42.7	–0.3
EU 15 base weighted	37.3	–0.9
arithmetic average	37.1	–0.1
ITR on total capital		
France	35.5	5.6
EU 15 base weighted	27.9	4.0
arithmetic average	27.5	5.8
ITR on capital and business income		
France	18.8	4.4
EU 15 base weighted	19.5	3.3
arithmetic average	19.7	4.5
ITR on corporate income		
France	22.9	9.7
EU 15 base weighted	20.8	6.6
arithmetic average	17.0	3.2
ITR on capital and business income of households and self-employed		
France	13.6	0.3
EU 15 base weighted	14.9	2.4
arithmetic average	11.6	0.5

Source: Structures of the taxation systems in the European Union, European Communities (2004).

obtained after selling bonds or shares is harmonised with the rate of withholding tax on interest income (27%), (it has been recently increased with the rise of the CSG to finance the social security deficit.) Since the 1st January 2004, capital gains on real estate are no longer included in taxable income, but taxed at a flat rate of 26%, (now 27% for the same reasons) with a tax threshold set at € 15 000 (as in the case of securities). Capital gains on real estate are completely tax exempt for assets which have been held for more than 15 years.

Capital transfers by inheritances and gifts are treated in much the same way, but the granting of the gifts is encouraged by tax deductions that depend on the age of the donor. For children and spouses the marginal rate of tax (after the personal allowances) is between 5 and 40%.

Corporate income tax rate has been reduced

Corporate income tax *(impôt sur les sociétés)* is levied on limited companies, (*societés anonymes*), most limited liability companies (*sociétés à responsabilité limitée*), limited partnerships with shares (*sociétés en commandite par actions*), permanent establishments (branches) of foreign companies, and cooperatives. The taxable profits of the company are net profits, calculated from gross profits, general expenditures, amortisations, provisions and loss carryovers. Companies subject to the corporate tax are liable to an annual lumpsum tax (minimum tax) even if they obtain no profits. *Dividend income* receives a tax allowance of 50% (which replaced the former tax credit or *avoir fiscal*). When the corporate tax rate was 50%, the tax credit of 50% of cash dividends eliminated half the double taxation, but with the corporate tax rate of 33.3%, it completely eliminated double taxation.

The rate of the corporate income tax was 35.4% in 2004 (34.33% without the social contribution on companies) and will slightly fall in 2005 and 2006 as the extra 3% surcharge on corporation tax which was introduced in 1995 and 1997 (at a rate of 10%, reduced to 3% in 2002) is removed in two stages. The overall corporate tax rate will thus fall to 33.3% in 2006. This rate (both for retained and distributed profits), which was 50% in 1965, came down in various stages (for retained profits) as from 1985. However, other countries also have cut tax rates and sometimes more than France and the tendency to reduce corporate tax rates as a form of tax "competition" seems to continue, at least in Europe. Small and medium-sized enterprises pay a lower rate of 15% and since 2003 special tax incentives are provided to young (less than eight year's old) firms with a certain share of R&D activity.

… and corporate tax revenues have increased as a share of GDP

Despite the cuts in the statutory rate over the past decades the revenues from taxes on corporate income increased over the past decades from around 2% of GDP to around 3% of GDP. Their share in total taxes increased from the mid-1980s (after a decline before) until 2000 to almost 7% and declined to 6.6% in 2002. The reason for the trend increase in corporate tax revenues as a per cent of GDP is that the share of profits in GDP has increased over time and that the strategy of tax-cutting has been accompanied by base-broadening measures.

