

ASSESSMENT AND RECOMMENDATIONS

In recent years, France has experienced strong growth of activity and employment, although there are doubts about its sustainability

1. From 1998 to 2000 France recorded strong GDP and employment growth, and low inflation. The output gap that had accumulated during the 1990s was closed and the unemployment rate declined, reaching its lowest level in more than fifteen years at the beginning of 2001. The payoffs from growth were shared by most economic agents: households saw an increase in their purchasing power, the general government collected substantial tax revenues and corporate profits improved. Inflation was one of the lowest in the euro area, thanks to moderate increases in labour costs and increased competition. Growth was largely attributable to the strong expansion of world trade and was facilitated by particularly accommodating monetary conditions in Europe. But it also reflected the efforts made since the early 1990s to consolidate the budget, reduce inflation and implement structural reforms. In particular, labour market reforms accompanied by moderate wage growth contributed to the strong expansion in employment in recent years. However, the severe pressure that emerged in 2000 on the utilisation of production factors suggest that the output gap accumulated over the past decade has been closed. In order to reach the authorities' goal of full employment, and for living standards to rise, the rate of growth of potential output will need to be raised above its current level. This requires continuing to implement structural policies to increase factor productivity gains, the employment rate and the investment ratio. Indeed, despite recent progress the latter two indicators still lag behind those of other OECD countries.

A perceptible slowdown has occurred since the beginning of 2001

2. The economy entered a phase of marked cyclical slowdown at the beginning of 2001. GDP growth eased, business expectations deteriorated and unemployment has been rising since June. This cyclical shift can be largely explained by the sharp slowing of the American economy and the dip in the Japanese economy, which impacted on Europe via world trade. Other international transmission mechanisms, like parallel swings in stock markets or the reactions of multinational firms, have probably amplified the slowdown. The turnaround in the new technologies sector has also affected France, even though this sector's share in output is limited. In this depressed environment, French exports have fallen back, businesses have reduced their investment and inventories have been run down. In addition, rising inflation at the start of 2001 curbed household purchasing power in France, and the risk of second-round effects in the euro-zone, among other factors, prevented the European Central Bank from significantly lowering its interest rates.

Growth should pick up next year, but the risk of a subdued economic environment remains,...

3. Since the terrorists attacks on 11 September in the United States, the international environment has become much less favourable. The OECD's new projections envisage a sharp slowdown in activity in the United States and to a lesser degree in Europe. As regards France, although private consumption growth should slow, it will continue to bolster activity via real wage growth, direct tax cuts and, to a lesser extent, net job creation. However, the world slowdown and uncertainty will continue to bear down on exports and investment in coming months and the first half of 2002. As a result, GDP is set to grow by only 2 per cent this year and by about 1.6 per cent next year. Accelerating from the second half of 2002, growth should approach 3 per cent in 2003. These projections are subject to exceptional uncertainties particularly as regards business and consumer confidence, which could worsen more than projected (both domestically and externally), or, conversely, improve more quickly than anticipated. Bearing in mind the decline in exports, investment and private consumption before the events in September, even an optimistic scenario for confidence would see the slowdown of activity continuing into the first months of 2002.

... which would justify allowing automatic stabilisers to operate fully on the revenue side

4. The impact of the cyclical slowdown on public finances is already perceptible. Tax receipts are lower than forecast and unlikely to show much increase this year or next. The budget deficit will consequently be higher than the projections in the 2002-2004 multiyear programme of public finance. This deterioration, due to the play of built-in revenue stabilisers, is temporary and does not necessitate corrective measures even if the slowdown and widening of the cyclical deficit worsens. Nevertheless, while consolidation efforts did make possible substantial tax cuts, they were not large enough to bring down the structural deficit during these years of fast growth. Fiscal policy should, therefore, continue to target bringing the structural deficit into balance by 2004. Indeed, the public debt is large, and borrowing requirements related to population ageing will be substantial in the long term. Over and above cyclical fluctuations, priority should thus continue to be given to reducing the structural deficit of the general government. The government's decision, within the context of the Act on Public Finances, to keep the structural deficit unchanged in 2001 and 2002 will make achieving structural balance more difficult. This being so, a plan to revive domestic demand by amplifying tax cuts or by increasing public expenditure, including expenditures that may be associated with the introduction of the 35-hour work week among small and medium enterprises, would be dangerous and should be avoided. Furthermore, in order to permit a return to structural balance the next stability programme should incorporate a tightening of public expenditure so as to achieve a substantial adjustment in 2003 and 2004.

