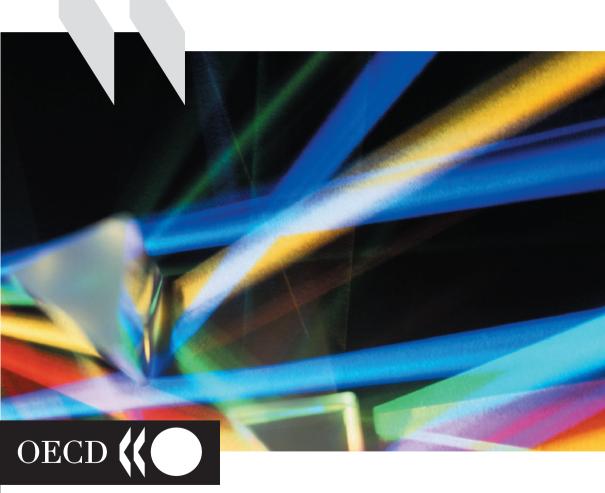
OECD Economic Surveys

France



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OECD ECONOMIC SURVEYS 2002-2003

France

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Table of contents

Asse	essment and recommendations	9
I.	Overview of economic developments and challenges Recent developments The short-term outlook Fiscal policy in 2003 and 2004 The challenge of ageing to long-term fiscal sustainability Improving potential output could improve prospects Action is required soon	23 23 37 39 40 42 47
II.	Policies to raise potential output Growth through resource deepening Reforms to improve firm-level performance Some aspects of sustainable development Summary	51 51 74 90 103
III.	Public expenditure management Spending in international comparison The challenges ahead Budgetary processes and arrangements across levels of government Policies to strengthen public expenditure management Summing up	111 111 113 117 130 154
Glos	sary of acronyms	158
Note	es	160
	iography Long-term fiscal simulations Chronology of main economic events	166 171 173
	••••	
Boxe	es	
1. 2. 3.	Recent measures affecting taxes The government's proposed pension reform Evaluating the employment impact of the 35 hours legislation	38 43 59

4.	Proposed measures to support the creation, financing and efficiency	
	of small and medium enterprises	75
5.	The State as entrepreneur	87
6.	Policy integration across sustainable development areas	91
7.	Fiscal relations between levels of government	119
8.	The social security system	126
9.	Special social security financing funds	129
10.	Incomes of the elderly	138
11.	Main difference between public- and private-sector pension schemes	142
12.	Decentralisation	152
13.	Summary of recommendations	155
Tab	les	
1.	Quarterly gross domestic product	25
2.	General government accounts	36
3.	Fiscal sustainability and structural reform	46
4.	Impact of spending reform on fiscal sustainability	48
5.	Employment programmes for youth under 26 years of age	54
6.	Expected change in labour costs for minimum-wage workers	66
7.	Early-retirement schemes and older-worker employment	70
8.	Legal corporate income tax rates	81
9.	Inflation of name brand versus in-house products	83
10.	Main indicators: climate change	93
11.	Greenhouse gas emissions and sectoral indicators	94
12.	Long run marginal costs of power generation	97
13.	Overview of progress in structural reform	104
14.	Major current government outlays	114
15.	Organisation of the public sector in France	118
16.	Preparation of the State budget	122
17.	Fiscal consolidation in the OECD	131
18.	Performance indicators: sustainable retirement income	139
19.	Official estimates of pension fund balances	143
Figi	ires	
1.	Recent economic trends	24
2.	Reduced supply-side tensions	26
3.	Business sector indicators	28
4.	Price developments	29
5.	Wages, labour costs and competitiveness	31
6.	Employment and unemployment	32
7.	Current account balance	33
8.	Monetary conditions	34
9.	Long-term debt dynamics	41
10.	Employment rates	44
11.	Trends in youth employment	53
12.	Minimum wages	62
13.	SMIC, take-home pay, labour and employment	63
14.	Harmonising minimum wages and low-wage worker social security reductions	65
15.	Older worker employment rates	69
16.	Financial incentives of retirement schemes	71
17.	Water quality of rivers and streams	100

Table of contents 5

18.	Nitrates in underground aquifers	101
19.	Financial costs of water pollution	102
20.	Public expenditure	112
21.	General government primary expenditure by economic category	116
22.	Expenditure shares by level of government	120
23.	Slippage in multiyear targets	133
24.	Asymmetric response of expenditures to the economic cycle	134
25.	Range of activity of social security schemes	148

BASIC STATISTICS OF FRANCE

THE LAND

TH	E LAND	
Area (1 000 km²), 1998 632. Agricultural area, excl. overseas departments (1 000 km²), 1998 300.	Paris 2 1 Marseille 7	125 798 445
THE PE	OPLE (2002)	
Population (thousands) 61 07 Number of inhabitants per km ² Average annual increase (thousands), 1990-2002 25	(thousands) 6 Percentage of employment in: Agriculture 1 Industry and construction 2	3.7 23.7 72.7
PRODU	CTION (2002)	
Gross domestic product at market prices (euros billion) 1 52 Gross domestic product per capita (euros) 24 93 Gross fixed investment as a per cent of GDP (current prices) 19.	O Agriculture Industry 2 5 Construction	3.1 22.2 4.3 70.4
GENERAL GO	VERNMENT (2002)	
ESA95 concept, as per cent of GDP: Current expenditure Current revenue Gross fixed investment	54.0 50.5 3.3	
FOREIGN	TRADE (2002)	
Exports of goods and services (% of GDP) Main exports as a percentage of total exports (SITC): Food, beverages and tobacco (0 + 1) Chemical products (5) Manufactured products (6 + 8 + 9) Machinery and transport equipment (7) 27. 12. 12. 13. 14.	Main imports as a percentage of total imports (SITC): Food, beverages and tobacco (0 + 1) Chemical products (5) Manufactured products (6 + 8 + 9)	8.3 3.3 8.8 87.6
THE	CURRENCY	
Monetary unit: euro	Currency unit per \$, average of daily figures: Year 2002 1.0 April 2003 0.91	061 199

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

The economic situation and policies of France were reviewed by the Committee on 20 May 2003. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 26 June 2003.

The Secretariat's draft report was prepared for the Committee by Andrew Burns, Alessandro Goglio and Boris Cournède under the supervision of Yutaka Imai.

The previous Survey of France was issued in November 2001.

Assessment and recommendations

French economic growth has slowed

Activity has slowed in the past 18 months, following several years of strong employment and output growth. Although GDP increased by only 1.2 per cent in 2002, the labour market has resisted remarkably well. Employment has continued to rise and unemployment has edged up only marginally. Accommodative monetary conditions and a sharp and largely structural relaxation of fiscal policy likely reduced the extent of the slowdown. However, the budgetary easing caused the general government deficit to reach 3.1 per cent of GDP, prompting the European Commission to initiate its excessive deficit procedure. The slowdown reflected a significant cutback in investment activity. While the average growth rate for 2003 should be less than 1 per cent, corporate and household balance sheets remain in good shape, suggesting that, as international uncertainty dissipates, growth could accelerate, reaching a rhythm of about 2 per cent during the course of 2004. Moreover, the slowdown has turned the output gap negative, greatly reducing supply side pressures. As a result, a return to higher growth rates is not expected to generate increasing inflation in the near term.

Rising pension and health costs pose a mediumterm challenge,...

France faces a daunting task in meeting the fiscal challenge posed by the ageing of its population, which is expected to result in the ratio of people retired to those employed doubling by 2030. As a result, there will be only one worker to support every retiree. This has obvious implications for the sustainability of the country's pay-as-you-go pension scheme, but will also add further impetus to health-care costs that are already rising strongly as a share of GDP. The challenge posed is all the greater because, at the same time as ageing raises spending pressures, the exit from the

workforce of the large baby-boom cohorts will reduce the rate at which employment and therefore potential output grow - thereby slowing the increase in the tax base needed to pay for these services. Notwithstanding continued improvements in productivity and income levels, the operational deficit of the health and pension systems would increase by some 5 per cent of GDP by 2030 in the absence of far-reaching policy changes. Allowing such deficits to accumulate over time is not a realistic option because the resulting build-up of debt would be unsustainable. OECD estimates suggest that the debt to GDP ratio could more than double by 2030. While the ageing challenge is a longrun one, actions to deal with it are nonetheless urgent, both because deep reforms can only yield results over time and because reform options become fewer and more costly the longer they are deferred.

... requiring fundamental reform to avoid an unsustainable build up of debt

Addressing the ageing challenge will require substantial efforts on a number of fronts. Raising taxes or social security contributions to close the emerging fiscal imbalance, might quickly become self-defeating in an increasingly integrated world economy. The tax burden in France is already very high in international comparison. Raising it further could induce both capital and skilled labour to go elsewhere, and, in so doing, threaten both the tax base and longer-term growth prospects. On the other hand, there would seem to be considerable scope for structural reforms that could generate savings while nevertheless respecting societal priorities. Proposals to reform the healthcare system by making both its administrators and its users more responsible for overall costs are important initiatives that could have significant medium-term impacts on the growth of expenditure. As concerns pensions, plans to align the mandatory contribution period of public servants to those of the private sector, currently 40 years, and extend both in line with improvement in life expectancy are sensible. Such steps should help reduce the substantial inequalities between the private and public systems, although many will remain. Proposals to abolish financial disincentives to continue working after reaching retirement age will serve to raise potential output and reduce imbalances. All of these are steps in the right direction. However, notwithstanding the real difficulties that such measures may imply, more changes along similar lines will be required. Moreover, the authorities will need to take steps to improve the way public expenditure is managed and programmes evaluated – issues addressed below.

As a result, fiscal policy needs to be tightened

The long-run fiscal challenge amplifies the need to strengthen the budget in the shorter term. The authorities will need to quickly redress the recent fiscal slippage and make concrete progress towards re-establishing mediumterm budgetary equilibrium in line with official objectives. Unfortunately, even taking into account decisions to cancel some State Budget credits and to create an additional reserve, the OECD expects the deficit to exceed 3½ per cent of GDP in 2003. While this represents a broadly neutral stance on a structurally adjusted basis and notwithstanding the current cyclical slump, the failure to reduce the structural deficit during recent years of fast growth requires policy to be more rigorous now. In this regard, the authorities' decision to seek a 0.5 per cent of GDP reduction in the structural deficit in 2004 is appropriate. For this to be achieved, additional measures, including importantly the partial non-replacement of retiring civil servants, will need to be taken. Once public finances are on a more sustainable path, a programme of tax cuts could yield a virtuous circle of higher growth, higher incomes and similar levels of public services.

Eliminating employment barriers would increase opportunities for people out of work and also bolster fiscal resources Over the longer-term and in order to minimise the social cost of addressing the rise in ageing-related costs, policy needs to concentrate on making more effective use of its resources. In this regard, raising employment rates and hours worked will help restore fiscal sustainability by increasing resources available to pay for existing programmes and the substantial contingent liability represented by France's public pension systems. France distinguishes itself from other OECD countries by combining very low youth and older worker employment rates, with higher than average ones for so-called prime-age workers. Favourable demographic trends in the recent past and policies designed to assist low-skilled and inexperienced workers price themselves into the labour market contributed importantly to the strength of employment

growth during the last ten years. Notwithstanding these successes, more needs to be done to eliminate barriers that prevent those who wish to work from doing so. Simulations suggest that a set of policies that succeeded in raising employment rates for youths and older workers to OECD average levels could raise potential output by 6 per cent and reduce fiscal pressure over the next several decades by as much as 2 per cent of GDP. Moreover, raising the employment rates of younger workers has the advantage of smoothing the pension burden. While additional contributions will come on stream precisely when operating deficits are projected to be growing most quickly, the associated pension costs will not come due until the middle of the century when the system's equilibrium is projected to be improving.

Extending on-thejob training would help raise employment levels...

In order to overcome impediments to the employment of youth and the low-skilled, policy needs to continue to reduce the cost of hiring such workers. While many statesubsidised employment programmes have limited impacts on job prospects, some have improved employability for well targeted population groups. The apprenticeship and qualification contract schemes have proven a particularly effective means of significantly and durably improving the employability of low-skilled workers, in part because of their significant reliance on co-financing by both employers and employees. By providing inexperienced and low-skilled workers with private-sector job experience in exchange for lower wages, such programmes help them price themselves into the labour market, and, at the same time, acquire valuable and marketable skills. In order that more individuals currently excluded from the labour market can share in such benefits, access to these programmes should be expanded.

... as would efforts to further reduce their labour costs Reducing labour costs of low-paid workers by reducing their social charges is also a successful strategy for raising employment. Unfortunately, the cuts in charges implemented since 1997 and those planned during the period 2003 to 2005 have served in part to offset the additional costs imposed by the 35 hour work week and the multiple minimum wages created in its wake. Because cuts in social charges are an expensive option for the public purse, care must be exercised

in the future, to ensure that any additional cuts really do reduce labour costs.

Offsetting the hike in minimum wages associated with their harmonisation by smaller increases later on... Following the period of harmonisation of the SMICs, the authorities should restrict further increases in the SMIC to the rate of inflation for several years, so as to re-establish a downward trend in the relative labour costs of lower skilled workers and to offset the negative impact of the planned 5 per cent real increase in the minimum wage. Here, the earned-income tax credit (*Prime pour l'emploi*, PPE) could be used, in combination with more moderate increases in the minimum wage, to lower labour costs. As long as it is focused only on households presenting a real social need, such a combination would be less expensive than an equivalent reduction in social charges. Moreover, all low-skill and youth workers would benefit from increased employment opportunities as the SMIC returns to more moderate levels.

... and decreasing the disincentives caused by out-ofwork benefits would help

Combating inactivity traps also requires a reinforcement of policies that promote greater labour force attachment on the part of those out of work. Here, there appears to be room to improve the effectiveness with which the locally administered public employment service helps the unemployed find work. In this regard, proposals to transfer financial responsibility for the main non-work income support scheme (Revenu minimum d'insertion, RMI) to the same governmental level that is responsible for job activation policy is a step forward. Associating financial responsibility for passive income support with the administration of activation policy should improve institutional incentives to get individuals off income support and into work. Moreover, the proposal to complement the RMI by allowing firms to hire beneficiaries for a limited period of time, but only pay them the difference between the minimum wage and their benefit, could be a powerful instrument to create job opportunities and reactivate such individuals. A careful individualised follow up by the public employment service will be necessary to minimise the impact of windfall gains.

For older workers, policy needs to restore financial incentives to work...

... by dramatically scaling back early retirement schemes, and... The main challenges facing the authorities as concerns older workers is to cut-back sharply on various state and unemployment insurance measures that subsidise early labour withdrawal and restore financial incentives to those that wish to continue working beyond the retirement age. Existing rules are at the root of low employment among older workers, and these reflect several decades of policy that explicitly sought to encourage early labour force withdrawal in the mistaken hope that this would help reduce unemployment.

In this regard, recent efforts to cut back on statesubsidised early-retirement programmes should reduce premature labour market exit. Similarly, the decision to reduce the extent to which the extended unemployment benefits offered by the UNEDIC (the unemployment insurance system) can be used to finance early retirement is welcome, although more needs to be done. Indeed, by making non-employment a viable alternative to work for older workers and implicitly subsidising firms that lay off such employees, the system appears to be a major cause of joblessness among older workers. More workers 55-60 years of age permanently exit the labour force on UNEDIC-financed schemes than via government early retirement schemes. Thus, policy-makers need to eliminate this programme as a source of job loss, while nevertheless preserving extended benefits for older workers who genuinely lose their jobs and providing lifelong training opportunities to workers so that they remain attractive as employees. Experience-rating firms that disproportionately lay off older workers would reduce recourse to early retirement by imposing more of the substantial social costs that such layoffs entail on to those firms taking advantage of the system. In addition, the responsibility of the social partners for the broader costs of these programmes would be enhanced if the State ceased subsidising the scheme by paying the pension contributions of new entrants to it. Finally, there may be scope for redirecting money spent on subsidising the non-employment of these workers towards programmes that reduce their labour costs.

... making pension income actuarially neutral

Additional reforms are necessary if workers who wish to work beyond the official retirement age are to find it financially worthwhile to do so. The authorities' plans to make benefits more actuarially neutral around age 60 could help raise employment levels by eradicating the existing massive financial incentive to take one's pension as soon as 40 years of contributions have been made and one reaches age 60. International experience suggests that when financial incentives are neutral, a significant share of people 60 years or older choose to continue working – resulting in higher levels of output and higher tax revenues. In this regard, proposals to extend "standard" contribution periods in line with improvements in life expectancy go in the right direction and should be implemented. Such a more actuarially neutral system could be further expanded by allowing individuals to draw reduced benefits at an earlier age.

Policies to promote investment and fast growing firms would spur productivity growth

Economic performance and longer-term fiscal sustainability would also benefit from higher investment rates and better productivity performance. Here current efforts to ease the administrative complexity of the regulatory environment and increase incentives for innovation are welcome. As regards efforts to stimulate R&D, the establishment of networks of industrialists and research laboratories to identify promising technologies for government programmes to support is likely an improvement over the previous model. However, these programmes need to be subjected to more systematic evaluation. In this respect, the consistency of R&D support would be reinforced by increasing the emphasis on the medium term in the financing and management of laboratories. Furthermore, R&D remains principally a statefunded activity, and researchers do not have a large enough stake in the fruits of their discoveries. In order to ensure that public-sector research continues to become more responsive to business and societal needs, reforms that reduce rigidities in the allocation of resources between programmes and research areas should be pursued. The recent creation of the National Science Fund and the Research and Technology Fund are reforms that go in this direction. So as to encourage more investment and thereby further boost potential output, the authorities should continue to reduce relatively high corporate income tax rates and rigid labour market regulations. Moreover, cross-country research suggests that a less onerous taxation of lightly capitalised firms (often smaller fast growing companies) and a less rigid regulation of employment conditions helps boost productivity trends by favouring fast-growing high-tech firms.

Better governance of state-owned firms and continued privatisation should also help

Overall efficiency would be further enhanced by the pursuit of privatisation. Although progress over the past twenty years has been impressive, with the State divesting itself of some 2000 firms, it still owns or controls 1 500 companies. Most of these are small, but several very large firms remain in State hands, and, as a whole, publiclyowned companies continue to occupy an important place in the business sector. Moreover, although many of these firms have been commercial successes, the sector's overall record is marred by a number of failures and large losses. The recent creation of a new structure (Agence des Participations de l'Etat. APE) to supervise state commercial assets and to exercise the State's shareholder rights should increase transparency and improve the State's governance of these firms. However, to be successful the link between stateowned firms and their ministry-owners will need to be broken and the APE should be granted more independence from the bureaucracy. A proposal to make explicit stateowned firms' public-service obligations and transform these into contracts would enhance transparency and should be implemented. It could also yield cost savings so long as private firms are allowed to bid for these contracts. Notwithstanding these efforts, the need for further progress on privatisation remains. The authorities are proceeding with some more large-scale divestments, but the very many smaller firms also need to be transferred to private hands and the State's many minority stakes sold off. Finally, given the projected pressures on public finances, privatisation revenues need to be applied to reducing the debt or transferred into the special retirement reserve fund. Too much money continues to be channelled back into money-losing and inefficient state-owned firms.

To accommodate ageing-related cost pressures, spending needs to be brought under control

Given the ageing of the population and in order to preserve fiscal sustainability over the medium and long-term without raising taxes, the authorities will have to do a much better job of controlling the rate of increase of public expenditure. Indeed, since 1990, a period during which most OECD countries substantially reduced general government expenditure as a share of GDP, public spending rose by 3 per cent of GDP in France. Between 1995 and 2002, however. better expenditure control and the introduction of expenditure norms for the State Budget resulted in the share of general government spending in GDP falling by 1.1 percentage points. Nevertheless, this reduction was significantly less than had been forecast by the authorities at that time. In order to permit them to better meet their fiscal objectives. public expenditure governance systems need to be improved. Indeed, the repeated failure to respect multiyear spending objectives reflects in part the authorities' inability to exercise effective control over that share of general government spending that lies outside the State Budget. There is a clear need to introduce reforms that allow the authorities to require all spending agencies to contribute to expenditure control efforts and at the same time to confront decision makers more directly with the longer-term consequences of their actions.

A more mediumterm and integrated approach to budgeting is needed

To assist policy makers allocate resources effectively. additional measures are required to raise the visibility of the tradeoffs between State Budget and other general government expenditures. In addition, the time frame over which budgetary decisions are made needs to be lengthened, so as to help prevent pro-cyclical and permanent increases in spending. The inclusion of the government's medium-term spending plan as an annex to the State Budget and the almost simultaneous presentation of the Social Security and State Budgets are steps in the right direction. They should be reinforced, however, by having parliament vote the plan (currently it is not voted) and by making the medium-term projections more detailed and better integrated into both the State and Social Security Budgets. They could then be brought forward to serve as an umbrella to the two annual budgets, with the out-year projections serving as a basis for the projections of the following year. If underpinned by more prudent macroeconomic assumptions than has been the case in the past, such a scheme would contribute to more realistic medium-term budgeting by making it more difficult to introduce politically expedient programmes with short-term gains but long-term costs. Moreover, they would increase the likelihood that the authorities' longer term objectives for public finances are attained

Moreover, roles and responsibilities need to be clarified... While such a coherent and integrated budgeting system will be essential to enhancing the authorities' ability to better manage public expenditures, it is unlikely to be successful unless mechanisms can be found to ensure that all spending agencies participate in the effort to control spending levels. The main challenge is to clarify the roles and responsibilities of the central government on the one hand and those of the various regimes and sub-national governments on the other. Indeed, in many cases ultimate financial responsibility is poorly defined and does not coincide with administrative power, resulting in recurrent cost overruns, weak incentives to improve efficiency and the failure to put in place certain reforms.

... including at the local level

The authorities' plan to clarify responsibilities for programme delivery at the local level and to transfer financial resources to the level where programmes are administered is a step in this direction. By allowing local governments to keep the savings generated, the reform significantly sharpens incentives to seek efficiency gains and should result in more efficient programme delivery. However, to generate overall reductions in spending, mechanisms need to be introduced that guarantee that lower levels of government assume their share in the overall effort at expenditure control. Moreover, while reforms that allow municipalities to jointly provide some services and overcome scale inefficiencies have been broadly successful, the vast majority of France's 37 000 municipalities are far too small and serious consideration should be given to their consolidation. While the creation of various institutions for intercommunal co-operation have helped in this regard, much remains to be done. Furthermore, the advantages of having both a regional and a departmental level of government remain to be demonstrated.

The authorities need to provide themselves with the means to ensure that their objectives are attained...

For social security, the problem is simultaneously more serious and more complicated. In so far as the parliament is ultimately responsible for ensuring overall fiscal sustainability, it may be necessary for it to provide itself with the means necessary to ensure that the various social security funds respect the objectives it fixes for them. This could be done while giving them more liberty to determine the content of programmes and how they are managed. Indeed, parliament has already assumed some of this responsibility with the passage of Social Security Budgets in 1996, and the State Budget support of some social security regimes is already substantial. In addition, more needs to be done to reduce the rigidities in budgetary allocations caused by earmarking and to make the financing of the schemes more transparent. In order to better ensure that objectives are realised and so as to make fund management more responsible for financial outturns, Parliament should include in the social security budget, ex ante mechanisms designed to correct any eventual overruns.

... and make budget constraints more binding

Such a measure would help make the budgets of the social security system more binding and is particularly necessary in the healthcare sector, a perennial source of expenditure overrun. Unfortunately, experience in all OECD countries attests that no easy solutions exist. Nevertheless, as discussed in the 2000 OECD Survey of France, a variety of measures could help slow the rate of increase of health insurance spending and make the government's spending objective (the ONDAM) more binding. In particular, reform should seek to force administrators, doctors and consumers to take greater responsibility for the costs their actions generate. In this regard, the introduction of a rolling cap on ambulatory-care services could help limit doctors' incentives to oversupply, by making the level of their future remuneration dependent on respecting the previous year's norms. In addition, softening the threshold effect associated with the means-tested universal health coverage (couverture médicale universelle, CMU), while at the same time conferring more of the overall costs to complementary regimes, would also help by making individuals and their insurance schemes more interested in controlling costs. Coupled with an increase in the cost actually borne by patients, such changes, like the decision to reimburse pharmaceuticals at the price of generic drugs, should exercise additional restraint on the demand side.

The new State Budget framework should increase efficiency...

The newly introduced budgetary framework law (the LOLF), by placing the emphasis on programme outputs and their regular evaluation, could constitute an important tool for increasing the efficiency with which government services are delivered. The law extends to parliament a greater policymaking role and responsibility for ensuring the population gets value for their money. However, international experience suggests that, for such systems to be effective. significant changes in administrative and even political culture are required, necessitating continued strong political and administrative support and leadership. Current efforts to involve staff in the definition of the indicators that will be used to evaluate programmes and the use of pilot projects to test ideas should both promote a sense of ownership among public servants and make the final product more relevant. Finally, given the importance that policy evaluation is to play in directing reform efforts, it will be critical for programmes to be designed so as to permit evaluations and for these to be conducted with an eye to proposing improvements.

... but its output orientation should be extended to other levels of public expenditure The notion of output oriented budgeting should also be extended to other areas of public expenditure. In this regard, the creation of a Social Security Budget has helped to expose such spending to more regular scrutiny, but the budget needs to be given a more explicit output orientation and the systems' administrators need to be made responsible for meeting them. The introduction of performance contracts between the State and the various social security administrations is a step forward and more should be done in this vein. Even so, there appears to be significant scope for efficiency improvement by rationalising the systems' overlapping contribution-collection and benefit-distribution networks. The recent decision to create a one-stop counter for small and medium enterprises goes partly in this direction by reducing the administrative formalities facing firms. Finally, as

reform of the pension and health systems proceeds, the authorities should look at the desirability of consolidating regimes and harmonising benefit systems, for reasons of both social equity and administrative efficiency.

Efforts are also required to assure environmental sustainability

Putting in place policies to ensure the environmental sustainability of growth is a further challenge facing French policy makers. In this regard, the authorities should reconsider their strategy for meeting their international greenhouse gas commitments. In particular, a central role for permit trading at the EU level should be envisaged and the expensive implicit subsidy of wind-generated energy reduced to levels consistent with alternative sources of reductions in greenhouse gases. Opportunities to reduce emissions in road transportation through higher taxes are limited but tax levels on emissions from sea and air transport are too low (although progress here will require international agreement). Extensive efforts have succeeded in improving water quality but were expensive. To improve their cost effectiveness, existing regulations need to be more vigorously enforced and an effective tax instrument introduced to control agricultural pollution. In the area of phosphates and pesticides, regulations need be better aligned with the actual toxicity of individual chemicals.

To sum up

In sum, after several years of rapid expansion the economy has entered into a period of below potential growth, with a negative output gap opening up. Monetary conditions have been relaxed, while fiscal policy has eased excessively, provoking the European Commission to initiate an excessive deficit procedure. As uncertainty dissipates towards the middle of this year, the economy should pick up speed, reaching a growth rhythm of around 2 per cent in 2004. Nevertheless, over the medium-term in the absence of substantial reforms, the ageing of the population risks to threaten economic and fiscal equilibrium. Current pension and healthcare reform initiatives and plans to redress spending over the medium term go in the right direction. However, in order to ensure medium and long-term fiscal sustainability, additional policies to slow the expansion of health and pension spending are required, while efforts to raise employment rates and potential output are needed to improve the economy's ability to finance

future ageing-related expenditures. Here, programmes that offer the possibility of on the job-training should be expanded so as to reactivate young and low-skilled workers. while reforms to early-retirement schemes and the pension system need to be continued so as to restore work incentives for older workers. Ongoing tax and labour market reforms and policies to facilitate the development of hightech and fast growing enterprises, which should help promote investment and higher productivity growth, also need to be pursued. The opening of the capital of state-owned enterprises, their eventual privatisation and planned improvements to governance structures should help promote growth, but revenues from sell-offs ought to be used to reduce debt. Finally, in order to better manage the totality of public expenditures, the authorities need to implement reforms that can be used to ensure that all spending organisms contribute to spending control. Here, it will be necessary to implement mechanisms that would improve the effectiveness of measures to control healthcare spending. Moreover, decision-makers need to be more directly confronted with the long-term consequences of their actions. Initiatives such as decentralisation and the new budget framework law should help in this regard. Pursuit of reforms along all of these lines should permit society to meet the fiscal challenge posed by population ageing, while retaining high levels of service.

I. Overview of economic developments and challenges

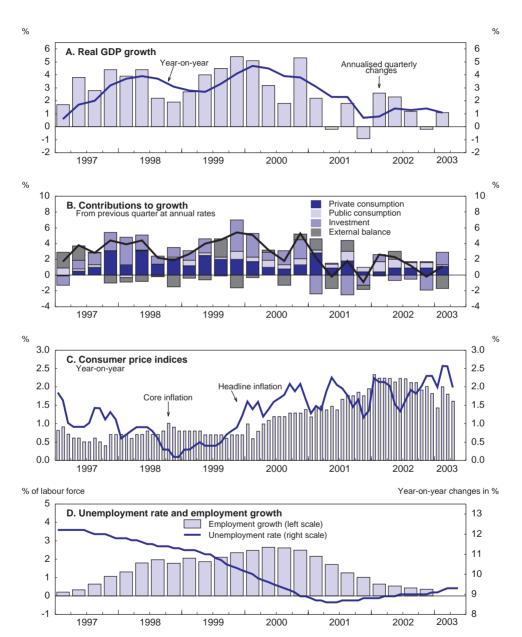
During the second half of the 1990s, the French economy grew strongly, outperforming the average for both the OECD and the euro area. Between 1997 and 2000 GDP grew faster than potential, reversing the output gap that had emerged in the first half of the decade. The recovery was sustained by strong domestic demand, itself supported by tax cuts, an investment boom connected to the stock market bubble, strong employment growth and, towards the end of the period, a relaxation of fiscal policy. In common with other European countries, growth was much more job-rich than in the past. This reflected both important structural measures that reduced labour costs and the 35 hour workweek legislation which accelerated the reabsorption of cyclical unemployment, allowing the unemployment rate to fall towards its structural rate. Although firms began to complain of difficulties in recruiting labour and of capacity constraints in a number of areas, wage growth remained moderate and inflation low. Beginning in 2001, the increased indebtedness of firms, the end of the stock market boom, the global downturn and a re-evaluation of future growth prospects conspired to sharply slow investment activity and exports (Figure 1). Overall GDP growth moderated less abruptly, partly because consumer and government consumption continued to grow rapidly.

Recent developments

Growth has been slow in 2002 and early 2003

Since then, activity has remained slack (Table 1). Consumption in 2002 and into 2003 albeit itself moderate continues to be the main source of what growth persists. This reflects a slowing in household demand counterbalanced by a strengthening in government consumption in 2002. Investment activity declined further as some firms cut back on expenditures as a part of efforts to redress their balance sheets, while others delayed projects in the light of uncertainty both as to future demand and international developments. Meanwhile, the weakness in world trade has persisted and firms report particularly weak export demand for intermediate

Figure 1. Recent economic trends



Source: INSEE, Bank of France and OECD.

 Table 1.
 Quarterly gross domestic product
 Percentage changes

					U							
	2001				2002				2003	2000	2001	2002
	QI	Q2	Q3	Q4	QI	Q2	Q3	Q4	QI			
	From previous quarter at annual rates											
GDP	2.2	-0.2	1.8	-0.9	2.6	2.3	1.2	-0.2	1.1	4.2	2.1	1.2
Private consumption	5.3	1.7	3.3	0.7	0.7	1.7	1.7	1.7	2.0	2.9	2.8	1.5
Public consumption	1.8	2.2	5.2	2.6	5.7	4.7	3.0	3.1	0.6	2.8	3.2	4.1
Gross fixed investment	1.5	-3.4	0.5	-1.7	-0.7	-0.7	-2.8	-4.3	0.9	8.4	2.1	-1.4
Household sector	4.5	-3.6	2.5	-0.1	-0.1	4.4	0.2	-0.7	1.1	3.4	8.0	0.8
Business sector	1.5	-1.3	-0.1	-2.9	-1.6	-4.6	-3.8	-6.5	0.9	9.7	3.5	-2.8
Government sector	0.6	-9.8	0.6	-2.1	-0.6	5.0	-4.9	-2.8	0.7	10.7	-0.2	-0.4
Stockbuilding ¹	-2.7	0.9	-2.6	-1.0	1.1	-0.6	0.1	-1.0	1.4	0.5	-0.7	-0.4
Total domestic demand	0.8	1.6	0.4	-0.4	2.7	1.3	1.1	-0.3	2.9	4.5	2.0	1.1
Exports of goods and services	-1.4	-11.0	0.9	-7.0	6.3	7.4	3.5	-2.0	-2.4	13.4	1.8	1.2
Imports of goods and services	-6.2	-5.9	-4.2	-5.6	6.9	4.1	3.4	-2.4	3.7	15.3	1.4	0.7
Net exports ¹	1.4	-1.7	1.4	-0.5	-0.1	1.0	0.1	0.1	-1.6	-0.2	0.1	0.2

Contribution to changes in GDP.
 Source: INSEE, quarterly and annual national accounts.

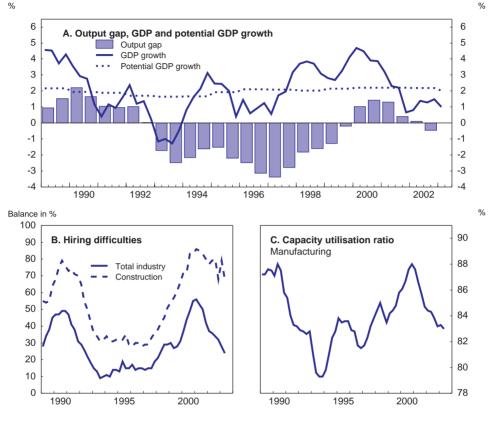


Figure 2. Reduced supply-side tensions

Source: INSEE and OECD.

goods. Although employment growth was weak in 2002, it remained positive and, notwithstanding some very visible plant closures, the unemployment rate has picked up only moderately, reaching 9.3 per cent of the labour force in May 2003.

The slowdown in demand has allowed the supply side to catch up to the demand side of the economy (Figure 2). Capacity utilisation rates have declined from historical highs to levels below their long-term average, and the number of firms reporting difficulties in meeting order and delivery commitments is down substantially. Overall, the output gap has reversed itself, moving from an estimated position of 1 per cent excess demand in 2000 to a negative gap estimated at –1 per cent of GDP in the first half of 2003.

Investment activity declined

The decline in investment activity and the substantial destocking that characterised the past 18 months were driven by balance sheet consolidation, partly provoked by the collapse of the stock-market bubble, which made the debt position of some firms unsustainable. Overall, firm debt levels are high, having reached in 2000 the same levels observed prior to the previous recession (Figure 3). However, because of lower interest rates, debt servicing charges as a share of value added are much lower than they were then, and on average the pressure to improve balance sheet positions is less intense now than in the past (the situation with respect to market value is likely considerably worse). Moreover, while total economy business sector investment volumes remain at high levels, nominal expenditures are close to average levels, suggesting that affordability is not a major constraint for most firms. Thus, while international tensions are doubtless contributing to a wait-and-see attitude by some companies, a more generalised uncertainty concerning demand conditions, stemming from weak economic performance in Germany and the lack of clear signals from the United States, is also playing a role. Indeed, although business confidence indicators are weak, they are not exceptionally so and have remained broadly stable for much of the last 18 months. Indeed, managers' own estimates of future investment prospects, which had been suggesting a rebound, were borne out by the return to positive business-sector investment growth during the first quarter of 2003.

