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The French Tax System:  
Main Characteristics,  
Recent Developments and  
Some Considerations for  
Reform

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**Paul O'Brien**

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**THE FRENCH TAX SYSTEM: MAIN CHARACTERISTICS,  
RECENT DEVELOPMENTS AND SOME CONSIDERATIONS FOR REFORM**

**ECONOMICS DEPARTMENT WORKING PAPERS No. 439**

**by Willi Leibfritz and Paul O'Brien**

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## ABSTRACT

### **The French Tax system: Main characteristics, recent developments and some considerations for reform**

France belongs to the group of OECD countries with relatively high tax levels. In recent years French governments have been increasingly aware that the tax system may have negative effects on growth and employment and some reforms have been introduced to reduce tax distortions. There has, however, been no grand reform design and it is also not clear in which direction it should go. This paper describes the main characteristics and the developments of the French tax system and examines some of its economic distortions and complexities. A future tax reform agenda could focus on the following five elements: First, reduce labour tax distortions by further reductions in social security contributions for low paid workers and reducing the withdrawal rate for in-work benefits, financing these either by increasing the *Contribution Sociale Généralisée* (CSG) or value added tax. Second, simplify the personal income tax, widening its base to permit lower top rates, and introducing deduction at source. Consider merging it with the CSG if this can be done in an administratively efficient way. Third, reduce capital tax distortions by cutting the corporate tax rate and widening the tax base by reducing the number of special incentives for certain kinds of activity, and also reduce the bias in favour of debt finance. Fourth, increase the role of “green” taxes because of the efficiency gains they offer — though not as significant sources of revenue. Fifth, improve, and reduce the costs of, tax administration by progressively merging tax administrations where possible.

This Working Paper relates to the 2005 OECD Economic Survey of France ([www.oecd.org/eco/surveys/france](http://www.oecd.org/eco/surveys/france)).

JEL : H2, H71, E62, J32.

Key Words : Taxation, Tax policy, Social Security, Tax administration.

## RÉSUMÉ

### **Le système fiscal français : principales caractéristiques, évolutions récentes et réflexions sur une réforme**

La France appartient au groupe des pays de l'OCDE ayant des niveaux d'imposition relativement élevés. Ces dernières années, les autorités françaises ont pris de plus en plus conscience des effets négatifs que le système fiscal peut avoir sur la croissance et l'emploi et des réformes ont été introduites pour réduire les distorsions fiscales. Il n'y a pas eu, toutefois, de grand projet de réforme et on n'appréhende pas encore très bien non plus dans quel sens la réforme devrait aller. La présente étude décrit les caractéristiques et les évolutions du système fiscal français et examine certaines de ses complexités et distorsions économiques. Un programme de réforme fiscale pour l'avenir pourrait être axé sur les cinq objectifs suivants : premièrement, atténuer les distorsions imputables aux prélèvements sur le travail en abaissant encore les cotisations de sécurité sociale pour les bas salaires et en diminuant le taux de réduction en fonction du revenu des prestations subordonnées à l'exercice d'un emploi, ces dernières étant financées par une augmentation de la Contribution sociale généralisée (CSG) ou de la taxe à la valeur ajoutée. Deuxièmement, simplifier l'impôt sur le revenu des personnes physiques, en élargissant sa base de façon à permettre une baisse des taux supérieurs d'imposition et en introduisant le prélèvement à la source. On pourrait envisager de fusionner cet impôt avec la CSG si cela peut être fait de façon administrativement efficiente. Troisièmement, réduire les distorsions imputables à l'impôt sur le capital en baissant le taux d'imposition des sociétés et en élargissant l'assiette fiscale grâce à une diminution du nombre d'incitations spéciales pour certains types d'activité, et également atténuer le parti-pris en faveur du financement par l'emprunt. Quatrièmement, accroître le rôle des impôts écologiques en raison des gains d'efficacité qu'ils offrent — même s'il ne s'agit pas d'une source importante de recettes. Cinquièmement, améliorer l'administration de l'impôt, et en réduire les coûts, en fusionnant progressivement les administrations fiscales lorsque c'est possible.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de la France, 2005 ([www.oecd.org/eco/etudes/france](http://www.oecd.org/eco/etudes/france)).

JEL: H2, H71, E62, J32.

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## **THE FRENCH TAX SYSTEM: MAIN CHARACTERISTICS, RECENT DEVELOPMENTS AND SOME CONSIDERATIONS FOR REFORM**

*Willi Leibfritz and Paul O'Brien<sup>1</sup>*

### **1. Introduction**

1. With a tax-to-GDP ratio of around 44% over the last 20 years France belongs to the group of OECD countries with relatively high tax levels. As in other high-tax countries this is mainly caused by the scope of the welfare system, in particular the financing of a good part of old-age pensions and health care services within the government sector. So long as the share of public spending in GDP remains high average tax rates also have to be high as well. Careful design of the tax system is therefore required to limit distortions on the economy.

2. The French system of taxation is also characterised by its high complexity. A large number of items or activities are subject to specific taxes, there are many institutions involved in calculating, collecting and allocating revenues and additional complexity is engendered by a multitude of more or less important exemptions and allowances for certain activities, sectors or agents. All this shows up in internationally high administrative costs.

3. In recent years French governments have been increasingly aware that the tax system may have negative effects on growth and employment and some reforms have been introduced to reduce tax distortions. There has, however, been no grand reform design and it is also not clear in which direction it should go.

4. This paper describes the main characteristics and the developments of the French tax system and examines some of its economic distortions and complexities.<sup>2</sup> It also discusses some options for future tax reform.

### **2. The tax to GDP ratio has been stabilized at a relatively high level**

5. 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 and how government activities are perceived by economic agents. 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.

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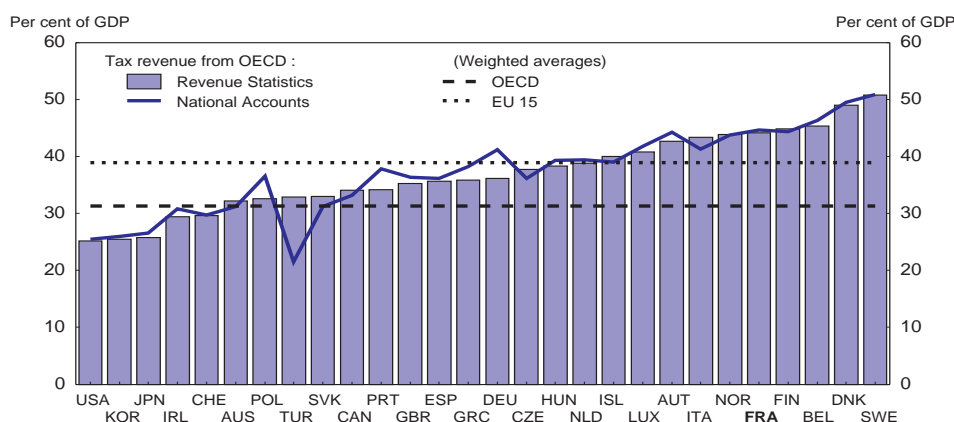
1. The paper is an extended version of the section on taxation in the *Economic Survey of France* published in June 2005 under the authority of the Economic and Development Review Committee. The authors are grateful to Val Koromzay, Andrew Dean, Christopher Heady and Christophe Heckley for valuable comments on earlier drafts. The paper has also benefited from discussion with French experts, in the private sector, as well as ministries and government agencies. Special thanks go to Roselyne Jamin for technical assistance and to Nadine Dufour and Deirdre Claassen for technical preparation.