Fiscal consolidation requires tighter control of public spending, especially on healthcare and staffing. Moreover,...

5. Control of public expenditure will thus be the cornerstone of macroeconomic policy for many years still. The authorities have already put mechanisms in place to control the growth of general government expenditure. Spending increase norms are set in the multiyear programmes of public finance, then written into the Budget Laws and the Social Security Financing Laws. They have helped to curb central government expenditure for some years now but have proved much less effective with health insurance and local government spending. The present norms are unlikely to be

stringent enough to consolidate public finances in the future, especially if economic growth falls short of the authorities' hopes. More ambitious and more tightly enforced norms should, therefore, be envisaged. Healthcare spending could be curbed by means of appropriate microeconomic reforms, as suggested in the previous *Survey*, but little has been done along those lines recently. The growth of staffing expenditure could be slowed by not systematically replacing the large numbers of public servants who will be retiring in the near future. Finally, expenditure related to employment policy has not been reduced, despite lower unemployment. In any event, the present efforts to make public finance more transparent, especially the adoption of the organic law on public finance, are useful in that they focus on the effectiveness of public policies, rather than on the amount of financial resources allocated to them. In this regard, the some 600 *fonds de concours*, which are administered by ministries outside of ordinary budgetary procedures, should be abolished.

... the tax reform recently begun should continue

6. Better control of public expenditure will also be essential in order to permit a sustainable easing of the tax burden in France, the level of which is one of the highest in the OECD area. For highly qualified individuals — and therefore the highest paid — the average income tax rate can be up to 58 per cent of income. In an environment of increased tax competition, and given the major tax reforms undertaken elsewhere in the European Union, failure to reduce taxes could result in losses of human and financial capital. The French authorities have thus initiated a programme to ease tax pressure. A start has been made on reducing the marginal income tax rate, and this reduction should, if possible, be amplified and extended in coverage. Across-the-board cuts that benefit all taxpayers are preferable to cuts targeted at certain professions (football players, performing artists, brokers). Measures to simplify the tax system and make it more efficient are also necessary. Here some taxes that were costly to collect and had a low yield, like the road tax, have been abolished. Other taxes might also be done away with (television licence fee or quasi-fiscal taxes).

Other structural reforms are more modest, notably in regard to pensions

7. In other areas, structural reform has advanced more modestly during the past two years. The brighter economic outlook may have made some analysts believe, wrongly, that growth would itself resolve the structural problems and that reforms would not be essential. Such an illusion may have extended to the implications of the ageing of the French population, a process that will accelerate as from 2005. The authorities do not share this view. Before embarking on major reforms, they have decided to set up a *Conseil d'orientation des retraites* (COR, pensions advisory board) to reflect on the issue and to facilitate the emergence of a consensus between social partners on future reforms. In the immediate term, the authorities have decided to endow the *Fonds de Réserve des Retraites* (pensions reserve fund) with FF 1 000 billion between now and 2020 in order to smooth the financial burden created by population ageing. Public finances will have to show surpluses in the future to supply this fund. Receipts from privatisation should also be paid into it rather than being used to subsidise loss-making public enterprises, as at present. The authorities have also expanded existing employee saving schemes. But these measures cannot be a substitute for a reform of the different pension schemes. On equity and sustainability

grounds, the main parameters for the public sector pension (minimum period of contribution, reference salary, mode of indexation) should be brought more into line with those of the private sector. According to the COR, alignment of the respective contribution periods would reduce the borrowing requirements for the pensions of central-government employees by one-third in 2040. In addition, free choice of the date of retirement could be introduced and pension amounts determined on an actuarially neutral basis. This would reduce the incentives to early retirement.