Consumer demand moderated

Strong consumer demand in the period 1998-2001 principally reflected strong income growth as employment was expanding by 2¾ per cent on average and real wages by 1¼ per cent. Policy factors also played an important role, with substantial reductions in social charges and personal income taxes contributing to the progression of disposable income. While the economic slowdown reduced incomes growth in 2002, a 5 percentage point reduction in personal income taxes had the opposite effect, helping to limit the slowdown in consumption demand. Looking forward, slower employment growth, relatively moderate wage growth and the absence of further tax cuts should moderate the pace of income growth. Notwithstanding the pick-up observed during the first quarter of 2003, limited income growth and the significant deterioration of consumer confidence should manifest themselves in slower household consumption growth during the second and third quarters of 2003.

Inflation and labour market tensions have eased

Concomitant with the relaxation of demand side pressures and partly as a result of the appreciation of the euro, the persistent rise in core inflation observed since 1999 began to reverse itself in 2002. Headline inflation, however, continued

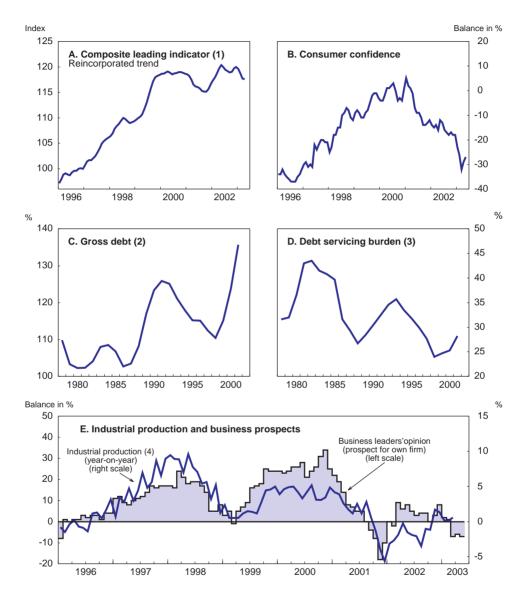


Figure 3. Business sector indicators

- 1. Computed by OECD.
- 2. Gross debt over value added of non-financial corporates.
- 3. Interest over gross operating surplus of non-financial corporates.
- 4. Seasonally-adjusted industrial production index excluding energy and agro-food industries.

Source: INSÉE, Bank of France and OECD.

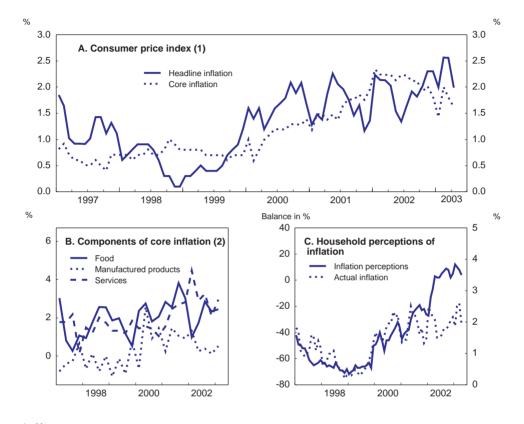


Figure 4. Price developments

1. Year-on-year rates.

2. Quarterly rates (saar).

Source: INSEE, Bank of France and OECD.

to be volatile, principally because of large swings in the rate of growth of energy and food prices (Figure 4). Rising inflation during the first half of the year in France and elsewhere in the euro zone, partly reflected the introduction of euro notes, notably as concerns the pick-up of service-sector inflation at the beginning of the year. The acceleration seems to have resulted from a much larger than usual number of firms revising their price lists at the same time and this seems to have been compensated for by slower price growth afterwards in some sectors, a phenomenon that may explain the deceleration of prices towards the end of the year. The introduction of euro notes on other goods was more muted because of agreements signed by large-scale retailers not to raise their prices during the first several

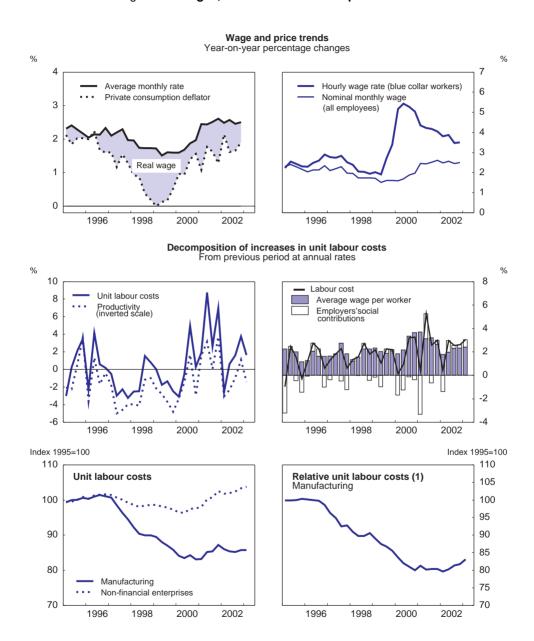
months of the year. Overall the introduction of the euro is estimated to have raised inflation by between 0.14 (INSEE, 2002) and 0.2 (Bank of France) percentage points, about the same increase as observed in other euro zone countries. Whatever the initial impact of the introduction of the euro on inflation, a rapid deceleration in core prices towards the end of the year suggests that competitive pressures and increasing slack were beginning to have their effect. Indeed, core inflation had slowed to a moderate 1.6 per cent (year over year) by April 2003. Notwithstanding this easing consumers' inflation perceptions in France and the euro zone have worsened considerably, resulting in a substantial rupture in the historical relationship between them and actual developments. Indeed, a very large proportion of households feel that prices have accelerated in the last few months. This, notwithstanding that wage growth remains moderate, could have unfortunate consequences if these perceptions translate into higher wage demands or reduced expenditures.

In this regard, moderate aggregate wage growth throughout the 1990s, with real wage increasing in line with or below productivity developments, was a major factor underlying France's good inflation and employment performance (Figure 5). The introduction of the 35-hour workweek legislation and the tightness of the labour market towards the end of the decade brought this to an end, provoking an acceleration in both monthly wages and more spectacularly hourly wages. This translated into an increase in the rate of growth of unit labour costs because higher wage growth was only partly compensated by increases in productivity and lower social charges. The trend towards increasing unit labour costs moderated in 2002, because of a cyclically-based rise in productivity and a slowdown in salary growth. Nevertheless, despite the growing slack in the economy, costs continued to rise in 2002 more quickly than in the 1990s, reflecting both a cyclical slowing in productivity growth and, perhaps, some catch-up effects as wage moderation pacts signed with the adoption of the 35-hour workweek legislation expired. Overall the rate of increase of unit labour costs has picked up over the past two years, although vis-à-vis other countries, France's relative cost position in manufacturing has not deteriorated.

Employment growth throughout the 1990s was stronger than in the past, a trend which continued in 2002 and 2003. Thus, notwithstanding the slowdown in the economy, employment grew by 0.4 per cent in 2002 on a labour force survey basis and 0.7 per cent on a national accounts basis. While the continued strength of employment likely reflects labour hoarding on the part of some firms, it also reflects the unwinding of excess demand conditions. Thus although the unemployment rate has risen to 9.3 per cent, it remains close to its structural rate (Figure 6).

A sharp slowdown in the rate of growth in world trade in 2001 persisted into 2002 and is reflected in the slowing of exports, which along with the deceleration

Figure 5. Wages, labour costs and competitiveness



1. Vis-à-vis 41 countries. Source: INSEE and OECD.

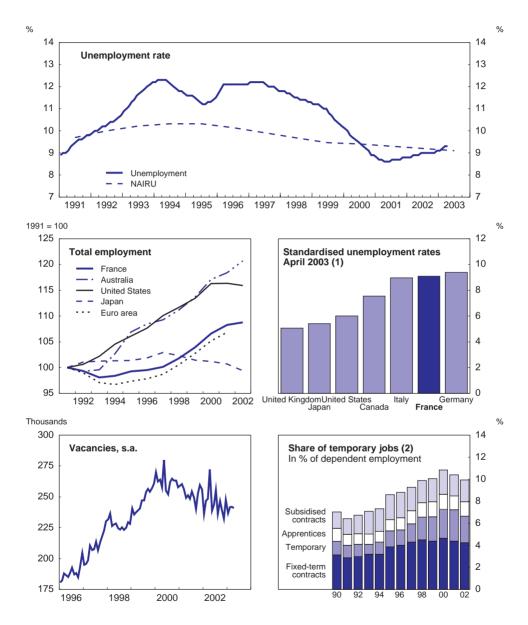


Figure 6. Employment and unemployment

1. United Kingdom: February 2002 and Italy: January 2003.

2. Employment surveys, March data except for 1999 (January).

Source: INSEE and OECD.

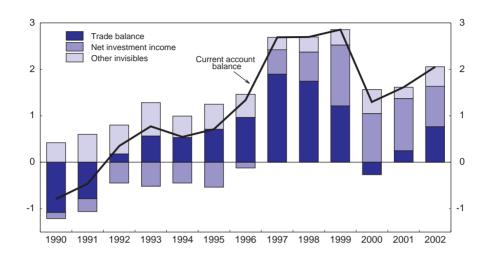


Figure 7. **Current account balance**Per cent of GDP

Source: INSEE and OECD.

in total domestic demand contributed to weaker import growth. These developments, plus falling oil prices in 2001 resulted in an improved trade balance. The improvement in the current account was less marked because of, among other things, increased insurance costs following the terrorist attacks in the United States and a reduced investment income balance, reflecting falling interest rates and smaller dividends on foreign stocks (Figure 7).

Macroeconomic policy was relaxed

Economic performance in the recent period was aided by accommodative monetary conditions and a substantial relaxation of fiscal policy. Short-term market interest rates fell from peaks of more than 5 per cent in late 2000 to around 3.3 per cent in early 2003. Insofar as inflation was rising over this period, real interest rates fall by even more. More recently, the 12 per cent real effective appreciation of the euro between January 2002 and May 2003 served to tighten overall monetary conditions somewhat, although they remain relaxed by historical standards (Figure 8). While calculating real interest rates with core, instead of headline, inflation suggests a smoother path for underlying monetary conditions, it does not fundamentally change the overall story.

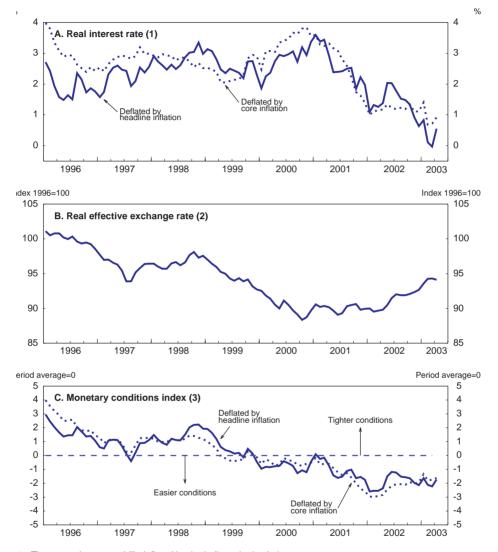


Figure 8. Monetary conditions

- 1. Three-month treasury bill, deflated by the indicated price index.
- 2. Real effective exchange rate calculated with forty-two countries, based on CPI.
- 3. The monetary conditions index is defined as:

MCI = MCI[t - 1] * (1 + (r - r[t - 1]) + w * (e/e[t - 1] - 1))

r = real short-term interest rate, deflated by the indicated price index,

e = real effective exchange rate, based on CPI

w = weight based on share of imports to GDP.

The index is shown as a percentage deviation from the period average. A value higher than zero indicates tighter conditions than on average.

Source: OECD.

Fiscal policy relaxed substantially in 2002. The general government budget deficit came in at 3.1 per cent of GDP, representing massive slippage as compared with budget documents, which had called for an overall deficit of only 1.4 per cent of GDP (Table 2). Only about one third of the overshoot was due to cyclical factors (the Budget had been predicated on 2.5 per cent GDP growth, an assumption viewed even at the time as very optimistic and substantially higher than the actual outturn of 1.2 per cent). The State Budget missed its target deficit by the largest margin (1.3 per cent of GDP), but this included unplanned transfers of 0.5 per cent of GDP to various other central government bodies outside the State Budget and is reflected in the larger than projected surplus for these organisms. Taken together, the overshoot of these central government bodies was nevertheless a substantial 0.8 per cent of GDP, of which 0.3 percentage points was due to lower than expected tax revenues. The second most important shortfall came from the social security system, which recorded a 0.3 per cent of GDP deficit instead of the 0.6 per cent surplus originally programmed. In contrast, sub-national levels of government actually turned in a larger than projected surplus.

Overall, the revenue shortfall was roughly equal to the slippage on the expenditure side. Revenues came in 0.8 per cent of GDP lower than in 2001 with most of this accounted for by discretionary tax cuts programmed earlier. Reforms to the income tax, increases in the employment tax credit (*prime pour l'emploi*, PPE), corporate income tax reductions for small business, the suppression of the part of the "professional tax" applied to salaries and reductions in social security charges linked to the 35 hour workweek legislation were of particular importance. Discretionary tax cuts totalled 0.5 per cent of GDP, with the 5 per cent reduction in personal income tax introduced by the government in the summer of 2002 accounting for 0.2 percentage points (2.6 billion euros).

Expenditures were 0.9 percentage points higher than budgeted, reflecting overruns in virtually all areas. Indeed, even the State Budget sector, which has traditionally succeeded in respecting the spending norms laid out in Budget documents, exceeded initial estimates by a wide margin. The largest overshoot came from healthcare spending, which grew almost twice as rapidly as allowed for in the social security budget (+7.2 per cent as compared with 3.8 per cent). In part this reflected increases (+20 per cent) to the honoraria received by general practitioners, but also the more general and persistent difficulties that the authorities have experienced controlling these expenditures (see OECD, 2000 and Chapter III). Large overruns in the accounts of the unemployment insurance system mainly represented cyclical factors, although changes to the parameters of the system adopted by the social partners in 2000 had substantially increased its structural deficit. Spending at the sub-national level of government came in below budget, principally reflecting the municipal-level election cycle, which sees investment expenditures fall in the year following an election – only to rise in following years as new programmes come on line. The improvement in local government finances

Table 2. General government accounts

						2002		2003		2004	
	1998	1999	2000	2001	Budget	Outturn	Budget	March revision	Multi-year programme	March revision	
Balance of the general											
government	-2.7	-1.8	-1.4	-1.5	-1.4	-3.1	-2.6	-3.4	-2.1	-2.9	
State budget	-3.0	-2.6	-2.5	-2.3	-2.4	-3.8	-3	-3.4	-2.8	-3.2	
Social security regimes	-0.1	0.3	0.5	0.3	0.6	-0.3	-0.2	-0.5	0	-0.2	
Local government Other central	0.3	0.3	0.2	0.1	0.3	0.2	0.2	0.2	0.2	0.2	
government entities	0.1	0.3	0.3	0.4	0.2	0.7	0.4	0.3	0.5	0.4	
Revenues											
Total	51.2	51.8	51.3	51.0	50.9	50.4	50.7	50.2	50.7	50.1	
Tax revenues	44.8	45.5	45.0	44.7	44.5	43.9	44.3	43.8	44.3	43.7	
State budget	17.1	17.7	16.9	16.6	16.6	15.9	16.5				
Social security regimes	20.5	20.8	21.5	21.5	21.7	21.6	21.9				
Local government Other central	5.7	5.6	5.3	5.0	4.9	5.0	5.0				
government entities	0.8	0.8	0.9	0.9	0.8	1.0	0.9				
EU	0.6	0.6	0.6	0.6	0.5	0.5	0.5				
Expenditures											
Total	53.9	53.6	52.7	52.6	52.3	53.6	53.3	53.6	52.8	53.0	
State budget	23.5	23.7	22.7	22.4							
Social security regimes	24.0	23.7	23.5	23.8							
Local government Other central	9.8	9.9	10.0	9.9							
government entities	3.7	3.6	3.5	3.6							
Debt	59.5	58.5	57.2	56.8	56.3	59.0	58.8	60.5	58.9	61.4	

Source: Ministry of Finance, Budgets 2002 and 2003, Perspectives économiques 2003-2004 (March 2003) and provisional general government accounts (Compte provisoire des administrations publiques), April 2003.

arose notwithstanding the introduction of a subsidy to support at-home long-term care (Allocation personnalisée d'autonomie, APA), which is co-financed by the departmental level of government, and whose overall take-up was much faster than initially expected.

The 2003 Budget introduced little in terms of concrete measures to deal with the cost overruns of the previous year. As passed, the budget law predicted a deficit of 2.6 per cent of GDP, based on assumed growth of 2.5 per cent and inflation (excluding tobacco products) of 1.6 per cent. Additional tax cuts of about 0.1 per cent of GDP were expected to be partly offset by higher revenues as previously legislated measures take effect (see Box 1). Similarly, notwithstanding important increases in planned expenditures in the defence, domestic security and education sectors, the share of overall expenditures in GDP was projected to fall by 0.5 per cent. This reflected a very strict 0.2 per cent volume increase in State expenditures and a slower 4.3 per cent rate of increase in social security expenditures (reflecting a somewhat more realistic expected 5.3 per cent increase in medical expenditures). Despite the beginning of large-scale retirements and widespread recognition that the civil service is overstaffed, the 2003 budget called for only limited reductions in staff levels (1 400 overall) or less than 0.2 per cent.

The failure of the economy to recover as the authorities had anticipated, forced them to revise their forecasts substantially. As a consequence, growth projections for 2003 were reduced in March to 1.3 per cent, the predicted deficit was raised to 3.4 per cent of GDP, and the debt, according to Maastricht definitions, was projected to exceed 60 per cent of GDP. Following this announcement, the European Commission took the first steps in its excessive deficit procedure, having taken note that the 3 per cent limit was exceeded in 2002 and having judged that this did not reflect exceptional circumstances. For the moment, little has been done to forestall growing fiscal imbalances. While the authorities have cancelled some 1.4 billion euros (0.1 per cent of GDP) in ministerial credits,² and created a reserve for a further 2.6 billion euros, they have repeatedly rejected any suggestion that a plan of budgetary rigour be introduced in the course of this year. They have, however, indicated that the introduction of further tax cuts will depend on the rate of growth of the economy. Indeed, the revised government forecasts foresee no important expenditure cuts, nor any additional tax cuts affecting the 2003 Budget year.

The short-term outlook

On the basis of these elements, the OECD projects that the French economy, like that of Europe as a whole, will continue to grow only slowly in the first half of 2003 before picking up towards the second half of the year. The lack of any additional fiscal stimulus in 2003 and a tightening of policy in 2004 (see below), plus the relatively slow progression of incomes, will cause household and govern-

Box 1. Recent measures affecting taxes

Background information

Personal income taxes

The 5 per cent cut in personal income taxes put in place in 2002, was confirmed in the 2003 Budget by a 6 per cent reduction in marginal tax rates, for an expected overall budgetary cost of about 3.1 billion euros.

Tax deductions for persons hiring domestic employees were increased at a cost of 74 million euros over two years.

The "employment premium" (Prime pour l'emploi, PPE), an earned-income tax credit, was doubled in 2002 and reformed in favour of part-time workers at a budgetary cost of 280 million euros. Taken together the measures are expected to cost 1.1 billion euros in 2003.

Firm-based taxes

The final portion of the "professional tax" charged on salaries was suppressed, at an estimated cost of 1.8 billion euros.

The share of earnings of non-profit organisations subject to the Professional tax was further reduced, at a cost of 88 million euros.

The cost in 2003 of the progressive elimination between 2003 and 2005 of the Financial institutions contribution (*Contribution des institutions financières*), a tax on banking fees is not expected to have a budgetary impact in 2003 because of an associated tax credit.

Social security contributions

To offset the additional labour costs associated with the harmonisation of the various minimum wages left after the implementation of the 35-hour workweek, the government introduced a harmonisation of social security reductions for low-wage earners. This measure, which is to come on line over three years, is estimated to cost 800 million euros in 2003.

Excise taxes

Tobacco taxes were raised by 700 million euros.

ment consumption demand to expand less quickly than in the recent past. Meanwhile, the dissipation of uncertainty surrounding both the international situation and demand conditions more generally should see firms begin putting into place much delayed investment projects towards the middle of the year. This, plus a

slowing in the destocking process, should help economic activity pick up in the second half of 2003 and into 2004. For the year as a whole, GDP is expected to increase by less than 1 per cent in 2003 before accelerating in 2004 to a rhythm of around 2 per cent. In this overall context, the relative insensitivity of employment to changes in activity is expected to persist, both because hiring difficulties in some sectors are only now being relieved and because of more classical labour hoarding. Thus, although the rise in unemployment in 2003 is projected to be moderate, its decline in 2004 – notwithstanding the pickup in the economy – is also likely to be limited.

There is a risk that wage pressures might strengthen during 2003-2005, following the authorities' decision to harmonise minimum wages towards the highest hourly rate (see Chapter II). This is particularly likely, if the increase, which will be as much as 11 per cent in real terms over three years for workers whose firms have not yet adopted the 35 hour legislation, propagates upwards into the salary distribution. Typically, such exceptional hikes to the minimum wage (coup de pouce) have an only limited influence on other wages, with the impact falling off rapidly so that individuals earning 120 per cent of the minimum wage receive (on average) half of the additional hike, while those earning 140 per cent or more of the SMIC see no increase. However, the overall increase planned this time is much larger than normal and has been announced well in advance. This increases the likelihood that future increases are taken into account in wage negotiations and that the boost spills over among those earning more than 1.4 times the SMIC. Nevertheless, associated reductions in social security charges (see Chapter II) should minimise the overall impact on labour costs and inflation, though at a cost to the budget.

Fiscal policy in 2003 and 2004

Notwithstanding the creation of a special reserve and the cancelling of ministerial credits reported above, the OECD projects that the general government deficit will widen in 2003 to about $3\frac{1}{2}$ per cent of GDP and that government debt on a Maastricht basis will reach some 61 per cent of GDP. Although the authorities have not yet announced concrete plans for 2004, the March projections included a forecast deficit of 2.9 per cent of GDP based on a growth scenario similar to that of the OECD's. This represents a substantial 0.5 per cent of GDP improvement in the structural deficit and is broadly consistent with the consolidation included in the government's latest multiyear plan. The authorities attribute this improvement to:

- 1. Revisions to eligibility criteria in the unemployment insurance system that they estimate will generate 2.4 billion euros in savings in 2004.³
- 2. A moderate 4 per cent increase in health expenditures (after 6.7 per cent in 2001 and 7.2 per cent in 2002). The authorities have set up working groups to determine how to achieve this objective

(see Chapter III for more details). Measures already taken include: a reduction in the reimbursement rate of some drugs of limited medical utility; reforms designed to make doctors more responsible in their prescription behaviour; and the introduction of diagnostic-related-group type billing in the hospital sector. These reforms are expected to generate savings of between 1.5 and 2.5 billion euros.

- 3. Holding the real value of expenditures in the State Budget constant, as compared with 1 per cent *per annum* real growth between 1998 and 2001 and 2.5 per cent last year.
- 4. A continued surplus from local government.

For the moment, only some concrete measures have been applied so far and they are unlikely to yield all of the hoped for savings. In particular, steps to slow the pace of State Budget spending have yet to be enacted and it is unlikely, given the local-level election cycle, for sub-national governments' surpluses to be as high as they were in 2002. Thus, incorporating all of the expected UNEDIC savings and the lower estimates provided by the authorities for healthcare savings, the OECD estimates that only about half of the $\frac{1}{2}$ percentage point improvement in the economy's fiscal balance, can be expected based on current policies. To bring the general government account close to balance by 2006 as projected in the authorities' multi-year plan, will require even larger savings in each of the coming three years.

Although the pension reform currently being worked out between the government and the social partners and a planned healthcare reform will clearly help relieve fiscal pressure over the medium term (see below), their impacts are likely to build up relatively slowly and are unlikely to generate substantial savings until 2005 or 2006. As a result, additional measures will need to be taken, particularly if the authorities are to maintain a real freeze on state expenditures and restrain the rate of growth of state medical insurance to 4 per cent (indeed, these grew more than 7 per cent in the first 3 months of 2003). Press reports suggest the authorities are considering replacing on average only one of every two retiring civil servants. If limited to central government civil servants, such a policy could be expected to save about 0.3 per cent of GDP each year or 2.3 per cent of GDP by 2009. Coupled with a real freeze in investment spending and a slowing of other non-transfer expenditures, this could yield the desired savings in 2004, although it is not clear for how long an investment freeze could be maintained. Extending the partial replacement of public servants to the whole of the general government would generate even larger savings, although the government lacks the instruments to institute such a policy.

The challenge of ageing to long-term fiscal sustainability

Looking further ahead much more profound and sustainable savings need to be found. As in the majority of OECD countries, the ageing of France's population

will increasingly place substantial pressures on the public purse, both because the number of older people will rise and therefore health and pension spending will increase, but also because the imminent retirement of the baby boom generation means that fewer people will be working and paying the taxes necessary to finance these programmes.

From a purely fiscal stand point, the ageing of the population will increase the combined expected funding shortfalls of the pension and healthcare systems by between 6.5 and 9 per cent of GDP⁴ (taking into account only the purely demographic impact of ageing on healthcare spending). While the necessity of preventing the general government deficit from reaching such levels is obvious, the problem is even more serious as these estimates fail to take into consideration debt dynamics. As deficits accumulate, so will interest payments, reinforcing the shortfall. Extending budgetary forecasts out 50 years and maintaining the no policy change hypothesis, the debt could grow to more than 250 per cent of GDP and the deficit to 19 per cent of GDP (Figure 9). While it is obvious that policy makers would not allow such a scenario to play out, the nature of the debt dynamics is such that the earlier steps are taken to create the fiscal room necessary to address ageing-related cost increases, the smaller the cost will be for society.

Deficit Debt 5 0 250 -5 200 -10 150 Primary balance excluding ageing costs (left scale) Primary balance (left scale) -15 Deficit (left scale) Debt (right scale) 100 -20 50 -25 -30 2050 2000 2005 2010 2015 2020 2025 2030 2035 2040 2045

Figure 9. Long-term debt dynamics
Per cent of GDP

Source: OECD.

Policymakers are responding to these pressures on all fronts. Reforms are under preparation or in place that seek to increase the level and the rate of growth of potential output by increasing labour supply, upping the rate of investment and by raising the rate of growth of productivity. At the same time, major reforms are in preparation to reduce future spending pressures. Here, the government has recently proposed a major reform designed to ensure that over the next twenty years the pension system remains in balance (Box 2). Moreover, it is has announced its intention to introduce further reforms, aimed at slowing the pace of rising healthcare costs. In addition, a reform of the State is underway that includes decentralisation projects, a move towards output-oriented budgeting and various regulatory reforms all of which should increase the efficiency with which government services are delivered. The details of these efforts and proposals by which they could be reinforced are discussed in Chapters II (raising employment levels and investment rates) and III (public expenditure management, pensions and health). The remainder of this chapter attempts to provide a sense of the macroeconomic and fiscal consequences of progress in these areas.

Improving potential output could improve prospects

As outlined in this year's Budget, one of the principal challenges facing France is to put in place a set of policies that ensure that those who wish to work can. France distinguishes itself from other OECD countries by having among the lowest employment rates for both young and older people but at the same time having relatively high employment rates for so-called prime-age workers (Figure 10), notably women. Low employment rates for workers over 55 years of age reflects several decades of policies, put in place by both various governments and the social partners, that have sought to lower measured unemployment by encouraging early labour force withdrawal. Indeed, the cumulative impact of those policies has been to virtually eradicate financial incentives to work beyond 60 and greatly reduce them for those over 55 (see Chapter II). For youth, rising labour costs brought on by heavy social security charges on the one hand and a high minimum wage on the other have interacted with a widening of educational opportunities to greatly reduce youth labour force participation. Indeed, notwithstanding substantial improvements following the reduction of social charges for low-paid workers, youth employment rates remain low. Chapter II enumerates a number of policies aimed at reducing incentives for older workers to withdraw from the labour force prematurely (both state and social-partner financed early retirement schemes) as well as ones designed to reduce unemployment and non-employment among youth – by helping them acquire skills and further reducing their labour costs. While raising youth employment rates will increase their eventual draw upon the pension system, these costs will only be born towards the middle of the century, when demographic cost pressures are declining. In contrast, higher employment rates will help assure fiscal sustainability by raising output and government

Box 2. The government's proposed pension reform

After several years of consultation and analysis, followed by months of discussion with social partners the Government submitted to parliament in June a bill to reform the pension system. The bill, which is to be debated and voted in June and July, proposes to:

- Align the period of time that public servants must contribute to the pension scheme before attaining full pension rights to the same period as for private-sector workers, which is to say, increase it from the current 37.5 to 40 years between now and 2008. And at the same time, the period over which benefits are prorated depending on years of service will be extended from 37.5 to 40 years in the general scheme.
- Introduce a regular process of revision to the pension system. The authorities envisage increasing required contribution periods in line with increases in longevity, such that the ratio of years worked to expected years retired is preserved (currently about 40:20). Concretely, they envisage increasing the contribution period for both private and public sector workers to 41 years by 2012 and to about 42 years by 2020.
- Reduce distortions in the private-sector system by permitting those who continue to work past the point in time when they acquire the right to draw a pension at the maximum rate to increase their pension rights in a more actuarially neutral manner, increasing pension rights by 3 percentage points for each additional year worked. Moreover, the penalty for early retirement in the private scheme will be reduced from 10 per cent to 6 per cent.
- Over the next decade, progressively introduce into the public-sector scheme a penalty similar to the one that exists in the private sector for people that take their pension early.
- To set an objective of attaining by 2008 a minimum replacement rate (85 per cent of the SMIC) for persons having 40 pensionable years to their credit.

These reforms are expected to reduce the expected private-sector system shortfall of 15 billion euros in 2020 by 5 billion. The remaining 10 billion private-system shortfall is to be accommodated by transferring part of the social insurance charges currently paid to the unemployment system to the pension system following a substantial hoped for fall in unemployment. Savings from planned changes to the public sector system are expected to reach 13 billion euros as compared with a projected pre-reform deficit of 28 billion in 2020.

revenues immediately and throughout the period when demographic pressures on expenditures are strongest, thereby smoothing the overall profile of public finances.

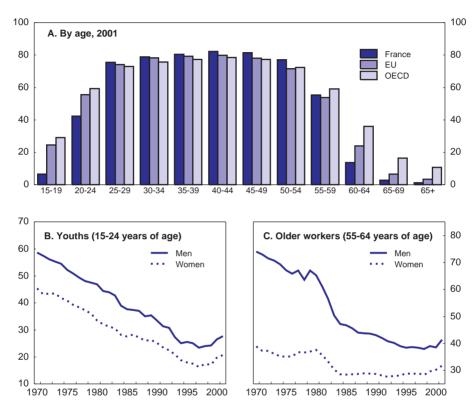


Figure 10. **Employment rates**Per cent

Source: OECD.

Substantial benefits would also accrue from policies that raise the level of investment and or increase the rate of growth of productivity. Higher rates of investment would contribute to an increase in the stock of capital and faster growth, at least temporarily. So too, would policies that raise the level of productivity while those that raise the rate of growth of trend productivity would have continuous pay off, principally in the form of higher standards of living for future generations. The long-run budgetary impact of higher productivity is, however, less clear. By raising potential output, higher productivity would increase the resources that the State has available to finance ageing-related expenditures. On the other hand, it would also have implications for spending – both because of

higher wages and therefore higher pension benefits (*ceteris paribus*) and also because demand for medical care, one of the principal unknowns in any long-term projection of health costs, may be significantly income elastic. Even so, the net effects would be positive for government finances because, like increased youth employment, the positive revenue effects will accrue almost immediately while increases in costs will come on stream only slowly.⁵

Substantial spending cuts are required

The first four sections of Table 3 illustrate the possible long and mediumterm impacts on potential output and public finances of such structural measures. The first section reports a base case "no-policy change" projection in which the ageing of society slows the rate of growth of employment, resulting in the rate of growth of potential output declining from some 2.1 per cent in 2002 to an average of 1.5 per cent in the 2020s before increasing somewhat in subsequent decades.6 Trend labour-productivity growth in this scenario is assumed unchanged from the recent past.⁷ The net increase in financing costs from the pension and health schemes is assumed to increase by 6.6 per cent of GDP and is consistent with COR (2001) reference scenarios where the structural rate of unemployment falls substantially to about 4.5 per cent and the private-sector replacement rates continue to fall because of the 1993 extension to 25 years of the reference period for calculating benefits. Moreover, the rise in health costs is assumed to be limited to purely demographic factors i.e. age-specific per capita expenditures grow at the speed of GDP - implying a substantial deceleration in health insurance costs as compared with the past. Taking into account debt dynamics, the end of period deficit and the debt to GDP ratios are estimated by the OECD to be 19 and 270 per cent, respectively. This assumes that private-sector replacement rates decline by between 9 and 17 percentage points as the impact of increasing the period over which the reference salary is calculated and indexing this to prices alone. The second scenario brings youth and older worker employment rates to OECD average levels and would raise potential output by 6 per cent by 2050, temporarily increasing its rate of growth by about 0.2 per cent during the period 2020-2030 and by about 0.1 percentage points afterwards. Overall, the impact on deficits is about 4 per cent of GDP and builds over time with the difference mainly explained by reduced debt servicing charges due to the accumulation of lower deficits. The third set of results builds on this by assuming that structural policies succeed in raising investment rates in the business sector by 2 percentage points, which produces an 15 per cent increase in potential and a 10 percentage point reduction in the debt. The final set of results shows the cumulative impact of the previous policies plus a 0.22 percentage point improvement in the ratio of growth of trend labour productivity which yields a 25 per cent increase in potential output over the whole period and a further reduction in both end point deficits and debt.

Table 3. Fiscal sustainability and structural reform

	Decade beginning				End point		
	2010	2020	2030	2040	2050		
	Annual averages (per cent)						
A. Reference scenario							
GDP growth	1.6	1.5	1.7	1.7	1.6		
Productivity growth Participation rate	2.0 70.4	2.0 70.5	2.0 70.6	2.0 70.9	2.0 69.1		
1							
Primary deficit, no ageing costs	0.8	0.7	0.5	0.4	0.3		
Primary deficit, ageing costs included Deficit	-1.2 -4.9	-2.9 -8.3	-4.2 -11.9	-5.2 -16.1	-5.7 -18.7		
Debt	77	108	158	225	267		
B. Reference plus higher employment rates							
GDP growth	1.9	1.8	1.9	1.8	1.6		
Productivity growth	2.0	2.0	2.0	2.0	2.0		
Participation rate	72.3	72.7	75.8	78.4	79.5		
Primary deficit, no ageing costs	0.8	0.7	0.5	0.4	0.3		
Primary deficit, ageing costs included	-0.9	-2.2	-3.0	-3.8	-4.2		
Deficit	-4.5	-7.0	-9.5	-12.5	-14.2		
Debt	74	97	133	180	209		
C. Reference plus higher employment plus i	nvestment in	creases					
GDP growth	2.0	1.9	1.9	1.9	1.8		
Productivity growth	2.1	2.1	2.1	2.1	2.2		
Participation rate	72.3	72.7	75.8	78.4	79.5		
Primary deficit, no ageing costs	0.8	0.7	0.5	0.4	0.3		
Primary deficit, ageing costs included	-0.8	-2.0	-2.7	-3.4	-3.7		
Deficit	-4.4	6	-8.9	-11.5	-13.1		
Debt	72	94	126	168	194		
D. Reference plus higher employment inves	tment rates a	and produc	ctivity grow	th rates			
GDP growth	2.2	2.2	2.2	2.1	3.0		
Productivity growth	2.3	2.4	2.3	2.4	2.4		
Participation rate	72.3	72.7	75.8	78.4	79.5		
Primary deficit, no ageing costs	0.8	0.7	0.5	0.4	0.3		
Primary deficit, ageing costs included	-0.7	-1.6	-2.1	-2.5	-2.6		
Deficit	-4.1	-5.7	-7.3	-9.0	-10.0		
Debt	70	86	110	138	155		

Source: OECD.