An important element determining the corporate tax base is depreciation allowances. In France the standard type of depreciation is the straight-line method but accelerated depreciation on a declining-balance basis with a switch-over to straight-line is allowed for equipment with a useful life of at least three years and for buildings having a useful life of below 15 years. Special investment incentives are provided for various purposes, such as investment in special regions, research and development expenses, antipollution investment. Furthermore (since 1988) companies are entitled to set up a tax-free reserve for investment in commercial establishments abroad under the condition that this is for the purpose of the marketing of products made in France by the enterprise. As a result of base broadening measures depreciation allowances have become less generous. However at the same time the lowering of inflation has worked in the opposite direction as it has reduced the disadvantage stemming from the fact that depreciation allowances are based on historical cost of the asset rather than being indexed to inflation. This has cancelled part of the negative effect of base-broadening measures as can be seen from the development of depreciation allowances (with time specific inflation rates) (Table 2.A3.4). As for industrial buildings standard depreciation has remained constant over time, the lowering of inflation has increased the present value of depreciation allowances (with time specific inflation rates) over time (for buildings only the base case with constant inflation is shown in the table). Overall it appears that in France the base-broadening measures have been more limited than in some other countries, such as the United Kingdom, Ireland, Canada and Austria, although most of these countries had before more generous depreciation allowances than in France.

Table 2.A3.4. **Corporate Income Tax Parameters**

Year	Statutory corporate tax rate in %[1]	Present discounted value of depreciation allowances in %						
		Base case with constant inflation rate				Alternative case with time and country-specific inflation rates		
		Plant and machinery		Industrial buildings		Plant and machinery		
	France	Average of other countries[2]	France	Average of other countries	France	Average of other countries	France	Average of other countries
1982	50	47	85	81	38	48	78	76
1990	37	40	80	76	38	40	80	73
1991	34	39	80	75	38	39	80	73
1992	34	37	80	76	38	38	81	75
1993	33	35	80	77	38	39	81	77
1994	33	36	80	76	38	38	82	77
1995	37	36	80	76	38	37	82	77
1996	37	36	87	75	38	35	88	77
1997	42	36	80	75	38	35	82	78
1998	42	35	80	76	38	34	83	79
1999	40	35	80	76	38	34	83	79
2000	38	34	80	76	38	34	82	77
2001	36	33	77	76	38	33	80	77
2002	35	33	77	75	38	33	80	77
2003	35	33	77	74	38	33	80	76

1. Including local taxes.
2. Unweighted average of 18 OECD countries (Australia, Austria, Belgium, Canada, Finland, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States).

Source: Devereux, Griffith and Klemm (2002).

The local business tax is under permanent reform pressure

The *local enterprise tax (taxe professionnelle)* was introduced in 1975 (replacing the traditional "*patente*") and its tax base originally comprised the part of the wage bill and the rental value of the fixed capital stock. Its rates are set individually by the three levels of local authorities (regions, departments and communes) and vary within the limits set by national law.[4] The tax is deductible from the corporate income tax base and there are also numerous exemptions. As a result, among the 3.6 million potential tax payers, only 2.7 million (75%) are actually paying the tax. To avoid an excessive burden, various reliefs were granted and a ceiling was set up so that the amount of the tax cannot exceed 3.5 to 4% of the value added, depending on the size thereof. The central government covers the financial losses of these relief measures to local authorities so that the tax burden of the firms amounts only to around two thirds of the funds received by local authorities. This has contributed to the relative buoyancy of local authorities' *vis-à-vis* central government's net revenues.

Originally the tax base was (after considering the tax-capping) relatively equally distributed to capital and labour (in 1998 with 53.5% falling on capital and 46.5% on labour) (*XV[e] rapport du Conseil des Impôts*). However, between 1999 and 2003 the salary part was removed from the tax base in order to reduce cost pressures for firms and to increase their labour demand thus transforming the *taxe professionnelle* basically into a tax on business capital.[5] Thus large capital-intensive firms are most affected by this tax so that the tax burden is unequally distributed across firms. Furthermore, as the tax is not related to the profit situation of firms, the tax burden (in relation to profits) increases if the return on capital falls, which tends to increase cyclical fluctuations of investment. However, the government has sometimes taken measures to counteract negative cyclical effects. The most recent stimulatory measure was to give firms tax relief on new productive investment carried out between 1st January 2004 and 31 December 2005.