A return to full employment in the medium term is possible

8. The government is aiming at a return to full employment by 2010, which is often defined in the public debate as a 5 per cent unemployment rate with higher labour force participation. Achievement of this full employment objective would make it possible not only to combat poverty and exclusion, but also to increase the economy's supply potential. But it would necessitate a steep fall in the structural unemployment rate, which most studies estimate to be around 9 per cent. It is, therefore, a goal requiring ambitious measures on the side of both labour supply and demand.

The authorities have already reduced wage costs for low-skilled labour...

9. Since the start of the 1990s, the authorities have made a big effort to reduce the *cost of unskilled labour*. This policy, which consisted mainly of substantial reductions in employer social security contributions, helped moderate the growth of labour costs and was bolstered by the slowdown of individual net wages. The beneficial impact of this reduction on employment is now well established. It helped to stimulate corporate demand for labour and to stabilise the share of low skill-workers in total employment for the first time since the 1980s.

... and introduced measures to stimulate labour supply

10. The authorities have also recently sought to implement supply-side measures to reduce the "inactivity traps" produced by the interaction of various social minima and the tax system. Recent analysis shows that net income from work is not necessarily higher than basic income support, which may discourage a return to employment. Indeed, hiring difficulties for low-skilled jobs have become more marked in recent years, attaining historically high levels. Increasing the incentives to work for the least well-paid is not an easy task, especially when the authorities wish, among other things, to preserve social minima. Initially, the authorities undertook to rationalise the tax-benefit system, notably by allowing individuals to combine temporarily basic-income support with income from work, and by reforming housing benefits and the *taxe d'habitation*. However, within the context of a complicated system, selective measures of this kind do provide adequate incentives. A more significant step forward was taken this year with the introduction of the "employment bonus", a tax credit that will benefit some 8 million low-income households. However, in its present form, the bonus primarily benefits those working full time and is less advantageous to part-time workers. The employment bonus should, therefore, be amended so as to provide more incentive for part-time working, which is often an effective bridge towards full-time employment.

Further employment policy measures are now necessary

11. Despite these important reforms, a hard core of unemployment still consists essentially of persons without qualifications or without experience. For these individuals, the challenge will be to stimulate labour demand by further reducing labour costs without affecting work incentives at the same time. To do so, the authorities should exploit the interaction of the three instruments at their disposal: the employment bonus to encourage the labour supply; cuts in employer social security contributions to reduce the cost of low-skilled labour, though the scope for further cuts is now limited, and the minimum wage, increases in which should remain moderate in order to safeguard recent progress. In this connection, a wider role for the employment bonus could be envisaged. It has the advantage of strengthening the incentive to work and permitting moderate wage growth, while protecting the purchasing power of workers who receive it. Corrective measures also need to be taken rapidly to prevent a sharp acceleration of the hourly minimum wage and the monthly guarantee as a result of the changeover to the 35-hour week. Otherwise, low skilled employment, especially in small firms, is likely to be penalised.

The gradual nature of the changeover to the 35-hour workweek needs to be reinforced,

12. The *reduction of working time* has been considered by the authorities to be the cornerstone of their plan for reabsorbing unemployment. About half of all employees in the market sector are now working 35 hours or less per week. The reduction in working time was accompanied by a range of state-financed aids designed to reduce its impact on labour cost. These aids, combined with the scope for work reorganisation offered by the changeover, explain why some businesses were keen to make the change. Yet there are a number of challenges to be faced as the process continues. First, even when possible feedback effects are taken into account, the changeover is proving to be costly for the government and the sources of future financing are not fully identified. Moreover, the forthcoming switchover of the civil service to the 35-hour week is likely to result in numerous new hires that will strain public finances still further. In addition, small businesses will experience difficulties when they move over to the shorter workweek on 1 January 2002. They will have to meet high fixed costs and, unlike larger businesses, will not necessarily be able to reap the benefits of work reorganisation. In anticipation of this, the authorities have decided to ease the arrangements for the 4½ million employees concerned.