Notwithstanding these substantial improvements in the performance of the economy and the significant reduction in implicit private-sector replacement rates in these scenarios, both the debt and deficit ratios remain unsustainable in all cases, emphasising the need for policy to address spending issues squarely.

Moreover, insofar as the State Budget only represents 35 per cent of all public expenditure, a substantial portion of these savings will have to come from the social security system and the budgets of the subnational governments. How to co-ordinate such reductions represents a real challenge given the decentralised nature of public expenditure in France; reforms to improve the authorities' capabilities in this regard are discussed in Chapter III. The extent of fiscal consolidation that will be required is illustrated in Table 4. To be prudent, the first set of results builds in only half of the structural gains modelled in Table 4. The second set of results shows the expected impacts of a 2 per cent of GDP reduction in the pension financing requirement by 2020. Although detailed evaluations of the savings to be derived from the pension reform bill were not available at the end of May, this is roughly equal to the amount of savings the authorities initially indicated they hoped to generate. This has a marked effect both on projected deficits between 2010 and 2050 and on the end period debt ratio, although at 130 and 8½ per cent of GDP they are still unsustainably large so that additional measures are clearly called for. The third simulation shows that an additional 2.3 per cent of GDP reduction in spending achieved gradually, either in the form of further pension reform or derived from savings elsewhere in the general government, would be sufficient to ensure long-term fiscal sustainability. Finally, the last set of results illustrates that moving quickly can significantly reduce the overall effort required. In this scenario, implementing cost-saving measures during the first two decades of the century reduces substantially the overall effort needed to ensure fiscal sustainability.

Action is required soon

The preceding simulations make clear the importance of fiscal consolidation. Debt dynamics and forthcoming spending pressures are such that unless steps are taken now there is a real risk that the accumulation of deficits would increasingly force France to cut into programme spending just in order to service the interest charges on the debt. The simulations that succeed in stabilising overall expenditure are those which succeed in redressing the deficit quickly and permanently. Although a comprehensive structural reform programme will help alleviate the burden, neither it nor even the current pension reform initiative will be enough to ensure fiscal sustainability. Moreover, even if the slowdown in the rate of growth of the labour force may facilitate a decrease in unemployment, the 45 per cent fall that forms the basis of two thirds of the projected savings in the private-sector scheme is by no means assured. By the same token, it is not clear whether the authorities will be able to resist pressure to prevent replacement rates from declining by the 17 percentage points included in the reference scenario especially if pubic-sector replacement rates, which are already higher, do not also decline. Slippage on either front would have to be compensated for by even more spending cuts elsewhere.

Table 4. Impact of spending reform on fiscal sustainability

		End point					
	2010	2020	2030	2040	2050		
	Annual averages (per cent)						
A. Structural policies only							
GDP growth	1.9	1.8	1.9	1.9	1.9		
Productivity growth Participation rate	2.2 71.3	2.2 71.6	2.1 73.1	2.1 74.8	2.2 76.0		
1							
Primary deficit, no ageing costs	0.8	0.7	0.5	0.4	0.3		
Primary deficit, ageing costs included Deficit	-0.9 -4.4	-2.2 -6.8	-3.0 -9.3	−3.7 −12.0	−3.9 −13.6		
Debt	73	96	130	174	202		
B. Structural policies plus current pension	reform						
GDP growth	1.9	1.8	1.9	1.9	1.9		
Productivity growth	2.2	2.2	2.1	2.1	2.2		
Participation rate	71.3	71.6	73.1	74.8	76.0		
Primary deficit, no ageing costs	0.8	0.7	0.5	0.4	0.3		
Primary deficit, ageing costs included	0.3	0.4	-1.3	-1.9	-2.2		
Deficit	-3.3	-4.3	-5.9	-7.6	-8.6		
Debt	68	76	93	117	133		
C. Structural policies, pension reform and	with gradual	spending c	uts				
GDP growth	1.9	1.8	1.9	1.9	1.9		
Productivity growth	2.2	2.2	2.1	2.1	2.2		
Participation rate	71.3	71.6	73.1	74.8	76.0		
Primary deficit, no ageing costs	0.9	1.0	2.0	2.5	2.6		
Primary deficit, ageing costs included	0.5	0.5	0.2	0.2	0.2		
Deficit	-2.8	-2.7	-2.8	-2.7	-2.6		
Debt	67	66	66	66	66		
D. Structural policies, pension reform with	front end loa	ded spend	ing cuts				
GDP growth	1.9	1.8	1.9	1.9	1.9		
Productivity growth	2.2	2.2	2.1	2.1	2.2		
Participation rate	71.3	71.6	73.1	74.8	76.0		
Primary deficit, no ageing costs	1.5	2.2	2.2	2.0	1.0		
Primary deficit, ageing costs included	1.1	1.1	0.3	-0.3	-0.5		
Deficit	-2.1	-1.4	-1.8	-2.3	-2.5		
Debt	64	55	50	50	52		

Note: Productivity growth is output per hours worked; employment rate is portion of workforce aged 15-64 employed; ageing costs are the increase in pension and health care costs and deficits and debt are expressed as a per cent of nominal GDP.

Source: OECD.

The preceding simulations give a notion of the extent of additional savings that will be required. The rationale for reducing spending and finding margins for efficiency is not to meet some arbitrary goal, but rather to ensure that future

generations will be able to enjoy improved levels of services and living standards at economically sustainable levels of taxation. Responsibility for deciding how to generate these savings lies with French society and the politicians who bear ultimate responsibility for the economy. While the required consolidation is large, it is within reach. Other countries including Canada, Finland, Italy and Sweden, have achieved as much or more over the last decade. However, to do so will require much better expenditure management than that which has been observed in the past ten years. As discussed in Chapter III, ongoing efforts to reform the pension and healthcare system, to improve the efficiency of public spending through decentralisation and the introduction of output-oriented budgeting techniques need to be complemented by changes that increase the authorities' ability to influence all of public spending, including social security and local government expenditures. To do so will require increasing the comprehensiveness of the budget process and its horizon but also a clarification of the roles and responsibilities as concerns expenditure containment of both the social partners and subnational levels of government. Finally, while reducing taxes is likely to help spur growth, priority must be given to expenditure reduction. Once public finances are on a more sustainable path, a programme of tax reductions could well yield a virtuous circle of higher growth, and higher incomes with similar levels of public services. Implemented prematurely, however, they risk exacerbating debt dynamics and making the overall cost of dealing with the ageing of the population more costly.

II. Policies to raise potential output

In order to raise standards of living and ensure the long-term viability of France's social welfare system, labour utilisation rates need to be increased substantially and the rate of growth of productivity raised. As indicated in Chapter I and notwithstanding the strong employment growth of the past several years, France has among the lowest employment rates in the OECD (22nd out of 30 countries in 2001). While raising France's employment rate to OECD average levels - or even that of the best performers - would not permanently raise the rate of growth of potential output, it would raise the long-term level of potential and, during the transition period, its rate of growth, Moreover, increased employment would simultaneously raise taxable income and reduce government expenditures. Such developments should open the way to improving the sustainability of public finances and creating the kind of fiscal room that would allow for a reduction in tax rates, which, in turn, might spur further growth (OECD, 2002). To maximise benefits these efforts will need to be complemented by policies aimed at increasing the rate of productivity growth, by promoting competition; improving corporate governance of private and public firms; and raising the quantity and effectiveness of research and development. This chapter examines policies and recent progress in each of these areas and makes suggestions for further reform.

Growth through resource deepening

Low rates of overall labour utilisation in France reflect three distinct phenomena: very low rates of youth employment; very low rates of employment among older workers; and low average hours worked. Indeed, while employment rates of workers between the age of 25 and 54 are, for many cohorts, above the OECD average, less than one in four French youth work and only slightly more than one in three persons between 55 and 64 years of age have jobs. Moreover, the average French employee worked only 1 532 hours in 2001, 14 per cent less than the OECD average and 5 per cent less than the average of other EU countries.

Low youth employment following 30 years of decline

Today's low youth employment rates are the result of a three-decade long process, during which the employment rates of 15-24 year olds declined from

more than 50 per cent in 1970 to less than 25 per cent now (Figure 11) as compared with 45 per cent for the OECD as a whole. The fall was progressive during the 1970s and 1980s and only stabilised during the 1990s, before reversing itself somewhat in the second half of the decade. Increased youth non-employment coincided with a generalised increase in the number of years spent in school, reflecting both longer periods of compulsory education and an explicit policy of broadening access to tertiary education. As a consequence, the educational enrolment rate of the population 15-24 years of age rose to 67 per cent by 2001. While it is tempting to interpret the decline in employment rates as a consequence of higher enrolment rates, low schooling costs or even the relatively underdeveloped system of apprenticeships, the causality is not clear. Similar increases in enrolment rates were observed in most OECD countries (including many countries with similar institutions) without anything like the associated decline in activity observed in France.8 This observation, plus the strong response of youth employment to the recovery of demand and measures to reduce labour costs during the last half of the 1990s (see below), led at least one official French report (Pisani-Ferry, 2000) to conclude that economic factors, rather than the increase in enrolment rates, were responsible for much of the decline in youth employment. Moreover, recent research indicates that youth who worked while pursuing their studies manage to find work much more rapidly than those who do not and suffer less unemployment (Minni and Brunet, 2003).

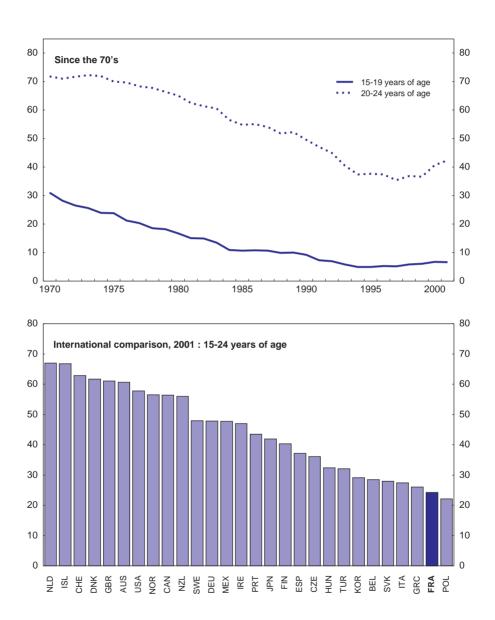
State aid to support youth employment

Until recently, the policy response to low youth participation rates *per se* has been relatively muted. Even now, to the extent that younger people are in school, low youth participation levels are not perceived as a priority policy problem (see for example Holcblart, 2002). Instead, policy has concentrated on dealing with the high unemployment rates (24 per cent in 2001) of the 30 per cent of this cohort not in school but in the labour force. Of particular concern are the 7.5 per cent of youth who leave school with no or low educational qualifications and whose subsequent labour market performance is especially difficult. For such individuals, a wide range of active labour market programmes has been put in place.

On-the-job training programmes (apprenticeships, qualification contracts and orientation and adaptation contracts) represent about 60 per cent of aided work aimed at youth. A second set of programmes aimed at assisting youth enter the labour market is operated in both the business and public sectors, either through subsiding their employment or through the provision of personalised job-search and training assistance. All told, some 40 per cent of all working youth are involved in one or another of these programmes (Table 5), with apprenticeship programmes the largest in absolute terms and public-sector employment the fastest growing in recent years. Moreover, this share would likely be even higher if

Figure 11. Trends in youth employment

Per cent of population age group



Source: OECD.

Table 5. Employment programmes for youth under 26 years of age

	-		-	_	
	1996	1998	1999	2000	2001
_			Thousands	I	
On the job training	473	543	573	603	609
Apprentices	315	352	374	383	385
Qualification contracts	158	191	199	220	224
Business sector (excluding on the job training)	345	321	337	301	216
Employment initiative contracts (CIE)	74	66	49	38	26
Employment reintegration contracts (CRE)	9	5	2	0	0
First job assistance for youth (APEJ)	50	0	0	0	0
Part-time abatements	157	192	229	208	138
First employee social charge exemption	33	31	35	35	34
Other	22	27	22	20	18
Public sector	109	160	192	199	194
Jobs for Youth	_	85	130	150	156
Employment solidarity contracts	96	60	51	39	29
Consolidated employment contracts	9	10	9	9	9
City employment contracts	4	5	2	1	_
Total	927	1 024	1 102	1 103	1 019
Total excluding apprentices	612	672	728	720	634
_			Per cent		
Share in total youth employment	38	41	40	39	36
Share of youth employment excluding apprentices	25	27	27	26	22

^{1.} Data represent the stock of recipients at the end of year. Source: DARES.

those benefiting from generalised reduction of social security charges for low-paid workers were included in the total. Overall, the authorities spend about 2 per cent of GDP on various training and subsidised employment programmes and a further 1 per cent of GDP in the form of tax expenditures associated with the reduction of social charges. Even though these reductions are not restricted to youth, younger people represent a large share of those benefiting from reduced social charges. The effectiveness of these programmes varies. Generally, those which provide participants with private-sector work experience and which include a significant amount of co-financing have the most success in improving employability. Thus, the various apprenticeship and employment qualification programmes have proven to be successful mechanisms for helping less skilled youth find a place in the labour force. Virtually all participants remain in employment within the private sector following the end of their training.

The efficiency of other measures is less clear. Indeed, the Youth Employment programme (emplois jeunes), which itself employed 213 000 youth (12 per cent of all

jobs held by 15-24 year olds) proved disappointing as a transition towards permanent private-sector employment. Despite concentrating assistance on individuals with relatively high educational qualifications, it failed to provide the kind of job experience that improved their chances of finding private-sector work; only one in three found work before their contract ended and only one in twenty did so in the private sector.⁹

Evaluations of the overall success of the "Access to Employment" (Trajet d'accès à l'emploi, TRACE) programme are more positive, although because it involves public-sector jobs it is less likely to provide participants with marketable skills. This scheme, which focuses on youth (16-25) with limited educational qualifications and from socially troubled backgrounds, has been successful in establishing a contact between participants and the labour market. Although it has not been subject to a statistically robust evaluation, it appears to have been effective in channelling participants into employment. Almost one in two participants is employed after leaving the programme (albeit 30 per cent of these within the context of a state employment programme), and the unemployment rate of participants, while still high at 37 per cent, is half that of their unemployment rate when they enter the programme (Mas, 2002). Tests of the effectiveness of the Fresh Start programme suggest that, with the notable exception of long-term unemployed youth, it has had some success in improving both the speed and rate with which the unemployed find work for most categories of workers (Micheau, Poujolly and Pommier, 2001).

In order to re-orient resources towards assisting those most at risk and to improve participants' chances of finding long-term employment in the private sector (thereby reducing dependency on state-financed jobs), 10 the authorities decided to cease issuing new emploi-jeunes contracts and instead increase assistance to private-sector firms hiring unemployed youth with low educational qualifications. Pre-existing emplois jeunes contracts will be allowed to run their course, leading to the eventual extinction of the programme in 2007, although some such posts, which fulfil a real need in the educational and non-profit sectors will continue to be funded. The new youth "Youth contracts" (contrats jeunes) programme provides private-sector employers a complete exoneration of social charges during two years and a 50 per cent exemption in the third year for each qualifying youth it employs in a full-time contract. The authorities signed some 44 000 such contracts in 2002. Reflecting the recentness of the programme, a significant proportion of these contracts have been accorded to individuals already employed, thus net job creation rates are doubtless much lower¹¹ (Zamura and Zoyem, 2003). As the programme reaches maturity, however, these rates should improve. In 2003, the authorities hope to sign a further 120 000 contrats jeunes. Nevertheless, the transition from the emplois jeunes to the contrats jeunes programme should reduce the total number of subsidised jobs in 2003.

Programmes to promote employment are, of course, not limited to youth. Similar schemes are available to other age-groups (including in some cases youth). The largest of these include solidarity-employment contracts (contrat emploi solidarité, CES), which were designed to improve the employability of individuals experiencing or likely to experience difficulty in finding employment¹² and insertion and training internships (Stage d'insertion et de formation à l'emploi, SIFE). In addition, the authorities operate the "Fresh Start" labour market insertion programmes and, in cooperation with the UNEDIC, a return-to-employment preparation scheme (Plan d'assistance au retour à l'emploi, PARE). The second of these programmes requires unemployment insurance beneficiaries to enter into a job-search and training programme with the public employment service as a condition for receiving benefits, while the first programme offers similar services to individuals requesting them, who meet certain criteria.

Generally, these programmes have been criticised for yielding limited improvements in the employability of participants. In this context, the Cour des Comptes was especially critical of so-called consolidated employment contracts (Contrats d'emploi consolidé, CEC), which "appear to be attributed in an effort to lower the rate of unemployment". It found that beneficiaries received neither the training nor individualised assistance provided for in the legislation, and that only 6.6 per cent of participants found work with a permanent contract. On the other hand employers - principally local governments, hospitals and schools - are satisfied given the heavy subsidisation of these jobs (8 500 euros per head or 44 per cent of the labour cost of a worker paid at the SMIC). Similar results were found by Berger et al., (2001) for both the CES and SIFE schemes. The overall effectiveness of the PARE programme has been called into question because of coordination problems between the UNEDIC, which pays unemployment insurance benefits, and the public employment service (PES), which is charged with enforcing the PARE contracts. In particular, some observers argue that the culture in the PES remains oriented to assisting individuals take advantage of state programmes, rather than to help them find or even coerce them into finding work. As a result, PES employees have not always enforced the contracts as vigorously as they might have and job seekers are not receiving a close enough individualised follow up. As a result, the programme is less likely to yield important improvements in participant's employment prospects. Following these evaluations, the authorities have indicated their intention to consolidate a number of aided employment programmes with a view to improving their performance. Such consolidation would provide a useful opportunity to rethink existing schemes, reduce their complexity and focus on those which seem to be the most effective in ensuring a transition to more permanent and fiscally sustainable employment.

Reducing labour market rigidities

Over the past several years, the authorities have taken a number of steps in an effort to reduce rigidities in labour markets. In this regard, efforts undertaken

during the past decade to reduce impediments to interim work and fixed-term contracts have played a role in the improvement in youth labour market performance. Such work forms allow workers to sample various careers and employers, while providing firms with the opportunity of testing the suitability of a prospective employee to a given task. Indeed, such contracts represent 75 per cent of total youth employment and official estimates suggest that they serve as a bridge to a permanent contract in 25 to 33 per cent of cases. While such jobs are less stable than permanent contracts, 75 per cent of those with a fixed term contract are employed a year later in contrast to the two-thirds of unemployed who remain out of work (Cancé and Fréchou, 2003)13. In addition, the 35 hours workweek legislation included a number of measures designed to increase firms' ability to respond to seasonal and cyclical fluctuations in the demand for their products. Thus, in the case of branch or firm-level negotiations, in exchange for reducing hours worked, firms were allowed to redefine working time and to move towards an annualisation of working-time so that employees' work schedules could be more easily adapted to peaks and troughs in production. Indeed, the authorities hoped that these reductions in rigidity would help spur productivity by enough (together with cuts to social security costs) to compensate any net increases in hourly labour costs posed by the reduction in working time. Moreover, some argue (Bathélémy and Cette, 2002) that by encouraging firms and sectors to negotiate branch level agreements the reform contributed to the establishment of more cooperative forms of labour relations, less reliant on rigid national regulations that necessarily fail to take into consideration firm and sector-specific factors.

Unfortunately, several reforms served to increase rigidities, either by reducing the room that firms have for manoeuvre or by imposing additional costs. These include new constraints introduced on part-time employment in 2000 that require such workers to be paid an "overtime" premium of 25 per cent if they work more than 110 or 133 per cent of their contracted working time. Even more penalising are rules that would require the hours in a part-time contract to be revised upwards if actual hours worked during 12 weeks of a 15 week period exceed contracted hours two or more hours per week. Such changes make these kind of work forms, which for many youth are effective bridges towards full-time employment, more expensive and less attractive to firms.

More directly, the 35-hour workweek reduced both individuals' and enterprises' options by imposing further restrictions on working time, raising labour costs and exacerbating production bottlenecks and labour shortages, at least temporarily (Leclair, 2002). While generally appreciated by the population, low-income workers tended to begrudge the working-time limit because it prevented them from increasing their incomes by working additional hours. As recognition of these problems grew, the authorities modified the initial 35 hours legislation – mainly in the manner in which it was implemented. Already in 2001, recognising the particular hardship that the law would impose on small-and medium-sized

enterprises, the government extended the deadline before which small and medium-sized enterprises had to conform to the new lower overtime hours contingent. 14 More recently even more steps have been taken. In particular, the overall monthly contingent (total hours, including overtime, authorised by the law) was increased by 50 hours, effectively raising it to the same level as prior to the 35 hours legislation. Moreover, the authorities also reduced from 25 to 10 per cent the overtime premium that small and medium-sized firms have to pay for the 36th through 39th hours (it remains 25 per cent for larger firms and for overtime hours in excess of the 39th weekly hour). Thus, although the relaxation of rules relieved employers and employees from the physical constraint imposed by the previous legislation, it nevertheless falls short of a return to the status quo ante as firms will still need to pay an overtime premium on the 36th through 39th hour, which was not the case under the 39-hour workweek. The overall impact on costs remains unclear however. Firms' recourse to overtime has diminished significantly, perhaps reflecting increased use of the annualisation of hours (made possible by the 35 hours legislation) in dealing with fluctuations in demand, instead of overtime. Box 3 summarises the overall impacts of this programme.

The authorities have also taken steps to reduce the rigidities imposed by the Social Modernisation Law (*loi de modernisation sociale*), which – among other things – imposed a number of new requirements on firms undertaking layoffs for economic reasons. The government considers that the law was passed without sufficient consultation with the social partners and that its negative economic impacts would be reduced if it better reflected sectoral and local conditions. As a consequence, they have moved to suspend, for an initial period of 18 months, several of the more constraining measures that were introduced by decree and have held off putting into force several others. Measures affected include those:

- Requiring social and territorial impact studies be included in "employment preservation" plans (plans de sauvegarde de l'emploi).
- Imposing separate staff consultations for both restructuring plans and employment preservation plans.
- Giving works councils the right to oppose restructuring plans, to undertake independent reviews of companies' books and imposing mediation.
- The introduction of a rule preventing the use of the professional competence of employees as a criterion in determining the order of layoffs.
- Increasing the powers of the labour inspectors. 15
- Permitting a reduction from 10 to 6 per cent of the premium imposed on firms by the Social Modernisation Law when a fixed-term contract expires, if social partners agree and if laid-off workers are given access to special training.

Box 3. Evaluating the employment impact of the 35 hours legislation

The reduction in the legal working time from 39 to 35 hours was certainly the most visible labour market reform of the past several years. Unfortunately, a definitive answer to the question of whether or not it contributed to a sustained increase in employment remains elusive. In part, these difficulties reflect the recentness of the reform, but they also reflect the fact that rather than a simple reduction in the legal hours worked, the policy comprised several separate initiatives, each likely to engender employment effects. These include:

- The reduction in legal working time.
- The associated reduction in social charges (viewed in a budget neutral manner)
- The purely Keynesian demand component of these tax reductions.
- The opportunity to reduce rigidities in the organisation of working time.

To date, no comprehensive study has been conducted that seeks to isolate the impact and influence of each of these effects, as well as the complications introduced by the fact that the policy was introduced during a Europe-wide cyclical upswing. Some studies (Rouilleault, 2000) have sought to analyse the 35 hours legislation taking into consideration selection bias. Indeed, the likelihood that firms that were going to increase employment anyway and adopted the legislation early, while those facing more sombre prospects did not, makes perilous even detailed comparisons of the relative employment performance of firms having adopted the 35 hour regime as compared with those that have not.

Despite these technical, but real, problems, a consensus of sorts has emerged as concerns the short-term effects of the policy.

- Research to date seems to concur that the initial expectations for the reform were greatly exaggerated and that even over the short-run somewhere between 150 000 and 300 000 (potentially temporary) job creations between 1997 and 2001 might be attributable to the programme, substantially less than initial estimates of 600 000 or more.
- Those firms who moved first under the Loi Aubry I and which were required to commit themselves to increase employment in exchange for financial aids have had the strongest employment growth and, indeed, the employment behaviour of firms that moved to the 35 hour regime in later years is very difficult to distinguish from firms that remained on 35 hours (Crépon, Leclair and Roux, forthcoming).
- The move to a shorter workweek during a strong cyclical upturn helped increase the speed at which cyclical unemployment was reabsorbed but also increased labour-market tensions and contributed to production bottlenecks at least during the transition period (Leclair, 2002).
- For the moment, even though the unemployment rates declined over this period, there is no evidence of a reduction in the structural rate of unemployment as a result of the policy.

Box 3. Evaluating the employment impact of the 35 hours legislation (cont.)

In contrast to the reduction of social charges prior to 1997 which helped to raise employment levels, those introduced with the 35 hour workweek served to offset the additional costs associated with higher hourly earnings.

- For the moment, little is known about the programme's long-term effects.

In the interim, the authorities invited the social partners to negotiate rules in each of these domains. Following the completion of such discussions, the government has indicated that it intends to present a new draft law reflecting these agreements and extending, if necessary, the suspensions of the Social Modernisation Law until such time as the new legislation enters into effect. Additional changes aimed at reducing rigidities in the labour market include: changes designed to reduce the incidence of unfounded moral harassment cases and marginal increases in the range of jobs where fixed-term contracts are permitted.

Finally, following the emergence of a substantial deficit in the budget of the unemployment insurance system, the social partners introduced a number of reforms, most important of which were:

- A 20 per cent increase in associated charges (from 3.4 to 4 per cent for employers and from 1.8 to 2.4 per cent for employees).
- A reduction of the duration of benefits for older workers, aimed both at reducing chances for abuse and making savings.
- An increase in the pension fund contribution required of unemployment insurance beneficiaries (unemployment insurance beneficiaries continue accumulating pension rights).

^{1.} A minimum engagement *vis-à-vis* employment was a pre-condition to benefit from the financial incentives associated with the Loi Aubry I scheme.

^{2.} The fact that the timing of companies' adhesion to the new norm was voluntary and that individual firms' decisions likely reflected the relative costs and benefits of adopting the new regime. A priori one would expect that those who intended to increase employment anyway would have adopted the new legislation earlier than those that expected to decrease, in order to benefit from the financial incentives offered or the possibility of renegotiating working rules. Indeed, this is observed in those studies that do correct for selection bias (Jugnot, 2002; Bunel and Jugnot, 2002). By the same logic those planning layoffs or in financial difficulty would have delayed in order to avoid the additional costs of raising hourly wages. As a result, comparing employment developments of firms that did move with those that did not adopt the legislation may give rise to false results, the reason that correcting for selection bias is so important.

- Eliminating the pre-existing possibility for a worker 55 years old to collect benefits of 70 per cent of his or her previous net salary for up to 10 years.
- In addition to a doubling of employer and employee contribution rates (agreed in June 2002), an agreement to review the very generous arrangements in the special regime for entertainment industry workers. The number of beneficiaries under this scheme has doubled since it was introduced in the early 1990s and its payments exceed total contributions by more than 800 per cent.¹⁶

Lowering the labour costs of low paid workers

A further major strand in the authorities' efforts to increase employment over the past ten years has been a policy to reduce labour costs of the low-paid, while at the same time preserving work incentives in the context of relatively high social assistance payments for certain classes of workers. Indeed, the combination of a high cost of unskilled workers (Figure 12) and a social assistance system that provides a substantial non-earned income for a significant number of households poses an important policy challenge and contributed to very high rates of non-employment among the low skilled.¹⁷

Policy has responded over the 1990s by reducing the social charges that firms pay on the earnings of the low paid. Overall, the policy has been very successful in improving the employment prospects of both youth and older workers with limited educational qualifications. Thus even though the minimum wage (Salaire minimum interprofessionnel de croissance, SMIC) has risen in recent years to reach some 52 per cent of average wages, large cuts to the social charges that firms must pay when hiring such persons have reduced the relative labour costs of such workers to about 42 per cent – about the level observed in 1974, when the process of disemployment began in France. Since then and notwithstanding successive hikes to the SMIC, additional reductions to social charges has meant that relative costs of low-skill workers to firms have been more or less stable since 1998. Econometric estimates suggest that about 400 000 jobs were created by the reduction in charges during the period 1993-97 (Crépon and Desplatz, 2001), which accords well with the observation that during the period 1990-1999 non-aided private-sector full-time employment of workers earning between 1 and 1.4 times the SMIC increased by 667 000 or 17 per cent. 18 The result is all the more encouraging because during the same period non-aided full-time employment in the private sector actually declined by almost 1 per cent (Panel B, Figure 13). An earnedincome tax credit (Prime pour l'emploi, PPE) introduced in 2001 (see OECD, 2001) has served to further raise low-income workers' take-home pay, while leaving their labour costs untouched. As a result, their incomes relative to those of an average worker have increased even more. Initially introduced at a relatively low level of

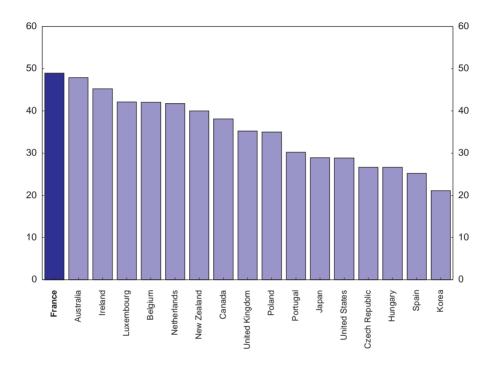


Figure 12. **Minimum wages**¹ In per cent of full-time average wages

1. Data are for 2000 and concern full-time workers. Source: OECD.

about 230 euros the *prime pour l'emploi* was raised to 460 euros in 2002 and to 558 euros in 2003.

The trend towards reducing the labour cost of low-paid workers is destined to slow or come to an end over the next several years as the authorities intend to substantially increase the average minimum wage over the next three years. This increase follows the creation of what are effectively 6 different hourly minimum wages, where the wage currently received depends on at what point in time a worker's employer signed a 35 hour workweek agreement (if at all). Those who moved to the 35 hour regime most recently have the highest hourly minimum wages, while those that moved earlier have lower ones and those who stayed at 39 hours the lowest. Those working for firms that never signed a 35 hour workweek

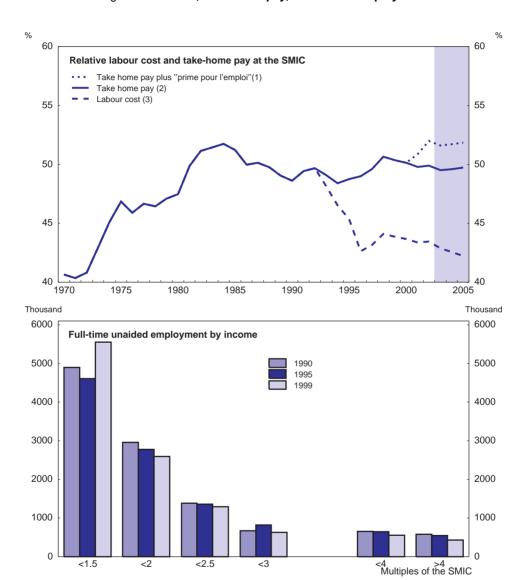


Figure 13. SMIC, take-home pay, labour and employment

^{1.} After tax earnings of a person earning the SMIC and receiving the "prime pour l'emploi" (PPE) as a per cent of after tax without PPE earnings of an average production worker (APE).

^{2.} After tax earnings of a person earning the SMIC as a per cent of the after tax earnings of an APW.

^{3.} Labour cost including social charges of hiring a worker at the SMIC as a per cent of the same costs for an APW. Source: OECD calculations using INSEE data.

deal earn 11.4 per cent less than those who moved after July 2002. The authorities have decided to adjust the various scales so as to return to a single SMIC by July 2005, by raising all the various hourly minimum wages up to that of the highest. In order to limit the overall increase, the reference rate during this period will be increased only by the rate of increase of inflation. All told, the average hourly SMIC should rise by 6.3 per cent in real terms between 1 July 2002 and 1 July 2005. For the vast majority of firms (90 per cent), and about half of employees paid the SMIC, 19 the increase in real wages will be the higher 11.4 per cent. In addition, unemployment insurance premia are to increase by 0.6 percentage points in July 2003, half of which will be at the expense of firms.

In an effort to limit the impact of this substantial increase in minimum wages on firms' overall labour costs and in order to simplify the rebates afforded to firms hiring low-paid workers, the authorities have decided to harmonise the various abatements on social charges. At the same time, they will increase the maximum abatement to which a firm still on 39 hours is entitled and extend the coverage to all enterprises and to all workers earning between 1 and 1.7 times the hourly reference SMIC - independent of the number of hours worked. The authorities will also eliminate the general abatement of about 650 euros, which was applied to all employees of firms that signed a 35 hour package, independent of salary levels including those in excess of 1.7 times the SMIC. As a result of these changes, the reduction in social charges on low-paid workers will increase for all workers earning between 1 and 1.4 times the SMIC as well as for those 46 per cent of employees whose firms have yet to move to the 35 hour workweek (Figure 14). The elimination of the general rebate will help pay for the new measure, reducing its overall additional budgetary cost to about 800 million euros, but it will do so at the expense of firms with more qualified staff who will no longer benefit from the generalised reduction associated with the 35 hours legislation. Overall tax expenditures in the form of lower social charges represent some 15.3 billion euros in foregone revenues or 1 per cent of GDP in 2003.

As compared with the previous system of rebates, the new one has several benefits:

- It offers the same degree of incentives to part-time and full-time workers, whether they are working 35 or 39 hours per week
- It reduces the effective cost of overtime because the reduction is calculated on the basis of hourly wages and applies to the whole of monthly earnings. This should allow low-paid part-time workers to increase their incomes by working longer hours, if the employer desires.
- It reduces the effective rate of taxation on salaries in the neighbourhood of the SMIC for firms still at 39 hours and thereby reduces the risks of creating low-wage traps.

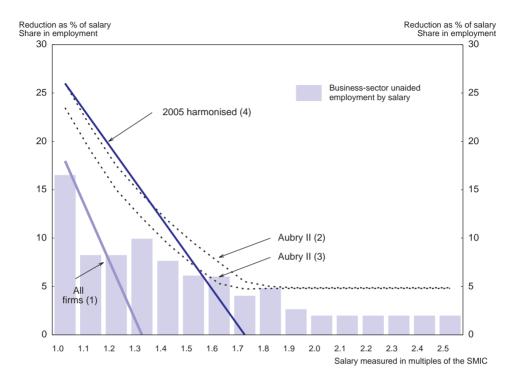


Figure 14. Harmonising minimum wages and low-wage worker social security reductions

- 1. Reduction currently available to all firms, "Ristourne Juppé".
- 2. Reduction available to firms having adopted a 35-hour workweek contract between 01/07/1999 and 30/06/2000.
- 3. Reduction available to firms having adopted a 35-hour workweek contract after 01/07/2002.
- 4. Reduction after harmonisation.

Source: Ministry of Economy, Finance and Industry; DARES.

– It progressively increases the extent of the rebate to 26 percentage points in 2005 for firms still at 39 hours and extends it to a much wider population by increasing coverage to those earning as much as 1.7 times the SMIC – i.e. over 60 per cent of workers.