Given the various exemptions and relief measures administrative costs for collecting this tax appear to be relatively high. By fixing the tax rates only at post after information about the base is available helps local authorities to stabilise their tax revenues over time but it makes tax liabilities less predictable for firms and it could also increase the tax burden during recessions if tax rates are increased in response to a fall in the tax base.

Revenues for local authorities from the *taxe professionnelle* increased over time from round 1% of GDP in the mid 1970s to around 2% in the second half of the 1990s and fell slightly to 1.8% in 2003. However, if one considers tax relief measures, including the cap as a share of company value added and also the deductibility from the corporate income tax base, the final tax burden for business and the net revenues for the general government are almost 40% lower (in 2003 1.1% of GDP) than revenues for local authorities.

Despite recent reforms this tax remains controversial as it is highly concentrated on larger companies, in particular in industry. It also leads to relatively large disparities of tax revenues between local authorities despite the equalisation scheme which has been set up to reduce imbalances. Furthermore, as the central government compensates local authorities for revenue losses from tax relief it is faced with a growing fiscal burden. The government is now planning a new reform and has established a Commission to find a replacement for the *taxe professionnelle* under the conditions that the new tax preserves the link with local economic activity, does not shift the burden on households and maintains financial autonomy of local authorities and facilitates the development across communes.

This commission[6] suggested replacing the current tax base of the *taxe professionnelle* by a tax base with two components: first the gross value added deriving from the firm's accounts which is – for firms with different locations – allocated by shares in employment, and second the rental value of the firm's real estate (*valeur locative foncière*). (Already in 1989 the Tax Council had suggested transforming the *taxe professionnelle* into a tax on local value added). Furthermore, local authorities should have the power to fix tax rates within a band of a minimum and a maximum rate. The commission also suggested to re-examine the exemptions and special allowances related to this tax in the light of the constitutional principle of equal tax treatment (*égalité devant l'impôt*). Special tax breaks which do not conform with this principle and also lead to unfair competition should be abolished. It is expected that this new tax would have many advantages, such as making the distribution of the tax burden more equal across firms, creating less economic distortions (as capital is taxed less) and improving firm's international competitiveness, better reflect the costs of firm's activity for local authorities (equivalence principle) and reducing administrative costs. One could, perhaps, argue that taxing local value added would go backwards as by taxing wages and salaries, which are the largest part of value added, labour would be taxed again and perhaps more than before the recent reforms. However, one also has to consider that for many (mainly large firms) the *taxe professionnelle* is already a de facto tax on value added, with fairly different methods of calculation, as their final tax payment has an upper limit determined by that value added; while these firms represent only around 5% of all tax payers, they pay almost 40% of the total net revenues of this tax.

Property taxes are another important revenue source for local authorities

Besides the *taxe professionnelle,* local property taxes are the main local taxes. Local property taxes have been rather buoyant over the past decade as tax rates have been raised and the number of buildings increased. There are two property taxes, the land tax, (with two components on land and buildings, the *impôt foncier non bâti* and *the impôt foncier bâti*) and the tax on occupied housing (*taxe d'habitation*). Where the property tax is paid by firms (impôt foncier) it is deductible from the corporate income tax base. The tax on occupied housing has to be paid by dwelling occupants, whether they are tenants or owners. It is collected at two levels: municipal and departmental, the regional part having been abolished in 2000. The tax base is the rental value of the dwelling and the rates are set every year by the different local authorities. There are tax allowances for dependent persons and old people and poor people are also often exempt. This tax has been criticised for a number of reasons (such as inappropriate tax base, unfairness, high administrative costs) which may lead to further reform.