2. For an earlier overview of the French tax system see also Laurence Blotnicki and C. Heckley (1998).

6. The ratio of total tax revenues (including social security) as a per cent of GDP is generally used as an indicator for the overall tax burden and we will first look at this measure before examining the characteristics of the French tax system in more detail. After rising rapidly during the 1970s and the first half of the 1980s, the tax-to-GDP ratio has remained broadly at a level of 44% over the last 20 years. The French tax tax-GDP ratio is significantly above the OECD average and the EU 15 average. It is similar as in Finland and Belgium and only Denmark and Sweden have markedly higher tax levels (Figure 1).

7. Despite relatively high level of taxation government revenues have never been sufficient to fully cover spending. As a result the level of Government debt increased from around 40% of GDP in the second half of the 1980s to currently over 70% (on a Maastricht definition the debt level is now slightly below 65%). 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, government 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 OECD estimates the long-term output elasticity of total taxes is only 1. 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 1).

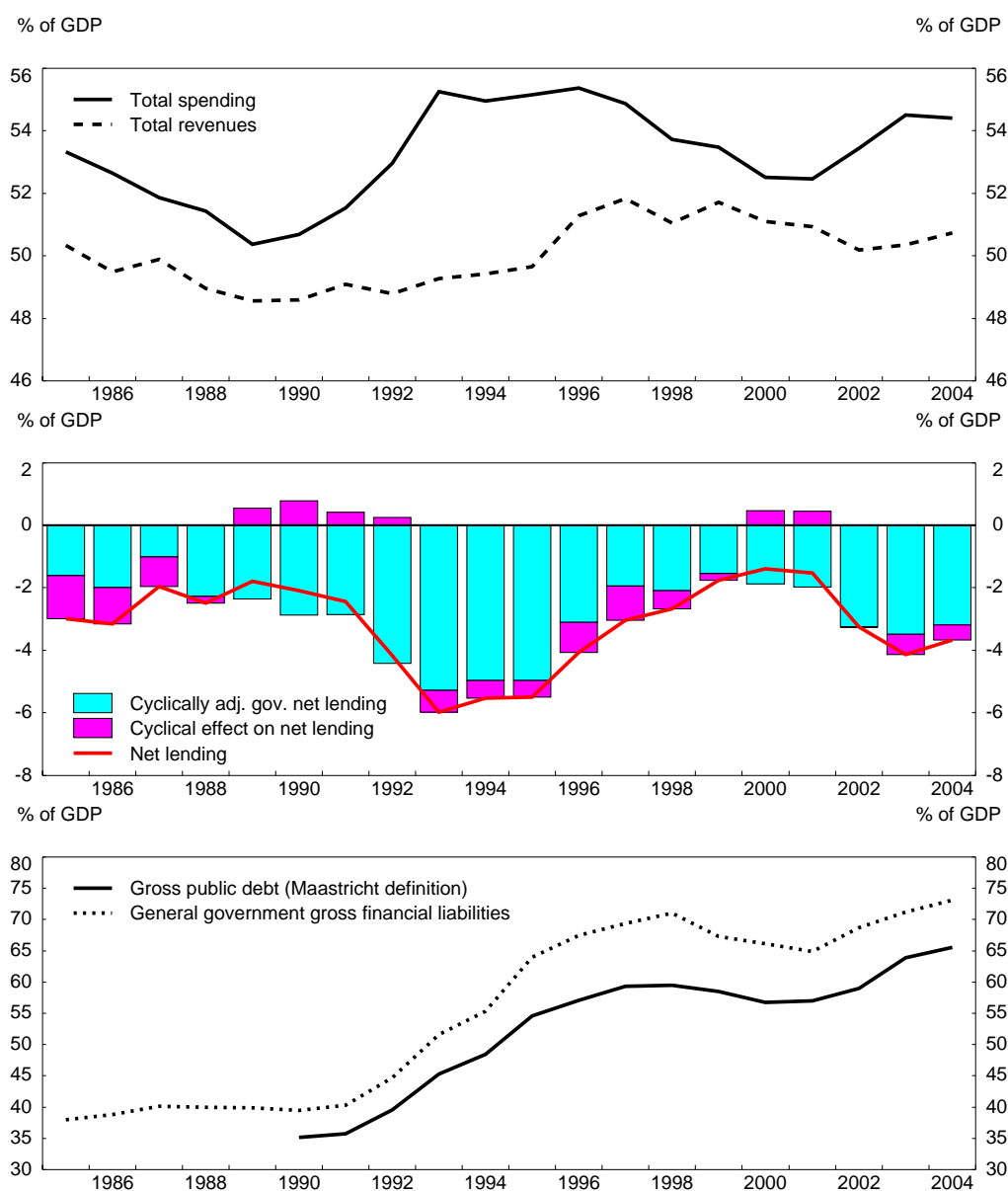
**Figure 1 Tax to GDP ratio in OECD countries**  
2003



**Note:**

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.

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

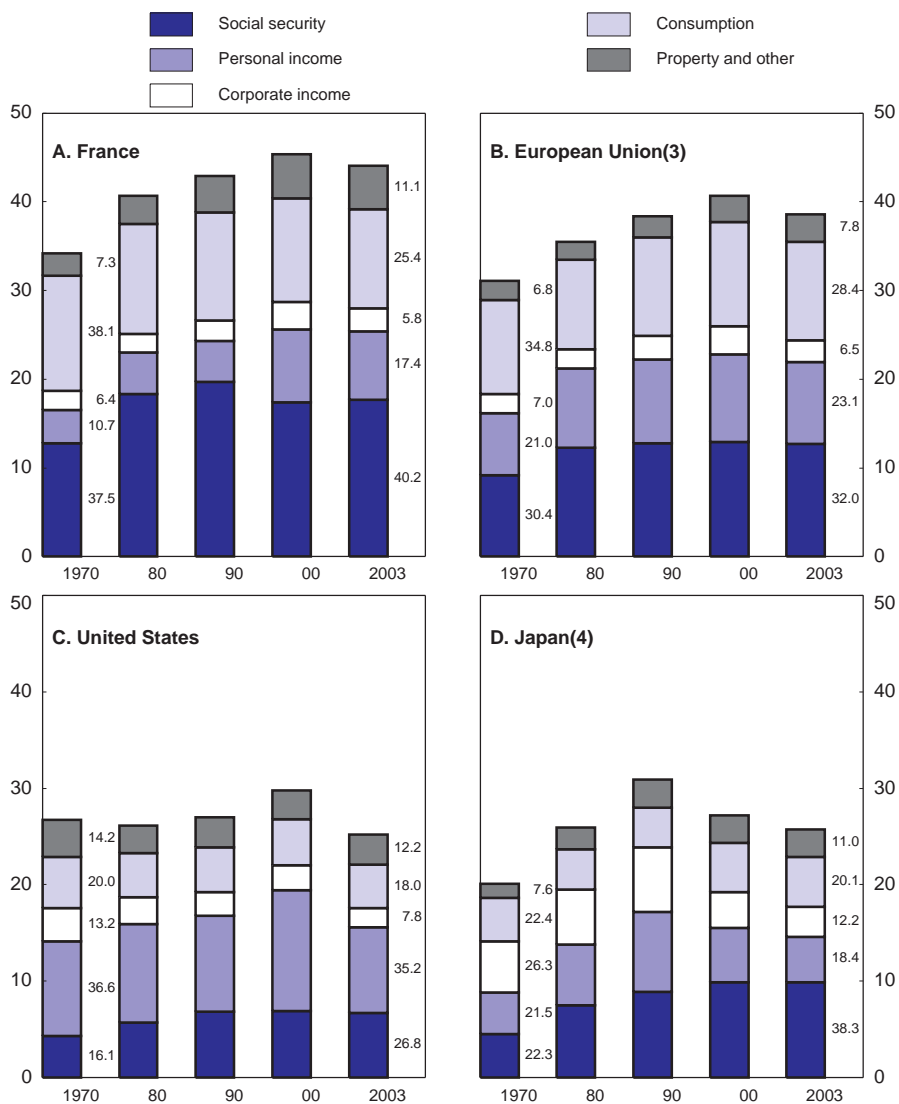
Source: OECD, Economic Outlook

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

8. The increase in the overall tax ratio 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 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, on corporate income and on property increased both in GDP and in total taxes (Figure 3, Tables 1 and 2).