While firms that have not yet moved to the 35 hour workweek will benefit from a significant reduction in charges (previously they only received the Juppé rebate), such firms will see the largest increase in SMIC and the net impact will be a 5.5 per cent real increase in labour costs. Firms that moved earlier will benefit less from the new tax regime for low-paid workers but, because they already pay

Table 6. Expected change in labour costs for minimum-wage workers

	Increase in real salary	Impact of harmonised social charge reductions	Increase in UI-related social charges	Change in real labour costs
No 35 hour pact signed	11.4	-6.5	0.3	5.2
35 hours before July 1999	4.9	0.3	0.3	5.5
35 hours between July 1999 and 2000	3.6	0.0	0.3	3.9
35 hours between July 2000 and 2001 35 hours between July 2002	1.8	-1.0	0.3	1.1
and 2002	0.6	-1.8	0.3	-0.9
35 hours after July 2002	0.0	-2.1	0.3	-1.8

Source: Ministry of Economics, Finance and Industry.

higher hourly minimum wages, they will be less negatively impacted by the harmonisation of the SMICs. Overall and including the 0.3 percentage point increase in unemployment insurance premia to be paid by firms, among firms that have already moved to 35 hour regime real wage costs will fall for those that moved most recently and rise by as much as 5.5 per cent for those who switched regimes before 1999 (Table 6). The overall impact on unit labour costs and therefore firm-level competitivity will be reduced to the extent that productivity rises. Nevertheless, the relative competitiveness of firms employing a large share of low-paid workers will be reduced.

Assessment

Globally the rapid increase in youth employment over the 1990s stands in sharp contrast to previous decades and, although this was a period of strong economic expansion, similar pick-ups in employment levels were not observed during previous cyclical episodes. To a large extent, the improvement reflects the substantial resources that have been put in place to support youth employment, although the abolition of compulsory military service for young men probably served to raise civilian youth employment rates during this period. The share of GDP spent on youth-oriented programmes increased by 62 per cent between 1992 and 2000, reaching 0.4 per cent, substantially more if tax expenditures in the form of reduced social charges for low-skilled workers were to be included. On a purely mechanical basis, the employment impact of subsidised employment programmes and the increase in part-time employment was large, both in the private sector (particularly apprenticeship programmes) and in the public sector (emplois-jeunes). Indeed, while business-sector employment expanded by 7 per cent between 1990 and 1999, more than all of that increase came in the form of state-aided and part-time employment

as unaided full-time business-sector employment actually fell by 1 per cent over the same period.

Given the substantial resources allocated to these policies, it is essential that the authorities develop a firm sense of the relative effectiveness of programmes. The Ministry of Labour and Solidarity regularly follows up on the labour market performance of programme participants and publishes much of its research. This is laudable, but more needs to be done to make these evaluations statistically robust and policy relevant. More of these studies should control for the characteristics of programme participants in such a way as to determine the programme's net impact on the employability and salaries of participants.²¹ Moreover, as discussed in Chapter III, in order for such studies to contribute to the improvement of policy effectiveness, they should include analyses of the strengths and weaknesses of schemes and prescriptions for reform. While a certain number of such studies are conducted, their scope and frequency need to be increased. Failure to do so runs the risk that large sums of money will continue to be spent on policies with small or no labour market impact, while more effective ones are starved of funds or are never implemented.

The French labour market continues to be challenged by the high labour costs of low-skilled workers on the one hand and the significant work disincentives generated by various non-work benefits. The reduction of social charges during the past decade has gone a long way to addressing this challenge, but at substantial cost to the public purse. Moreover, the combination of hikes in the SMIC, increases in unemployment insurance charges and rising hourly wages because of the 35 hour legislation tend to raise the relative labour costs at the level of the SMIC notwithstanding measures designed to prevent this, such as the additional cuts in social security charges associated with the 35 hour workweek and more recently those associated with the harmonisation of the various SMIC. This suggests that the positive employment impact that the original reductions have had may have come to an end.

In order to ensure that the past period of employment-rich growth continues, additional steps to reduce labour costs for low-skilled and younger workers are required. In this regard, so as to permit projected increases in the relative cost of low-paid labour following the harmonisation of the various SMICs to dissipate, the authorities may wish to substitute increases in the employment tax credit for additional *coups de pouces* in the post 2005 period. Such a policy would allow relative labour costs to moderate and return to the levels observed in the mid 1990s, while allowing the revenues of low-paid households to keep pace with those of average workers. Moreover, steps should be taken to increase the targetting of the employment premium, which currently is taken up by about one quarter of households and which can have perverse impacts on employment incentives of secondary workers. Recent steps to increase administrative incentives to reactivate the long-

term unemployed may also help. The authorities decentralisation initiative (see Chapter III) transfers financial responsibility for the principal non-work benefit to the departmental level, which is also responsible for implementation of active labour market policy. In so doing it is hoped that the locally managed public employment service will become more effective in its activation efforts. To help in this effort the authorities propose creating a minimum activity revenue (Revenu minimum d'activité, RMA). To be introduced on an experimental basis at first, the RMA would allow firms to hire long-term RMI beneficiaries (more than two years) for a period of 6 months (renewable two or three times) paying them only the difference between the RMI and the SMIC. Such a step, when implemented, would represent an important step towards increasing the demand for excluded workers and should help combat dependency. The effectiveness of such a policy could be enhanced by making continued benefit receipt contingent on workers' acceptation of job offers.

The authorities might also wish to extend the scope of apprenticeship and qualification contract programmes, which are currently limited to specific sectors, where a well defined training programme can be elaborated. By relaxing somewhat the requirements for programme certification, young people seeking to embark in a much wider range of trades could benefit from the unique kind of secondary workers on the job-training programmes currently limited to those embarking on a career in an area where apprenticeships have been created. Unlike classical training programmes, which are often provided as a condition of access to benefits, the success of such on-the-job training schemes derives in large measure from the substantial element of co-financing embedded into the programmes. Trainees trade reduced earnings for an entry into the workforce, practical experience and enhanced future employability (and earnings), while employers provide a real commitment to on-the-job training in exchange for a low-cost proving ground for recruits. Moreover, such programmes have the advantage of requiring little direct financial input from the public purse.

Making work pay for older workers

The decline in the employment rates of older-workers reflects the introduction of a number of reforms that sought, among other things, to reduce labour supply as a way to lower unemployment. Most visible of these reforms was the 1982 decision to lower the official retirement age from 65 to 60 and associated reforms to the pension system. These had the effect of simultaneously reducing the number of years of service necessary to collect a full pension and eliminated the possibility of increasing one's pension rights by continuing to work after "full" pension rights were achieved. At the same time, the UNEDIC extended the range of programmes and the length of time during which older workers could claim unemployment insurance benefits. As a direct result of these reforms, employment

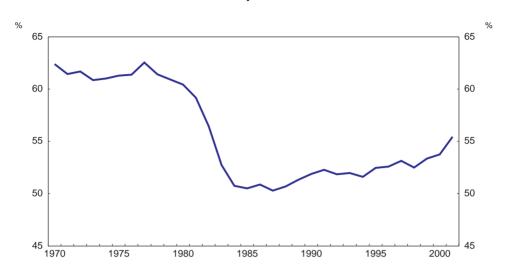


Figure 15. **Older worker employment rates** 55-59 years old

Source: OECD.

rates of older workers plummeted. Those of the 60-64 year old cohort dropped gradually from 35 per cent in 1980 to about 13 per cent in 2001, while those of the 55-59 years old group dropped much more quickly, from almost 60 per cent in 1980 to less than 51 per cent by 1984 (Figure 15). For men, the decline was even more precipitous, with employment rates falling by 13 percentage points in four years, withvirtually all of the decline in the participation rates of the 55-59 year old cohort due to early-retirement incentives (including those of the UNEDIC).²² Since then, the ageing of younger female cohorts has contributed to a trend rise in the employment rate of 50-59 year old women while those of men have remained stagnant.

The ineffectiveness of early retirement programmes as a means of reducing unemployment²³ and the necessity of bringing older cohorts back into productive life has prompted the authorities to reduce the extent of state-financed early retirement programmes. Over the past twenty years, several initiatives have sought to limit the extent of early retirement programmes (see Zaidman *et al.*, 2000). The most recent wave has included steps to eliminate or restrict access to state-financed programmes. In this regard, no new entrants have been accepted to the employment replacement allowance (*Allocation de remplacement pour l'emploi*, ARPE) since 1997 and by the end of 2003 its last beneficiaries will have moved on

 Table 7.
 Early-retirement schemes and older-worker employment

	1992	1995	2000	2001	2002		
	Per cent of population 55-60						
Early retirement schemes							
Conventions ASFNE	10.9	10.6	4.0	2.8	2.3		
ARPE		0.2	5.8	4.3	3.3		
CATS			0.3	0.6	0.7		
Asbestos workers early retirement scheme							
CAATA			0.3	0.5	0.5		
Progressive early retirement	0.9	3.6	2.8	2.5	2.6		
End of work (CFA)			1.2	1.3	1.3		
Subtotal	11.8	14.4	14.4	12.0	10.7		
Unemployment insurance based schemes for	older work	ers					
Exempt from job search	0.0	0.0	15.1	14.1			
Extended benefits	0.0	0.0	8.1	7.2			
Subtotal	0.0	0.0	23.2	21.3			
Grand total	11.8	14.4	37.6	33.3			
Memorandum items:							
Employment rate	51.9	52.5	53.8	55.4			
Inactive	35.5	29.5	5.8	8.8			

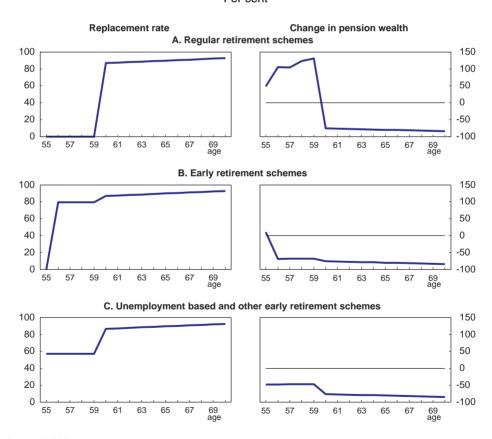
to the normal retirement scheme. More generally, the authorities have sought to restrict access to existing early retirement programmes administratively²⁴ and to promote the use of progressive or part-time early retirement schemes. As a consequence, the share of the 55-60 year olds enrolled in the various state-financed early retirement schemes has fallen from 16 to 10 per cent between 1996 and 2002 (Table 7). Unfortunately, a simultaneous and substantial increase in the number of older individuals receiving extended unemployment insurance benefits with no job-search requirements meant the effective number of individuals on early retirement programmes rose throughout the 1990s. As of 2002, some 520 000 older workers benefited from some sort of pre-retirement scheme, fully one third of those 55-60 years of age.

Both the authorities and the social partners indicate their intention to take additional steps to reduce the substantial incentives for early retirement currently in place for both firms and employees. The abolition of the ARPE and tighter conditions governing the ASFNE have already been evoked. The government hopes to place more emphasis on partial early-retirement programmes in an effort to make better use of available labour supply. Indeed, this programme already represents a substantial share of all state-financed early retirement schemes. In addition, the social partners, who govern the UNEDIC decided in

December 2002 to tighten both eligibility and the duration of its unemployment insurance schemes for older workers. Nevertheless, the financial consequences of an individual losing his job and moving onto either a state-financed or an unemployment insurance based early retirement programme are limited – especially as compared with the individual's expected pension income. Thus, a 56 year old redundant worker can receive unemployment insurance benefits equal to between 57.4 and 75 per cent of their salary for as many as 3½ years, without any job-search requirement (see Panel C, Figure 16).²⁵ Moreover, this period counts as service years for the purposes of calculating his or her pension – increasing the value of his or her eventual pension. In these circumstances it would not be surprising, as

Figure 16. Financial incentives of retirement schemes

Per cent



Source: OECD.

appears to be the case, that workers and firms collude in laying off older workers – either to replace them with less expensive and perhaps more flexible younger ones (see Anglaret, 2002 and Anglaret and Massin, 2002) or in order to reduce staffing levels (see Anglaret 2002).

The steps to reduce reliance on early retirement are thus welcome but need to be reinforced substantially. In particular, while moving to partial pre-retirement will doubtless make the policy change more politically acceptable, such a step can only be a temporary measure. There is a strong need to move towards a regime where any form of state-subsidised early retirement is an exception rather than a rule. Indeed, as the population ages the issue will increasingly be not how to remove incentives to retire prematurely but how to revise the tax and benefit system so that those individuals who wish to continue working past the retirement age will no longer find it financially penalising to do so. Currently, pension rules that claw back an individual's complementary pension if the combination of their pension income and their earned-income exceeds their pre-pension after-tax salary effectively makes working beyond retirement age economically uninteresting.

The authorities have conducted a number of studies evaluating alternative mechanisms to reverse the decline in older worker employment rates in the context of the ongoing pension reform deliberations (Taddei, 1999, Charpin, 2000, COR, 2002). Among the solutions that have been put forward is the introduction of a more actuarially neutral treatment of earnings and pensions around the statutory retirement age (see for example Blanchet and Caussat, 2000 and Sedillot, 2000). Such a reform would allow those workers that choose to do so to continue working and thereby improving their living standards. Currently once a worker has contributed 40 years deferring his or her pension has no impact on his or her pension benefit. At the same time, they would be contributing to national production and, therefore, government revenues, which would have the additional advantage of easing the overall financial burden represented by the ageing of the population. There are grounds for considering that a change in these incentives would result in a considerably altered behaviour. Currently, individuals' retirement behaviour clearly reflects such incentives, with distinct peaks in the transition to retirement that are associated with current regulations. The ages at which men cease to be employed has three peaks (58, 60 and 65), corresponding to the ages at which unemployment benefits can be drawn without having to search for work, the standard age for retirement (after which additional work ceases to add to pension rights for people with 40 years work) and the mandatory upper limit on the age of retirement. For women, the peaks are very different, with a greater proportion of women drawing pensions for the first time at 65, as their shorter working life implies that they continue to accrue pension benefits while working between 60 and 65 (Direction de la sécurité sociale, 2001).

Adopting a more actuarially neutral determination of pension benefits as a function of the period in which a person has contributed could also obviate, in

large measure, the need for early retirement programmes. Under such a system, individuals who find their work difficult could choose to retire early, with a reduced pension of course. Such a solution would have the further advantage of permitting the elimination the various special regimes, which seek imperfectly to achieve the same goals by offering special early-retirement packages to certain categories of workers. Not only do these systems raise serious questions about horizontal equity,²⁶ firms would no longer have a financial incentive to use subsidised early retirement programmes as a mechanism to rejuvenate their workforce (and at the same time reduce its costs). Indeed, prior to the 1982 reform the pension system offered much stronger incentives to work past the official retirement age and more flexibility to draw upon one's contributions before the legal limit. Moreover, surveys suggest that workers would embrace the kind of flexibility that such a reform would offer.²⁷ Finally, for those unfortunate older workers who do lose their jobs and whose unemployment benefits have expired, the actuarially reduced pension could replace or complement extended unemployment insurance - offering in many cases more money.

The authorities have proposed revising the "contribution Delalande", a penalty (equal to between two and 8 months salary) that firms laying off workers older than 50 years are required to pay to the UNEDIC. Although firms that hire workers over 50 years of age who have been collecting unemployment insurance for at least 3 months are not currently required to pay the penalty, it is felt that by increasing dismissal costs, this special tax may dissuade firms from hiring older workers (45 to 50 years of age). As of now, firms hiring a worker 45 years of age or older will be exonerated from the contribution. While this should help, the provision would continue to introduce real distortions. In particular, it tends to artificially reduce the opportunity of older workers for inter-firm mobility and increases the incentive to lay off those workers hired with the exoneration

While such measures would help to eliminate current early-retirement and extended benefit schemes as a source of unemployment, policy still needs to help older workers that do lose their job. Firms are reluctant to hire such workers because, given their age, there will be less time to recuperate investments made in their training. A similar argument holds for the worker, who will be less willing to relocate or change professions than a younger person. Rather than subsidising these individual's non-employment, policy should perhaps consider subsidising their employment – perhaps by affording similar financial incentives to firms that hire unemployed older workers as those currently provided for hiring younger workers. In addition, in order to help older workers maintain their skills at high levels and thereby reduce their likelihood of lay off in the first place, training and requalification programmes need to be elaborated and made available.

Reforms to improve firm-level performance

A wide range of proposals (see Box 4) recently formulated would, if adopted, help promote the small and medium enterprise sector and, over the longer term, revitalise the economy by promoting the creation of new enterprises and the purchase of existing ones as their owners retire. In particular, an economic initiative law in the process of being adopted seeks to increase the rate at which new enterprises are created and improve the access of small and medium sized firms to the capital and expertise that would allow them to grow more quickly and improve survival rates for start ups. This initiative follows upon a range of earlier efforts going in this direction, such as the Loi Allègre which was centred on innovation, the "États généraux" of enterprises held in 2000, and the 2001 Stability and Growth Pact. In addition to financing and enterprise creation/transfer initiatives, the new law includes measures to introduce e-government and reduce administrative complexity facing firms, notably by establishing a single-wicket service for social security. Particularly significant steps in this regard include the ability to get immediate provisional approval for the creation of a firm²⁸ through a single internet form, and the reduction in the minimum capital required to a symbolic euro.²⁹ In parallel, a government-wide programme has been underway for several years in an effort to simplify administrative formalities. More recently this effort is being expanded with a view to clear away unnecessary authorisations, with the explicit goal of moving from a philosophy of that which is not approved is rejected to one coupling a presumption of good faith with a process of *ex post* verification.

These are welcome steps, which need to be vigorously pursued and expanded in order to reduce the administrative complexity that still plagues businesses and start-ups in France. Thus, the recently introduced one-stop internet solution for registering a new business needs to be extended to include registration with the bewildering variety of state and quasi-state agencies that face a new firm. Moreover, a centralisation of information reporting would help relieve the ongoing burden that dealing with these agencies places upon firms. In this regard, the recent decision by the authorities to ask that its regulatory system be reviewed by the OECD (forthcoming in 2004) suggests a willingness to push forward with reforms and is recognition of the important benefits that a more efficient regulatory environment can yield.

Policies to promote Research and Development and innovation

In addition to these general initiatives, several more targeted steps have been introduced to help raise productivity growth. In particular, the authorities "Innovation Plan" announced in April 2003 hopes to raise total Research and Development (R&D) spending from its current level of 2.2 per cent of GDP to 3 per cent by 2010 and in particular increase R&D spending in the private sector, which currently only spends 2 per cent of GDP on R&D (OECD, 2002). Measures to foster

Box 4. Proposed measures to support the creation, financing and efficiency of small and medium enterprises

Simplification of rules

- A proposal to reduce the existing 956 forms that firms may have to complete.
- In order to progressively streamline processing, authorisations will be restructured so that after a short period (about 30 days in most cases), requests will be deemed accepted unless explicitly rejected.
- To reduce the administrative costs of hiring part-time and temporary workers¹ a special payment mechanism "chèque emploi associatif" will be put in place in 2004 along the lines of that already in place to pay for domestic services. This would allow small and medium-sized non-profit associations to write a cheque to such workers covering only their salary net of social charges, with the associated social charges then calculated by the social security itself and deducted automatically from the association's bank account.
- Introduction of a single wicket between small enterprises and the wide variety of social security agencies.

Promoting the creation of new firms and the transfer of ownership of existing ones

- Employees wishing to create a new enterprise will be able to work part-time
 or take a leave of absence from their current employer for one year, while
 retaining the legal right to return to their previous post if the enterprise does
 not work out.
- Moreover they will be exonerated from all social charges during this period except those associated with their condition as an employee.
- More scope will be provided for housing a start-up in one's principal residence.
- Stay-at-home partners who create a new enterprise will be able to continue to benefit from the social insurance of their spouses for one year.
- In addition, a new firm may delay payment of social security charges for one year and then pay them over the following five years. This measure is expected to cost about 200 million euros but it is hoped that this will be offset over the long term as firms survive and overall employment increases.
- The EDEN programme for individuals receiving social assistance or youth under 30 having left an *emploi-jeune* who are starting their own firm or taking control of a troubled firm will be expanded to include individuals over 50, resulting in a doubling of the number of beneficiaries. Payment will now be made in the form of an advance repayable over five years.
- In order to facilitate the transition of firms from one owner to another, the taxes associated with the transfer of the ownership of firms will be reduced and administrative requirements reduced (due to ageing, some half million entrepreneurs are expected to be seeking to sell their companies over the next ten years).

Box 4. Proposed measures to support the creation, financing and efficiency of small and medium enterprises (cont.)

A fixed share of an entrepreneur's personal capital corresponding to a fraction of the value of his/her principal residence will be sheltered from seizure if his enterprise fails, unless there is a pre-existing agreement with creditors.

Improving access to capital

- So-called business angels (a single investor who invests capital into promising small firms and at the same time provides business expertise and advice) will be granted the same kind of fiscal advantages currently enjoyed by larger venture capital funds that provide the same kind of services but on a larger scale.
- Local investment funds (Fonds d'investissement de proximité, FIP) are to be created that must invest at least 60 per cent of their portfolio within three contiguous regions and at least 10 per cent of the funds must go to firms less than 8 years of age.
- Individuals investing in FIPs will be afforded an income tax deduction equal to 25 per cent of their invested capital to a maximum of 12 000 euros (24 000 per couple). Moreover, the capital will be exonerated from capital gains to a limit of 10 000 euros per individual (20 000 per household).
- An increase will be granted in the income-tax reduction made available to individuals investing in non-traded firms and an increase in the ceiling for deductions in case of related losses.
- The profile of entrepreneurs and entrepreneurship will be raised by promoting school visits to firms and revising school texts to reflect the critical role that business plays in creating wealth, employment and rising living standards.²
- Several measures are in the process of being adopted concerning the wealth tax (impôt de solidarité sur la fortune, ISF):
 - A reduction in the tax base for the fraction of individual's capital represented by a small enterprise covered by a shareholders pact destined to ensure their ownership share in the firm does not change.
 - An abatement for minority shareholders that commit to keeping their shares for a long period.
 - A relaxation of conditions permitting an exoneration for "professional goods".

^{1.} The programme will be limited to jobs of short duration, less than 8 hours per week or less than four successive weeks of full-time work.

^{2.} Pascal Garnier, "Jean-Pierre Raffarin met en œuvre un plan destiné à créer un million d'entreprises en cinq ans" Le Monde, October 8, 2002.

the creation and survival of young and innovative firms include exonerating such enterprises from corporate income tax for their first three profitable years, an eight year exemption from employers' social charges for employees working on research projects, an exoneration from local taxes and a three year exemption on capital gains taxes for firm's shareholders followed by a gradual increase as they mature. In addition, the 2003 Budget exonerates R&D investments from the "taxe professionnelle". Access to R&D aids will be simplified and the authorities are considering introducing additional income tax deductions for expenditures on research and development and re-establishing the favourable amortisation treatment that related investment enjoyed in the past. In particular, they are considering reforming the way tax credits are extended to cover all R&D expenditures. One option under consideration is to include the levels of R&D expenditure when calculating the amount of tax credit. Currently, such credits are authorised only for increases in the level of R&D expenditures.³⁰ Such a step would increase assistance to firms already investing at high levels and might favour their maintenance at high levels. By subjecting the credit to a per-firm ceiling, the authorities indicate that the measure should help contribute to a rebalancing of the level of research as between the private and public spheres in a revenue neutral manner, while at the same time limiting windfall gains.

The authorities have also put in place a number of initiatives aimed at spurring technological advances and improving their economic relevance and their diffusion among private firms. Recent measures include enabling doctoral candidates to pursue their theses in private-sector laboratories, the creation of on-the-job internships for such students and reinforcing support for innovative firms. In this regard, there are now 16 research and technology networks (Réseaux de recherche et d'innovation technologique, RRIT). The networks, introduced in 1998, are tripartite bodies comprised of representatives from government, industry and the research community. They have been put in place in an effort to facilitate interactions between firms and researchers and are charged with defining promising areas of research and helping to channel government funding towards economically promising projects. In so doing, it is hoped that they will increase the economic benefits derived from the substantial sums currently allocated to supporting public-sector R&D activity. Each network is supervised by one or more ministries, and, although they are putatively organised on thematic lines, in practice many run on sectoral lines. Indeed, some pre-existing government-run programmes have been transformed into networks with, however, the essential difference that now researchers and firms play a more central role in dictating the direction of spending. Network activities range from those aimed at helping disseminate best practices (e.g. in the textile sector) to orienting fundamental research towards areas likely to generate longer-term benefits (e.g. in the Telecom sector). Programmes are co-financed using funds from more traditional pre-existing schemes.³¹ The degree of co-financing is generally exceeds 50 per cent, with the details differing as between networks. State participation in the networks is thought to help prevent cooperative behaviour from constraining competition, although the oversight role for the competition council (conseil de la concurrence) remains important in this regard. The ownership rights and policies of diffusion are supposed to be determined prior to financing of research. While no systematic evaluation of the networks has been conducted as yet (many have been put in place very recently), they are generally viewed positively and the authorities intend to subject the results of each to external review with an eye to reducing support to those that are less effective and re-allocating that support towards those that are more so.

As concerns dissemination of technological innovations to small enterprises, the authorities have developed an outreach system involving local chambers of commerce. Here the goal is to make practical solutions available to local artisans facing problems by funding training programmes that seek to disseminate best practices, somewhat along the lines of agricultural technical services. The chambers make the entrepreneurs aware of programmes and how to get money and training to deal with new areas, for example new techniques for the fabrication of parking lots according to existing norms. For larger firms, the networks can perform a similar role by facilitating technological dissemination among firms, such as occurs in the textile RRIT.

Financing of high-tech firms and the transition from an idea to a large and successful enterprise is an ongoing issue in France, as elsewhere. Programmes in place cover the incubation of ideas and assistance in the creation of business plans for firms just starting out. There are also programmes destined for those seeking to expand (facilitating access to risk capital and technical assistance for firms planning IPOs). But for the moment, the intermediate stages during which a startup evolves into a medium sized firm is, in the opinion of the authorities, under served. In this regard, it is hoped that the Fonds d'investissement de proximité (see Table 5) can play a role as well as the already discussed efforts to increase incentives for business angels, an activity which is currently underdeveloped in France.³²

Globally, these measures are steps in the right direction, which should over time help spur an increase in private research and development activity and a more effective cooperation between the research and business communities. Nevertheless, problems remain. On the one hand, as yet no formal or systematic evaluation of programmes is conducted, which makes rational policymaking particularly difficult. The new tripartite networks may help improve results by implicating business directly in the process, but, in the absence of stringent evaluations, vested interests will impede the reallocation of resources towards more viable networks. In particular, it will be important to evaluate the manner in which projects are supported financially. Current efforts are designed to help firms

gain access to credit and this is why aid to SMEs is provided mainly in the form of partial loan guarantees (mainly for between 40 and 70 per cent of the loan), which, understandably, increase banks' willingness to provide loans. Notwithstanding that guarantees are only honoured if the lending bank has diligently sought to recover the loan, such guarantees introduce a moral hazard in the banks' decision making process and could reduce their incentives to ensure that projects are economically viable, thereby raising the probability that public funds go to unviable projects. For the authorities, the measures in place to reduce this moral hazard are sufficient. In particular, banks must be shareholders in SOFARIS on the one hand and pay a premium on the other in order to benefit from the guarantee mechanism, which serves to internalise some of the costs. Indeed, the authorities note that the National Auditor has made a point of praising the way these loans are administered. While a programme that relied on subsidised interest rates would not introduce this problem of moral hazard and could ensure more effective use of public resources, the authorities feel that past experience with subsidised interest rates was less than fully satisfactory.

Several indicators point to a weakening trend as concerns the international impact of French research. French researchers' share in world patents fell from 8.8 to 6.3 per cent between 1985 and 2000. Their citations in academic journals fell by 6 per cent over the same period, reflecting, in part, a catch up process among other EU countries to reach the high levels already attained by France. Moreover, French R&D expenditures were the slowest growing among EU countries during the second half of the 1990s. Some argue that the problem lies in the application of rules and regulations inspired by researcher's status as civil servants, which limits the financial incentives to which the best researchers are exposed, and promotion and resource allocation rules that seem excessively constraining for talented younger researchers.³³ It is even argued that France is paradoxically burdened by too many researchers chasing too few resources. Here the measures outlined in the loi Allègre, which allow discoverers of new innovations to share in the revenues generated is a step in the right direction. However, rules that allow their employers to deduct overhead costs before sharing licensing revenues means that only 10 researchers make a significant living from their discoveries. To increase incentives a minimum share of the revenues should be assigned to researchers, before deductions for overhead are taken into account. A related problem concerns the geographic dispersion of expertise. While recent steps to create centres of excellence have been helpful more could likely be done to encourage regional specialisation.

Tax policy and the attractiveness of "site France"

Among the results of the OECD Growth Study (2002) is that a high tax burden (or a large government sector) tends to reduce the rate of growth of potential output. Although seated within a much more detailed micro-economic analysis of

the determinants of growth, these findings confirm earlier results based on macroeconomic data.³⁴ While it is unclear whether it is the overall size of government and a tendency for the state to make less productive use of resources than the private sector, or the distortions introduced by the high taxes necessary to finance those expenditures, the implications of these results are clear. Chapter III deals with questions of public expenditure generally. This section presents some recent evidence on those aspects of the French tax system most likely to introduce distortions that impinge on investment and high-tech activity to the detriment of growth. As concerns foreign direct investment (FDI), France was the biggest recipient country in 2002 (54.7 billion euros) ahead of China (52.4 billion euros) and Germany (40.4 billion euros). In 2001, France was third behind the United States and the United Kingdom. Nevertheless, in net terms, outflows exceeded inflows by 16.7 billion euros in 2002, leaving France in 26th position among 30 OECD countries, a performance nevertheless superior to that of the United States or United Kingdom.

The Growth Study argues that a large government sector can both reduce the level of potential output and its rate of growth through several channels. On the one hand, high taxes required to finance high levels of expenditure may crowd out private investment, inciting locals to invest abroad and dissuading foreigners from investing domestically. Secondly, taxes themselves tend to introduce distortions, which can both reduce the level of efficiency of an economy and, perhaps, its rate of growth. A number of studies suggest that these channels may be at work to some degree in France.

A recent report by the Prime Minister's Economic Analysis Council (*Conseil d'Analyse Économique*, CAE, 2003) argues that for a relatively large country like France, neighbouring countries can successfully attract investment away by offering lower tax rates and a relatively easy access to the large country's markets. This logic is confirmed by surveys that indicate that while taxation is not a critical factor in determining plant location decisions, it is a determining one when deciding between otherwise equally attractive options (OECD, 2002; Ernst and Young, 2002). While France has made a number of efforts to reduce its corporate income tax rates, steps taken by other countries have been much more important (Table 8). Moreover, successive changes to the tax system have resulted in the corporate income tax rates fluctuating considerably over time, ³⁵ a negative factor for prospective investors as it introduces uncertainty into the calculation of future after-tax revenues.

Of course, the legal rate is only one factor determining the actual taxes paid by firms. But even when differences in tax bases are taken into consideration, France's relative tax position is not strong (even though taxation is far from being the only criteria upon which foreign investment decisions are made, it plays a non-negligible role). Thus, Bénassy-Quere *et al.* (2003) determined that even when bilateral tax arrangements are taken into consideration, France is either the

Table 8. Legal corporate income tax rates

	1986	1991	1995	1998	2001	Difference 1986/2001
Austria	50.0	30.0	34.0	34.0	34.0	-16.0
Belgium	45.0	39.0	39.0	39.0	39.0	-6.0
Denmark	50.0	38.0	34.0	34.0	30.0	-20.0
Finland	33.0	23.0	25.0	28.0	29.0	-4.0
France	45.0	42.0	33.3	41.6	36.4	-8.6
Germany	56.0	50/36	45/30	45/25	25.0	-31.0
Greece	49.0	46.0	35/40	35/40	35.0	-9.0
Ireland	50.0	43.0	40.0	32.0	20.0	-30.0
Italy	36.0	36.0	36.0	37.0	36.0	-0.0
Luxembourg	40.0	33.0	33.0	30.0	30.0	-10.0
Netherlands	42.0	35.0	35.0	35.0	35.0	-7.0
Portugal	42/47	36.0	36.0	34.0	32.0	-15.0
Spain	35.0	35.0	35.0	35.0	35.0	-0.0
Sweden	52.0	30.0	28.0	28.0	28.0	-24.0
United Kingdom	35.0	34.0	33.0	31.0	30.0	-5.0
EU average	44.3	36.7	35.1	34.9	32.0	-12.4
United States	46.0	34.0	35.0	35.0	35.0	-11.0
Japan	50.0	50.0	47.5	46.4	46.4	-3.6

Note: Rates are for the central government only. The EU average is unweighted.

Source: OECD, Bretin Madies (2002).

14th or 15th least favoured destination for investors from 12 of the 15 EU countries (including France), and does no better than the 12th least attractive. Only in the manufacturing sector and after allowing for tax optimisation, does France come in with an average rate, and this is a result of a tax system that is strongly beneficial to manufacturing firms. Indeed, somewhat surprisingly and in contrast to the United States where small companies pay less than two thirds the tax rate of large ones, in France small and medium enterprises pay effective corporate income tax rates that are 123 per cent of those paid by large companies³⁶ (Nicodème, 2001). To a certain extent, the tax measures outlined in Box 4 redress this bias for small and medium enterprises in the high-tech area, but more needs to be done to make the tax treatment of small firms more neutral. Here, the recent reduction of the lower CIT rate faced by small and medium enterprises from 25 to 15 per cent, and the abolition of the salary portion of the professional tax should help. However, theses steps should be reinforced, perhaps by a more neutral treatment of amortisation regimes, and a reduction in legal rates. Finally, as emphasised in CEC (2001) it is critical to lower compliance costs for small and medium-sized enterprises, which impact these firms' activities disproportionately (especially cross border activities). Moreover, wealth and estate taxes place a special burden on

small and medium enterprises, a problem that will be increasingly significant in the near future as demographic developments will see a significant number of these changing hands either through succession or sales.

Labour market regulations are also important in determining firms' locations, both because a company's labour force is often among it most important cost but also because rules governing layoffs and plant closures can raise the costs of an eventual failed venture and therefore the *ex ante* cost of the investment. Indeed, France's industrial structure may well have been influenced by such laws. The Economic Analysis Council argues, and the results of the Growth Study (OECD, 2003) confirm, that France's strong employment protection legislation tends to favour large slowly growing manufacturing firms, who benefit from a stable workforce. However, such rules work to the detriment of smaller more rapidly growing start-ups, whose labour force requirements are much more unstable and which are therefore more seriously penalised by rigid rules concerning fixed-term contracts and dismissals. Thus, not only would a reduction of rigidities in this area help labour market performance (see above), it may also contribute to improving overall productivity growth.

France's personal income tax system has been criticised for its unfavourable treatment of high earners (see 2001 Economic Survey and Rapport Charzat [2001] inter alia). Two basic problems emerge. First, despite very high marginal rates France's personal income tax system yields very little revenue (3.3 per cent of GDP, CSG excluded). Indeed as many as 50 per cent of households pay no personal income tax. The (Cotisation sociale géneralisée, CSG) on the other hand is applied to largely the same revenues but with fewer permitted deductions. As a result, most individuals pay the same level of direct personal taxes as in the US or UK. However, the overall tax burden is very high, largely because of social charges. Here a particularly heavy burden is generated by the health insurance contribution which is not subject to a ceiling, resulting in very high overall burdens for high income earners. Thus, the overall tax burden, 49 including both firms and individual social charges, is 79 per cent for someone earning around 75 000 euros a year and rises to 83 per cent for some one earning 450 000 euros which compares unfavourably with rates of 61 and 53 per cent in Germany and 48 and 43 per cent in the United Kingdom (CAE, 2003). For knowledge workers that might be exposed to these rates of taxation or the firms that would employ them, the financial disincentives to locating in France are substantial. In this regard, the authority's decision to lower personal income tax rates last year will help, but much more needs to be done. A first step would be to place a ceiling on the health insurance contribution, which for high income earners clearly bears much closer resemblance to a tax than an insurance premium. Current rules exonerating foreigners from social security contributions for a period of 5 years (as long as they are otherwise covered) is a positive move, but does not deal with the long-term costs imposed by the system.