Besides the local taxes on property there exists a personal net wealth tax on large properties (*impôt sur les grandes fortunes*). It was first introduced in 1981 but again abolished in 1987. In 1989 this tax was re-introduced with a new name (*impôt de solidarité sur la fortune*, ISF). Only personal wealth is taxable. Business wealth, works of art and antiques are not taxed. The tax rate is progressive, with marginal rates between 0.55 (in 2003 for wealth above € 720 000 and in 2005 above € 732 000) and 1.8% (in 2003 for wealth above € 15 million and in 2005 above € 15 255 000). For many years, the tax brackets remained unchanged, but inflation was taken into account for the 2005 tax year, whereas some people had advocated the abolition of this tax to follow the example of many other European countries and avoid capital flight. In 2003 this tax was paid by around 300 000 tax payers (up from around 180 000 in 1997) and its yield amounted to around € 2.3 billion or around 1% of central government net taxes.

The share of consumption taxes in government revenue has declined over time

The relative size of taxes on goods and services has declined over time. In 2002 their share in GDP amounted to 11.2% and their share in total taxes (including social security contributions) to 25.4%. In 1990 the respective shares were 12.2% and 28.4% and in 1965 13.2% and 38.4%. Both taxes on general consumption and on specific goods and services contributed to this decline.

The Value Added Tax has a standard rate of 19.6 % which corresponds to about the average of the EU member states (including the new members). The rate has been raised by 2 percentage points since the end of the 1980s, with the latest increase in 1995 from 18.6% to 20.6% before its reduction to the current rate in 2000. There are also reduced rates (2.1% and 5.5%) for food products and a number of other consumption items, such as pharmaceuticals, passenger transport, hotel accommodation, books and newspapers. While differentiated rates and exemptions reflect social or other policy objectives, they may also distort competition and have the effect of changing consumption patterns (Joumard, 2001). Furthermore, international differences in VAT rates may affect cross-border shopping in boundary areas, as is the case in the Northern part of France as gasoline prices are much lower in Luxembourg, mainly because of lower VAT and excise taxes than in France. In recent years, the emergence and rapid expansion of e-commerce and the increased risk of fraud, for example by declaring fictitious intra-Community deliveries, are putting additional pressure on tax administration and the EU Commission has made various proposals to improve international co-operation and make VAT systems less vulnerable to fraud. As a result of various exemptions, the reduced rates and other special regimes, the gap between the statutory standard tax rates and the implicit tax rate on final household consumption, as calculated by dividing VAT revenue from household consumption by its macroeconomic base (*i.e.,* consumption exclusive of consumption taxes) was estimated in 2000 to be 4.4 percentage points, or 22% of the standard tax rate which was higher than on average in the EU 15 and much higher than in Denmark, Finland, Sweden, Austria and Germany (Table 2.A3.5).

Environmentally related taxes are relatively low apart from petroleum taxes

Taxes on petroleum products (TIPP) remain relatively high in France (although they have been reduced recently) and account for the bulk of environment-related taxes, although heating oil and gas are also taxed. The new laws on decentralisation have changed the distribution of TIPP revenues. Since 2004, part of the revenues from these taxes has been transferred from the central government to local authorities (departments) (together with the insurance tax, TCA) to cover the fiscal costs of new spending responsibilities (for the two social benefits, the RMI and the RMA). It is planned to extend the revenue sharing of TIPP to the regions and also to give them the power to fix tax rates (within certain limits) which is not possible for departments.

Table 2.A3.5. **Implicit VAT rates and statutory standard VAT rate in 2000**

	Implicit VAT rate for final household consumption (%)	Implicit VAT rate (%)	Statutory standard rate (%)	Gap standard *vs.* implicit rate (%)	Gap standard *vs.* implicit rates, as a % of the standard rate
Belgium	16.3	16.9	21	4.1	19
Denmark	NA	25	25	0	0
Germany	14.1	14.7	16	1.3	8
Greece	12.6	14.2	18	3.8	21
Spain	10.8	10.9	16	5.1	32
France	14.7	15.5	19.9[1]	4.4	22
Ireland	16.0	15.2	21	5.8	28
Italy	14.8	15	20	5.0	25
Luxembourg	10.5	11.1	15	3.9	26
Netherlands	13.3	14.6	17.5	2.9	17
Austria	16.5	17.3	20	2.7	14
Portugal	12.8	13.2	17	3.8	22
Finland	19.4	19.9	22	2.1	10
Sweden	20.2	21.4	25	3.6	14
United-Kingdom	13.9	13.7	17.5	3.8	22

1. 19.6% and 20.6%.