**Figure 3. The evolution of the tax mix<sup>1</sup>**  
 % of GDP<sup>2</sup>



1. The breakdown of income tax into personal and corporate tax is not comparable across countries. In France the personal income tax includes the contribution *sociale généralisée*, CSG.

2. Data along the bars are shares in total revenues.

3. Weighted average.

4. Last year available: 2002.

Source: OECD, Revenue Statistics database

Table 1. Structure of tax revenue as% of GDP

	1970	1980	1985	1990	1995	2000	2002
<b>Total tax revenue</b>							
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
<b>Social security contributions</b>							
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
<b>Total tax excluding social security contributions</b>							
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
<b>Taxes on personal income</b>							
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
<b>Taxes on corporate income</b>							
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
<b>Taxes on property</b>							
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
<b>Taxes on goods and services</b>							
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

Table 2. Structure of tax revenue as% of total tax revenue

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

Source : OECD Revenue Statistics

9. 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 that 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 area as a whole like in France but increased slightly (Cary and Rabesona, 2004). The French government has taken various measures to limit the tax burden both on workers and firms. More recently, 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 3).

**Table 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).

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

10. 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 14.8%) and is imposed on family income per head above 4 000 euro. The top marginal rate is relatively high (48.09% and including social taxes 56.09% for taxable

income up from around 48 000 euro in 2004). 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 euro). 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.<sup>3</sup>

11. As a consequence the income tax base has been eroded and only about half of the population pays any 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. The share is much higher (see Table 3) when the (*Contribution Sociale Généralisée*, discussed further below) and associated taxes are defined as taxes on income, which is standard practice for international comparisons; the French authorities prefer not to refer to these levies as taxes, even though they do not in themselves give rise to any rights to social benefits. 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.<sup>4</sup> 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.

12. *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 obtained after selling bonds or shares is harmonised with the rate of withholding tax on interest income (16%) (capital gains are also subject to the CSG and associated social levies, at an overall rate of 11% since 1/1/2005). Since the 1<sup>st</sup> January 2004, capital gains on real estate are no more included in the taxable income, but taxed at a flat rate of 16%, (plus 11% CSG etc.) except for sales of less than 15 000 euros (same as in the case of securities). Capital gains on real estate are progressively reduced when they have been held for more than 5 years and are completely tax exempt when held for more than 15 years

13. *Capital transfers by inheritances and gifts* are generally treated in the same way although 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%.

## 5. Effective tax rates on labour remain high and create inactivity traps

14. 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 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.

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3. 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.

4. 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.

15. 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*) which is also levied on transfer income and capital income (which yield about a quarter of total CSG revenue) was introduced and in 1996 another levy, known as CRDS (*Contribution au Remboursement de la Dette Sociale*). 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 are now about one third higher than revenues from the personal income tax.<sup>5</sup> Total payroll taxes yield around 55% of total tax 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 the CSG.

16. Social security contributions are payments into social insurance and are to some extent related to the benefits received. However, the link between contributions and benefits is only partial although it has strengthened recently in the old-age pension system. There is no link at all for the CSG, although some argue that such a link is *perceived* by taxpayers.

17. The link between labour taxation and employment is complex and has been explored in many studies, including some by the OECD.<sup>6</sup> 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 (Nickel, 2003). 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 (see Box 1). Thus, tax-shifting and hence negative employment effects appear to be lower in countries where labour 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-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.

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5. In 2003 the CSG and CRDS together yielded 63.62 billion euro and the personal income tax 47.28 billion euro.

6. See, e.g., Leibfritz *et al.* (1997), OECD (1999).

### **Box 1. Theoretical aspects of the employment effects of labour taxes**

The literature on tax effects on the labour market suggests that:

The employment incidence of a tax depends on the degree of “shifting forward” the tax into producers’ real labour costs (production wage). This happens if workers resist reductions in their real take-home pay, either because they demand wage increases in response to an employee tax, or because they resist wage cuts in response to an employer tax. As a result labour costs increase and demand for labour falls. If instead the tax is borne by workers as these accept a reduction in their take-home pay, labour costs do not rise and labour demand is not affected. However, workers may respond to the fall in wages by reducing their labour supply; in this case employment also falls. As the labour demand elasticity is generally larger than the labour supply elasticity, the negative employment effect of a labour tax is larger, the higher the degree of forward-shifting of the tax.

The degree of tax shifting into product wages is likely to be inversely related to the extent of labour-market competition. Thus with a low degree of competition, forward-shifting of labour taxes and negative employment effects are more likely. Low competition in the labour market may be the result of stringent labour market regulations (e.g., high minimum wage and high employment protection legislation), union bargaining power, or “insider” behaviour of employed workers. For example, where a minimum wage exists, firms cannot entirely shift increases of social security contributions onto workers so that real labour costs increase.

The degree of product market competition also affects tax shifting. In a market with low competition, *i.e.*, where monopoly rents of firms are shared with employees, increases in labour taxes are more likely to shift forward into product prices than in a more competitive market.

The longer-term analysis of these effects also has to consider adjustments in the capital stock. If labour taxes reduce employment the capital-labour ratio rises in the short-term and the rate of return on capital declines below its equilibrium level. As a result the capital stock declines, reducing the real product wage. In the new equilibrium the capital-labour ratio, the capital stock and employment are likely to be lower. In an open economy with fully mobile capital, the world market return to capital would determine the real wage which is feasible in the long run. This also means that in the long run (*i.e.*, after considering capital stock adjustments) labour demand elasticity is much higher than the short-term. An analysis of the long-run employment consequences of higher labour taxes should therefore focus on how wage-setting behaviour is influenced. If, for example, higher labour taxes lead to more wage pressure, higher unemployment is needed in equilibrium in order to discourage wage setters from raising wages. In this case taxes have increased the NAWRU (Non-Accelerating-Wage Rate of Unemployment).

In theory the direction of the effect of a higher labour tax on labour supply is ambiguous due to opposing substitution and income effects. A rise in the tax which is borne by workers lowers the net wage and therefore the price of leisure relative to work and thus discourages work (substitution effect). At the same time, it reduces disposable income and workers may increase their work efforts to recoup income losses (income effect).

18. The degree of tax-shifting may also depend on which type of labour tax is raised. While employer labour taxes raise the product wage of firms immediately, higher employee taxes may initially reduce the after-tax consumption wage, as nominal wages may be slow to rise which also depends on the length of wage contracts. Such differences in adjustment speed have been found in empirical work. Furthermore, if workers consider their contributions to social security as insurance (pension, sickness, unemployment), they may not raise their wage claims in response to an increase in contribution rates. Over

the longer-run differences in wage response between employer and employee contributions have, however, not been supported by empirical studies (a phenomenon known as the Invariance of Incidence).