Regulations in the retail trade sector

France is a country characterised by extensive product-market and labour-market regulation. The OECD Growth Study has highlighted the impact that excessively rigid rules in these areas can have on productivity and economic growth. In recent years, France has taken a number of steps to reduce the administrative burden faced by firms and to reduce rigidities in labour markets (see above). Nevertheless, administrative complexity continues to be perceived as a problem.³⁸

In this regard, the rules governing the implementation of large-scale commercial outlets, and those which specify the limits within which firms are free to set prices, appear to have had perverse effects. Indeed, the 1996 loi Raffarin, itself an amendment to the 1973 loi Royer was initially designed to prevent large-scale "hyper markets" from driving out smaller firms. However, it has dramatically reduced entry into the retail sector and paradoxically increased considerably the market share of the largest firms. Hyper-markets were unable to expand by building new stores to the extent they desired and instead have expanded by growing internationally on the one hand and via mergers and acquisitions on the other. By 2001, the 5 largest firms controlled 80 per cent of the French market, as compared with concentration ratios of 60 per cent in and the United Kingdom, Germany and Spain; and 30 per cent in Italy. Perhaps reflecting the administrative difficulties in getting approval to build or occupy even a medium-sized commercial space, discount retailers hold less than 12 per cent of the French market as compared with more than 32 per cent in Germany, although they are gaining market share.

This increased concentration of the retail sector and weak low-cost competition appear to have combined with rules prohibiting loss-leader sales to result in a much higher rate of inflation for name-brand goods (Table 9). In practice, the Loi Galland prevents retailers from selling below invoice price, but authorises suppliers to pay retailers what are called "back margins" (marges arrières) in exchange for favourable placement on store shelves, or special promotional services that stores might provide. Given the importance of the market share of large

Table 9. Inflation of name brand versus in-house products

	In-house brand market	Inflation rate in February 2002			
	share	Name brand	In-house brands	Difference	
Pet food	20.8	5.3	2.1	3.2	
Fruits conserves	32.4	8.9	2.1	6.8	
Prepared foods	22.4	8.8	6.2	2.6	
Beauty products	4.4	8	0.9	7.1	

Source: Etude Iri Business Conseil.

retailers, they are able to charge substantial fees in this form. In effect, the large retailers may be getting a discount on the prices they pay suppliers, but the benefit is not passed on to consumers in the form of reduced prices. As a result, and recognising that causality is very difficult to determine, it would appear that wholesale distributors and producers of name-brand products chose to raise their prices so as to offset the increased back margins and maximise their own profits. In these circumstances it would appear that a relaxation of rules governing large and medium-sized stores is needed in order to increase competitive pressures within the sector and so as to allow firms to pass on economies of scale in the form of lower prices. International data suggests that France has already reached a point where the development of hyper markets has peaked and at which more traditional supermarkets can be competitive.

Corporate governance and regulation

The end of the internet bubble revealed a number of excesses, both in legal terms and in the governance of firms. The opaque accounting practices of Enron in the United States and Ahold in Europe are emblematic of some of the abuses, while the large losses accumulated by France Telecom and Vivendi Universal, which together lost more than 2 per cent of French GDP in 2002, have been raised as examples of problems in corporate governance of both state- and privately-owned companies. Globally, the French authorities are of the view that there were fewer excesses in France than elsewhere and that the French regulatory framework has worked relatively well. Nevertheless, they took steps in 2002 to reinforce financial market supervision by creating a new and powerful integrated regulator of financial markets.

Following extensive consultation with relevant parties, cabinet drafted a new legislation bill on financial security that was presented to parliament in February 2002. The bill is intended to respond to the crisis of confidence that recent high profile losses and apparent examples of conflict of interest have generated in both the United States and Europe. It is a three pronged reform, including a thorough overhaul of the supervisory authorities responsible for financial activities; the creation of new mechanisms to reinforce the protection of small investors and the insured; and the modernisation of supervisory mechanisms for corporate accounting and governance. Measures proposed, include:

- The unification of the financial market council, the securities commission (Commission des opérations de bourse) and the financial management disciplinary council (Conseil de discipline de la gestion financière) into a single body, the financial markets authority (Autorité des marchés financiers).
- The merger of the authority responsible for supervising insurance companies with that responsible for supervising the activities of mutual insurance companies.

- Authorisation procedures facing insurance companies and credit institutions will be harmonised.
- The clarification of rules governing direct solicitation for securities and redefinition of the minimum professional requirements for financial investment consultants
- The creation of a guarantee fund to ensure against the default of non-life insurance companies.
- The reinforcement of the role of the general shareholders meeting. In particular, it requires the shareholder meeting to oversee more closely the decisions made by company executives.
- The enhancement of disclosure and transparency requirements.
- The prohibition of auditors from acting as both auditor and consultant to a single client and the requirement that companies change auditors on a regular basis.
- The creation of a supervisor, working under the authority of the Ministry of Justice, charged with overseeing the audit profession and safeguarding auditors' independence.

In addition, the authorities have pursued liberalisation efforts in the network industries. Here the most important steps were the decision to transpose EU regulations on competition in the electricity sector into French law, and the decision to transform the historic monopolist (Électricité de France et Gaz de France, EDF/GDF) into joint stock companies, with an eye to their eventual privatisation. As discussed in the previous Economic Survey (OECD, 2001), the transposition of the EU directives will likely have only a limited impact on prices in France or on ex post market shares because retail electricity prices are already relatively low in France and administrative steps have already been taken to allow foreign firms access to commercial contracts. Moreover, the management of the electricity grid remains in EDF's hands, and although the Energy Regulatory Commission is charged with ensuring the transparency of the grid's operation, the management links between EDF and the grid remain a source of potential conflict of interest. A cleaner separation of the two entities would help eliminate any doubt in this regard. The transformation of EDF and GDF into joint stock companies will mean they no longer enjoy the special status of EPIC (Public enterprise of a industrial and commerical nature). As a result, they will no longer benefit from an implicit State guarantee and, therefore, the lower interest rates that provoked an EU investigation to determine whether or not this constituted an unfair state aid. Finally, with an eye to the eventual privatisation of the two firms, steps will need to be taken to deal with their substantial pension liabilities, either by significantly increasing company debt or by transferring the liability to the State.

Progress in reducing the role of the state in the business sector

France has a long history of State involvement in the economy, with the latest wave of nationalisations having occurred some 20 years ago in the early 1980s. Since then, a long process of privatisation has been pursued at varying levels of intensity, with the result that public sector no longer has a significant position in the banking and insurance sectors, nor among the most important industrial sectors. Nevertheless there remains a close (although weakening) linkage in popular perception between the notion of public service and public ownership, which is frequently reflected in strong and vocal opposition to privatisation initiatives. These attitudes reflect widespread satisfaction with the level and quality of services that have been provided by state-owned firms and collective pride in the highly visible and successful technological products and industrial enterprises that were developed under state ownership. On the other hand, they may also reflect largely past practices, whereby the full cost of providing these services was not passed on in the prices charged to end users.³⁹

Notwithstanding the contentiousness of the issue, successive French government have substantially reduced the role of the state in the business sector (see Box 5). In some areas (notably telecoms), the elimination of former stateowned monopolies and their (partial) privatisation has resulted in a phenomenal expansion of services and decline in prices, helping to make clearer the benefits of a more competitive environment (Economic Survey, 2001). In the recent past, the authorities have continued the trend to reduce the role of the state in the economy. Sell-offs of state-owned business assets yielded 2.1 and 6.1 billion euros in each of 2001 and 2002. Major transactions have included, the sale of the State's remaining 10 per cent holding in Credit Lyonnais (2.2 billion euros), a further sale of Renault shares, the sale of Thomson Multimedia and the opening to private investors of the capital of Autoroutes du Sud. Looking forward the authorities hope to sell a further 8 billion euros of assets in 2003, bringing the total over the 3 years to about 1 per cent of GDP - although attaining this goal will depend on market conditions. Additional sales under consideration include the State's remaining minority stakes in Renault and Thomson Multimedia and further reductions in its holdings in Air France, SNECMA (an aeronautical manufacturing firm) and possibly France Telecom. In addition, plans are well advanced to convert EDF and GDF from Établissements publics à caractère industriel et commercial (EPICs) to jointstock companies as a first step towards an opening of their capital to private investors and a possible future privatisation.

These are positive steps, which when completed should help these enterprises take full advantage of market opportunities and effectively harness private capital to finance their international operations and acquisitions. In the past, their status as State-owned companies has constrained their activities. In the case of France Telecom, existing legislation requires the state to retain a majority stake. The

authorities' unwillingness to change the legislation and, perhaps, the reluctance of target firms to accept France Télécom shares – given its state ownership – forced it to finance much of its investment and expansion activities by taking on debt, in contrast to many of its competitors. As a result, towards the end of 2002 and following the end of the Telecom bubble, France Telecom was among the most indebted companies in the world (68 billion euros or about 5 per cent of GDP) and doubts emerged as to the firm's liquidity, resulting in a downgrading of its debt. Following a change in management, a restructuring plan was announced (15 billion euros in debt restructuring, 15 billion in the form of a recapitalisation: and 15 billion in the form of increased internal earnings). The same day, the State indicated its support of the plan and its willingness to open a line of credit worth 9 billion euros, if necessary, in advance of its own participation in the capital increase. It also indicated its willingness, if necessary, to modify the law requiring it to retain a majority stake. The line of credit was never put into place, as the simple announcement of the government's willingness to extend it

Box 5. The State as entrepreneur

Since 1982, the authorities have privatised (reduced its ownership position below 50 per cent) some 2 000 firms. As a result, employment in majority state-owned enterprises has declined by 1.35 million and such firms no longer play a significant role in a number of sectors where they were once dominant or major players (notably banking, insurance and manufacturing).

Nevertheless, the state remains an important actor in the French economy. In 2000, it still owned some 1 500 enterprises, employing over a million individuals representing 8 per cent of total employment in the non-financial sector, 12 per cent of value added and 30 per cent of assets.

Only 97 companies are directly held by the State, with the remainder controlled indirectly – either as daughter firms or wholly-owned subsidiaries. Of these, six companies (Air France, France Telecom, La Poste, EDF/GDF, RATP and SNCF) represent the bulk of the economic weight represented by these state-owned firms. Of these, two have already been partially privatised (Air France and France Telecom), while initial steps that would permit the introduction of private capital into EDF and GDF are currently underway.

In addition to the 1 500 state-owned enterprises, the State also has a minority stake in some 40 firms.

These firms represent almost 90 per cent of employment in state-owned enterprises. Of the 97, 45 have no subsidiaries, while 21 are holding companies with 12 or more subsidiaries, which may or may not also have subsidiaries. The Caisse des dépôts et développement and the SNCF each have over 300, while the Commissariat à l'énergie atomique (Atomic Energy Commission). EDF/GDF, and have between 100 and 200 each.

appears to have been enough to reduce the risk premium associated with France Télécom bonds and thereby facilitated the restructuring of its debt on financial markets. In March 2003, the company proceeded with its recapitalisation effort, with the State taking up its share through a special purpose EPIC, the ERAP. These steps and others aimed at strengthening its balance sheet have helped reduced the company's net debt to 53 billion euros. The steps taken by the State in favour of France Télécom have been contested as unfair State-aid by several of France Telecom's competitors and is currently under investigation by regulators in Brussels.

As concerns, EDF, the European Commission has determined that its special status as an EPIC, which entitled it to preferential interest rates because of an implicit state guarantee, gave it an unfair advantage (an enquiry is currently underway to determine whether the extent of this aid exceeds the value of the public service tasks performed by the company). Moreover, the issue of the contingent liability represented by EDF's pension scheme has yet to be resolved. Transferring this liability from the firm either to the government or to the Réseau de transport d'Electricité as has been proposed by some⁴⁰ would represent a significant and possibly uncompetitive aid to the historic monopolist.

The authorities' decision to transform EDF and GDF into joint-stock companies resolves the issue of preferential interest rates but does not address the asymmetry that their state ownership poses as concerns their foreign acquisitions. The same problem concerns Air France and France Télécom. While these organisations have taken advantage of the wave of liberalisation by entering into foreign markets either by purchasing shares or outright ownership positions in former state monopolies, foreign enterprises have been denied a reciprocal right as long as the French government refused to sell its majority stake, a factor which in the case of EDF and GDF has led foreign governments to place restrictions on the ability of these companies to exercise a management role in firms they have taken stakes in. Indeed, one of the motivations underlying the authorities' decision to reduce the State's stake in Air France from its current 54 per cent to somewhat less than 20 per cent is the recognition that other European airlines would be unwilling to go beyond simple and already existing commercial alliances with Air France as long as the State retains its majority stake.⁴¹

The money earned from these sales should be used to reduce the debt or to build up the various contingency funds that have been created to help ease the financial burden in the various French pension schemes as the population ages (see Chapter III). However, virtually all (97 per cent) of the 30 billion euros (2 per cent of GDP) in privatisation receipts collected since 1996 have been used instead to support other state-owned companies by reducing their debt or increasing their capital. Over the most recent period (2001-2), the bulk (40 per cent) of privatisation revenues have been provided to the French railroad infrastructure company (Réseau ferré de France, RFF), with other important beneficiaries including: EPFR (a

public corporation set up to carry the debt contracted by the restructuring of some of the assets of Crédit Lyonnais in 1995), GIAT (an armament company) and the Direction des constructions navales (a shipbuilder).⁴²

Questions about the capacity of the state to provide effective governance over state-owned enterprises arose in the context of the large debts accumulated by France Telecom over the past several years and some of the less successful foreign investments of EDF. Critics argue that for a number of acquisitions, which resulted in substantial losses (most notably the German MobilCom), companies failed to get approval from their supervisory boards, in particular the representatives of the Ministry of Finance charged with overseeing the state's holdings. Moreover, they question the confused governance of partially privatised or state-owned firms that are supposed to be managed according to commercial principles but which are, nevertheless, required by the State (acting not as a shareholder but as a guardian of public policy) to provide unprofitable public services or undertake operations that are not in the interest of the firm itself.⁴³ Indeed, a recent report commissioned by the Minister of Finance concludes that "the State does not exercise its stockholder role effectively" and criticised the inherent conflicts in its efforts to simultaneously act as stockholder, strategist, regulator and client of such firms. It was particularly critical of the effectiveness with which the State effected its role as owner, arguing that it gave unclear guidance to managers, that State-owned firms had poorly functioning Boards of directors and that the State played an excessive role in the day to day operations of the enterprise (Barbier de La Serre et al., 2003).

The report also recommended that State-owned companies should be managed according to commercial principles, that those still operating as Public Companies (EPICs) should be transformed into joint-stock companies and that the financial costs of public services should be made clear, via explicit contracts for the provision of such services. Moreover, it argued that the number of directors on their Boards should be reduced to about 12 (exceptionally 18) and that, where the State was a majority owner, at most 6 of these should be State employees. In addition, it argued that the commercial experience and expertise should play a larger role in determining who represents the State on company boards. All of these are sensible recommendations that would go along way to preventing the kind of very expensive excesses of the past. Indeed, the authorities have taken up one recommendation by announcing the creation of a State Ownership Agency (Agence des participations de l'État, APE), which will be charged with watching over the State's holdings and exercising its rights as a shareholder in all State-owned companies, except the Caisse des dépôts et consignations (a state-owned financial intermediary).

The creation of the APE is a clear step in the right direction and government assurances that companies are to be operated on commercial principles is welcome. However, it is not yet clear to what extent the Agency will, in fact, have

the authority to pursue its mandate. The APE will employ both private-sector employees and civil servants, with the former paid according to private-sector wage scales. However, the agency will be administratively attached to the Treasury and operationally attached to the Ministry of Finance to which it will be ultimately responsible. Moreover, ownership of companies will stay with individual Ministries – leaving open the possibility that they be instructed to act according to noncommercial principles. In order to ensure that the full potential of this agency to rationalise the governance of state-owned firms is realised, additional efforts should be made to implement many of the other recommendations of the Barbier de la Serre report. In particular, the suggestion that the public service obligations of state-owned enterprises be made explicit and contractualised would not only increase transparency but could be a first step towards providing such services on a competitive basis. Indeed, the authorities will soon present a bill transposing the European directive on Telecom packets into French law and this, if passed, will allow the contracting out (after a call for tender) of the public service component of Telecom services. This could be an important first step, to the extent that the tender is designed in such a way as competitors are in a position to compete. Indeed, the dominance of France Telecom and other State-owned firms in some sectors underlines the necessity of strengthening regulatory functions especially if these companies are to increasingly act on a purely commercial basis.

As concerns the remaining 1 500 state-owned enterprises and the forty-odd firms where the state retains a minority position, the authorities should take steps to reduce their holdings of these companies. To the extent that the state's ownership position in these firms is not strategic, there seems to be little economic or political justification for retaining them. Indeed, for these firms governance issues may be even more serious as the sheer number of them makes effective monitoring of their activity difficult. Moreover, for healthy and productive firms, statutory and budgetary constraints limit the authorities' capacity to invest in them, possibly preventing then from realising their true economic potential. In order to resolve these issues, the authorities should consider accelerating the disinvestment programme by confiding their sale to investment bankers specialised in such transactions.⁴⁴

Some aspects of sustainable development

There is growing concern that long-run sustainable development may be compromised unless measures are taken to achieve balance between economic, environmental, and social outcomes both domestically and on a global basis. This section looks at two specific issues of sustainable development that are of particular importance for France. In each case, indicators are presented to measure progress and the evolution of potential problems, and an assessment is made of government policies in that area. The section considers French policies in the realms of mitigating *climate change and reducing water pollution* and follows up a more comprehensive treatment of

Box 6. Policy integration across sustainable development areas

Economic and social objectives have been integrated in policy assessment for many years. There is a wealth of reports analysing problems and making proposals for remedies but these are not always translated into actual policy reform. In addition to this general policy analysis, every legislative proposal must include studies of its impacts on the economy and on employment. However, the assessment of economic impact is often limited to an estimate of budgetary costs.

In the last decade, efforts have been made to improve the extent to which environmental factors are taken into account in designing major investment projects. Environmental Impact Assessments were made compulsory in the 1992 Water Management Act and their scope widened in the 1996 Air Pollution Prevention Act. For example, a complete cost-benefit analysis, including externalities, is now made for every road project as well as a report on non-quantifiable environmental effects. For many externalities, a standard set of monetary values has been established in order to provide a straightforward method of integrating many environmental concerns into the decision taking process on a uniform basis. As from 2004, analysis of environmental impacts will be widened to cover plans and programmes as well as projects. However, in line with the 2001 EU directive on "Strategic Environmental Assessments", such policy assessment does not encompass economic and social outcomes, nor does it require the use of cost-benefit analysis. The institutional capability of the Ministry of the Environment to undertake such analyses has been strengthened and this could lead to more weight being given to economic factors in these analyses. A widening of the scope of the SEA's could draw on the long experience of ex post evaluation of public policies first at the General Planning Commission (CGP) and, since 1999, at the independent National Council for Evaluation. In 2001, this institution completed a thorough examination of water policy and is currently reviewing waste management.

France has embarked on a comprehensive consultative process to decide how to add environmental objectives to its constitution. Though the precise form of proposals have not been decided, the main objective is to give more weight to environmental objectives in order to bring them into line with the treatment of economic and social goals in the constitution. Such treatment could also provide a renewed opportunity to generalise use of the polluter-pays principle and cost-benefit analysis.

environmental issues in the 2001 Economic Survey. Various aspects of the sustainability of pension and healthcare expenditures are treated in Chapters I and III. The section also considers whether institutional arrangements are in place to integrate policy-making across the different dimensions of sustainable development (see Box 6).

The sections in this report dealing with mitigating climate change, reducing water pollution, and ensuring sustainable retirement income are inputs into the Organisation's follow-up on sustainable development, as mandated by the Ministerial Council decision in May 2001.

Climate change⁴⁵

France is participating in international efforts to limit greenhouse gas (GHG) emissions in line with the Kyoto Protocol. Under the EU burden sharing agreement, France is committed to containing its emissions in 2008-2012 at their 1990 levels (in contrast to the 8 per cent fall for the EU as a whole). Given the low carbon intensity of the economy, suggesting possibly high marginal abatement costs, it may be particularly difficult but also especially important to achieve compliance with Kyoto-related requirements in a cost-effective manner.

Low GHG emissions per unit of GDP are largely due to the predominance of hydro and nuclear power (Table 10). These sources accounted for 87 per cent of electricity generation in 1990 rising to 91 per cent in 2000,⁴⁶ thereby contributing to a notable reduction in the emissions intensity of the electricity sector during the 1990s (Table 11). Emission intensities also fell in other sectors, with large cuts in emissions of nitrous oxides from chemical industries. On the other hand, emission intensity in transport was constant but increasing volumes meant that overall emissions in this sector rose faster than economic growth (Table 10). All in all, emissions in 2000 were 1.7 per cent below their 1990 level (MIES, 2002). Despite this good performance in the past and assuming policy remains unchanged, GHG emissions in 2010 are forecast to be 6 per cent above the stabilisation target (MIES, 2001), mainly because only a further limited increases in the share of nuclear energy are possible and transportation growth is likely to remain high.

This expected overrun of emissions led the French authorities to introduce a climate change strategy in January 2000 that assuming economic growth does not exceed 2.2 per cent annually in the decade to 2010 aims at achieving the EU burden-sharing target without the purchase of any carbon credits from abroad.⁴⁷ The plan would put in place a dual system of ceilings on the costs of avoiding carbon emissions, amounting to 76 euros per tonne for instruments and double that where regulations are being considered. Both these limits are significantly higher than some estimates of the likely price of permits in a future open EU market of 20 euros per tonne of carbon (IEA [2002] and Criqui *et al.*, [2002]). Despite the economic efficiency of carbon taxation as an instrument to reduce emissions in the industrial sector, the decision to implement such a scheme has now been shelved (see OECD, 2001). It had been estimated that this tax would have achieved about one-third of the required reduction in emissions relative to a baseline without policy actions.

Since then, firms have pledged to contain their emissions in the periods 2003-2004 and 2005-2007 under the supervision of an association controlled by the participants in the scheme. Each member would set its own target but would need approval from the supervisory body that would then monitor compliance and possibly claim fees from companies exceeding their targets. Following the rejection on constitutional grounds of the initially proposed tax measure, the

Table 10. **Main indicators: climate change**Indicators of greenhouse gas (GHG) emission intensity, grams of CO₂ equivalent per \$PPP of GDP, in 1995 prices

	Total GHG emissions	CO ₂ emissions, electricity	CO ₂ emissions, transport	Other GHG emissions	Total GHG emissions	CO ₂ emissions, electricity	CO ₂ emissions, transport	Other GHG emissions
		Level	, 1999		Average a	nual percer	ntage change	1990-1999
Australia	1 053	370	155	528	-2.07	-0.21	-1.93	-3.24
Austria	419	72	91	256	-1.87	-2.75	-0.52	-2.06
Belgium	617	97	101	419	-1.36	-2.12	0.16	-1.52
Canada	893	151	193	549	-0.98	-0.12	-0.36	-1.41
Czech Republic	1 058	457	88	513	-3.05	2.55	5.53	-6.93
Denmark	549	194	94	261	-1.64	-1.43	-1.49	-1.85
Finland	652	181	105	366	-1.88	-0.02	-1.29	-2.83
France	416	32	103	280	-1.69	-2.04	0.16	-2.26
Germany	536	169	96	271	-4.00	-3.86	-0.57	-5.05
Greece	813	275	130	408	-0.24	0.07	0.74	-0.73
Hungary	786	250	84	453	-2.33	1.44	0.38	-3.74
Iceland	395	4	88	303	-1.28	0.00	-2.31	0.81
Ireland	694	165	103	426	-4.27	-2.41	0.79	-5.75
Italy	439	105	92	242	-1.05	-0.82	0.37	-1.64
Japan	432	130	82	221	-0.30	-0.03	1.24	-0.99
Luxembourg	344	6	242	97	-11.46	-30.20	-0.45	-18.81
Netherlands	573	138	82	352	-2.38	-1.03	-0.94	-3.15
New Zealand	1 096	92	175	828	-2.28	4.58	0.65	-3.32
Norway	487	4	113	369	-2.54	1.31	-1.53	-2.87
Poland	1 195	481	90	624	-4.96	-6.63	0.50	-4.12
Portugal	540	149	106	285	0.41	2.58	3.37	-1.39
Slovakia	957	200	76	680	-4.47	-1.21	3.13	-5.78
Spain	537	127	130	280	0.41	1.12	1.28	-0.26
Sweden	358	41	112	204	-1.55	0.07	-0.65	-2.30
Switzerland	276	3	79	195	-0.62	-1.96	-0.28	-0.73
United Kingdom	526	132	108	287	-3.66	-5.30	-1.38	-3.61
United States	792	278	196	318	-1.89	-0.60	-1.18	-3.28
OECD total	649	196	140	312	-1.80	-0.98	-0.38	-2.83
EU	506	120	103	283	-2.36	-2.60	-0.16	-2.95

Source: Greenhouse gas emissions: national submissions to the UNFCCC and national publications. Carbon dioxide emissions for electricity and transport: IEA (2001). GDP: OECD, SNA database.

government now supports the voluntary scheme, acting as a simple observer within the supervisory association. The employers' association envisages that emission allowances would be traded amongst participating companies, although it is not clear that a trading scheme can be built efficiently using voluntary rather than mandatory limits (Lenain and Vourc'h, 2002). As yet, neither the coverage of the scheme, nor the extent of emission reductions, nor the possible role of legislation in the scheme has been settled. While the effectiveness of such a scheme is

 Table 11.
 Greenhouse gas emissions and sectoral indicators
 Manufacturing Residential CO₂ out

	Total GHG	emissions	CO ₂ emissions per Kwh electricity	CO ₂ emissions per unit of industrial production	Residential CO ₂ emissions per unit of private consumption	Road transport CO ₂ emissions per vehicle		Industrial output per unit of GDP
	Level million tonnes			Annual a	average percentag	e change		
	CO ₂ equivalent 1999		1990-	1999 ^{1,2}		1990-1998	199	0-1999
Australia	489	1.6	0.4	-0.5	-2.0	-1.7	-0.6	-1.9
Austria	80	0.3	-2.5	-3.1	-4.6	-1.8	-0.2	1.1
Belgium	151	0.6	-2.0	-1.0	-1.3	0.0	-0.1	-0.3
Canada	699	1.6	0.4	-3.1	-3.4	1.4	-0.6	1.0
Czech Republic	138	-3.4	1.9	-12.6	-11.4	-1.4	0.6	1.7
Denmark	73	0.6	-3.7	-3.6	-5.5	0.5	2.4	0.8
Finland	76	-0.1	-1.0	-5.4	-7.7	-0.6	1.0	2.9
France	549	-0.1	-2.8	-1.5	-1.2	0.1	0.8	-0.2
Germany	994	-2.3	-2.2	-2.7	-5.0	-2.6	-1.7	-0.9
Greece	124	1.9	-1.7	-1.6	8.0	-1.1	1.8	-1.4
Hungary	84	-2.0	-1.2	-13.5	10.0	-2.0	2.7	6.2
Iceland	3	1.1			-8.5	-1.6	2.9	
Ireland	65	2.2	-0.6	-11.2	-5.6	3.5	-1.8	5.6
Italy	540	0.4	-1.6	-1.8	0.4	0.4	0.8	-0.4
Japan	1 328	1.0	-1.1	0.7	-2.3	0.1	1.1	-1.9
Luxembourg	6	-6.4	-21.5	-13.8	-1.2	1.0	-11.1	-3.3
Netherlands	218	0.4	-0.3	-2.4	-4.1	-0.2	-0.7	-0.8
New Zealand	76	0.5	5.6	0.3	-3.4	-0.6	-0.9	-1.0
Norway	56	0.9	4.8	-2.0	-7.8	0.9	-3.4	-1.5
Poland	400	-1.5	-3.7	-6.3	15.6	-1.7	-3.0	3.8
Portugal	86	3.1	0.6	1.2	1.9	-0.4	2.0	-1.2
Slovakia	53	-3.6	-2.0	-6.3	-0.4	0.6	0.9	-2.4
Spain	371	2.9	0.1	-1.5	1.9	-0.2	1.0	-0.4
Sweden	71	0.0	1.0	-4.0	-4.1	0.4	-0.9	1.5
Switzerland	53	0.0	-3.8	0.1	-2.5	-0.7	1.9	1.0

Table 11. Greenhouse gas emissions and sectoral indicators (cont.)

	Total GHG emissions		CO ₂ emissions per Kwh electricity	Manufacturing CO ₂ emissions per unit of industrial production	Residential CO ₂ emissions per unit of private consumption	Road transport CO ₂ emissions per vehicle	Electricity use per unit of GDF	
	Level million tonnes		Annual average percentage			ige change		
	CO ₂ equivalent					1990-1998	199	0-1999
United Kingdom	647	-1.5	-4.7	-1.7	-0.7	-0.2	-0.7	-1.6
United States	6 830	1.2	0.2	-5.3	-2.3	1.1	-0.8	1.2
Total of above OECD countries	14 257	0.5	-0.7	-3.1	-1.6	0.1	-0.3	0.1
OECD excluding US	7 428	0.0	-1.8	-2.0	-1.1	-0.6	0.0	-0.6
EU countries	4 048	-0.4	-2.4	-2.2	-2.0	-0.6	-0.2	-0.5
			1				1	

^{1. 1995-1999} for Czech Republic; 1991-1999 for Germany; 1992-1999 for Hungary and Slovakia; no data for Iceland.

Source: GHG National submissions to UNFCCC, national sources and UNFCCC; carbon dioxide data, IEA; industrial production, private consumption, OECD.

^{2. 1991-1998} for Czech Republic; 1995-1999 for Slovakia.

uncertain, experience gained using the infrastructure for the voluntary scheme may help in the implementation of the EU system.

In the transport sector, taxes have been lowered, rather than increased as suggested in the strategy, and policy is now relying on the markedly inferior instrument of capacity constraints to divert traffic to public transport. The goal of the strategy was to hold emissions from transport at their 2001 level for the next twenty years, in contrast to the 18 per cent increase in the previous decade. The plan acknowledged that such a target would require the doubling of motor fuel taxes and proposed more modest increases. In practice, taxes have not been raised; rather in the case of commercial diesel fuel, they have been lowered. As a consequence, the favoured domestic instrument to achieve the goal has become the reduction of expenditure on roads and an increase in the supply of public transport.

Some help in reducing emissions may come from the European voluntary agreement to reduce the average fuel consumption of new vehicles by 25 per cent in the period from 1998 to 2008. This goal could be achieved at an estimated cost to consumers of 500 euros per tonne of carbon abated over the lifetime of a vehicle. In France, vehicle owners would gain from the higher vehicle costs associated with such an agreement as the implicit carbon tax paid on fuels, that will be saved through higher fuel-efficiency, is more than 500 euros and 900 euros per tonne on diesel and gasoline, respectively. Seen as an instrument to reduce emissions, the agreement will lead to over-investment in fuel-saving technology. Indeed, there are other means of attaining France's greenhouse gas objectives, notably by purchasing carbon rights on the international market or via emission reductions in other sectors, such as industry. To rationalise efforts in the transport sector, would require that the tax on gasoline be separated into different instruments dealing with the small remaining air pollution externalities, infrastructure costs and finally the externalities due to carbon emissions. One way to achieve this would be to move to a greater use of charges based on distance travelled (ECMT, 2003). Such charges could incorporate the pollution externalities and user cost charges, while the gasoline and diesel tax would reflect the carbon externalities.

In the electricity sector, the strategy aims at promoting conservation and increasing considerably the share of renewable energy. The strategy, which is also motivated by other energy policy concerns, such as the security of supply, is relatively expensive given the carbon emissions reductions expected. Currently, 17 per cent of electricity is generated from renewable sources, primarily hydroelectricity. This proportion is slated to rise to 21 per cent by 2010 with three-quarters of the increase coming from an expansion of wind power. This form of generation capacity is not suited to reducing carbon emissions from the French electricity system as most of these come from fossil-fuel plants that are used in short periods of high demand. If instead, the objective is to replace base-load

Table 12. Long run marginal costs of power generation

Variation with the pre-tax cost of capital and externalities

Euro cents per kilowatt hour

Pre-tax cost of capital		Overall pr	ivate costs			Externalities	
Pie-tax cost of capital	5%	8%	10%	12%	Carbon	Health	Total
Nuclear power Combined cycle gas	2.8	3.4	3.9	4.4	0.0	0.0	0.0
turbine	4.0	4.1	4.2	4.3	0.2	0.4	0.6
Cogeneration	3.9	4.1	4.2	4.3	n.a.	n.a.	n.a.
Coal	3.7	4.2	4.4	4.6	0.3	2.2	2.5
Wind	3.9	4.5	4.8	5.1	0.0	0.0	0.0

Notes: The following assumptions underly this table:

The nuclear programme consists of ten generators.

The gas price is USD 3.24 per Mbthu.

The coal price is USD 32.4 per tonne.

The capital cost of wind generation plant is EUR 907 per kw.

Study was based on 1995 prices and has been uprated to 2002 prices and concerns baseload electricity.

The exchange rate is USD 1.01 per EUR.

The results for a 10 and 12 per cent cost of capital have been obtained by extrapolation.

Estimates of external costs are taken from Externe and are based on a carbon price of EUR 15 per tonne.

Source: DIGEC (1997).

demand, then it does not appear competitive (Table 12). In addition, in 2001, the instrument used to foster the expansion was changed from competitive bidding for subsidies to the obligation for the public electricity company to purchase all renewable output at a price fixed for the next fifteen years. According to the energy regulator, these tariffs are resulting in returns on investment of up to 20 per cent, well over the cost of capital of these firms (CRE, 2002). The net result of these policies is that, for some 700 megawatts of installed capacity, the additional wind-based electricity will add 0.9 billion euros annually to electricity costs (CGP, 2002) at a cost of 900 euros per tonne of carbon emissions avoided, about 45 times greater than some estimates of the likely price of emissions in the international market.

A further challenge will be to find a market structure that ensures the financial stability of the nuclear industry when the electricity sector is liberalised. One major uncertainty that faces the industry is managing the cost of both end-of-cycle nuclear fuel and decommissioning nuclear power stations. For the former, a decision is needed for a site for long-term storage of waste. As to the latter, no second-generation plants have come to the end of their life and, as a result, actual costs have not been observed. For the existing inventory of plants, these costs are estimated to be equal to 15 per cent of total construction costs an estimate that concords with international concensus for such reactors and that has been confirmed by detailed studies undertaken by EDF. On this basis, the company makes provisions each year to cover the future cost of dismantling its reactors. However,

until recently these provisions have been reinvested in the company, with the result that no separate fund has been accumulated to cover decommissioning costs. ⁴⁸ Given that estimated decommissioning costs are equal to twice the equity capital of the company (net of these costs), small fluctuations in their estimation could have a significant impact on the value of the company. Longer term financial security would be better served by creating a separate fund held in escrow by an institution independent of the electricity company. Progress has been made in this direction as EDF has begun building up a portfolio of dedicated assets. The opening to competition of the electricity market will require a re-examination of the degree of security of these funds, with an eye to finding a mechanism that ensures their availability at the moment when they are called upon.

France's current climate-change strategy relies mainly on domestic measures to reduce greenhouse gas emissions. As the European directive concerning tradable emissions permits is put in place by 2004, the range of options will widen. For France, the tradable permit system would cover between 20 and 25 per cent of national emissions, which should allow for a substantial reduction in the costs of lowering pollution levels. Other than this community-wide measure, which is available only to large industrial firms, the French anti greenhouse gas programme (adopted in January 2000) does not envisage using the system of tradable credits created by the Kyoto accords to help achieve national GHG objectives. As currently constituted, it is unlikely that new measures to reduce domestically produced transportation based GHGs will be able to reverse the growth of these pollutants and, although estimates are not particularly precise, such measures will doubtless be much more costly than the expected future price of international carbon credits. Indeed, partial steps in the right direction would include making greater use of distance based taxation in this area, allowing gasoline and diesel taxes to be aligned on carbon externalities and introducing carbon taxes for air and sea transport, although here international co-operation would be needed.