... the match between labour supply and demand needs to be improved...

13. It is also recognised today that the *functioning of the French labour market* lacks fluidity, as evidenced by the coexistence of mass underemployment and severe recruitment difficulties for employers. The mismatch between labour supply and demand is making the economy more vulnerable to recurrent shocks and slowing the return to equilibrium following those shocks. Even though they represent only a small proportion of total employment, fixed-term work contracts have increased and become more common in certain limited segments of the labour market. Also, in order to bring more young people into the labour market, the authorities created the "*emplois jeunes*" (youth employment) scheme, which provides five-year contracts in the public sector. About 15 per cent of the young people on the scheme have managed to find dependent employment before the end of their contract. Nevertheless, it is not clear that the scheme helps young persons to

find steady employment in the market sector when their initial contracts come to an end. As a result, the scheme risks increasing the public sector workforce. Renewal of the initial contracts for another period of five years should be accompanied by targeted and effective training as a bridge to jobs in the private sector. In this regard, the social partners and the authorities have decided to set up schemes to assist persons wanting to rejoin the workforce by providing them with custom-made re-entry strategies that include further training. International experience suggests that an initiative of this kind can be effective. However, the concomitant abolition of the degressive scale for unemployment insurance benefits is likely to reduce further labour market flexibility. To prevent this from happening, it is important that the authorities apply more strictly the regulations resulting in the removal from the unemployment register of jobseekers who refuse jobs matching their qualifications, without a legitimate reason.

... and labour regulations need to be simplified

14. Another generally accepted fact is that *French labour legislation* is extremely complex. This applies in particular to redundancy legislation and the formalities an ailing business must comply with in order to reduce its workforce. The government has proposed in the draft Social Modernisation Act to make redundancy regulations even more restrictive. If the bill goes through, it will increase the formalities, lengthen the periods of redundancy notice and increase dismissal costs. Employee consultation procedures will be more complicated, the departmental préfet is given a formal role, and the employees concerned will be able to appeal against dismissal to the courts. International experience indicates that legislative initiatives of this type are liable to reduce hiring flows to the detriment of the jobless. Indeed, there is nothing to prove that employment protection policies are an effective means of combating unemployment. If businesses are unable to lay off employees, they tend to hire less and make more use of temporary workers or workers on fixed-term contracts.

A number of network industries have been successfully opened up to competition

15. One area in which structural reform has progressed has been the opening of several network industries to competition, pursuant to EU directives. This major development has had positive effects on the economy as a whole: lower prices and better-quality services for consumers and higher incomes for the industries' employees. In the *telecommunications* sector, competition has developed strongly, though unevenly across the market. It established itself early-on for long distance and international telephone calls, but much later and only partially for local calls. The introduction of competition rapidly brought new investors into the sector and has generated entrepreneurial excitement, which has stimulated activity and employment. Similarly, in *air transport* the big European and non-European airlines have increased their flights to and from France, obliging Air France to squeeze its prices. The fragility of "low cost" airlines is nevertheless still a weakness of the French market. The opening of the *electricity* sector to competition is more recent. The creation of the increasingly independent Electricity Transmission Network (RTE) business unit within EDF was an important step towards separating the generation and transmission of electrical power in France. This process should be completed by fully separating the two entities, which would facilitate the further opening of the sector to competition.

Extension to other sectors is being held back by several concerns to which responses exist: competition need not compromise universal service,...