19. Tax-shifting may also be affected by wage bargaining systems. It has been argued that tax-shifting is relatively low in either fully decentralised or highly centralised or coordinated systems but relatively high in intermediate systems with strong but decentralised or un-coordinated trade unions (wage bargaining at the level of sectors/industries). The reason is that centralised or coordinated unions are more likely to consider in their wage claims the broader employment implications and also the benefits related to higher social security contributions. These differences in union behavior may help explain why tax-shifting is low in Nordic countries where unions are highly centralised or coordinated and higher in France, which belongs to the group of countries with an intermediate wage bargaining (Calmfors and Nymoen, 1990). These considerations also imply that policies which increase labour market flexibility may also minimize the distortionary impact of any given tax level.

20. In France the average and marginal tax wedges of the average production worker are relatively high despite some reductions in recent years (Figure 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 change in total labour costs relative to disposable income of workers, 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.

21. 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 *intéressement* 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 tax credit for low-income earners at a maximum basic rate of 4.6% of the gross wage.<sup>7</sup>

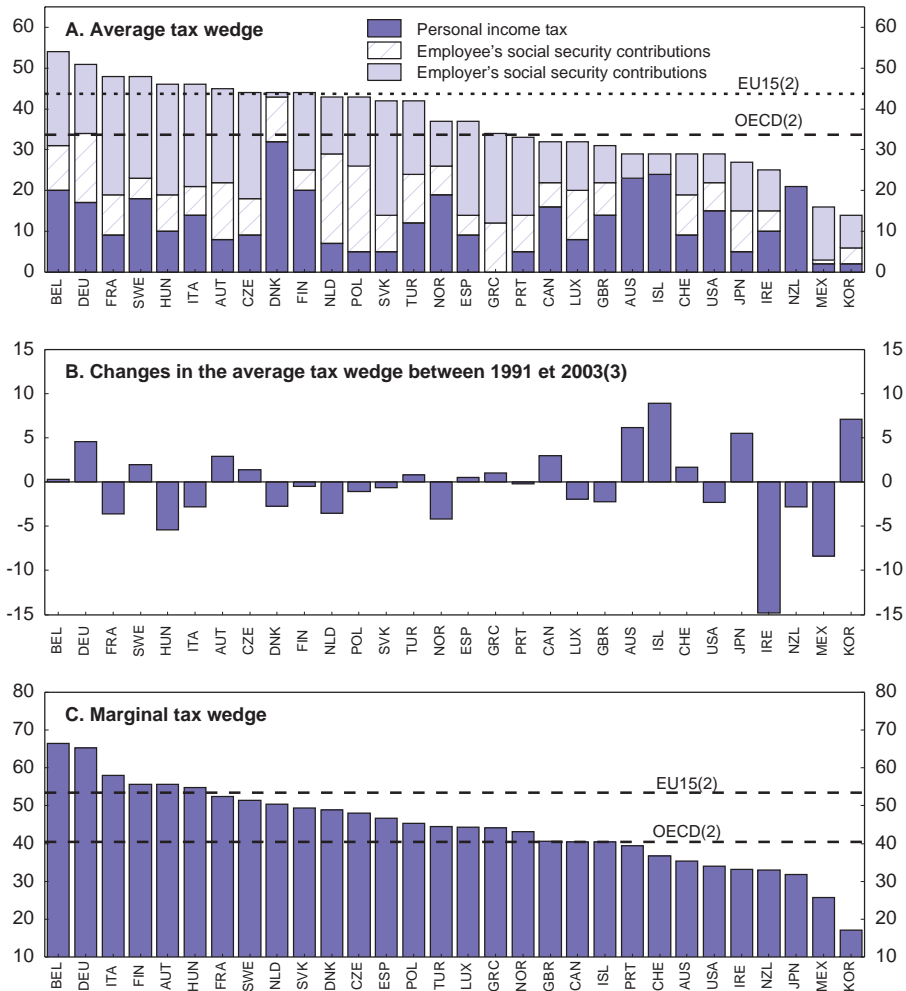
22. Rebates on employers' social security contributions for low-income employees also affect METRs. As a result of these measures, the METR is relatively low for workers earning as little as half of the SMIC, but they are quite high nevertheless and increase quite steeply in the range of incomes over which the income-related benefits — PPE and employers' contribution rebates — are withdrawn. The French tax and benefit system therefore provides a strong disincentive for additional work for persons with wages around the minimum wage. 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' side there are offsets since employer contribution rates decrease somewhat at higher income levels (Figures 4-6).

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7. 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 2 ½ 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.