Reducing water pollution

Clean drinking water is a vital commodity that depends in part on the quality and supply of surface and ground water. Moreover, water is a valuable source of recreation and important input into many economic activities. While pollution from industry and households is broadly in check, excessive emissions from agriculture have pushed water quality below mandated levels in many areas. Besides consolidating past achievements for industrial and domestic sources, the main issue is to find efficient mechanisms to curb discharges from farming.

A range of pollutants can adversely affect the quality of water. This section focuses on four key pollutants, phosphates, oxygen depleting substances, (expressed as biochemical oxygen demand), nitrates and pesticides. *Phosphate* concentrations in rivers have been trending downwards for two decades with the

decline starting earlier in urban areas. Concentration levels are still higher in urban areas than in rural areas. The reduction in concentrations has not led to a fall in algae production (and eutrophication) in rivers, as phosphate concentrations were not always the factor limiting algae growth. In urban areas, a fall in industrial toxic waste has allowed more algae growth, even though concentrations have fallen. However, in rural areas the falls in concentrations have lowered algae production. The biochemical oxugen demand has therefore declined and this has resulted in a slight upward movement in the oxygen content of rivers, with 85 per cent of rivers having enough oxygen to support salmon. Both these improvements are the result of an increase in the number of households connected to primary or secondary sewage treatment facilities (Figure 17), better treatment facilities and a reduction in the use of phosphates in detergents. For nitrates, excessive concentrations have been stable over the past decade at 20 per cent of measuring stations, while for groundwater the proportion has been lower at 10 per cent (Figure 18). High concentrations, relative to the level of nitrates allowed in drinking water, are observed in a number of farming areas. 49 For pesticides, the standards for individual substances were originally set in the 1980s at the lowest level that could then be measured and reflected a desire to eliminate pesticide concentrations in drinking water.⁵⁰ These limits were confirmed and even lowered for four pollutants in 1998. Judged by this standard, only 4½ per cent of surface water is unpolluted, although here EU objectives are less strict calling only for "good ecological status". Indeed, less than 7 per cent of water contains a level of pesticides that precludes its use in the domestic water supply (five times greater than the minimum level). In addition, French and EU legislation each impsose an overall limit on pesticides in drinking waters.

Policies to address emissions are based on regulation and subsidisation, rather than economic instruments. Livestock farmers are required to have sufficient storage capacity to stock animal slurry during the year until the optimal time for application. Farmers have been encouraged to build storage facilities by large subsidies. The high cost of this programme, more than double initial estimates, and concern that the programme might be considered as an illegal state aid, have led to a reduction in subsidies that are henceforth only to be paid in areas at risk of nitrogen pollution. Moreover, in areas classified as at risk from nitrate pollution – half the country according to EU definitions – the annual input of nitrogen per hectare (from organic and inorganic sources) has been capped at 200 kg per hectare, slightly above the level set by EC directives. However, little enforcement has ensued and only a few of the farmers who exceed limits have been brought to court.

Some limited use has been made of pricing to reduce emissions of nitrates and pesticides. Large livestock units are subject to tax on the amount of pollutants produced based on the average estimates of emissions for different types of animals. However, the tax bill is reduced depending on agricultural practices, with the

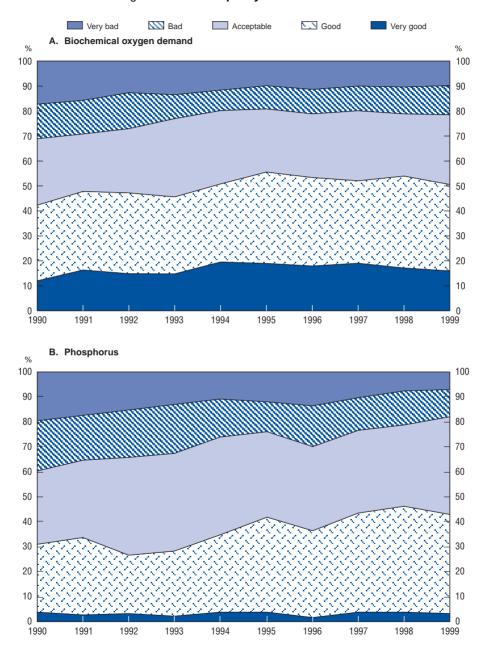


Figure 17. Water quality of rivers and streams

Source: Data from Agences de l'eau - RNDE computed by IFEN, BNDE.

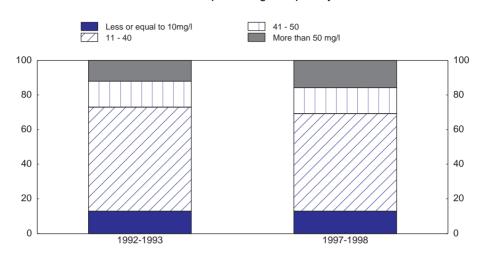


Figure 18. **Nitrates in underground aquifers**Share of aquifers at given quantity

Source: Ministère de l'Aménagement du Territoire et de l'Environnement (DE). Ministère de l'Emploi et de la Solidarité (DGS). IFEN, September 2000.

result that tax payments are not related to emissions (MINEFI, 2001). The share of agriculture in total payments of the water pollution tax was only 4 per cent in 1998. To ensure that the cap on fertiliser application is respected, farmers are offered agronomic advice on the desirable use of nitrogen inputs. This is unlikely to remedy a problem that does not stem from a lack of information but from the absence of internalisation of pollution costs.⁵² On the other hand, pesticides have been taxed in line with their toxicity since January 2000 – in contrast to the regulatory limits on pesticides that take no account of the relative toxicity of different pesticides. Preliminary assessments suggest that this tax is reducing the use of the most dangerous products, but not by enough to stop the build up of pesticides in aquifers (CGP, 2001). However, the most commonly present pesticide (triazin) is being banned in 2003. There is also a tax on detergents that varies according to their phosphate content.⁵³

While taxes are an efficient instrument to reach a given goal, objectives for water policy have been set without adequate cost-benefit analysis. This is particularly the case for nitrates where large investments have been made in drinking water treatment, whereas research suggests that in France the environmental impact of this pollution is the more serious problem and the area where the largest potential benefits are to be found. (Miquel, 2003). Here, wider use of economic instruments such as mandating economic analyses and pricing based on cost-recovery principals,

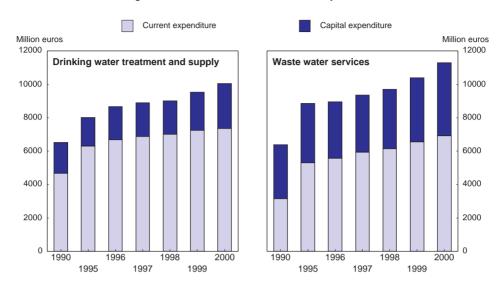


Figure 19. Financial costs of water pollution

Source: IFEN.

as called for in the 2000 EU Water Framework Directive, as well as taxation in line with environmental costs would help improve the efficiency of environmental efforts.

The water treatment and distribution industry is spending increasing amounts both on reducing their discharges and on treating water to ensure it conforms with norms (Figure 19). The cost of drinking water distribution and wastewater are almost entirely borne by users, with metering almost universal (Rideau, 2002). However, cost-recovery pricing of water provided by public distribution systems for agricultural irrigation is much less developed than for domestic and industrial users. A tax on the discharge of pollutants into rivers and lakes is paid to the regional water agencies. However, these taxes are based on average pollution intensities for different products in a given industry. Consequently, investments that reduce the pollution intensity of a given plant do not, in general, result in a decline in the tax to be paid by the polluter.⁵⁴ Equally, the tax paid by wastewater treatment plants depends not on actual discharges but on average national emissions per household. If plants meet regulatory norms, then a rebate of the tax is paid. Livestock farmers are subject to the pollution tax but paid only 4 per cent of the total tax yield in 1998. The pollutant tax is subject to a number of drawbacks. The fundamental incentive effect of the tax has been lost, as there is little link between actual emissions and the amount of the tax paid. In addition, the national structure of the pollution tax means that there is no incentive to concentrate

abatement investment in the areas where the consequences of the pollution is the greatest. Finally, even with the limited need to measure actual emissions, almost two-thirds of the revenue raised by the pollution tax is absorbed by administrative and monitoring costs (Iteris, 2003). The regional water agencies use part of their revenues to subsidise investments to reduce pollution. However, the agencies appear to give little weight to the relative effectiveness of different anti-pollution investments. Rather the subsidies appear to be paid in order that, in the long-run, each local authority receives subsidies in line with tax payments (Commissariat général du plan, 1997).

The cost of complying with drinking water quality standards has been high. Given the mandated levels of concentrations of certain chemicals in water, more effort is required to dissuade the original emission of such pollutants. A first step would be to enforce existing legislation on the application of fertiliser more effectively, especially in areas where nitrate concentrations are high. In addition, a means of applying an effective tax to reduce excess fertiliser application needs to be found. It would need to have low administration costs and to be applied ideally only in those areas where excess nitrates are a severe problem. For non-farm forms of pollution, the current tax system does not generate a sufficiently clear link between actual discharges and the amount of tax that is paid. As a result, the fundamental reason for implementing the tax, to provide a price signal for decentralised decisions about investment in abatement control, is absent. Moreover, such welfare gains from reduced pollution have to be set against the high administrative costs of this tax. Price signals also ought to be strengthened in the area of pesticides and phosphates. Finally, well-founded estimates of the public health and environmental benefits that would flow from reductions in the nitrate, phosphate and pesticide concentrations in water are needed, otherwise pollution tax rates cannot be set at efficient levels.

Summary

France has made or is introducing a number of reforms that should improve the operation of the economy and which should help contribute to raising both the level and rate of growth of potential output. Nevertheless, more needs to be done. Table 13 summarises the evaluations made both in this and previous Economic Surveys of various aspects of structural policy, progress that has been made since and the OECD's current evaluation of policy in these areas.

The preceding paragraphs have emphasised the changes required to raise younger and older workers' employment rates. For youth, measures such as expanding access to the pension system, ensuring that the relative value of the SMIC returns to earlier levels all work seek to better align the cost to firms of hiring inexperienced and sometimes unskilled younger workers with their productivity levels. They do so by providing them with work experience that raises that

Table 13. (Overview o	fprogress	in structural	reform
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Previous recommendations	Measures since the last Survey	OECD comments
I. Labour market		
Reduce wage costs for unskilled labour Reassess the level of the SMIC minimum wage. Index it on consumer prices instead of wages.	11.6 per cent in real terms over 3 years in an	Restrict increases in SMIC to inflation following harmonisation so as to realign it with average wages and promote demand for low-skilled workers.
	has been increased and made available to part-	Continue efforts to make the activation efforts of the public employment service more effective Making acceptance of a job offer under the RMA a condition for benefit would help.
	term unemployed get gainful employment. The issuance of youth employment (emplois-jeunes) contracts has been ceased and replaced with increased assistance to private-sector firms hiring unemployed youth with low educational qualifications. Various forms of abatements on	Continue to give priority to measures that increase the employability of the jobless in the market sector. Extend the scope of on-the-job training programmes.
Continue to scale back early retirement schemes, which deprive the economy of experienced workers. Make the definition of "arduous" jobs more precise.		Continue the reform of early retirement and eliminate recourse to the unemploymen insurance system as a form of subsidised early labour-market withdrawal.
Simplify the administrative regulation of the labour mark Ease the restrictions on the renewal of fixed-term contracts. Introduce 5-year fixed-term contracts.		Make these changes permanent. Pursue effort to revise the "contribution Delande". Reduce the disparity of the conditions imposed on fixed and indefinite-term contracts.
Enhance active labour market policies Evaluate active labour market policies on an ongoing basis.	follows up on the labours market performance	Pursue efforts to make results transparen particularly as concerns the analyses of the strengths and weaknesses of schemes and prescriptions for further reforms.

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Table 13. Overview of progress in structural reform (cont.)

Previous recommendations	Measures since the last Survey	OECD comments
Make the shift to the 35-hour week more flexible The application of the 35-hour work week to SMEs needs to be made flexible.	The overtime contingent was increased by 20 hours and the related overtime premium reduced.	Consider eliminating overtime premia for first four weekly over time hours.
II. Product market competition		
Enhance competition in network industries.	sector have been transcribed into French law.	
Improve governance of state-owned firms and speed up privatisation.	<i>l'Etat</i> , APE) has been created with a view to improve the management of state commercial	Break the linkages between State-owned firms and their ministry-owners and make the APE more independent of the State bureaucracy. Speed sales of state assets, including minority stakes and use proceeds to reduce debt.
Apply regulations that protect consumers and ensure supply security in a pro-competitive manner.		Apply this approach to opening up all network
Relax rules governing large and medium-sized stores.	The authorities are considering amending rules of the so called Loi Galland that distorts the way large retail companies set prices.	Relax zoning and price competition rules so as to permit savings from economies of scale to be passed on to consumers.
Increase the legal and material resources available to the competition authorities.		Give the Competition Council the means to take up anti-competitive practices on its own initiative. Extend these prerogatives to areas where competition is restricted because of public service responsibilities.
III. Policies to favour firms creation and expan	sion	
Support to the creation, financing and efficiency of small and medium enterprises.		Continue to support the reduction of administrative complexity by extending one-

firms to capital and expertise.

improve access of small and medium sized stop internet solutions for registering a new

business.

Table 13.	Overview o	f progress	in structural	l reform ((cont.)
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Previous recommendations	Measures since the last Survey	OECD comments
	Measure have been undertaken to increase incentives for innovation, including the establishment of network of industrialists and research laboratories.	Ensuring that a certain proportion of revenues from licenses goes directly to the discoverers.
IV. Taxation		
contributions.		Bring corporate income tax rates down towards the European average also with an eye to making the tax treatment of small and medium enterprises more neutral.
Abolish expensive to collect taxes	None.	The cost of collecting certain quasi-taxes remains excessive in relation to the proceeds (e.g. the television licence fee). Do away with them.
Reduce taxation for people with middle and high incomes.	The marginal rate of income tax has been lowered.	Overall tax burdens are still excessive for certain categories of income. The health insurance contribution should be subject to a ceiling.
V. Pensions		
schemes by introducing forms of collective capitalisation or employee savings schemes. Promote actuarially neutral methods of pension calculation.	pay-as-you-go but which opens up new opportunities for private savings. The authorities have proposed to introduce a	Increase collective savings to fund future pensions expenditure. Use privatisation revenues to build up pension reserve fund. An actuarially neutral early retirement scheme could be used to replace subsidised schemes operated by the UNIDIC and the State.
Ensure greater equity between public and private pension schemes.	The authorities propose raising contribution	Implement proposals but also take steps to reduce the implicit subsidy of civil servan pensions by raising employee contribution rates

the recommendations that follow from that are presented in a special Recommendation Box at the end of that Chapter.

VII. Environment

Better align environmental taxes with costs of None externalities

Implement the recommendation

Table 13. Overview of progress in structural reform (cont.)

Previous recommendations	Measures since the last Survey	OECD comments
Subject diesel fuel to a similar tax treatment as petrol.	None	Ensuring such a treatment appears reinforced by that the persistent difference between petrol and diesel tax rates is unjustified both from the point of view of greenhouse gases and other pollutants.
Increase tax levels on emissions from sea and air transport.	None	Currently, sources of greenhouse gasses are undertaxed. Accelerate international discussions to introduce environmental taxes on fossil fuels used for these purposes.
Introduce a tax or cap and trade scheme for greenhouse emissions in a revenue neutral manner.	The authorities are pursuing voluntary agreements	Closely monitor voluntary agreements to ensure effectiveness, consider introducing a tax or making use of tradeable permits. Ensure that voluntary agreements are based on independently determined reference scenarios.
closely to the cost of externalities and ensure		Where costs remain excessive policies need to be reshaped. Ensure a central role for permit trading at the EU level.
Increase intra-governmental coordination to reduce urban traffic levels.	been created	explicit traffic and pollution objectives.
Introduce tolls to limit peak-period traffic levels in major urban areas.	None	Implement the recommendation.
Implement tax on excess nitrogen.	None	Implement the recommendation. The tax should be differentiated by zone as a function of environmental risk.
Cease attributing the revenues from water to finance local depollution efforts.	None	Implement the recommendation with a view to ensuring that taxes are better aligned to externalities to externalities provoked and subsidies allocated.
Enforce existing regulations concerning nitrogen inputs.	None	Implement the recommendation.

 Table 13.
 Overview of progress in structural reform (cont.)

Previous recommendations	Measures since the last Survey	OECD comments
Subject agricultural nitrogen inputs to taxation.	None	Implement the recommendation taking into account that at present tax levels on nitrogen content of commercial fertilisers are much lower than the environmental cost that their use imposes
Reform regulatory limits on pesticides and adjust tax rates in line with toxicity	None. Current regulations do not distinguish adequately between the toxicity of different pesticides.	1

Source: OCDE.

their productivity and by temporarily reducing the costs and risks that firms must undertake in hiring such workers.

For older workers, policy needs to focus on eliminating the substantial financial incentives which encourage firms to layoff older workers, which is the principle reason for low employment among those 55 to 60. In so doing, it needs nevertheless to recognise the real problems faced by older workers who are unemployed. Here instead of subsidising their non-employment, policy should consider subsidising their employment – perhaps by affording similar financial incentives to firms that hire unemployed older workers as those currently provided for hiring younger workers. Moreover, in order to help older workers maintain their skills at high levels, training and requalification programmes need to be elaborated and made available.

For workers that have reached retirement age, policy needs to eliminate the perverse features of existing retirement schemes that destroy all financial incentive to continuing work after age 60 (with 40 years contributions). Current reform proposals go in this direction and should be implemented, although even more flexibility could be imagined. Indeed, an actuarially neutral treatment of pension benefits for those that retire early, along the lines of the one currently being proposed could be combined with a reduction in early-retirement programmes to ensure that older workers that do lose their jobs have a satisfactory income. Such a reform would be all the more attractive if complemented by the possibility to simultaneously work and collect a pension.

At the firm level, several policies have been announced to reduce red tape and increase the effectiveness with which technology is diffused towards firms. These reforms go in the right direction and should probably be reinforced. Reform to tax policy would also likely help contribute to improving economic performance. High corporate and income tax rates likely influence investment decisions, while rigid employment protection legislation may work to the disadvantage of small and fast growing firms. Similarly, the authorities privatisation programme needs to be accelerated with proceeds being used to pay down debt or build up the pension reserve. In particular, the State should disengage itself from large partially privatised firms, like France Telecom and Air France, where its continuing presence, which effectively prevents foreign firms from purchasing these companies, is perceived as introducing an element of unfair international competition.

Finally, in order to assure the long-term sustainability of growth, policy needs to come to terms with a number of environmental issues. On climate change, efforts should seek economic instruments to increase the likelihood that the current strategy of voluntary agreements will achieve the country's emissions targets. In this regard, efforts may need to be concentrated at the *supra* national level. Current policies to promote wind-generated energy sources appear to be un-economic and GHG objectives might be better pursued through the use of

trading permits. As concerns water pollution, policy needs to deal more forcibly with the problem of nitrate pollution from agricultural sources, partly by enforcing existing rules and partly by introducing dissuasive taxes. For pesticides a more disaggregated regulation is required, which distinguishes between the toxicity of different molecules and which imposes concentration limits more in line with levels considered harmful.

III. Public expenditure management

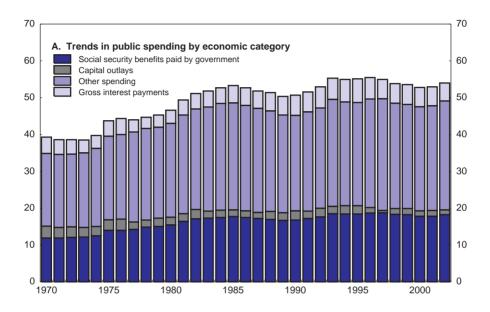
The past 50 years have seen the role of the public sector change dramatically in France. As the economy grew and society became richer, the public sphere took on increasing responsibility for providing services to the population. For the most part, responsibility for administering the delivery of these services has been delegated to the social partners and sub-national levels of government. As a consequence, the share of the State Budget in total spending has decreased in line with the increase in government expenditure. These developments reached a point in the 1990s where the taxes required to pay for all of these programmes was increasingly recognised as having reached unacceptably high levels. This, plus the growing awareness that the ageing of the population would put substantial additional demands on the public purse (while at the same time slowing the pace of economic growth), appears to have brought the course of public expenditure in France to a turning point. For several years now the authorities have sought to control the expansion in government spending, with limited success. This chapter examines the tools available to the authorities to manage public expenditure, with a view to recommending reforms that will simultaneously help preserve fiscal sustainability and allow society to enjoy the high level of public services to which it has been accustomed.

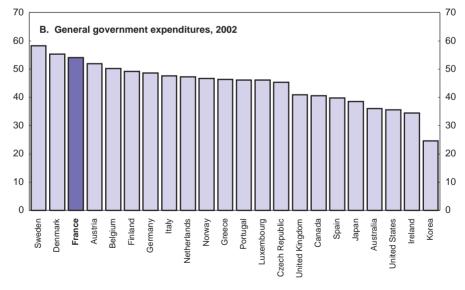
The remainder of this chapter is organised as follows. A first section situates public expenditure both internationally and over time. It is followed by a short description of factors likely to influence public spending over the next several decades. A brief description of the institutions of public expenditure in France and the budget process is then followed by a longer section outlining areas where policy reform might improve the capacity of existing institutions to respond to tomorrow's challenges. A final section summarises the recommendations of this chapter.

Spending in international comparison

At the beginning of the 1970s total general government expenditures in France were equal to 40 per cent of GDP (Figure 20, Panel A), 8 percentage points higher than the OECD average at that time but close to the average of current-day

Figure 20. **Public expenditure**Per cent of GDP





Source: INSEE and OECD.

EU countries. During the following decades they increased rapidly, peaking at about 55 per cent by the mid 1990s. 55 Most recently, the share of public expenditure in output has stabilised (on a cyclically adjusted basis), although at 54 per cent of GDP, it is still the third highest in the OECD, 16 percentage points higher than the OECD average and 8 percentage points above the European Union average (Figure 20, Panel B). To a certain extent this comparison is influenced by the fact that some countries provide health, education and pension services through the private sector, whereas these are provided by the general government in France. Indeed, France spends the fifth highest share of GDP on merit goods (government services), with relatively high expenditure shares for education, health, services for the elderly and other family services (Table 14). However, even after excluding such spending France's public expenditure share remains one of the highest in the OECD (seventh).

The increase in spending mainly reflects rising primary expenditures (total spending less interest payments), which increased by 12 percentage points over the period in question to 50 per cent of GDP in 2002. More than half of the increase represents growing transfers, both as a result of rising unemployment and an expansion of both the coverage of and replacement rates in the social security systems (Figure 21). From a functional point of view, France spends more than any other OECD country on income transfers, with disbursements on old age and survivors' pensions and unemployment among the highest in the OECD. Currently, 62 per cent of French citizens live in households that receive at least one social benefit⁵⁶ (Marlier and Cohen-Solal, 2000). Including pensions, raises this ratio to 80 per cent.

As the role of the government expanded, public-sector employment also grew, from 3.7 to 5.9 million between 1970 and 2002, when it represented 24 per cent of total employment. As a result, the government wage bill yielded the second largest increase in spending shares, representing about one third of the total increase over the period. As deficits accumulated and interest rates rose, debt servicing charges also picked up, although during the 1990s these have declined both as a result of reduced debt levels and lower interest rates. National accounts data suggest that France spends about 1.3 per cent of GDP on subsidies of all sorts although if tax expenditures were included, this would be much more.

The challenges ahead

As elsewhere in the OECD, the ageing of the population will significantly determine both the nature of public expenditure and France's ability to finance it over the next several decades (see Chapter I). During the next 30 years, the population over 65 years of age is projected to increase by almost 75 per cent, while the working-age population (15-64) will be broadly stable or decline.⁵⁷ As a result, the old-age dependency ratio is expected to increase from about 2.4 workers per

Table 14. **Major current government outlays** 1999, per cent of GDP

	Merit goods						Income transfers ²						
	Total	Education	Health	Services for the elderly disabled people	Family services	Total	Old-age pension	Survivors pension	Disability	Sickness	Family cash benefits	Unem- ployment	
Australia	10.9	4.3	5.4	0.8	0.4	10.2	4.0	0.2	2.1	0.0	2.2	1.5	
Austria	13.8	6.0	5.8	0.9	1.1	19.0	9.9	2.9	2.3	0.2	1.9	1.4	
Belgium	11.4	5.0	6.1	0.1	0.2	18.1	7.3	2.5	1.7	0.4	2.0	3.8	
Canada	12.1	5.5	6.6			11.2	5.0	0.5	0.9	0.1	0.8	1.4	
Czech Republic	11.1	4.1	6.5	0.5		12.7	6.7	0.9	1.8	0.9	1.6	0.5	
Denmark	18.8	6.8	6.8	3.0	2.2	17.8	6.8	0.0	2.0	0.7	1.5	5.0	
Finland	14.0	5.7	5.3	1.5	1.4	18.3	7.0	1.0	3.1	0.4	1.9	3.9	
France	15.0	5.9	7.3	0.7	1.2	19.7	10.6	1.6	1.1	0.5	1.5	3.1	
Germany	13.7	4.4	7.8	0.7	0.8	18.0	10.5	0.5	1.4	0.3	1.9	2.6	
Greece	9.1	3.4	4.7	0.3	0.7	16.9	10.2	2.0	1.1	0.8	1.2	0.7	
Iceland	16.8	6.5	7.0	2.1	1.1	8.2	3.8	0.5	1.5	0.1	1.2	0.5	
Ireland	9.5	4.3	4.6	0.4	0.2	10.6	2.5	0.9	0.8	0.7	1.6	2.9	
Italy	10.8	4.8	5.5	0.2	0.3	19.1	12.8	2.6	1.0	0.7	0.6	1.4	
Japan	9.8	3.6	5.6	0.3	0.3	8.4	5.7	1.1	0.5	0.1	0.2	0.7	
Korea	6.7	4.1	2.4	0.2	0.1	3.3	1.9	0.2	0.4		0.0	0.6	
Luxembourg	6.3		5.4	0.5	0.4	15.2	7.8	0.9	2.4	0.7	2.3	0.8	
Mexico	6.3	4.1	2.0	0.0	0.1	6.0	4.7	0.1	0.1		0.0	0.1	
Netherlands	12.1	4.5	5.9	1.3	0.4	16.1	6.2	0.8	2.4	1.0	0.8	3.9	
New Zealand	12.3	6.0	6.1	0.0	0.1	13.8	5.2	0.1	1.5	1.3	2.4	2.2	
Norway	18.6	6.8	7.1	3.4	1.4	15.2	6.0	0.4	2.8	1.5	2.2	1.4	
Norway (using													
mainland GDP)	21.5	7.8	8.2	3.9	1.6	17.6	6.9	0.4	3.3	1.7	2.6	1.6	
Poland	10.2	5.3	4.6	0.2		18.4	8.1	2.1	4.8	1.1	0.9	1.0	
Portugal	11.3	5.6	5.1	0.3	0.3	12.5	6.3	1.4	1.9	0.5	0.6	1.6	
Slovak Republic	0.5			0.4	0.1	13.3	5.3	1.0	2.0	1.2	1.8	0.8	
Spain	10.2	4.4	5.3	0.3	0.1	13.9	8.1	0.8	1.3	0.9	0.3	2.2	
Sweden	18.6	6.6	6.6	3.7	1.7	18.9	7.5	0.7	2.4	1.1	1.6	3.9	
Switzerland	13.9	5.4	7.7	0.7	0.1	19.9	11.2	1.4	2.9	0.5	1.2	1.8	
Turkey	8.2	2.9	5.0	0.1	0.1	9.1	5.1	1.2	0.2	0.0	1.0	1.0	
United Kingdom	11.6	4.6	5.6	8.0	0.5	17.8	9.8	1.0	2.7	0.1	1.7	0.6	

Table 14. **Major current government outlays** (cont.) 1999, per cent of GDP

	Merit goods					Income transfers ²							
	Total	Education	Health	Services for the elderly disabled people	Family services	Total	Old-age pension	Survivors pension	Disability	Sickness	Family cash benefits	Unem- ployment	
United States	11.0	4.8	5.8	0.0	0.3	8.2	5.1	0.9	0.9	0.2	0.2	0.4	
OECD average ³	11.5	4.7	6.0	0.4	0.4	12.3	7.0	1.1	1.2	0.3	0.8	1.2	
EU average ³	12.8	4.9	6.4	0.7	0.7	17.9	9.9	1.3	1.6	0.5	1.4	2.3	

^{1.} Or 1998 when not available. Education data always concern 1998.

^{2.} As indicated in Adema (2000) the interaction of the tax and benefit systems complicates the interpretation of the relative generosity of these transfers, as benefits are taxed in some countries but not others.

^{3.} Weighted average based on 1995 GDP and purchasing power parities (PPPs), excluding Korea, Luxembourg, Mexico and the Slovak Republic and using Norway total. Source: OECD, Social Expenditure Database and OECD, Education at a Glance, 2001.

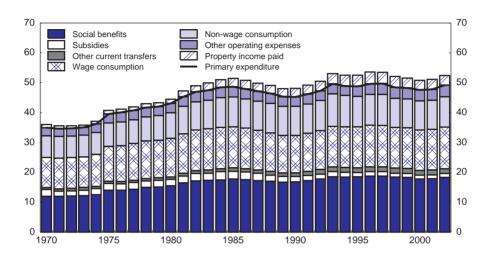


Figure 21. General government primary expenditure by economic category

Per cent of GDP

Source: INSEE and OECD.

person over 65 to 1.5 workers in 2030 and 1.3 workers by 2050. Taking into account the high incidence of early retirement and the official retirement age of 60, the ratio of workers per retiree is expected to decline from 2:1 to 1:1 by 2030. In the absence of reforms to the pension system, ageing is expected to increase the pension system's funding shortfall by 8 per cent of GDP. Even assuming substantial improvements in labour force participation and unemployment rates, rising pension expenditures are expected to increase the deficit by 4.7 per cent of GDP (COR, 2001). Meanwhile, even if age-specific health expenditures rise only as fast as GDP, the purely demographic impact of ageing on health costs would be 1.9 per cent (Economic Policy Committee of the European Union, 2000) between now and 2050. If recent health cost trends were to persist this projected deficit would be very much larger.

The challenge of ageing for the state as an employer is even more acute. Over the next 15 years some 900 thousand workers are expected to retire or 41 per cent of State-sector workers.⁵⁸ While this outflow represents a substantial opportunity to restructure the civil service by not replacing retirees in low priority areas, overcoming insider's opposition to any reduction in their numbers will not be easy.

If France is to make a successful transition to this more constrained fiscal environment, it is essential that policy makers develop tools that permit all areas of public expenditure to share the burden of creating the necessary fiscal room. Given

the State Budget's shrinking share in total spending, it will be impossible to meet the spending pressures of the next several decades unless social security and subnational spending are restrained. Moreover, in order to prevent vested interests from blocking necessary reforms, efforts need to be made to clarify the roles of the State and the Social Partners in the governance of the Social Security system. In this regard, recent experience during which several reform efforts were withdrawn following widespread popular protests is not promising. The kind of extended consensus building that has preceded current efforts at pension reform might represent a model for the future, but its success has yet to be demonstrated. Whatever mechanism is used to achieve agreement, the need to avoid gridlock in the future is essential if authorities are to be able to make the sometimes difficult choices that will need to be made.

Finally, the ongoing reform of the State represents an important challenge. In this regard, the implementation of the new framework law for the State Budget (Loi organique relative aux lois de Finances, LOLF) will be difficult. Reorienting the focus of the State Budget process towards outputs and policy objectives rather than just on the inputs into public service delivery involves substantial changes in "corporate" culture, which experience from other countries suggests are not easy to achieve. Here, the phase-in of new procedures by 2005 represents an ambitious schedule. Ultimately intangible factors impacting on the degree to which the spirit rather than the letter of the law is adopted and implemented may determine the extent that this innovation succeeds in increasing the efficiency with which public services are provided. Similarly, the results of the authorities' initiative to decentralise service provision and improve the matching between the financial and administrative responsibilities underlying programme delivery will determine to what extent the efficiency with which services are delivered can be increased. Moreover, if such steps are to help create fiscal room, mechanisms to ensure that savings are not spent elsewhere will need to be found.

Budgetary processes and arrangements across levels of government

France is a unitary state, which nevertheless has several levels of subnational government (*collectivités territoriales*): these include 36 763 municipalities (*communes*), 100 departments and 26 regions (Table 15). In addition, the state has some 1 400 extrabudgetary institutions, with activities ranging across commercial, educational and cultural domains (Box 7). While the municipalities and departments date back to the French Revolution, the regions were created in the mid-1980s. From the point of view of expenditure, the general government is comprised of the state budget, these sub-national groupings and various extrabudgetary funds principally concerned with social security. Overall the State budget represents only 37 per cent of general government expenditure, while extra budgetary funds represent 45 per cent. The remaining 19 per cent is accounted for by the activities of sub-national governments (Figure 22).⁵⁹

 Table 15.
 Organisation of the public sector in France

Public sector	General government	Central government	State	Directions d'administration centrale (Central administrative directorates) and Services à compétence nationale (Administrations under national competence). The main responsibilities of the Directions are analysis and projections of public needs; draft of regulations and laws, including the Budget; management, co-ordination and supervision of the local administrative branches of the state; evaluation of the impact of public policies impacts. The responsibilities of the services à compétence nationale are: the legal system, management of National museums, the fight against illegal immigration, and production of specialised studies. They also ensure the provision of numerous operational services. Services déconcentrés de l'État (local services of the state) are the purview of the préfets (prefects) who are directly appointed by the government. They are responsible for the implementation of all national civilian policies (education, culture, agriculture, etc.), and for police.					
			Other entities of the central government	Établissements publics à caractère administratif, EPA (public agencies with a service and administrative vocation), i.e. the securities commission, the national school of administration (COB – Émissions des opérations de bourse, ENA – École nationale d'administration, etc.). Établissements publics à caractère scientifique et technologique EPST (public agencies with a scientific and technological vocation), i.e. the CNRS, national research institute, etc). Établissements publics à caractère scientifique culturel et professionnel, EPSCP (universities, national museums, etc.).					
		Regional and local governments	Local administrations	They include municipalities (communes), departments (départements), regions (régions and various entities responsible for local co-operation initiatives.					
			Other local entities	Locally financed non-market entities (for example, primary and high schools, Chambers of commerce, etc.).					
		Social security	Social insurance schemes	They include 37 mandatory schemes, or régimes, each managing at least one of the following classes of risks: healthcare (both medical treatments and wage replacing per diem sickness benefits); retirement and survival (including complementary regimes); family and maternity; housing benefits; poverty and social exclusion. In addition, the special financing funds (FSV, FFR, etc.) are included. Though administratively and financially more independent, the UNEDIC (Union nationale inter-professionnelle pour l'emploi dans l'industrie et le commerce), which is responsible for unemployment insurance, is also part of the social insurance system in the national accounts classification.					
			Entities administered by the social insurance schemes	Example, public hospitals.					
	Large publicly owned enterprises	RFF, railways infrastruct Poste, EDF/GDF, energy agencies with an industr	network. These en	r service, ADP, Parisian airports, RATP, Paris public transport network, France Telecom, La trerprises have status of Établissements publics à caractère industriel et commercial, EPIC (public al vocation).					

Source: OECD.