Source: EU Commission.

Taxes on petroleum products which have initially been introduced for fiscal purposes do in their current form not adequately reflect the pollution content of fuels. For example diesel which has higher environmental costs is lower taxed than unleaded premium which encourages the shift towards diesel engines in cars (see main text above). An earlier plan of the government to reduce the tax differential of diesel fuel to the average European level within seven years was – after two years of reductions – suspended in 2000 when oil prices increased sharply and it has not been resumed**.** Furthermore, a number of tax exemptions or relieves are provided to certain sectors and activities in order to protect them against losses in competitiveness (OECD, 2001a).

Various taxes and charges on polluting emissions or products have been introduced since the early 1980s. Most of these taxes were at the time allocated to the budget of the Agency for Environment and Energy Management (ADEME) and were earmarked for pollution cleanup expenses and not intended to provide an incentive proportional to pollution costs. Among them the tax on air pollution (*taxe parafiscale sur la pollution atmosphérique, la TPPA*) was introduced in 1985 on sulphor dioxide (SO_2) emissions, and extended in 1990 to encompass nitrogen oxides (NO) and hydrochloric acid (HCI) emissions and then, in 1995, emissions of volatile organic compounds (VOC). The revenues from the tax were earmarked for subsidies for abatement investments or for research and development. It was estimated that this tax had a significant negative impact on VOC and SO_2 emissions but not on NO emissions (Millock *et al.*, 2004). However, according to this study the subsidy seems to have increased emissions to such an extent that the impact of the tax on pollutant emissions was greatly reduced. The authors explain this by output effects (which were, however, not directly measured) so that even if emission coefficients were reduced by the abatement subsidy, the installation of modern end-of-pipe abatement appeared to have increased total production enough to reverse the effect on absolute emission levels.

In 1999 all these taxes, including the TPPA, were grouped under a general pollution tax (*taxe générale sur les activités polluantes*, TGAP) and were initially assigned to the general budget and in 2000 to the social contribution reform fund (*fonds de financement de la réforme des cotisations patronales de sécurité sociale,* FOREC) that finances tax relief for employers on their welfare charges, specifically in the context of the introduction of the 35 hour working week. In 2004 this fund was dissolved and its transactions were included in the budget. The TGAP is thus currently assigned to the general budget.

Notes

1. For an overview of the French tax system see also Laurence Blotnicki and C. Heckley (1998).
2. Taxable income is divided by a coefficient that varies according to the number of family members and the family status. The tax rate is then applied to the resulting income and the tax so computed is then multiplied by the same coefficient. For example the splitting coefficient for married persons without children is 2, with one child it is 2.5, with two children it is 3 and it rises by one for each additional child.
3. Two equal instalments on provisional assessment are paid in February and May, the third within two months after receiving notice (usually in September). A 10% penalty based on the tax liability is levied in the case of late payment.
4. There is ceiling for local rates as they cannot be higher than the double of the national average. Commission de réforme de la taxe professionnelle, rapport au Premier ministre, (présenté par Olivier Fouquet, président de la commission, 8 Juillet 2004).

5. The tax base consists of three parts: 1) the sum of the cadastral value of the business buildings (tax base of the land tax), 2) the sum of 16% of the acquisition costs of business fixed assets, and 3) any rent paid for other business equipment. Furthermore, many smaller firms are taxed according to a minimum tax base, which is derived from the inhabitant tax (taxe d'habitation).
6. Commission de Réforme de la Taxe Professionnelle, report to the Prime Minister, (presented by Olivier Fouquet, Commission chair, 21 December 2004.