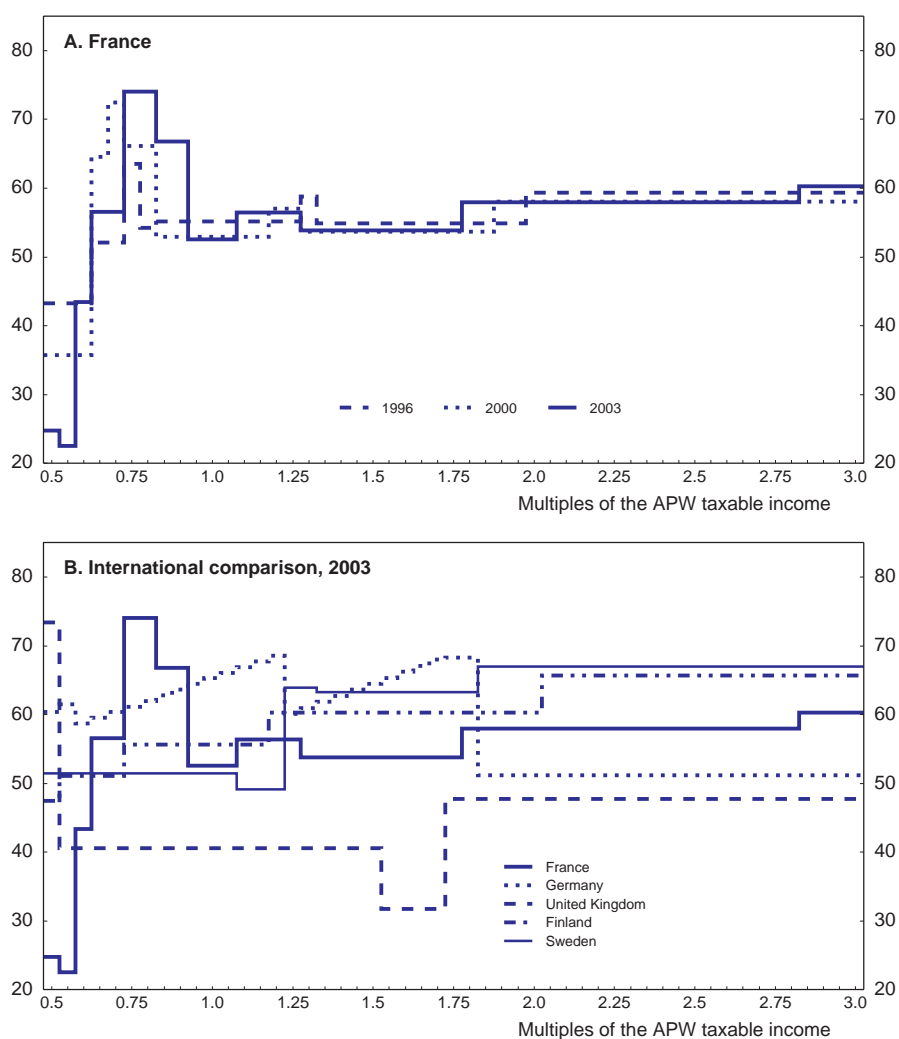


**Figure 4. Tax wedges on labour, international comparison<sup>1</sup>**  
As% of gross labour costs, 2003



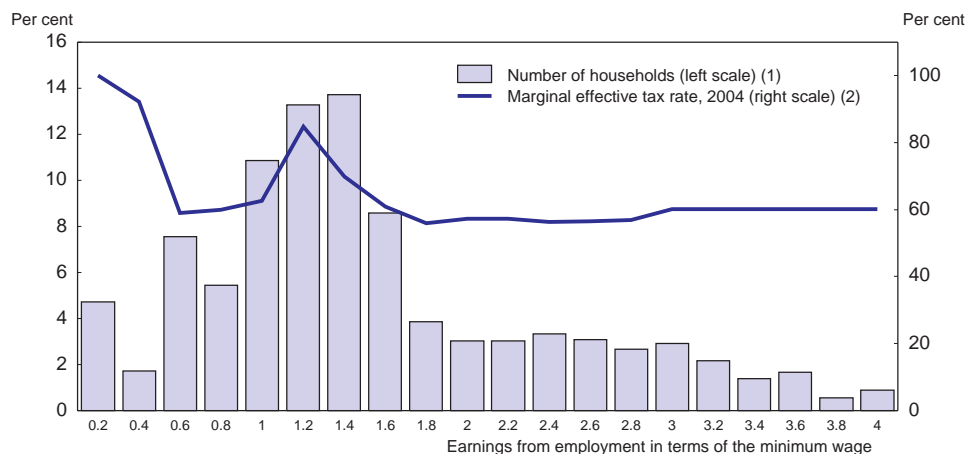
1. For a single individual without children at the income level of the average production worker. on estimated wage levels of the average production worker.  
 2. Weighted average using 2000 GDP and PPA  
 3. 1991 or the earliest year available.  
 Source: OECD, Taxing Wages, 2003.

**Figure 5. Marginal tax wedge on labour<sup>1</sup>**  
For a single person with no children, %



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.

**Figure 6. Effective marginal tax rate, one-earner households with two children<sup>1)</sup>**

1. As a percentage of all one-earner households with two children.

2. The effective marginal tax rate is calculated using marginal taxes and social security contribution paid by the employee and the employer, plus withdrawal of social benefits.

Source: Ministry of Finance.

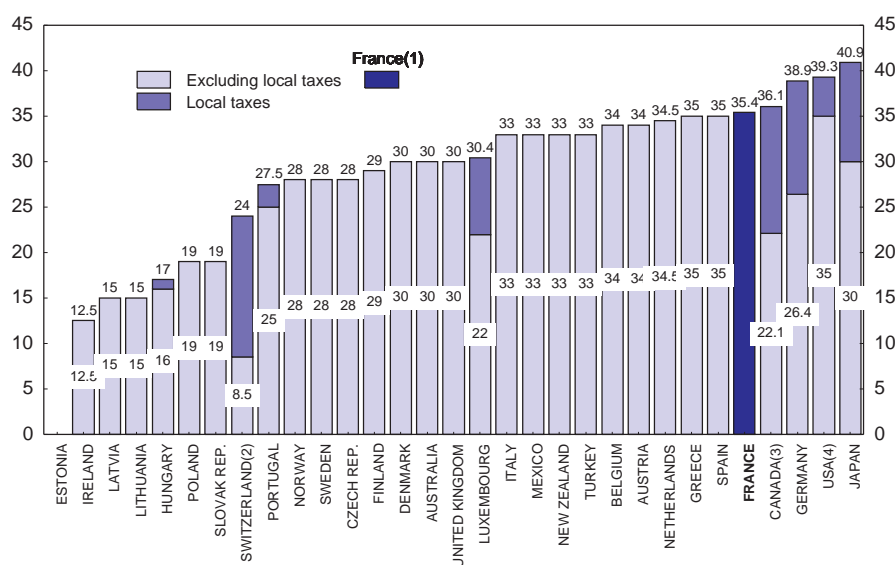
## 6. The corporate income tax rate has been reduced

23. The corporate income tax (*impôt sur les sociétés*) is levied on 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, and provisions. Companies subject to the corporate tax are liable to an annual lump-sum tax (minimum tax) even if they obtain no profits. *Dividend income* receives a tax allowance of 50% (which recently replaced the former tax credit or *avoir fiscal*).

24. In France as in many other OECD countries statutory corporate tax rates have been reduced over 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 systems more neutral by reducing distortions between different types of investment and sources of financing (horizontal equity). 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. It rose again after a 3% 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. 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, with the new EU member Estonia not taxing retained profits at all (Figure 7).<sup>8</sup>

8. In 2005 Finland has reduced the corporate tax rate from 29% to 26%, Austria from 34% to 25%, the Czech Republic from 28% to 26% (with a further cut to 24% planned for 2006). For 2007 the Netherlands are planning to reduce the corporate tax rate from 34.5% to 29%. The German government planned to reduce the central corporate tax rate from currently 25% (excluding solidarity surtax) to 19% but it is currently unclear if and when this will be implemented.

Figure 7. Statutory corporate tax rates on retained profits, 2004  
%



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.

25. 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. 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% this tax credit completely eliminates double taxation although the tax burden on new equity remains relatively high (see below).

***...and corporate tax revenues have increased as a share of GDP***

26. 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 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.

Table 4. Corporate income tax parameters

Year	Statutory corporate tax rate in% <sup>1</sup>		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		Average of other countries	
	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).

### ***Depreciation allowances remain relatively generous***

27. Depreciation allowances are an important element determining the corporate tax base. 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 and 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. As for industrial buildings standard depreciation has remained constant over time (Table 4). 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 the other countries including France.

### ***Effective corporate tax rates have also declined***

28. In the literature various indicators have been constructed to measure *effective corporate tax rates* as impact measures on business investment. These are generally derived by applying the current tax system (proxied by the key parameters of the system, such as the standard tax rate and standard depreciation allowances) to a hypothetical investment project that just earns the minimum required rate of return. The impact of taxes on the cost of capital of a marginal investment (the rate of return before taxes) is calculated for a given after-tax rate of return and the effective marginal tax rate (EMTR) is defined as the difference between the pre-tax and the post-tax rate of return. The higher this rate is the lower is the incentive to invest. In addition the effective average tax rate (EATR) can be defined for a hypothetical project with a given pre-tax rate of return by the net present value of tax payments as a proportion of the net present value of total pre-tax capital income. Thus it also considers the tax on inframarginal return. It is clear that the calculation of the effective tax rates are sensitive to the various assumptions made which are generally very simplistic so that considerable care should be taken when interpreting the results. It should also be noted that these are simple impact measures which say nothing about the final incidence of capital taxes. For example if capital is more mobile than labour, then capital taxation, by reducing the capital stock and thus labour productivity and real wages, is finally born partly or entirely by workers. Nevertheless these measures below may still provide useful information about the broad trends of capital taxation and are preferable to statutory tax rates as they also consider the key factors affecting the tax base.

29. Tables 5 and 6 show the development of the EMTRs and the EATRs for France and the (unweighted) average of 18 OECD countries over the past two decades as calculated by Devereux, Griffith and Klemm (2002). In France as in many other OECD countries effective marginal and average tax rates declined over the past two decades for investment financed by equity and retained earnings. Thus the effect of cuts in the statutory corporate tax rate was bigger than the reduction in the generosity of depreciation allowances. The tables show that French effective marginal and average tax rates are quite close to the average of other countries, and the bias in favour of debt finance is also similar. Within the group of other countries for which the effective tax rates have been calculated, Ireland has the lowest effective tax rates (as its statutory tax rate is also lowest) while effective tax rates in Japan and the United States are above average, because of their relatively high statutory tax rates, even though these have also come down over time.