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Box 7. Fiscal relations between levels of government

In France, both the central government and the local authorities comprise several levels of governments (see Table 15).

Central government

The central government operates at three levels: central services, local services of the central government (services déconcentrés de l'État), and Public establishments (établissements publics de l'État). Overall, State employees represent 73 per cent of all public-sector employees with most of them employed at the level of administrative districts.

The central services are provided by and operate under the direct authority of Ministers, deputy Ministers and State Secretaries, and mainly provide technical support functions.

Local state services are provided by administrative districts (circonscriptions administratives), which differ from the local governments (collectivités territoriales, see below) in that, while the former are run by prefects, who are directly appointed by the government, the latter are autonomous entities, administered by locally elected assemblies.

The prefects channel all relations between the state and the local authorities. They have the power to review local government by laws and are responsible for the implementation of all national civilian policies (culture, agriculture, etc.) and the police. In addition, they help monitor the application of national regulations and community services. Finally, they can order modifications to sub-national budget proposals if they do not comply with budgetary rules. In municipalities, however, for certain functions, such as those concerning vital statistics, the state is represented by the mayor.

Public Establishments (of which there are 1 400) are moral persons placed under separate public code. Although they enjoy a certain degree of financial and managerial autonomy, they report to at least one ministry which appoints the management, supervises strategic decisions and decides upon the allocation of subsidises. There are different kinds of Public Establishments involved in activities like education, R&D, cultural promotion, social protection and solidarity, work and employment, construction, urbanism and environment. These activities are all part of the general government. A wider definition of the public sector also comprises a number of large publicly owned enterprises involved in public transport, the postal network and energy.

Local governments

There are also three levels of local governments: municipalities (communes), departments (départements), and regions (régions).

The municipalities are responsible for local matters such as town planning, municipal infrastructure, subsidised housing, local public services (waste treatment,

Box 7. Fiscal relations between levels of government (cont.)

water, public transport, lighting), health and social services, education (operation of primary public schools, their construction and their maintenance), cultural affairs (museums and theatres), security, public order, hygiene, aid to employment and to business (subject to EU competition rules).

The departments focus mainly on departmental roads and the management of everyday affairs, such as welfare benefits, health care benefits, job placement for the unemployed, secondary education, local transports.

Finally, the regions, are mainly responsible for land-use planning and economic development: vocational training; secondary education; rail and waterway transport; and aid to development.

In its role as the administrator of the local governments' receipts, the State collects local taxes, a mission that it accomplishes relying upon its own information network. While the State is committed to provide local governments with the full extent of the budgeted revenue envelope it does this at a fee. Own local tax receipts still represent a small proportion of total local tax revenues.

37% Central government
45% Social security

19% Local administration

Figure 22. Expenditure shares by level of government 2001

Source: Ministry of Economy, Finance and Industry and OECD.

The State budget

The State budget is annual, although the obligation to produce a three year budget projection in the context of the Stability and Growth Programme has introduced a multi-year element to the process. The elaboration of the Budget begins the year before with the closing of the previous year's accounts. The Ministry of Finance (Ministère de l'Économie, des Finances et de l'Industrie, MINEFI) proposes to the cabinet a very aggregated budget based on a preliminary set of spending priorities and a macroeconomic framework (Table 16). Documentation is streamlined and focuses on functional priorities, rather than detailed spending chapters. Once the broad lines of the budget are approved by the cabinet, including global revenue and expenditure envelopes, the Ministry of Finance proceeds to elaborate a more detailed budget, negotiating with line ministries and the cabinet concerning allocations between ministries (cadrage budgétaire). Once approved by cabinet, this draft budget (Projet de loi de finance, PLF) is presented to parliament – no later than early October.

The Budget itself is relatively detailed and is supported by a variety of additional documents, the so called *bleus* and *jaunes* (blue and yellow papers), which are appended to it. The *jaunes* are usually distributed after the PLF but early enough to contribute to parliamentary discussions. They consist of policy oriented discussions of various topical issues. Thus, in 2003, areas covered included the social role of the state, national defence, and audio-visual broadcasting policies. The *bleus* are distributed with the PLF and provide technical information concerning:

- the macroeconomic forces shaping the government's economic forecast;
- expected fiscal and quasi fiscal revenues (including tax expenditures), distinguishing between revenues based on unchanged policies and the impact of new measures;
- transfers and earmarked revenues allocated to specific extra budgetary funds:
- separate annex budgets for six entities dependent upon the state, most notably that of agriculture social fund (Budget annexe des prestations sociales agricoles, BAPSA);
- finally, an outline of expenditures by individual chapters (of which there are 840), each one distinguishing between pre-existing and new spending appropriations.

Parliamentary debate of the budget passes through three readings and must be completed before the 31st of December. Historically, Parliament has had only very limited powers to amend the Budget. With the introduction of a new framework law in 2001 (see below), Parliament may now propose amendments to spending within Budgetary missions (large areas regrouping government objectives) but not between them. As a consequence, it cannot revise the total level of

 Table 16.
 Preparation of the State budget

Phase	Reference period	Objectives	Actions undertaken
A. Global budgetary s	trategy		
Projections	December (n-2) -mid March (n-1)	To finalise multiyear (n+3) budget commitments with the European Commission based on expected macroeconomic developments; To review budgetary needs for the year n on the basis of current policies (budgets de reconduction).	Multiyear budget programme prepared jointly by the Forecasting Directorate (Direction de la Prévision) and the Budget directorate (Direction du Budget) and sent to the European Commission; Sectoral divisions of the Budget Directorate prepare sector specific spending dossiers for the year n. Budget Directorate transmits a budget summary note to the Economy Minister.
Framework letter (Lettre de cadrage)	Mid March-mid April	To set out budgetary policy for the year n in light of the announced macroeconomic projections.	Inter-ministerial debate After consultation with the Minister of Finance, the Prime Minister signs a framework letter and sends it to line Ministries
B. Budget definition			
First stage	Mid April-May	To allow Ministries to express and discuss their priorities; To allow the Direction du budget to evaluate such priorities in light of the government's global priorities.	Ministries' representatives meet with the Budget Directorate's vice-directors who are responsible for a negotiating specific budgetary allocation issues (Conférences budgétaires).
Arbitration (Arbitrage)	June	To set out a list of unsettled spending issues; To eliminate as many elements of disagreement as possible.	Based on the of the outcomes of the Conférences budgétaires, the Budget directorate transmits an arbitration document (dossier d'arbitrages) to the Finance Minister; The Minister of Finance discusses unsettled issues bilaterally with the other Ministries.
Ceiling letters (Lettres-plafonds)	July (first half)	To summarise the terms of the various arbitration agreements concluded; To define each Ministry's budgetary means.	The Ministry of Finance sends a detailed ceiling letter to his colleagues.
Second stage	Mid July-September	To fix final spending details; To assess budgetary revenues; To calculate the budget balance; To draft Ministry specific budget documents; To draft the general budget (PLF, projet de loi de finances)	Ministries' representatives have supplementary (mainly technical) meetings with the Budget Directorate's representatives (Conférences budgétaires de deuxième phase); Technical/legal work within the Ministry of Economy focussed on the revenue side; Finalisation of budget documentation.
Official presentation	End-September	To adopt and diffuse the PLF	Council of Ministries adopts the budget, PLF is presented to the press.
Submission to Parliament (Saisine du Parlement)	October-December	To ensure that Parliament receives, discusses and votes the PLF	s The PLF is deposited in the office of the President of the Assemblée Nationale before the first Tuesday of October and it is thereafter transmitted to the Sénat.

 Table 16.
 Preparation of the State budget (cont.)

Phase	Reference period	Objectives	Actions undertaken
Submission to the Constitutional Council (Saisine du Conseil Constitutionnel)		To ensure that the PLF respects legal requirements	The PLF is submitted to the scrutiny of the Constitutional Council.
Publication	December	To publish the Loi de finances on the Official Journal.	Publication to be done before the 31 of December of the year n-1.

spending and cannot reallocate money from large spending items such as defence to education, for example. Nevertheless, the ability to affect allocations within missions is an important new power.

The French budgetary system includes a tight treasury function, with a complex and relatively heavy process of *ex ante* and *ex post* controls conducted by various departments within the Ministry of Finance. The process includes a sharp distinction between the person who authorises an expenditure commitment and the one who authorises payment. Spending authorisations are made by line ministry spending officers (*ordonnateurs*). Before such authorisations may be executed they must be approved *ex ante* by the financial controllers employed by the Ministry of Finance but physically located in ministries. The expenditure is subject to a third verification by Ministry of Finance accountants prior to authorisation of payment. Finally the whole process is subject to *ex post* audit by the General finance inspectorate (*Inspection générale des finances*, IGF) and also the National Auditor (*Cour des Comptes*). Moreover, the National Auditor provides regular examinations of the effectiveness of government programmes.

In the course of the budgetary year, the Ministry of Finance has significant, although not unrestricted, powers to revise budgetary allocations as needed. It enjoys wide discretionary powers to transfer appropriations within and across line ministries, provided that this does not change the nature and the amount of the budget. The Ministry of Finance (acting for the government) can freeze credits awarded to any given Ministry and has the power to formally declare a given programme "without object", an action that entails the immediate cancellation of any related spending appropriations. However, the total of such cancellations cannot reduce total expenditures by more than 1.5 per cent of initially authorised credits, unless parliament passes a revised budget (Loi de finances récapitulative), which can also be used to authorise additional expenditure. All in all, approximately 20 per cent of Budget chapters are modified in this way during the course of a year by government decisions (Chevauchez, 2002).

Sub-national governments

Budgetary rules at the sub-national level are much more restrictive. The regions, departments and municipalities, must present balanced budgets (équilibre réel). In practical terms, this means that their operating budgets (section de fonctionnement) must be in surplus and this must be large enough to fully cover planned capital expenditures (section d'investissement), and, except for municipalities with fewer than 3 500 citizens, projected debt payments during the year (interest payments, depreciation costs and expected realisations of contingent liabilities). The fiscal year for sub-national budgets is the same as for the State, but local governments do not need to adopt their budget until the end of March (well into the current fiscal year).

The State exercises the treasury function for local governments, providing them with equal monthly instalments according to their initial budgets. Local taxes are collected by the State. Although local governments have some limited ability to choose rates applied to some tax bases, own revenues account for less than 5 per cent of all revenues. Payments are made irrespective of how tax revenues are evolving. Moreover, local authorities are not free to manage their nontax revenues, but must deposit them in State Treasury accounts operated by the Bank of France. Their expenditures are subject to a similar *ex post* and *ex ante* financial control process, except that the *ex post* audit function is conducted by the regional audit courts (*Chambres régionales des Comptes*). Prefects can, based on a finding of the regional audit court, require that missing expenditures be inserted into the budget law.

Historically these restrictions have ensured the overall balance of the sub-national level of government.

Social protection

The draft Social security budget (Projet des lois de financement de la sécurité sociale, PLFSS) sets forth the expected revenues and expenditures of the various healthcare, pension and social assistance funds (Box 8). The PLFSS is presented to parliament immediately after the draft State Budget and is based on the same underlying macroeconomic and revenue assumptions. The two budgets are debated more or less simultaneously so as to emphasise their interdependence and the tradeoffs that there may be between them. In this respect the PLFSS, which was introduced in 1996, is a recent innovation that seeks to impose a degree of parliamentary oversight over social security expenditures that did not exist previously.

The PLFSS is elaborated by the Ministry of Health in close cooperation with the Ministry of Finance before being decreed by the Cabinet. In contrast to the State Budget, it has no associated balance because the range of expenditure programmes (obligatory schemes with more than 20 000 subscriptors) and revenues (all of the regimes and organisms that contribute to their financing) are not identical. The budgets allocated to the pension regimes and, to a lesser extent, the social assistance regimes pose relatively few technical challenges. The parameters that determine their revenues (contribution rates, earmarked revenues, transfers from the State Budget) and their expenditures (benefit rates, eligibility rules) are determined by the government. As a result, the authorities have in their hands not only the tools necessary to predict both expenditures and revenues, but also the ability to adjust parameters so as to ensure financial sustainability. The Healthcare budget is more complicated (see OECD, 2000 for a fuller discussion of the French health care system). Although tariffs and unit costs are also defined by the government, the quantities supplied, and therefore overall costs,

Box 8. The social security system

Structure of the social security system

Most of the French social security system is administered by extrabudgetary funds. There are some 37 social security schemes (*régimes*), which include general and professional health insurance, workman's compensation and invalidity insurance; oldage and survivors insurance and social assistance. In addition an unemployment insurance scheme and some elements of active labour market policy are run by the UNEDIC (*Union nationale inter-professionnelle pour l'emploi dans l'industrie et le commerce*).

Compulsory basic insurance is provided by three general regimes and 28 special firm- or sector-specific regimes, the most important of which are those covering the public sector and many state-owned firms. Most of the special schemes deal only with retirement income, although four also cover healthcare. Three broadly based and widely subscribed regimes are:

- CNAVTS (Caisse nationale d'assurance vieillesse des travailleurs salariés) administers the mandatory pension contributions of most dependent employees and manages the old age targeted social assistance programmes.
- CNAMTS (Caisse nationale d'assurance maladie des travailleurs salariés) administers health, maternity, invalidity, professional sicknesses, death and on the job accidents insurance for broadly the same categories of employees. Moreover, it co-ordinates the medical verification system and participates in the organisation of health prevention campaigns.
- CNAF (Caisse nationale des allocations familiales) is responsible for the administration of most social assistance programmes, including: housing benefits, anti poverty programmes, such as the guaranteed minimum revenue (Revenu minimum d'insertion, RMI).

Of these only CNAF provides universal coverage. The CNAMTS covers about 84 per cent of individuals, while the general pension scheme covers less than half of pension benefits.

In addition there are so-called complementary old-age regimes, which are organised along professional lines (clerks, managers, for example). Despite their name, these regimes are compulsory. Unlike the general regime they are not subject to relatively low contribution and benefit ceilings, thereby allowing combined pensions to achieve significant levels.

Although contributions are collected locally, all collected revenues are integrated in a special account at the Central Fund for Social Security (Agence centrale des organismes de sécurité sociale, ACOSS), which provides the treasury services across-schemes and distributes resources.

Interactions between social security and the State

The regimes' administrative autonomy from the State varies widely. The three nation-wide regimes are state entities (Établissements publics). Thus while they are outside the State administration, their supervisory board is appointed by the

Box 8. The social security system (cont.)

government, as are several members of their administrative boards (the others being appointed by representatives from the trade unions and the employers associations). Similarly, the special public-sector regimes (including those of several state-owned enterprises) are under the direct responsibility of the state and their accounts are integrated in the State Budget, or directly into the firms' balance sheets. The employers' and complementary regimes operate under private-sector law and enjoy more autonomy.

- 1. The special regimes for agents of SNCF and RATP cover both risks, while the Fonctionnaires de l'État contribute to the general regime for healthcare and to their own pension regime.
- 2. Five of the 28 special regimes manage both the basic and the complementary component of their subscribers' pensions.

are largely unconstrained. Parliament seeks to exercise some influence by establishing a national health spending target (Objectif national des dépenses d'assurance-maladie, ONDAM), within the PLFSS. With the exception of the hospital sector, where the government has the ability to impose a binding budget constraint, the ONDAM is not a cap on reimbursements. For the ambulatory care (private fees, prescriptions, per diem sickness benefits) and medical-social sectors (the elderly, maladjusted children, handicapped adults) the ONDAM specifies spending targets that are consistent with financial stability and defines policy priorities. A combination of the non-binding nature of the ONDAM and unrealistic targets has, over the years, resulted in actual outturns systematically exceeding the ONDAM by large margins.

The budget of the UNEDIC, the umbrella agency responsible for unemployment insurance, is not covered by the PLFSS. The UNEDIC operates as a delegated public service and has much more autonomy than the other social security agencies in determining both contribution rates and benefits that it pays. Union and business representatives, who are equally represented on its board (organisational representations were last fixed in the mid 1980s), meet biannually to agree proposals on these rates. The board's propositions are then presented to the government, which, if it agrees, passes a decree giving them the force of law. While not a voting member of the UNEDIC, the necessity of having its agreement to any accord means that generally the government's voice is heard in discussions and only rarely has the government imposed an agreement on the social partners. Moreover, the UNEDIC provides additional services for the State, such as extended unemployment insurance benefits to the long-term unemployed, reimbursed by the State Budget.

The financial relationship between the State Budget and the social security funds is complex. Approximately two-thirds of social security funding comes from social security contributions levied on payrolls⁶⁰ and one-sixth comes from a special income tax⁶¹ (Contribution sociale généralisée, CSG) that is levied on a wider base including income from capital. In 2001, indirect and direct State Budget transfers to the social security system represented about 125 billion euros or more than 8 per cent of GDP, not including the 25 billion euros spent on public servant pensions, which do not pass through the social security regimes. Of this amount, the State Budget makes a direct contribution of 35 billion euros (2.4 per cent of GDP): 10 billion euros to the various organisms of the social security system; 21 billion euros to compensate the social security schemes for programmes that they administer for the State; and 4 billion in direct subsides to compensate for the deficits of the regimes of various state owned enterprises (Box 9). The remaining 90 billion euros (6 per cent of GDP) are distributed in the form of earmarked revenues from a wide range of sources including the CSG, excise taxes and duties (levied on products such as tobacco, alcohol and gasoline). Two thirds of this goes directly to the social security regimes and $\frac{1}{3}$ goes to the special funding schemes. Of this last third, about half is paid to reimburse the social security regimes for the reduced revenues from special payroll tax reductions instituted in effort to lower the cost of low-paid labour and to offset costs associated with the 35 hour workweek. Finally, substantial additional money is channelled to and between the social security funds through various special vehicles. In 2002, the total of these transfers and additional revenues from the special funding schemes amounted to 44 billion euros (about 2½ per cent of GDP).

Both the collection of revenues and distribution of benefits of the various social security funds is coordinated by a Public Enterprise, the Central Agency of the social security schemes (Agence centrale des organismes de sécurité sociale, ACOSS). Since 1996, the ACOSS operates as an independent agency under contract to the State, with specific objectives and mutual obligations specified in a contract (convention), the most recent of which is to run for the period 2002-2005. The ACOSS in turn signs similar contracts with the 100 plus regional agencies responsible for collecting social security contributions (known collectively as URSAFF, Union de recouvrement des cotisations de sécurité sociale et d'allocations familiales) and the 37 funds charged with distributing benefits. The ACOSS manages its own treasury function, although this is monitored on a monthly basis by the Treasury Department of the Ministry of Finance. Overruns are financed by loans from the state-owned "Caisse des dépôts". In contrast to the other social security schemes, the UNEDIC maintains its own parallel collection and benefit distribution system. It performs its own treasury function and relies on the private banking sector for cash management and borrowing operations alike, but as a special entity recognised as "pursuing a mission of general interest", its liabilities are guaranteed by the state, which on several occasions has been called upon to cover its accumulated debts.

Box 9. Special social security financing funds

The accumulated deficits of some social security funds, and government programmes promoting various policy objectives affect the overall balance of the social security funds. In response, the authorities have created a variety of special funds, whose revenues are assured by the General Social Security Contribution (Contribution sociale généralisée, CSG), excise taxes and privatisation revenues to supplement the earmarked revenues of the social security system. Some of the most important of these are the following:

- The old age solidarity fund (Fonds de solidarité vieillesse, FSV) was created in 1993 and is financed by the overall budget of the family assistance regime and certain taxes, notably a 2 per cent surcharge on capital revenues (part of the base for the CSG) and the surplus of the social solidarity contribution paid out by firms (Contribution sociale de solidarité des sociétés). It funds assistance-related aspects of old age expenditure, like the minimum pension (minimum vieillesse) and other special old age benefits. As of 1996, the fund for the amortisation of the social debt (Caisse d'amortissement de la dette sociale, CADES) has taken on some of these activities.
- The Retirement Reserve Fund (Fonds de réserve pour les retraites, FRR) was created in 1999¹ is supposed to be funded from privatisation revenues and the same taxes and surpluses that finance the FSV. It is hoped that by 2020 it will accumulate some 153 billion euros (10 per cent of GDP in 2002) which can then be gradually disbursed in order to smooth the pension-related costs from the ageing of the population (see OECD, 2001).
- The Fund to Finance the Reform of Enterprises' Social Charges (Fonds de financement de la réforme des cotisations patronales de sécurité sociale, FOREC), was created in 2000 as a means to offset the revenue losses incurred by various regimes due to the reductions in social charges associated with the 35 hours legislation.
- In addition, there are several smaller special funds, namely the Fund for the financing of special assistance allowances to the elderly (Fonds des financement de l'allocation personnalisée d'autonomie, Fonds APA), the Solidarity Fund (Fonds de solidarité), the Asbestos- workers early retirement Fund (Fonds de cessation anticipée d'activités des travailleurs de l'amiante, FCAATA) and the agriculture work accident fund (Fonds commun des accidents du travail agricole, FCATA).

Ex post auditing of the social security regimes is provided by the National Auditor (*Cour des comptes*), which issues regular reports on the legal execution of the budgets of the social security, but also provides more analytical reports on the

Enabling legislation was passed in 1999 but the directive actually creating the fund was not issued until 2001.

efficiency with which their expenditures were made, an activity that is consuming an increasing share of its energies. Moreover, the regimes are subject to constant oversight from the Ministries of Health; Family and Social Affairs; and Finance. Day-to-day operations are supervised by the social affairs general inspectorate (Inspection générale des affaires sociales). Finally an end of year report (loi de règlement) outlining the out turn of the previous year's social security budget is reported to parliament prior to the presentation of the budget for the coming year.

Policies to strengthen public expenditure management

Given the strong financial pressures facing public expenditure in the medium to long term, the authorities' capacity to direct, successfully plan, and implement a medium-term spending strategy will be of increasing importance. Moreover, the tools available to public officials to help them arbitrate between competing demands will be crucial. While steps are already being taken to strengthen structures in both of these areas, more can be done. The following paragraphs seek to identify the directions for reform susceptible to improve policy makers' ability to exercise fiscal control effectively, while at the same time continuing to offer an appropriate range of services to their citizens in a cost-effective way.

Improving the authorities' control over expenditure

The problems posed by increasing spending pressures as the population ages and the economic and social costs of higher taxes are well known and have been the focus of policy reforms throughout the OECD over the past two decades. As Chapter I highlighted, for France these pressures suggest that in the absence of reform total spending is likely to rise by as much as 8 per cent of GDP (19 per cent if the debt is allowed to accumulate) over the next 50 years, with significant increases beginning in the next decade. Unlike many of its economic partners France has made relatively little progress in preparing the fiscal room to meet these pressures (Table 17). Thus while other OECD countries have reduced the share of public expenditure in GDP by one percentage point since 1990, spending in France actually increased by 3 percentage points. More recently, France has reduced spending by 1.1 per cent of GDP since 1995, but this mainly reflects cyclical factors and pales in comparison with the progress made in other OECD countries. Countries such as Sweden, Finland and Canada have been able to cut spending by as much as 10 per cent of GDP, while other European countries such as Belgium, the United Kingdom, the Netherlands, Norway, Denmark, Italy and Austria have made two to three times as much progress as France.

The repeated failure of the authorities to meet their medium-term spending objectives and the long-term ratcheting up of government expenditure reinforce the need to improve the capacity of decision makers to control public spending. With the exception of 2002, the authorities were able to respect their

Table 17. Fiscal consolidation in the OECD

		Share of Public expenditure in GDP							Change		
	1990		1995		2000		2001	2002		2002-1990	2002-1995
		Per cent of GDP (rank)									
Sweden	59.0	(1)	67.3	(1)	57.0	(1)	56.7	57.2	(1)	-1.8	-10.1
Finland	49.0	(10)	59.6	(3)	48.6	(6)	48.9	49.7	(6)	0.8	-9.8
Canada	48.8	(11)	48.5	(13)	41.2	(15)	41.7	40.9	(18)	-7.9	-7.6
Ireland	43.2	(17)	41.5	(19)	31.9	(24)	33.6	34.4	(24)	-8.8	-7.1
Austria	53.1	(5)	57.3	(4)	52.5	(4)	52.3	52.1	(4)	-0.9	-5.2
Hungary	47.3	(12)	56.9	(5)	44.6	(12)	46.7	51.8	(5)	4.5	-5.1
Italy	54.4	(4)	53.4	(7)	46.9	(8)	48.4	48.4	(9)	-6.0	-5.0
Denmark	57.0	(2)	60.3	(2)	54.8	(2)	55.3	55.3	(2)	-1.7	-5.0
Norway	45.4	(14)	50.6	(10)	43.6	(13)	44.6	46.0	(13)	0.7	-4.6
Netherlands	54.8	(3)	51.4	(9)	45.3	(10)	46.4	47.3	(11)	-7.5	-4.1
Poland	52.5	(6)	47.2	(14)	40.7	(16)	42.4	43.2	(16)	-9.3	-4.0
United Kingdom	42.2	(20)	44.6	(17)	37.0	(20)	40.5	41.4	(17)	-0.9	-3.2
Belgium	52.3	(7)	51.7	(8)	48.4	(7)	48.3	48.6	(7)	-3.7	-3.1
New Zealand	45.5	(13)	38.4	(21)	37.4	(19)	36.3	35.7	(21)	-9.8	-2.7
Greece	50.3	(9)	50.5	(11)	50.1	(5)	48.5	48.0	(10)	-2.4	-2.6
Australia	35.4	(22)	38.8	(20)	36.0	(21)	36.7	36.4	(20)	1.0	-2.4
France	50.7	(8)	55.2	(6)	52.7	(3)	52.7	53.8	(3)	3.1	-1.4
United States	36.5	(21)	36.4	(22)	33.6	(22)	34.9	35.5	(22)	-1.0	-0.9
Germany	44.5	(15)	49.4	(12)	45.9	(9)	48.3	48.6	(8)	4.1	-0.8
Iceland	42.5	(19)	43.8	(18)	43.1	(14)	43.4	43.6	(15)	1.0	-0.3
Mexico	17.3	(26)	18.2	(26)	18.0	(26)	18.2	17.9	(26)	0.7	-0.3
Luxembourg	43.3	(16)	45.1	(15)	39.8	(17)	40.4	44.9	(14)	1.6	-0.2
Switzerland	30.5	(24)	34.7	(24)	33.4	(23)	34.2	35.4	(23)	5.0	8.0
Portugal	42.9	(18)	45.0	(16)	45.3	(11)	46.3	46.3	(12)	3.4	1.3
Japan	32.1	(23)	36.1	(23)	38.6	(18)	38.0	38.6	(19)	6.5	2.5
Korea	19.5	(25)	20.6	(25)	24.3	(25)	24.8	24.6	(25)	5.2	4.0

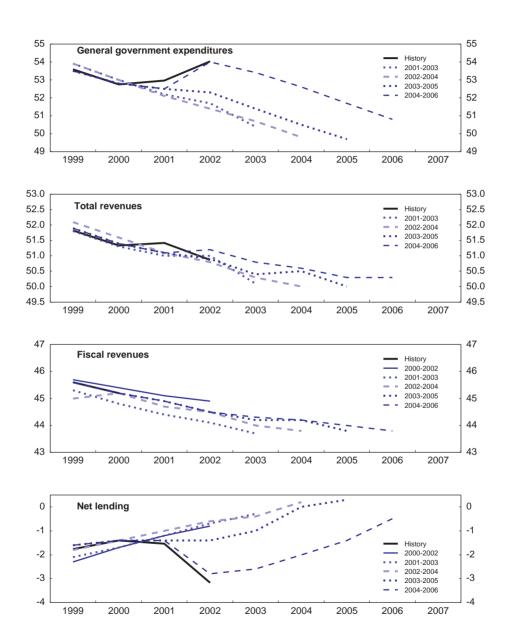
Source: OECD.

goals at the level of the State Budget. But constant and significant expenditure overruns in the social security account (mainly healthcare) meant that rather than the Budget balance predicted in the 1999 multiyear plan, the authorities now expect the deficit for 2003 to come in at 3.4 per cent of GDP, a full percentage point higher than the level observed before this process of fiscal consolidation began. While cyclical and electoral factors appear to have influenced the most recent slippage, its extent and the similarity to previous episodes where expenditures reached new levels during economic downturns are disturbing (see Figure 23).

In many respects, the system of managing expenditures in the State Budget is of the highest quality. Stringent controls both ex post and ex ante help ensure that public funds are spent only as authorised, while the central treasury function means that the authorities have a strong sense of fiscal developments, allowing them to employ their significant discretionary powers to counteract any apparent slippage in the State Budget. However, the State Budget represents only 35 per cent of total spending, and even if it cut its activities by 50 per cent, these savings would not be sufficient to compensate for rising pension and health costs.⁶³ As a consequence, rigour in the State Budget needs to be accompanied by slower growth in social security expenditures and improved mechanisms for reflecting national spending objectives at the sub-national level. At the level of social security, less comprehensive controls and oversight over mandatory spending, plus the large number of overlapping responsibilities, complicate the task. At the subnational level, tight budgetary rules limit deficits. Moreover, their track-record in delivering programmes in a cost-efficient manner is perceived to be better than of the central government. However, there are no mechanisms for co-ordinating spending levels at the sub-national level. Thus, as more of public expenditure is transferred to this level, it will become increasingly difficult for central authorities to direct overall general government spending both for short-term fiscal policy reasons and so as to meet longer term strategic objectives. Therefore, in concert with steps to raise the spending authority of sub-national levels of government, it will become increasingly necessary to introduce mechanisms that guarantee that they play a part in the overall effort of expenditure control.

The case of the social security regimes is even more complicated because while the State exercises considerable control over the parameters of the various systems and covers their revenue shortfalls, the administration of each (and some cost levers) are in the hands of the social partners. With the possible exception of the UNEDIC, neither the government nor the social partners have the exclusive means to control expenditures (or revenues). This lack of symmetry between responsibilities and authority to act, coupled with the mandatory and politically sensitive nature of these expenditures, is a recurring source of conflict between the government and the social partners – one which has contributed to the lack of progress in reforms. Indeed, on several occasions, efforts of each to control costs have been frustrated by the other.

Figure 23. **Slippage in multiyear targets**Per cent of GDP



Source: Various issues of Projet de loi de finances; INSEE and OECD.

There is no simple solution to this asymmetry. The reforms outlined below should improve the system's capacity to contain cost pressures. It privileges mechanisms that might improve the ability of the Parliament and the government to manage expenditure, not because they have done or are necessarily likely to do a better job than the social partners, but because, as the elected representatives of the whole population, they bear ultimate responsibility for the public debt and the performance of the economy.

Exercising better control over the expenditure path

If policy makers are to assert control over public expenditures, they need to be confronted with accurate and comprehensive information about budgetary developments, both in the current year but also for the future. For the moment, the strictly annual nature of the State and social security budgets prevents decision makers from having a clear vision of the longer-term implications of policy decisions. This increases the risk of passing legislation whose in-year costs may not be that large, but which have long-term implications on spending. Indeed, the ratcheting up of public spending over the past thirty years suggests that there has been a marked tendency to increase spending in a permanent manner during cyclical peaks (Figure 24), with the result that during downturns the ratio of public expenditures to GDP has risen.

Cyclical peaks Cyclical troughs 45 Total expenditure (left scale) 55 Primary expenditure (left scale) Total expenditure less social security (right scale) 40 50 35 45 30 40 25 1975 1980 1985 1990 1995 2000 1970

Figure 24. Asymmetric response of expenditures to the economic cycle

Per cent of GDP

Source: INSEE and OECD.

In order to improve the information available to policymakers and to combat tendencies to raise the level of expenditures permanently during revenue-rich periods of the cycle, new spending and revenue measures should systematically include evaluations of their medium-term impacts on the general government budget. In order to ensure consistency, these should be based upon centrally defined macroeconomic assumptions, and the technical assumptions that underlie these evaluations should be submitted to a central agency for review. Currently, such evaluations are done by the Ministry of Finance for large programmes, but not for smaller ones and, even with larger ones, these analyses are not integrated into the budgetary process. Of course, for such a system to be effective it is critical that macroeconomic and revenue assumptions be prudent, which has arguably not been the case in the past. Indeed, the deficit reduction plans of the French authorities in 2001 and 2002 were predicated on the economy growing at 3 per cent, substantially higher than its potential rate of growth and, in the event, much faster than actual growth. A superior solution would be to base medium-term projections on assumptions of GDP growth more in line with the economy's potential. In this respect, the 2.5 per cent growth assumption in 2002 was more realistic, even if substantially higher than most estimates of potential growth, which tend towards 2.1 and 2.2 per cent.⁶⁴ Moreover, the ONDAM would need to be set at a more realistic rate. If healthcare reforms (see below) do not succeed in generating sufficient savings a high but realistic ONDAM will help impress on policy makers the need to generate savings elsewhere. Finally, given that the longer-term sustainability of public expenditures in France has yet to be assured (see Chapter I), any revenue windfalls, deriving from better than expected macroeconomic performance or privatisation should be immediately assigned to paying down the debt.

While such a setup would help impress upon decision-makers the longerterm fiscal consequences of new policy initiatives, the authorities' capacity to engineer a reallocation of resources and perhaps a reduction in overall spending levels would be enhanced further if the State and Social security budgets were more clearly integrated into a medium-term framework. Significant progress towards integrating multiyear forecasts into the parliamentary debate have been made. In particular, the budget orientation debate, the inclusion of the multiyear plan into the budget documentation and reports on the evolution of tax revenues all go in this direction. However, these projections remain an annex that is presented to parliament as a programme of the executive. In order to consolidate recent progress and so as to increase the visibility of the medium-term consequences of various decisions, these projections should be integrated into the budgetary procedure, discussed, debated and approved by parliament. Moreover, because information on individual Budget and social security programmes or "missions" is not included, it is not possible to isolate the influence of different spending initiatives in out years, nor the basis for the fiscal consolidation that is asserted (a factor, which along with unrealistic assumptions helps explain the failure of these goals to be achieved).

Given the major changes in budget procedure already implied by the introduction of the LOLF (see below), it is probably inopportune to move towards a true medium-term expenditure framework at this time. One solution might involve maintaining the separation of the State Budget and the Social Security Funds and their single year focus, but presenting and anchoring them within a more detailed and rigorous medium-term projection. This enhanced medium-term projection could serve as an umbrella for the two single-year budgets but also extend them several years into the future, based on common macro assumptions and unchanged policies (or on explicit indications of where savings would be generated to meet medium-term goals).

As compared with current practice, this would imply including more detail into the multiyear plan concerning spending missions and the activities of the social security funds. The outyear budgetary projection, after adjustment for changes in macroeconomic developments, could then be used as the basis for the following year's budgets. This would help reinforce the virtuous circle created by the existing examination of the past year's outturn, by increasing its scope to the whole of the general government and by linking it more directly to the discussions of the next year's budget.

Bringing forward the preparation of local government budgets would also help. In so far as their activities represent 19 per cent of GDP, the ability of central-government decision makers to plot both short-term and medium-term fiscal policy at the general government level would benefit from more timely contributions from the local level. Moreover, given that revenue estimates are decided well in advance of the actual voting of the Budget, there is no apparent technical impediment for local governments to provide provisional budgets in time for the parliamentary debate and to finalising them much more quickly after passage of the State Budget. To help ensure that expenditure savings at the central level are not undone at the subnational level, the authorities might wish to introduce mechanisms that ensure subnational governments take responsibility for the macroeconomic consequences of their actions. Here, departmental and regional spending norms analogous to those at the national level or other mechanisms that would guarantee that subnational levels play a part in overall efforts to control spending might be envisioned.