16. On the other hand, little progress has been made in opening up the *rail transport, natural gas and postal services* sectors. True, some moves have been made in this direction, but here the traditional monopolies remain essentially unchallenged. Certain fears are holding back reform in these sectors. The *first* is that competition will undermine the "public service" tradition, which in France is understood to mean that network industries should provide their services over the whole territory at identical prices that are affordable for the whole population. There is strong popular support for this tradition and further reform will not be possible unless the fear is quelled. But what has been achieved so far shows that maintenance of "public service" is not incompatible with competition. The reform of the telecommunications sector and the ongoing reform of the electricity sector have maintained universal access to network industry services, including for the poorest and most isolated segments of the population. The social mission of "public service" can therefore be preserved—even if certain practices lacking in transparency like cross-subsidisation have to be abandoned.

... the employees of operators need not lose their social benefits, ...

17. The *second* concern is for the future of labour relations within the incumbent operators, whether in respect of work practices, fringe benefits or retirement arrangements. The experience of the telecommunications and air transport sectors offers useful lessons on how to make employees active participants in the process of change, even if this experience cannot be transposed in identical form. These experiences have shown that labour unrest can be resolved with less difficulty if employees are associated with the commercial prospects opened up by the firms' changed status. The transformation of the capital structure could provide an opportunity for their employees to acquire equity stakes and a share of future profits. Moreover, at a time when the entry of certain public network undertakings into foreign markets has prompted reservations about the conditions in which that entry might develop, this trend will help to create conditions of competition that are more transparent and, in some respects, probably more favourable to French firms themselves.

...and security of supply and stability of services need not be compromised

18. The *third* fear is that enterprises exposed to competition will be disinclined to undertake the very long-term investments needed to ensure security of supply, whereas public corporations are less constrained by profitability requirements and have a different approach to long-term risk. Appropriate regulation could put this fear to rest. The regulatory authorities can, at the time of licensing and with the necessary incentives, get private operators to maintain a level of investment sufficient to ensure security of supply and stability of services over the long run. Although the misgivings of public opinion are real, they should not be allowed to justify a halt in reforms. Solutions exist that can dispel the fears expressed both by service users and by service employees.

Environmental policies still lack overall coherence and...

19. Like most other OECD countries, France has been endeavouring for some years to make its growth environmentally sustainable. These efforts, which are reviewed in the special chapter of this *Survey*, have been based on the traditional instruments of environmental protection—regulatory standards, in particular. However, this approach is not very economically efficient because it does not allow efforts to be concentrated on pollution sources with the lowest abatement costs. Environmental taxes and charges have been used, but more with a view to financing expenditure on pollution control than providing adequate microeconomic incentives. Maintenance of this financing has also reduced the economic and environmental efficiency of the aid distributed. Aware of these inadequacies, the authorities have adopted a new approach that involves more extensive and more efficient use of economic analysis and instruments. However, recent action, notably that concerning petrol taxation, has been a step backward if anything, and the withdrawal of a proposed tax on intermediate energy consumption attests to the difficulty of framing a coherent environmental strategy. This is especially the case with greenhouse gas emissions, water pollution and emissions in urban areas.

... economic instruments are required to reduce greenhouse gas emissions efficiently

20. France has pledged to reduce its greenhouse gas emissions under the Kyoto Protocol. For that purpose, the government planned to introduce a tax on the intermediate consumption of energy by enterprises. However, the Constitutional Council overruled this project in December 2000, essentially on the grounds that its provisions for tax allowances and exemptions among treated taxpayers unequally. Yet some inequality is difficult to avoid if the aim is to provide the same marginal incentive to all sectors, while moderating the losses of competitiveness due to the lack of international co-ordination in this area. Even if the tax project was not perfect, alternative solutions could have been found to introduce an effective instrument for curbing greenhouse gas emissions. The aim was not to increase tax pressure but to bring taxation to bear more on scarce resources (the environment) than on abundant resources (*e.g.* labour supply). The government is currently studying alternative solutions to the ecotax overruled by the Constitutional Council, in particular the possibility of negotiating voluntary agreements to reduce greenhouse gas emissions with industrial enterprises. However, international experience has shown that such agreements often result in unambitious objectives and that they are unlikely to result in a significant and low cost reduction in these emissions. The possibility for firms to trade emission reductions would reduce the cost for them but would not modify the inherent problem of voluntary agreements. Only a real market in emission permits with a cap on the overall level of emissions and rules for allocating permits, or an adequate tax, would provide the necessary incentives. A more coherent approach to fuel taxation is also necessary; even though they are consistent with Community law, the exemptions and excise duty reductions appear inadequate, in both their environmental and economic impacts. Similarly, the present tax differential between diesel oil and gasoline is sending out an inappropriate signal, both from the standpoint of greenhouse gas emissions and from that of emissions contributing to urban air pollution.