Table 5. Effective marginal tax rates (EMTR) in%

Year	Base case with constant inflation rate						Alternative case with time and country-specific inflation rates	
	Investment in plant and machines						Investment in plant and equipment financed by equity or retained earnings	
	Financed by equity or retained earnings			Financed by debt			Industrial buildings financed by equity and retained earnings	
	France	Average of other countries	France	Average of other countries	France	Average of other countries	France	Average of other countries
1982	26	28	-72	-67	46	39	33	32
1990	21	26	-43	-47	33	35	21	28
1991	19	25	-38	-45	30	34	19	27
1992	19	24	-38	-44	30	33	18	25
1993	18	23	-37	-43	30	32	17	23
1994	18	23	-37	-41	30	32	17	22
1995	21	24	-42	-41	33	33	19	23
1996	15	24	-48	-42	33	33	14	23
1997	24	23	-51	-41	38	33	22	21
1998	24	22	-51	-39	38	32	21	19
1999	23	21	-48	-38	36	32	20	19
2000	22	20	-44	-37	34	31	20	19
2001	22	20	-40	-35	33	30	21	19
2002	22	20	-39	-34	32	30	20	18
2003	22	21	-39	-33	32	30	20	20

Source : Devereux, Griffith and Klemm (2002).

Table 6. Effective average tax rates (EATR in%)

Year	Base case with constant inflation rate						Alternative case with time and country-specific inflation rates	
	Investment in plant and machines			Industrial buildings financed by equity and retained earnings			France	Average of other countries
	Financed by equity or retained earnings	Financed by debt		France	Average of other countries	France		
1982	41	40	15	16	48	44	43	42
1990	30	34	9	12	35	38	30	35
1991	28	33	8	12	32	37	27	34
1992	28	32	8	11	32	36	27	32
1993	27	31	8	10	32	34	26	31
1994	27	30	8	10	32	34	26	30
1995	30	31	9	11	35	35	29	31
1996	28	31	7	11	35	35	27	31
1997	35	31	12	11	40	35	34	30
1998	35	30	12	10	40	34	33	29
1999	33	29	11	10	38	33	32	28
2000	31	29	10	10	36	33	30	28
2001	30	28	10	9	35	32	30	27
2002	29	28	9	9	34	32	29	27
2003	29	28	9	9	34	32	29	27

Source: Devereux, Griffith and Klemm (2002).



30. With the decline of the effective marginal and average tax rates, incentives to invest have improved over time in France (as well as in other OECD countries). At the same time with the reduction of statutory rates and the lowering of the generosity of depreciation allowances tax systems have become more neutral with respect to different investment projects and different sources of financing, although restoring full neutrality between the different sources of finances would have required more radical reforms.

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

### ***Capital taxation is not neutral***

32. Effective (marginal and average) tax rates are different for the different types of investment and different sources of investment financing. They are generally somewhat lower for investment in plant and machinery than for investment in industrial buildings, because depreciation allowances are less favorable for the latter. Furthermore effective tax rates are higher if investment is financed by equity or retained earnings than if it is financed by debt, because interest payments are deductible against firms' profits. 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).

33. In France the tax rate on interest income is lower (16%) than the corporate tax rate (which determines the tax advantage of interest cost deductibility) so that the lower tax burden for debt-financed investment as compared to investment financed by retained earnings remains. In the case of an investment financed by retained earnings besides the corporate tax on retained profits one has to consider that retained profits will be reflected in higher share prices and savers have to pay the flat rate tax of 16% on (realised) capital gains (above the exemption level). (Interest income, dividend income and capital gains are all subject to the additional 11% from the CSG and CRDS.)

34. If instead the investment is financed by new share issues to households, the tax burden on its return depends on taxes paid by the firm, any measures to alleviate double taxation and on the personal income tax rates of households receiving the dividends. France provides a tax credit of 50% on dividend income (replacing the former *avoir fiscal*) which *de facto* eliminates double taxation of dividends. Taking the firm level and the household level together the dividends are *de facto* taxed by the progressive personal income tax and various additional charges. For households who pay the top marginal tax income tax rate, the overall marginal tax rate on dividend income is currently around 58% (considering the 33.3% corporate tax on dividends, the 50% tax credit on dividend income, the top marginal rate of the personal income tax and various flat and partly deductible additional charges such as CSG and CRDS). As this rate is much higher than (flat) tax rate on interest income (including social charges) capital costs of an investment financed by new equity appear to be significantly higher than those of a debt-financed investment, at least if no other factors are considered. According to simplified model calculations it is also higher than in most other European countries (Eykmans, 2004)<sup>9</sup>. Most other countries either have lower top marginal income

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9. It is assumed that dividend recipients are in the highest income bracket and therefore have to pay the top marginal income tax rate.

tax rates or have a flat tax on capital income, which is the case in France only for interest income (flat rate tax of 16% excluding CSG) but not for dividend income.<sup>10</sup>

35. 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 schemes (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.

36. Past corporate tax reforms in France 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 (Gresik, 2001).

**Box 2. Assessing distortions of capital taxation between different sources of investment financing: some theoretical considerations.**

By driving a wedge between the pre-tax and the post-tax rate of return, capital taxation affects saving and investment. Saving is reduced if the post-tax rate of return falls and substitution effects (from future to current consumption, causing current savings to fall) dominate income effects (the lower net return requires higher savings to meet a targeted level of consumption, causing current savings to rise). Investment is reduced if taxation increases the required minimum rate of return before taxes so that the less productive investments are not undertaken any longer. Capital taxation may also have different effects on the various types of investment (equipment investment, construction, inventories), the various sources of investment financing (debt, retained profits, new issues of shares), and the various owners of capital (households, indirect holdings via insurance companies, domestic versus foreign owners). Capital taxation can therefore distort the structure of capital formation and its financing and thus lead to economic inefficiencies. An analytical tool to analyse these tax distortions is to examine the effects of capital taxes on the capital cost of investment or the minimum required rate of return before taxes. These effects depend not only on the statutory corporate tax rate but also on the corporate tax base which is affected (among others) by depreciation allowances (or more precisely by the difference between tax depreciation and the true economic depreciation) and other investment incentives (investment tax credits etc.). The effects also depend on the tax treatment of dividends, capital gains and interest income at the level of savers and can therefore be different for the various sources of investment financing.

10. 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.

Assuming (for simplification) that depreciation allowances are equal to the true economic depreciation and that there are no investment allowances and that inflation is zero, it can easily be seen that for a debt-financed investment formula (1) applies:

$$(1) p = r$$

where  $p$  is the required minimum rate of return before tax (which is also the capital cost of the investment net of depreciation) and  $r$  is the (risk-adjusted) real market interest rate. Thus, the minimum and pre-tax rate of return of a debt-financed investment is equal to the real market interest rate and is therefore not affected by taxation. This is so because the return on debt-financed investment is not taxed at the level of the firm (as interest payments are deductible) but only at the level of the saver where interest income is taxed similar as other interest income so that savers receive the same net return as they would have invested in other interest-bearing assets of the capital market (such as government bonds).