Executive summary

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

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

Focusing fiscal policy more on transparency and long-term needs

Above all, long-term fiscal sustainability requires better control of public expenditures, including social expenditures and those of regional and local governments. It is important to reform the fiscal system, by reducing the number of organisms involved and simplifying the tax structure through eliminating those tax breaks that are insufficiently justified. This would permit reduction in some high tax rates, which currently create economic distortions.

Creating employment by improving the functioning of the labour market

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

Allowing competition to create new opportunities for growth and employment

International experience suggests that still substantial public ownership, the only gradual market opening in network industries, protection of some service sector professions and the absence of competition in parts of retailing in France reduce the potential for growth, innovation and employment. Reforms should give greater weight to consumer welfare as against special

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interest groups. The whole economy would benefit from stronger competition in network industries, reduction in restrictions on entry to many professions and a deep reform of controls on retailing.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of France were reviewed by the Committee on 9 May 2005. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 2 June 2005.

The Secretariat's draft report was prepared for the Committee by Paul O'Brien, Stéphanie Jamet, Jens Høj, Michael Wise and Howard Oxley under the supervision of Willi Leibfritz.

The previous Survey of France was issued in July 2003.

This Economic Survey may not include an examination of certain policies that are relevant to the country but fall within the competence of the European Community. While some of these policies may be examined in the Survey of the Euro Area, other policies may not be examined by the EDRC, as the European Commission currently maintains that the Economic Surveys should be limited in their coverage. No limits apply to the policies that can be covered in the Economic Surveys of other OECD countries.

The Commission and the member States of the European Union are working actively on ways of reviewing EC and EU wide policies within the context of the EDRC.

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BASIC STATISTICS OF FRANCE

THE LAND

Area (1 000 km^2), 2002	632.8	Major cities (thousand inhabitants), 1999:	
Agricultural area, excl. overseas departments (1 000 km^2), 2002	302.8	Paris	2 125
		Marseille	798
		Lyon	445

THE PEOPLE (2004)

Population (thousands)	62 177	Total labour force, excl. overseas departments (thousands)	27 330
Number of inhabitants per km^2	98	Percentage of employment in:	
Average annual increase (thousands) 1990-2004	286	Agriculture	3.5
		Industry and construction	23.0
		Services	73.5

PRODUCTION (2004)

Gross domestic product at market prices (euros billion)	1 624	Gross value-added by activity, at basic prices (per cent):	
Gross domestic product per capita (euros)	26 202	Agriculture	2.7
Gross fixed investment as a per cent of GDP (current prices)	19.5	Industry	17.3
		Construction	5.3
		Services (excl. FISIM)	74.7

GENERAL GOVERNMENT (2004)

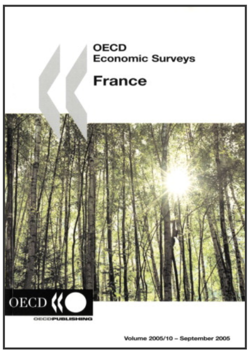
ESA95 concept, as per cent of GDP:	
Total expenditure	54.4
Total revenue	50.7
Gross fixed investment	3.3

FOREIGN TRADE (2003)

Exports of goods and services (% of GDP)	25.8	Imports of goods and services (% of GDP)	24.7
Main exports as a percentage of total exports (SITC):		Main imports as a percentage of total imports (SITC):	
Food, beverages and tobacco (0 + 1)	11.5	Food, beverages and tobacco (0 + 1)	8.4
Chemical products (5)	16.9	Chemical products (5)	13.6
Manufactured products (6 + 8 + 9)	24.1	Manufactured products (6 + 8 + 9)	28.7
Machinery and transport equipment (7)	42.8	Machinery and transport equipment (7)	36.9

THE CURRENCY

Monetary unit: euro	Currency unit per $, average of daily figures:	
	Year 2004	0.8049
	April 2005	0.7727



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