Improvement of urban air quality is being hampered by many obstacles and...

21. Air pollution due to road traffic in cities poses a serious health hazard for urban dwellers. Admittedly, air policy, which has rested principally on enforcement of emission standards and development of public transport, has made it possible to reduce the emissions of some local pollutants, but it has not prevented a steep growth of motor traffic in urban areas. While there are no miracle solutions to this complex problem, the following approaches might enable some progress to be made. Parking charges should be revised so as to discourage the use of motor vehicles. The introduction of urban tolls in big cities should be studied. And incentives for car pooling should be provided. For these measures to work, there would have to be better co-ordination of local stakeholders (municipalities, public transport operators, associations, employers). In particular, joint targets for improving air quality and reducing traffic would have to be adopted.

... the reduction of water pollution, particularly of agricultural origin, necessitates an extensive reform

22. The quality of ground water and water in rivers, lakes and estuaries is deteriorating owing to pollution of agricultural origin, particularly the presence of nitrates connected with intensive livestock farming, fertilisation and irrigation. The proposed new legislation on water provides for the introduction of a tax on excess nitrogen. This is a first step towards internalising the cost of agricultural pollution, which up to now has been virtually exempt from all payment. However, to reduce agricultural pollution of water it would also be necessary to reform the domestic and European systems of agricultural aid, which encourages intensive farming and hence pollution. To improve the efficiency of water resource management, the charges paid for water consumption and pollution should no longer be earmarked to the budgets of water agencies. They should be more closely aligned with the cost of existing externalities and aid allocation procedures should be reformed so as to increase their environmental and economic efficiency. Finally, preferential charge rates for certain sectors or users should be avoided.

To sum up

23. After years of economic stagnation and unemployment, France has experienced a period of job-rich growth. The efforts made to consolidate the budget situation, bring down inflation, reduce labour costs, open markets to competition and privatise public enterprises have finally paid off. However, the rapidity with which strains on the factors of production have emerged shows that progress still needs to be made in boosting productive capacity. The French economy is on track but a substantial improvement in living standards and employment is still possible. Since the beginning of the year, activity has slowed appreciably and unemployment is rising again. For the time being, private consumption is underpinning growth, which should continue to run at close to potential. But the picture in the near term is cloudy and the economic environment may remain subdued. Fiscal policy, while continuing to exercise control over public expenditure, should therefore not attempt to offset the revenue shortfalls linked with the cyclical slowdown. Although this will mean a slightly larger budget deficit in the short term, the authorities should maintain their objective of a balanced budget in 2004. The growth slowdown usefully underscores the importance of structural reforms. These remain essential in order to deal with the problems regarding pensions and to achieve the goal of full employment so desired by public opinion. Here

there is a need for additional measures to bring down structural unemployment, such as extending the employment bonus to part-time working, introducing a new approach to setting the minimum wage, reducing labour-market skills mismatch, increasing gradualism in the phasing of the 35-hour work week and simplifying labour regulations. Also, further opening of network industries to competition would create new entrepreneurial opportunities. Finally, a new approach to environmental policy is needed in order to provide more microeconomic incentives to reduce polluting emissions. Pursuit of such policies with respect to public finance, employment, competition and the environment should enable France to, once again, achieve sustainable non-inflationary growth.