If the firm finances its (marginal) investment by equity it has to earn a pre-tax rate of return which after all taxes paid by the firm and the savers provide savers with the same (risk-adjusted) net rate of return as if they would have invested their savings in the bond market (opportunity costs). Two cases of equity financing of an investment can be distinguished: financing by retaining profit and financing by issuing new shares. If the firm retains profits it has to pay the corporate tax. With the retention of profits the value of the firm rises which is reflected in higher share prices and so that capital gains accrue to the owners of shares. These capital gains may or may not be taxed depending on the existence of a capital gains tax. Where capital gains are taxed the tax base is generally not current accruals but only realised capital gains and with realisation in the (perhaps distant) future the effective tax rate on accrued capital gains can be significantly lower than the statutory tax rate. But an equity-financed investment also has to earn a pre-tax rate of return which after all taxes yields a net return to savers which is equal to what they would have earned by investing in the bond market (opportunity costs). Thus, the tax rate on interest income of savers (households) also affects the minimum pre-tax rate of return of this type of equity financing. Formula (2) determines (under the simplifications made above) if capital taxation introduces a distortion between debt-financed investment and investment financed by retained profits:

$$(2) \begin{array}{l} > \text{tax distortion against equity} \\ t + z(1-t) = m \quad \text{no tax distortion} \\ < \text{tax distortion in favour of equity} \end{array}$$

where  $t$  is the corporate tax rate (on retained profits),  $z$  is the (effective) capital tax and  $m$  is the income tax on interest income. Thus, when capital gains are not taxed ( $z = 0$ ) and the corporate tax rate is equal to the tax rate on interest income ( $t = m$ ), there is no tax distortion as the return on investment financed by retained profits bears the same tax burden as an alternative investment in government bonds. However, if the corporate tax rate is higher than the tax rate on interest income ( $t > m$ ) (as is the case in France), there is a tax distortion against equity financing even if there is no capital gains tax. Where capital gains tax exists, a tax distortion can arise even if the corporate tax rate is lower than the tax rate on interest income (depending on the size of  $z(1-t)$ ). From formula (2) it can also be seen that tax neutrality between equity-financed and debt-financed investment can also be achieved without taxing corporate profits at all ( $t = 0$ ). In this case the effective tax rate on capital gains must, however, be equal to the tax rate on interest income ( $z = m$ ).

If the firm finances its investment by issuing new shares (new equity), one has to consider the taxation of dividends. Corporate tax systems are quite different on how they tax dividends. In so-called classical corporate tax systems distributed profits are both fully taxed at the level of the firm and at the level of dividend recipients, so that there is double taxation. By contrast, systems with full imputation of the corporate tax at the household level tax dividends (*de facto*) only at the level of households, so that there is no double taxation. There exist also intermediate systems which grant not full but partial relief from the corporate tax at the level of dividend recipients. In a system with full imputation and where dividend income is taxed at the same rate as interest income the required pre-tax rate of return of an investment financed by new share issues is equal to that with debt financing ( $p = r$ ), namely the real market interest rate. In this case there is no tax distortion for investment financing by new equity. However, where tax systems do not (as in the classical corporate tax system) or only partially eliminate double taxation of dividends there is a tax distortion for investment financed by new equity ( $p > r$ ). A tax distortion against new equity financing

can also exist if double taxation of dividends is *de facto* fully eliminated (by full imputation or by correspondingly high tax credits) but if dividend income is taxed at the household level at a higher rate than interest income as is the case in France.

## 7. Local taxes

### *The local business tax is under permanent reform pressure*

37. The local business tax (*taxe professionnelle*) was introduced in 1975 (replacing the traditional “patente”) and its tax base originally comprised a combination 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.<sup>11</sup> The tax is deductible from the corporate income tax base and there is also a long list of exemptions.<sup>12</sup> 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 of the firm. . Furthermore, between 1999 and 2003 the part based on the wage bill 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.<sup>13</sup> 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.

38. Given the various exemptions and relief measures administrative costs for collecting this tax appear to be relatively high. By fixing the tax rates only *ex 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.

39. Revenues for local authorities from the *taxe professionnelle* increased over time from around 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 measures of tax relief including the VAT cap 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.

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11. There is a 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).

12. For example, a recent measure was to exempt from the base of the *taxe professionnelle* any investment carried out between 1st January 2004 and 30 June 2005.

13. The tax base now 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*).

40. Despite recent reforms this tax remains controversial as it is highly concentrated on larger companies, in particular on large capital-intensive firms. Furthermore, as the tax is not directly 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. 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.

41. This commission suggested (in its majority) to replace the current tax base of the *taxe professionnelle* by a tax base with two components: first the value-added of the firm which is -- for firms with different locations -- allocated by shares in employment, and second the rental value of the local land of the firm (*valeur locative foncière*).<sup>14</sup> (Already in 1989 the *Conseil des Impôts* 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 a re-examination of the exemptions and special allowances related to this tax in the light of the constitutional principle of equal tax treatment. Special tax breaks which do not conform to 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 as their final tax payment is determined by the value-added cap; 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***

42. Besides the *taxe professionnelle* local property taxes are the main source of local government revenue. 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 has three parts, the municipal, the departmental and the regional part. 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.

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14. Commission de Réforme de la Taxe Professionnelle, rapport au Premier Ministre, (présenté par Olivier Fouquet, président de la commission, 21december 2004.

43. 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).

44. Besides the local taxes on property there exists a central net wealth tax (*impôt sur les grandes fortunes*). It was first introduced in 1981, then 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, work 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 euro) (above 732 000 euro in 2005) and 1.8% (for wealth above 15 255 000 euro in 2005) and tax brackets are indexed for inflation. Inflation has been taken into account for the tax year 2005, but for many years, the tax brackets have remained unchanged. The indexation of this year is a concession obtained by some politicians and representatives of enterprises who 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 euro or around 1% of central government net taxes.

## 8. Consumption taxes have declined over time

45. The relative size of taxes on goods and services has declined over time. In 2002 their share in GDP amounted to 11.2% 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.

46. *The Value Added Tax* has a standard rate of 19.6 %, 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. There also exist 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 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. In recent years the emergence and rapid expansion of e-commerce and the increase in fraud, for example by declaration of fictitious intra-Community deliveries, are putting additional pressure on tax administration. As the result of various exemptions, the reduced rates and other special regimes, as well as tax evasion, 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) has been 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 7).

**Table 7. 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	n.a.	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
<b>France</b>	<b>14.7</b>	<b>15.5</b>	<b>19.9<sup>1</sup></b>	<b>4.4</b>	<b>22</b>
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.

## 9. Environmental taxes may be under-utilised

47. 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).

48. Various taxes and charges on polluting emissions or products have been introduced since the early 1980s. Until recently, most of these taxes were 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. (The ADEME is no longer financed in this way, however.) Among them the tax on air pollution (*taxe parafiscale sur la pollution atmosphérique*, TPPA) has been introduced in 1985 on sulphur dioxide (SO<sub>2</sub>) emissions, and extended in 1990 to encompass nitrogen oxides (NO) and hydrochloric acid emissions and in 1995 also emissions of volatile organic compounds (VOC). The tax revenues from the tax were earmarked for subsidies for abatement investments or for research and development. It has been estimated that this tax had a significant negative impact on VOC and SO<sub>2</sub> emissions but not on NO emissions (Millock *et al.*, 2004) However, according to this study the subsidy seemed to have increased emissions to an extent that dwarfed the negative impact of the tax. 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.

49. 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.

50. In general, environment-related taxes are not particularly well-aligned on known pollution externalities. 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, 2001 Economic Survey of France). 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. 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. However, while up to the late 1980s the tax on petrol was arguably too low to compensate for pollution externalities, especially on diesel fuel, it may well be too high (from this point of view) today; this is because emission standards have been tightened enormously so that the environmental costs per litre of fuel have diminished by an order of magnitude.

51. 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); other environmental taxes are mostly earmarked for the Agency for Environment and Energy Management (*Agence de l'environnement et de la maîtrise de l'énergie*, ADEME). The pesticides tax, however, is better designed to reflect differences in pollution damage of the products.

52. The TIPP remains an important source of revenue, however, which is largely socially accepted. Since 2004 part of the revenues from these taxes are transferred from the central government to departments (together with the insurance tax, TCA) which distribute them to municipalities 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.

53. 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 (TGAP) to industrial energy consumption. As initially proposed, this was a fairly straightforward tax on carbon dioxide (CO<sub>2</sub>) emissions but the final legislation contained a large number of provisions 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 the link between what firms would have paid and their CO<sub>2</sub> emissions was insufficiently direct, 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 EU CO<sub>2</sub> emissions trading system will in fact have results that are in some respects similar to the abandoned tax on intermediate energy consumption under the 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.<sup>15</sup>

54. The constitutional principle of fairness in taxation may thus not be well 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. The recent incorporation of an environmental charter into the constitution may change this balance, though the notion of potential conflict and trade-offs between environmental, economic and social objectives is not very strongly presented. A notable aspect of the environmental charter, not strictly related to taxation, is its incorporation of the precautionary principle in article 5 of the charter, which is subject to a good deal of controversy as to how it should be interpreted, although it is already an accepted part of French jurisprudence.<sup>16</sup> Article 5 does not make the definition of the principle any clearer, and the meaning of its requirement of action “proportional” to the risk, which is by definition unknown, is unclear. However, an important part of this article is that these “proportional” measures are to be temporary while work is undertaken to evaluate risks that have been subject to the application of the precautionary principle.

## 10. The tax system is complex and administrative costs are high

55. 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 due consideration for how they may interact with other parts of the tax system or with other policy objectives. Sometimes particular measures 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.<sup>17</sup> Other paradoxical measures include a tax credit to encourage low-income people to take out complementary health insurance schemes, at the same time as these schemes are subject to a specific insurance tax. As far as company taxation is concerned, there is also a number of specific reliefs, such as measures in favour of research and development expenditures, measures to avoid delocalisation (that is, firms who close production facilities in France to shift production to other countries), and measures in favour of apprenticeship contracts.

56. 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 partly because this sector composes a significant part of the informal economy, also because of the high rate of value added tax imposed. This example has generated pressure to extend this favorable tax treatment to hotels and restaurants, particularly as food consumed off these premises is charged at the lower rate.

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15. So that a company with relatively high emissions may be paying more, 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.

16. The text of article 5 is the following: “Lorsque la réalisation d’un dommage, bien qu’incertaine en l’état des connaissances scientifiques, pourrait affecter de manière grave et irréversible l’environnement, les autorités publiques veillent, par application du principe de précaution et dans leurs domaines d’attributions, à la mise en oeuvre de procédures d’évaluation des risques et à l’adoption de mesures provisoires et proportionnées afin de parer à la réalisation du dommage.”

17. 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.

57. 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 poorly evaluated: of some 400 individual tax expenditures<sup>18</sup> 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, none of these largely reasonable suggestions has been implemented.<sup>19</sup>

58. Complexity may also arise from the number of small taxes which may exist simply because they have been inherited from the past even though their net return for the government is low. Furthermore complexity is increased by the different levels of government and public institutions which are entitled to raise their own taxes with different tax bases. 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 8). This does not 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.

59. Tax administration is also more fragmented in France than in most other countries. Within the Finance Ministry there are significant organisational divisions between the different tax functions (Direction Générale and Direction Générale des Impôts, DGI) and there are also two separate administrations for calculating tax liabilities (mostly by the DGI) and for tax collection (mostly by the Direction Générale de la Comptabilité Publique, DGCP). 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. While since 2002, income tax payers can file and pay taxes online on the websites created to this end, for those 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. People who are newly unemployed can 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 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 wage tax would probably meet some resistance from the business sector although it should not be too costly for firms as these are already withholding social security contributions and the CSG.

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18. 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.

19. 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.

Table 8. Sources of revenues by sub-sectors of government

	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	•	•	•	•	•	•									
Non-recurrent taxes															
Other recurrent taxes on property															
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

60. An informative measure of the complexity of the tax system and its administration is the resource cost of collecting taxes. In international comparison France belongs to the countries with relatively high costs per unit of collected revenues and also has relatively high tax arrears. This is illustrated by the indicators shown in Table 9 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, have a relatively narrow tax base and a low compliance rate.

**Table 9. 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 <sup>1</sup>	820	415	6.6
<b>France</b>	<b>1.44</b>	<b>788</b>	<b>358</b>	<b>16.1</b>
Germany		665	324	2.6
Hungary	1.35	768	309	
Ireland	0.95 <sup>1</sup>	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 <sup>1</sup>	629	320	
New Zealand	1.17	853	425	4.0
Norway	0.59 <sup>1</sup>	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 <sup>1</sup>	985	494	1.9
UK	1.15 <sup>1,2</sup>	730 <sup>3</sup>	360 <sup>3</sup>	17.2 <sup>2</sup>
USA	0.52 <sup>1</sup>	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), Centre for Tax Policy and Administration

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

61. 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 be reluctant to pursue reforms under pressure from particular sectors or interests, since the burden of taxes in one area can only be relieved by moving it elsewhere.

62. While lump-sum taxation is not possible, quite a number of measures amount to lump sum exemptions. This is the case where the government creates tax incentives for particularly activities but limits the revenue cost of these by imposing quite strict conditions and ceilings. This means that revenue losses tend to be maximised while the real incentive effect is low; the revenue losses have to be made up elsewhere, most likely with taxes that themselves do have negative incentive effects. Many such measures are discussed in the annual report of the *Conseil des Impôts* for 2003 and implementing the recommendations of that report would be an important step towards 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.

63. 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, but the rights and obligations under these programmes are determined by central government.

64. Tax administration costs are relatively high in France. This is partly due to the complexity of the tax system, but also due to an excessive number of entities responsible for assessing and collecting (but often with insufficient co-ordination between these two functions). Income tax and assessment in France has 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 perfectly feasible - it is already used for the CSG - and would probably improve overall efficiency, though transition arrangements would need to be devised. Consideration should 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. 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), but has no obvious economic justification if constitutional objections could be overcome. The income tax structure and system of collection should be reformed, however, even if it is decided to keep it separate from the CSG.

65. 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.

66. 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.

67. One possible radical reform, though not currently under serious consideration, is to switch financing of social insurance from an earnings 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. It may also be noted that, while the share in 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, but there may be a case for reviewing the balance between the different types of taxation with the aim to reduce the impact of tax distortions on employment and growth.

68. 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, for example by reducing depreciation allowances, which are still relatively favourable in France. 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. The system would also become more neutral between investment financing by debt and by retained profits. This might be thought to mark a break with the government's aim of encouraging investment and research and development expenditures through tax breaks. However, revenue from these tax breaks has to be made up somewhere else and if the overall neutrality of the tax system could be improved, general incentives to invest should improve too.

69. 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 new equity (new share issues) financed investment 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 over 50%. 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 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.

70. In summary, a tax reform agenda could have the following elements:

- Further reduce labour tax distortions by continuing reductions in social security contributions for low paid workers and reducing the withdrawal rate for in-work benefits, financing these either by increasing the CSG or value added tax.
- Simplify the personal income tax, widening its base to permit lower top rates, and switch it to a system of deduction at source. Consider merging it with the CSG if this can be done in an administratively efficient way.
- Reduce capital tax distortions by cutting the corporate tax rate and widening the tax base by making depreciation allowances less generous and reducing the number of special incentives for certain kinds of activity. Reduce the bias in favour of debt finance.
- Increase the role of “green” taxes because of the efficiency gains they offer. But green taxes should not be promoted as significant sources of revenue because their environmental efficiency is largely independent of the revenue they raise. Questions of “equality” in such taxes have to be explained carefully in legislation to overcome potential problems from too limited an interpretation of constitutional constraints in this area.
- Ensure that reforms are revenue-neutral since in current circumstances medium term budgetary sustainability is in question - do not spend anticipated gains from reforms until they materialise.
- Improve, and reduce the costs of, tax administration by progressively merging tax administrations where possible.

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