Such solutions have several advantages:

- 1. They would not require any fundamental legal changes;
- 2. They would further reinforce the notion of the general government and the inter-relationships between social security and other forms of public expenditure;
- Unchanged policy projections would make explicit the savings or revenue shortfalls that would be required to meet medium-term spending objectives;

- 4. The use of the previous year's projection as a starting point for the following years' budgets, would enhance transparency;
- Prudent assumptions for future developments would help prevent windfall revenue increases from being transformed into permanent increases in spending commitments.⁶⁵

Controlling mandatory expenditures

Mandatory expenditures (health, unemployment insurance, pensions and social assistance) represent more than 40 per cent of general government spending and are its fastest growing component. As such, the ability of the authorities to control these expenditures (principally social security spending) will determine crucially their success in containing overall cost pressures. The increased prominence of social spending in overall public expenditure, 66 which has been observed in virtually all OECD countries, reflects three main factors: a substantial widening of the roles undertaken by the general government; 67 the mechanical impact of ageing on health, pension and family assistance expenditures (the only factor taken into account in the projections of Chapter I); and technological and demand-side changes associated with rising incomes, which have weighed heavily on the rate of increase of healthcare costs.

· Pension reform

The simulations in Chapter I illustrate the substantial additional fiscal pressures that the ageing of French society is likely to entail and the risks they pose to fiscal equilibrium. The current pension reform initiative is a first step towards meeting these pressures. However, even at their most ambitious, current proposals only seek to address somewhat more than one-third of the system's underfunding. In particular, the remainder of the financing as concerns the private sector is achieved at a constant overall tax burden by assuming substantial reductions in unemployment insurance expenditures. Thus, whatever shape this reform eventually takes it will need to be extended. While decisions as to the precise nature of any final reform are the responsibility of the French authorities, international experience and the nature of the current system suggest some courses of action over others that would generate savings while respecting social and equity concerns.

Raising social contributions yet further seems a particularly unattractive option, given the already high tax burden and the considerable economic inefficiencies that would likely be generated by the 10 percentage point hike estimated necessary by the government's Retirement orientation council (Conseil d'orientation des retraites, COR).

Box 10. Incomes of the elderly

In France, the disposable income of individuals over 65 is 90 per cent of those of working-age (Förster and Pellizari, 2000), making French retirees the fourth richest in the OECD. Moreover, if an imputation is made for owner-occupied housing, they actually have higher incomes than working-age people (see Table 18). While the overall pension scheme contributes significantly to this result, it reflects to a large extent the substantial wealth accumulated in non-pension private-sector savings schemes such as those operated by the insurance sector. These resemble defined-contribution private-sector pension schemes seen in other OECD countries and benefit from similarly favourable tax treatment. In recent years, there has also been increased take up in two new voluntary saving schemes (plans d'épargne entreprise – PEE and plans partenariaux d'épargne salariale volontaire – PPES). These receive very favourable tax treatment; contributions are exempt from both income tax and social charges, while benefits are only subject to a 10 per cent tax rate.

Finally, while 10 per cent of the elderly have less than half the disposable income of an average person, minimum pensions and additional dependency allowances have virtually eliminated absolute poverty among the elderly.

- 1. All told, individuals over 50 hold about three quarters of these assets, which combined with other financial assets are worth 3.7 times household disposable income (a higher ratio than in Spain, Germany and Italy).
 - There is likely scope for reducing replacement rates without endangering the income adequacy of the elderly. Indeed, the average revenue of a retired person in France is higher than the rest of the population (see Box 10).
 - Increasing contribution periods, as proposed by the authorities, in line
 with improving longevity also seem reasonable. At a minimum these
 should be increased in an actuarially neutral manner, although given the
 overall disequilibrium of the system and the substantial improvements
 in life expectancies already achieved a non-neutral increase might also
 be merited
 - Augmenting individuals' freedom to decide when to retire by stopping
 the subsidisation of early retirement and by permitting early withdrawal
 with actuarially reduced benefits would be helpful, especially if combined with the ability to continue working while increasing pension
 rights or to work and simultaneously draw a pension (see below).

Table 18. Performance indicators: sustainable retirement income

	Projected increases in old age pension	Low income rate of the elderly	Relative disposable income of the	Private pension funds 1999		rithdrawal,	Participation rate, 2001, per cent			
	spending	of the elderly	elderly ¹	Tulius 1999	1994-1999 -			Aged 55-64		
	Change in per cent of GDP 2000-2050	Per cent of the elderly with income less than 50 per cent of median disposable income	Per cent of the disposable income of all individuals	Per cent of GDP	Male	Female	Aged over 65	Male	Female	
Australia	1.6	16.1	67.6	63.8	59.7	61.3	6.0	60.0	36.9	
Austria	2.2	14.9	86.6	3.6			2.81	42.1^{1}	17.5^{1}	
Belgium	3.3	13.8	77.9	6.1			1.3	36.6	15.7	
Canada	5.8	2.5	97.4	45.7	62.6	61.1	6.0	61.3	41.7	
Czech Republic	6.8			3.8			4.0	55.0	24.5	
Denmark	2.7	9.2	73.0	24.4	62.4	61.5	4.6	65.5	51.8	
Finland	4.8	7.5	79.0	10.7	59.8	60.0	3.7	51.2	49.5	
France	3.9^{2}	10.7	89.7	6.3	59.3	59.8	1.2	43.8	34.1	
Germany	5.0	10.4	85.6	3.2	60.5	60.8	3.0	50.6	32.4	
Greece		29.2	76.8	4.6	61.7	62.2	5.0	57.0	23.6	
Hungary	1.2	6.0	85.2	2.2			3.1	36.3	15.4	
Iceland				86.0			19.9	92.8	81.7	
Ireland		16.7	74.6	57.8			7.9	66.1	29.5	
Italy	-0.3	15.3	84.1	3.0	59.3	58.4	3.4	57.8	26.6	
Japan	0.6			18.7	69.1	66.0	21.8	83.4	49.2	
Korea	8.0			3.2	67.1	67.5	29.6	71.3	47.9	
Luxembourg		6.7^{3}					0.0	38.1	14.3	
Mexico		32.9	85.3	2.4			30.5	80.5	27.6	
Netherlands	4.8	1.9	86.3	119.3	61.6	60.1	3.1	52.0	26.9	
New Zealand	5.7						8.6	74.6	51.7	
Norway	8.0	19.1	74.1	7.4	64.2	64.7	13.2	73.6	63.2	
Poland	-2.5	8.4^{3}					7.5	41.5	24.1	
Portugal				11.4	65.3	66.5	19.0	63.7	41.9	
Slovak Republic							1.1	43.0	11.2	
Spain	8.0	11.3^{3}		2.3	61.1	61.1	1.6	61.4	23.6	

Participation rate, 2001. Projected increases Relative disposable Low income rate Private pension Age of withdrawal, per cent in old age pension income of the of the elderly1 funds 1999 1994-1999 spending elderly1 Aged 55-64 Per cent of the Aged elderly with income Change Per cent of the over 65 in per cent less than 50 per cent disposable income Per cent of GDP Male Female Male Female of GDP 2000-2050 of median of all individuals disposable income Sweden 89.2 1.6 3.0 63.3 61.8 9.4 73.5 67.4 8.4^{3} 97.3^{4} Switzerland 11.4 82.4 56.1 Turkey 23.1 92.7 18.1 50.8 18.4 United Kingdom 77.8 -0.711.6 84.1 62.0 61.2 4.8 64.4 44.6 **United States** 1.8 20.3 91.7 74.4 65.1 64.2 13.1 68.1 53.0

Table 18. Performance indicators: sustainable retirement income (cont.)

Source: Förster and Pellizzari (2000); Jesuit and Smeeding (2002), Luxembourg Income Study; OECD Labour Force Statistics, Scherer (2002).

^{1.} Förster and Pellizzari (2000).

^{2.} Secretariat estimate in OECD (2001). Official reports suggest a 4.4 per cent increase on unchanged labour market policies for the period 2000 = 2040 (COR, 2001).

^{3.} Smeeding (2002).

^{4. 1998.}

The system should be made more equitable by:

- treating pensions and earnings in a more actuarially neutral manner (Guegano, 2000 calculates that 9 per cent per year (de) increment to a pension per year of contributions would be actuarially neutral at age 62);⁶⁸
- eliminating subsidised early-retirement programmes;
- reducing the inequalities in the treatment of public-sector and private sector workers.

As concerns this last point, the differences between public- and private-sector regimes are substantial and exist along virtually every dimension of the two systems, working almost universally in the favour of public servants (Box 11). In part, the existing differences reflect steps taken in 1993 to improve the sustainability of the private-sector system and the failure to implement similar reforms in 1995 for the public-sector regimes. Overall the favourable treatment of the public sector regimes is reflected in the fact that although their adherents represent only 25 per cent of workers, the projected deficit of their regimes is expected to be about the same size as that of the private-sector regimes, implying that the per capita contingent liability of the public sector scheme is three times that of the private sector one (Table 19). Indeed, the present value of current government liabilities to civil servants, at between 600 billion euros to 800 billion euros, is more than the outstanding gross public debt (Marini, 2002). Harmonising the two systems, by bringing the public-sector scheme into line with the private sector could be expected to eliminate $\frac{1}{3}$ of the total expected shortfall.

The pension reform bill that was presented to Parliament in June 2003 proposes a number of changes aimed at reducing some of these inequalities. In particular, it proposes raising the public-sector normal-contribution period to 40 years (see Chapter I). These are steps in the right direction, but will only begin to deal with the discrepancies between the two systems. In particular, they leave untouched the various special regimes allowing for very early retirement within the public-sector regime *per se* and those operated by state-owned enterprises. Moreover, the reform does not deal with the abusive practice of giving public servants substantial promotions just before their retirement, nor does it deal with the fundamental inequity that replacement rates in private-sector pensions, which are already lower than those in the public sector, will be falling by between 9 and 17 percentage points over the next several decades (as the impact of the 1993 reform comes on line), while those in the public-sector will not if the individuals concerned continue working so as to receive a full pension.

Healthcare

Given the demand-driven nature of costs in the Healthcare system, slowing the speed at which expenditures rise will be more complicated, as indeed it is in all

Box 11. Main difference between public- and private-sector pension schemes

- 1. **Contribution periods:** In general public servants must work only 37.5 years before qualifying for a full pension, in contrast to 40 years in the private sector. Moreover, many public servants and employees of State-owned enterprises benefit from special regimes which allow them to leave at 55 or even 50 years of age. Mothers of three or more children can retire after only 15 years of service, with no reduction in benefits to reflect the long period they will be collected. In contrast, private-sector workers must work until 60 and do not qualify for a full pension until they have worked 40 years.
- 2. **Contribution rate:** Public sector employees contribute only 7.85 versus 10.3 per cent in the private sector.
- 3. Calculation of benefit: Private-sector workers benefits are based on the average of 25 years of inflation (not wage) adjusted salary. Public-sector workers pensions are based on the salary excluding bonuses, which are not subject to charges) earned in their last 6 months of work. Moreover a significant percentage of public servants receive substantial promotions just prior to their retirement effectively substantially increasing their replacement rate.
- 4. Replacement rate: While the pension an individual receives does depend on his or her contributions, both system are highly redistributive. Thus, in the private sector system overall replacement rates in the private sector vary from 54 per cent for managers that received many promotions to 87 per cent for blue collar workers. In the public sector they vary less, ranging from 60 to 78 per cent depending on how much of an individual's income comes from bonuses and excluding the effect of end career promotions. Moreover, the degree of inequality is projected to increase as private-sector replacement rates are projected to fall by between 9 and 17 percentage points by 2040, reflecting the impact of the 1993 reform of the private-sector scheme.¹
- 5. **Indexation:** civil servants' pensions are indexed to public-sector wages, whereas those fo the private-sector are adjusted according to price inflation.

OECD countries (Docteur and Oxley, 2003). Several recent and planned initiatives should serve to slow the pace of health insurance costs. In this regard, recent reforms to increase the use of generic drugs and to ease or lower the rate of subsidisation of drugs of questionable medical efficiency are positive steps, which

^{1.} In addition to increasing working requirements from 37½ to 40 years, the reference period for determining benefit rights was extended from 10 to 25 years and inflation replaced wage growth as the mechanism for indexing earlier salaries in the calculation.

Table 19. Official estimates of pension fund balances

	Number of workers	Pension ex	penditure	Pension fund balances ¹							
	Million	€ billion % GDP		% GDP							
	1998			2000	2005	2010	2020	2040			
Base case	•										
Private-sector employees	14.2	95.5	6.7	0.4	0.7	0.5	-0.6	-1.9			
Government employees ²	4.4	37.5	2.6	0.2	-0.1	-0.5	-1.3	-2.0			
Public enterprise employees ³	0.4	7.7	0.5	-0.2	-0.2	-0.2	-0.2	-0.2			
Self-employed ⁴	0.9	2.6	0.2	0.0	0.0	0.0	0.0	-0.1			
Farmers ⁵	1.4	12.0	0.8	-0.6	-0.5	-0.9	-1.3	-2.0			
Others	1.8	9.5	0.7	-0.4	-0.6	-1.0	-1.8	-2.5			
All covered workers	23.7	164.8	11.6	-0.6	-0.5	-1.0	-2.8	-4.7			
Base case assumptions											
Economic growth ⁶					3.0	3.0	1.5	1.4			
Unemployment rate				9.7	7.5	4.5	4.5	4.5			
Alternative scenario ⁷											
all covered workers Alternative assumptions				-0.6	-0.9	-1.9	-3.9	-5.9			
Unemployment rate ⁸				9.7	9.0	9.0	9.0	9.0			

^{1.} Contributions minus pension spending. A positive value shows a surplus. As regards civil servants, employers contributions reflect actual receipts for local government employees. For central government employees whose pensions are paid from the budget, the fictive rate of employers contribution that balances contributions and pensions in 2000 is kept constant onwards to run the simulations reported here.

Source: OECD computations on the basis of COR (2001) for financial projections. Charpin (1998) for number of employees apart from the item "others" which is a OECD estimate.

^{2.} Including government employees on private law contracts.

^{3.} Namely SNCF, EDF, GDF and RATP. The method of the fictive rate (see above) is also used here for determining employers contributions.

^{4.} Excluding self-employed farmers.

Including farm employees.

^{6.} OECD estimate of potential economic growth to 2005 is 2 per cent.

^{7.} The alternative scenario has been extrapolated from the sensitivity analyses given in COR (2001).

^{8.} OECD estimate of the structural unemployment rate in 2005 is 9 per cent.

can, by lowering the level of spending in a given year, slow the overall progression of costs. Similarly, proposals to reduce the extent of the coverage of the compulsory healthcare system but simultaneously extending universal coverage to more individuals, while augmenting the share covered by voluntary complementary insurance schemes and allowing them to determine reimbursement rates for nonessential medical services, would also help if implemented (Chadelat, 2003). Such a reform would tend to raise awareness among healthcare demanders of the costs of various options – and in so doing reduce the rate of growth of healthcare costs – while at the same time ensuring that all continue to have access to a high level of care. By the same token, it will be necessary to make the ONDAM more binding. The government would also like to produce a report on the medicalisation of the ONDAM in order to be able to forecast its evolution on medical grounds. Such an initiative, if put in place, would have the further advantage of emphasising objectives as opposed to inputs when planning for healthcare. Additional measures that might be considered, which could improve the authorities leverage over the rate of growth of expenditures were outlined in the special chapter on the health care system included in the 2000 Economic Survey. These included:

- The introduction of diagnosis-related payments for hospital-based care.
 This has entered on experimented phase and once generalised it should increase incentives to reduce administrative, medical and pharmaceutical costs.⁶⁹
- Expand the role of the regional hospital agencies (Agences régionales d'hospitalisation, ARH) so that they can operate as care purchasers, which would give them incentives to limit supply-side based increases in costs.
- Work with private insurers to devise a mechanism of complementary health insurance that covers additional risks, but which does not eliminate the dissuasive effect of co-payments.
- Extend the system of referring doctors so as to better control access to some kinds of specialists, where considerable sums are spent subsidising medically dubious activities. One solution might be to reimburse visits to specialists that are made without referral at the same rates as visits to general practitioners.
- Introduce a rolling cap on ambulatory-care medical services, such that if the ONDAM is violated in a given year, the remuneration per service in the nfollowing year is reduced by the amount of the previous year's overshoot.

While introduction of such changes would not eliminate the tendency for healthcare spending to rise, they would increase the levers available to the authorities to exercise pressure on both demanders and suppliers as well as increase each group's private incentives to limit reimbursable spending. This, plus

the continued pursuit of changes that offer one-off reductions in health care costs appear to offer the best hope for controlling costs in this area.

Managing fiscal consolidation in the social security system

Effectively applied, the institutional reforms to the budget process outlined above (joint presentation of the social security and State budgets in a medium-term context) will help by forcing decision makers to confront the medium and long-term consequences of adding tasks to the social security system without provisioning them and make it more difficult to mistake cyclical improvements in revenues for permanent ones. In this regard, further integrating the discussion of the social security budget with that of the State should help extend to these programmes the kind of scrutiny and arbitrages currently undergone by programmes covered by the State Budget. Moreover, by treating the Social security and State Budgets together, it should increase the visibility of opportunities for reallocating resources between programmes. Finally, it should help the authorities avoid increasing the unfunded tasks assigned to (or taken on by) the social security system, ideally by explicitly identifying savings in non-priority areas to finance additional tasks. For instance, a medium-term analysis of family assistance expenditure based on unchanged policies should, given demographic developments, reveal falling expenditures and therefore the possibility of reallocating resources to other priority areas where expenditures are growing (such as healthcare or pensions).

To be able to effectuate such reallocations, the government will need to rethink the financing of the social security system. Reliance on earmarked funds for the financing of the various social security regimes and the mixed administration of these programmes seriously constrains opportunities for reallocations and effectively eliminates 40 per cent of public expenditure from any fiscal consolidation programme, significantly increasing the pressure on other programme areas. Dedicating resources to a particular policy problem demonstrates the political importance attached to an issue and can, in certain cases, serve as a hard budget constraint. However, it also unnecessarily constrains policy makers' ability to respond to changing priorities and conditions and can result in mission creep and budgetary inertia when the constraint is not binding. 70 For example, the strict budget constraint imposed by earmarking has, in conjunction with the considerable administrative autonomy enjoyed by the administrators of the UNEDIC, meant that this unemployment insurance system has more or less succeeded in maintaining budgetary equilibrium. In contrast, demographic developments have tended to reduce demands on the family assistance system, which has responded by seeking new missions for itself in order to make use of the resources that its fixed share in social security charges generate. Finally, in the case of healthcare and pensions, popular expectations for and the costs of the systems have evolved much faster than the funds' ability to pay. As a consequence, the budget constraint could not be

respected, resulting in the build up of a substantial debt in the case of the health-care system and a huge unfunded contingent liability in the pension scheme. Because of the public policy nature of these activities, responsibility for finding a solution to these problems has tended to fall to the government.

In order to redress the asymmetries in the governance of the social security system, the government needs to take a more active and responsible role. The compulsory nature of the funds, the contributions they impose and the substantial redistributive nature of these contributions gives the State the obligation to oversee their activities (indeed, this is implicit in the requirement that the State decree the contribution rates proposed by the funds). Moreover, given the large sums required to finance these activities and the impact that associated charges and taxes have on the functioning of the economy, the State would appear to have a legitimate right (if not obligation) to dictate (or at least negotiate) the level of expenditure and contribution rates for the regimes. The introduction of the Loi de Finances de la Sécurité Sociale, by placing these issues before Parliament, constituted an assertion of the Parliament's legitimate interest in these areas of public expenditure. However, if the authorities are serious in their efforts to control overall expenditure levels, they will inevitably need to assert this right more directly. In exchange, however, they may need to take a step back from the management of the expenditures of the social security systems themselves, giving the social partners the responsibility and the authority to meet the budget constraint imposed by the State.

One step worth considering would be to replace the funding of the social security by earmarked taxes with direct financing from the State Budget. Such a move would have the considerable advantage of facilitating budgetary reallocations and clarifying the true costs of these programmes. Moreover, it would obviate the need for the complicated cross-subsidisations and extra-budgetary funds that currently characterise the system. The proposal to transfer contributions from the unemployment insurance scheme to the pension scheme as society ages works in this direction, although it retains the earmarking of funds. While stop-gap measures have allowed the system to be maintained, they obscure the financing of the social security system and mask the true costs of these services in the public eye. Moreover, such transfers of "dedicated" resources are frequently perceived as an illegitimate misappropriation of funds destined for one objective towards an unrelated one (from families to pensioners on the one hand and from the medical and family systems to labour market policy in the other). Finally, the combination of the rapid increase in these expenditures and their financing through social contributions resulted in an overall tax wedge that was particularly penalising of labour. To a considerable extent, the distortions that this created have been eliminated by various reductions in the social charges imposed on lowskilled workers (see Chapter II), but only by transferring these charges to the State Budget and further undermining the contribution-based characteristics of the social security systems.

A less radical reform in the same direction would see the authorities make greater use of transfers from general revenues in subsidising the activities of the various funds. Transforming the State-based financial support that are currently generated in the form of earmarked excise taxes (90 billion euros, or 6 per cent of GDP) into a direct transfer would allow the authorities to apply these funds according to their priorities, and could be used as a mechanism to tighten the budget constraint of the funds. Indeed, such funds could be managed in a countercyclical way to help smooth funds revenues and prevent the observed tendency for parameters to be adjusted in a procyclical manner. Moreover, the authorities might wish to reconsider the contributions they make to funds to extend coverage for certain classes of individual. For example, the State currently pays the social security contributions of unemployed workers, effectively subsidising the UNEDIC's de facto early retirement scheme. Making these funds conditional on a reform to this programme would not only improve the coherence of government policy but also serve to reduce the spending of both the UNEDIC and the State Budget. Finally, the various special funds that serve only to move money from one arm of the government to another, albeit social security funds, should be abolished and replaced by direct transfers.

The authorities (and the social partners) also need to take a close look at opportunities to generate administrative savings in the social security system. The resort to 38 separate funds and associated administrations to deliver 3 public services (health, old-age pensions and social assistance) results in significant inefficiencies (Figure 25) and horizontal inequity. Moreover it would appear that a consolidation of the administration of the funds could result in substantial savings. Indeed, it is difficult to see the utility of the hundreds of independent local administrations, especially given that modern advances in informatics technology should enable a more centralised and economic treatment of dossiers.

Improving the oversight and efficiency of public expenditure

The new State Budget framework law

The new Budgetary framework law (Loi organique relative aux lois de finances, LOLF) represents an important step towards enhancing the quality and efficiency of public spending programmes. This law, which defines the legal framework for the annual Budget Laws, was passed in 2001 and is to be phased in gradually over the 2002-2006 period. It substantially enhances the oversight and investigative powers of the Parliament and gives the State Budget process much more of a results and output-based orientation. Moreover, by requiring the government to present to Parliament a closing account of the previous year's Budget (Loi de règlement) before it considers the proposals for the following year, the authorities hope that the LOLF will introduce an element of multiyear planning in what remains a

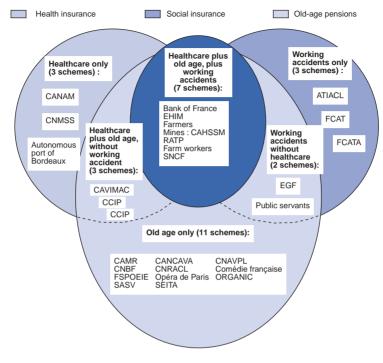


Figure 25. Range of activity of social security schemes¹

1. Excluding general regimes. Source: Direction de la Sécurité sociale.

strictly annual budgetary process. Finally, concomitant with the move to an output-based orientation it delegates much of the responsibility for the allocation of budgetary envelopes to public-sector managers, while making them responsible for reporting on and delivering results.

As part of the phase-in of the LOLF, the current 848 budget chapters detailing the inputs allocated to each Ministry will be replaced by some twenty-odd missions, grouping together various programmes by objectives. The government retains the sole authority for defining budgetary missions and their objectives as well as the funds to be allocated to each. Although the parliament can change allocations within missions it cannot affect them between missions and cannot change the total level of expenditure. Given the resource allocations made available to them by the parliament and the government, managers are free to allocate funds across inputs.⁷⁴ Coupled with this delegated authority will be an enhanced responsibility, with managers to be responsible for determining and

reporting indicators of the extent to which parliamentary objectives are attained. Parliament, in turn will be responsible for evaluating these results and revising its policies and law in consequence.

While Parliament does not have the authority to amend total budgetary allocations or those for given missions, its oversight role does give it a platform to make such recommendations, which the government may or may not decide to incorporate. This extends parliamentary influence. Nevertheless, there is scope for extending it further. In particular, while initial budgetary allocations across missions should remain the purview of the government, the capacity of the authorities to define and pursue priority objectives could only be enhanced if Parliament were allowed to revise mission allocations (as long as the original expenditure cap is not exceeded).

The introduction of the LOLF represents a major step forward and an important opportunity to raise the effectiveness of public policy and the quality of public expenditure. However, experience from other countries suggests that its implementation will not be straightforward, in part because of the substantial changes required in terms of both administrative and political culture. Even in countries that have instituted such a system for many years, results have been mixed. While a real culture of evaluation has developed in some countries and in some ministries, in others implementation has been pro forma and the process is considered an additional and not very useful administrative burden. Thus, notwithstanding the four years allocated for the phase-in of the LOLF, its success is not guaranteed and much will depend on the political and administrative will to see it through, to allow for experimentation (and failure) and to nurture a spirit of evaluation and responsibility among both public servants and elected representatives.

To facilitate the transformation in administration culture, it will be essential for spending Ministries and departments to participate actively in the preparation of mission objectives and evaluation strategies. To be effective, such objectives must not only be measurable, relevant and attainable, they must also be seen as legitimate by those that are called upon to achieve them. Thus, while development of these targets should be overseen by a central agency (so as to ensure the diffusion of best practices in terms of methodology, design and publication of results), care must be exercised to ensure that ownership of the targets remains with those who will be responsible for their execution. In this respect, Ministries are in the process of creating objectives for the 2004 Budget exercise and special Ministry-specific groups, supervised by the Department of the Budget, have been put together to follow the process offering advice and encouraging laggards. Moreover, pilot projects have been run both at the departmental level and within the Ministries in an effort both to give an example but also to determine in advance what does and does not work.

In order for new public-expenditure management techniques to improve the quality and cost-effectiveness of programmes, the policy evaluation process needs to be reinforced. Evaluations need to be structured with an eye to improving programmes, so that specific proposals can be put forward to policy makers on how programmes can be made more effective and ultimately so that parliament can be advised as to how appropriations could be amended, cancelled, or distributed over the medium term. Without this, the evaluation process, and Parliament's role, risks becoming formulistic rather than part of a genuine process geared towards continually improving the quality of public spending. Too often programme evaluations fail to adequately control for selection bias and other statistical phenomena. To assist in this process, new policies should be designed in such a way as to facilitate their subsequent evaluation in a statistically conducive manner. While the LOLF gives Parliament virtually unlimited evaluation powers⁷⁵ over almost all public finance issues (including public entities, state enterprises, the local authorities and the social security sector), ad hoc parliamentary investigations cannot substitute for ones conducted by those knowledgeable about and responsible for programme results. Parliamentary studies might most usefully be used as a "corrective tool" in cases where specific Ministerial evaluations are judged to be inadequate, and to mandate specific analyses into new policy areas or to analyse longer-term questions (i.e. pensions or healthcare). In this respect, the synergies between public service evaluations and active parliamentary oversight would be enhanced if the discussions of the Loi de règlement were better integrated with those of the current year's budget and if the administration was required to make intermediate reports on new programmes in the context of the Budget debate.

More generally, the resources allocated to evaluation will have to be increased. Already the *Cour des comptes* has indicated that the implementation of the LOLF places substantial new and different demands upon its resources. To a large extent meeting these new demands should be achieved by reallocating posts and expenditures within existing budgets, something made easier by the new budgetary rules. For ministries the new emphasis on evaluation will require new staff with different skills. Fortunately, the imminent retirement of a large proportion of public servants should allow for new hiring even as overall staff levels are reduced. Meanwhile, the introduction of a new data system (mission oriented ACCORD⁷⁶) should help facilitate the flow of information about indicators, costs and objectives between the Ministry of Finance, the *Cour des Comptes* and Parliament.

Although not a specific part of the LOLF, the authorities should consider making much greater use of techniques such as sunset clauses that require specific-task spending programmes to be abandoned after a set period of time (typically several years), unless parliament renews their mandate. Such simple measures, which can be introduced retroactively, help combat programme and spending inertia. While such clauses have been criticised as ineffective in some cases, they have been effective in other jurisdictions. Using them to force a regular review of tax expenditures might be useful as such programmes, which involve billions of euros, tend to fall out to the public eye because of their passive nature.

The authorities might also wish to re-examine the process by which budgetary expenditures are authorised. The authorisation and audit process, involving three ex ante verifications, is relatively heavy and seems in many respects contrary to the spirit of delegation of authority and responsibility incorporated into the LOLF. Perhaps a system involving a single Ministerial ex ante verification and a reinforced ex post audit system would be just as effective and less expensive to administer.

The LOLF only applies to the State Budget. As a result, the remaining 50 per cent of consolidated central government expenditure continues to be budgeted on the basis of inputs. Nevertheless, progress has been made in establishing political oversight of social security expenditures. As noted, since 1996, spending at this level has been exposed to parliamentary scrutiny in the context of an annual Budget Bill for Social Security, the PLFSS, which allows parliamentarians to discuss social security funding at the same time as the State Budget. Moreover, an element of output-oriented budgeting has also been introduced into the State's budgetary relations with the social security agencies. Increasingly, the State is passing explicit contracts with the regimes that detail both their objectives and responsibilities (Conventions d'objectifs et de gestion, COG). These could perhaps be improved by requiring a more regular reporting of the impacts of programmes and incorporating a discussion of these into the debate on the PLFSS held each year in parliament. Indeed, a thorough and regular confrontation between the objectives of these programmes spending and their results would help ensure that their goals are achieved at least cost. Moreover, it might well lead to a clearer societal definition of what those objectives are and in this way help to contribute to a constructive reform dialogue.

Raising efficiency at the sub-national level

Existing financial rules concerning sub-national governments strike a good balance between national and local interests by ensuring fiscal sustainability while granting substantial autonomy to local governments as concerns the content of expenditure. Balanced budget requirements and the strict pro rata release of funds to local authorities help guarantee the smooth execution and monitoring of local level public expenditures by the central government and prevent the emergence of major fiscal imbalances. While these rigid cash-flow rules may prevent sub-national governments' from organising their capital expenditures in an optimal manner, they have the advantage of granting local governments budgetary predictability and the liberty to manage money in accordance with local needs.

Ongoing efforts to rationalise and better identify the roles of different governmental actors working at the local level should be pursued, especially given the large and rising share of general government services delivered by these levels of government. The authorities' proposed decentralisation initiative seeks to do just that (Box 12). Currently, overlapping responsibilities and various

Box 12. Decentralisation¹

The government hopes to put in place a major decentralisation reform and has already amended the constitution, with an eye to creating a framework for subsequent changes. The reform seeks to clarify the roles of various levels of government in the hope that clearer responsibilities will lead to better (and more efficient) governance. In particular, under the reform the:

- State retains the responsibility for setting national norms, ensuring national security, justice, education, employment, public health, taxation, national infrastructure and territorial equilibrium.
- Regions should ensure the coherence and strategy at the level of the department for:
 - youth employment and training programmes,
 - universities.
 - · lifelong learning,
 - industrial policy,
 - regional and sub-regional transportation infrastructure,
 - certain healthcare programmes, notably regional hospital agencies, ARH.
- Departments are given substantial additional powers, principally having to do
 with social policy and local infrastructure projects. In particular, they will be:
 - made responsible for the management of the RMI,
 - given responsibility for the maintenance of regional infrastructure, including schools and national roadways (but not autoroutes),
 - take responsibility for some 100 000 school maintenance employees.
- Municipalities remain in charge of the provision of local services.

In order to ensure that sub-national governments have the appropriate incentives to manage their new responsibilities the state will transfer an equivalent amount in financial resources. In particular, it proposes to transfer to the regions part of petrol taxes (Taxe intérieure sur les produits pétroliers, TIPP) and to allow them to set (within bounds) the rate at which the tax will be applied.²

Moreover, it intends to improve and simplify the system of regional equalisation so as to ensure that less wealthy subnational governments have the financial means to deliver the services required of them.

co-financing mechanisms have weakened service providers' incentives to reduce costs. Under the planned reform both financial and administrative responsibilities will be more closely aligned with the natural geographic hierarchy of existing government

^{1.} The bulk of this box is based on the Speech by M. Jean-Pierre Raffarin, the Prime Minister of France, given in Rouen on 28 February 2003 (www.premier-ministre.gouv.fr).

^{2.} Such a step requires the approbation of Brussels, which has yet to be provided.

levels. Thus, regions are to be made responsible for defining broad strategies, departments for delivery and coordination of most local services and infrastructures, while municipalities are to continue being the primary deliverer of such services.

This is an important initiative, which if implemented (certain aspects of the reform have recently been put into doubt and its implementation delayed) could generate substantial efficiency gains. In particular, the transfer of both a fixed budget envelope and responsibility for the regional administration of hospitals could help rationalise the distribution of small hospitals and clinics, which until now has been slowed by the conflicting interests of their owner-managers (local municipalities) and the State, which was responsible for financing them. Similarly, transfer to the departmental level of financial and administrative responsibility for both active labour market policies and the main cash social benefit (Revenu minimum d'insertion, RMI) should help sharpen incentives to actively help beneficiaries to find work (the further proposal to transform the RMI into a more active instrument was discussed in Chapter II).

The success of efforts to increase the incentives for municipal level governments to cooperate in the provision of services illustrates the effectiveness of such strategies to increase efficiency and the quality of services. Here, the 1999 reform creating a special category of Public Enterprise for municipal cooperation (Établissements publics de coopération intercommunale, EPCI) has helped overcome the serious problem posed by the large number of municipalities with fewer than 20-30 thousand inhabitants, a level estimated to equal the minimum efficient size for this level of government. These EPCIs permit smaller municipalities to jointly provide services and infrastructures (such as those for local transport and waste management) in conjunction with a larger one, which acts as a hub. 77 Already some 2 360 EPCIs have been formed, covering 90 per cent of France's population, effectively taking over the activities of various other cooperative forms previously created to address this issue. A less clear success are the local public-service companies (Sociétés d'économie mixte locales, SEM), which have until recently enjoyed an unfair competitive advantage vis-à-vis private firms. A recent ruling requiring municipalities to place the management of large projects to public tender should help harness competitive pressures, reduce costs and spur the development of a sounder market for public works at the local level.

The benefits of output-based budgeting should be extended to sub-national governments. Technically, there are no obvious impediments to moving in this direction. Within the context of the LOLF, the decentralised services of the State are already moving in this direction (departmental prefectures were some of the first groups to experiment with defining objectives and indicators) but more could be done. A more systematic and rigorous implementation of results-oriented budgeting could, for instance, break down local-level resistance to the closure of underutilised and uneconomic services, if in fact they resulted in improved services or significant cost savings for the locality.

Summing up

Since the early 1990s, when France's general government deficit reached a disturbing 6 per cent of GDP, the country's public finances have progressed substantially, even though significantly further improvements are required. This principally reflects a substantial increase in taxes and a stabilisation of expenditures' share in output. Looking forward, the ageing of the population is expected to generate substantial new spending pressures and at the same time slow the pace of growth, putting into question the economy's longer-term fiscal sustainability. Given the already very high tax burden, policy needs to focus on controlling the rate of increase in public expenditures, including those of the State and subnational-level governments - but especially those of the social security system where cost pressures are likely to be strongest. The future progression of ageingrelated costs is relatively well known, as is the unsustainability of public finances in the absence of reform (see Chapter I). To meet this challenge, fiscal room needs to be made now and the overall debt reduced so that when these additional expenditures arise they can be met without threatening the overall sustainability of public finances.

This chapter has examined the tools available to policy-makers to meet this challenge and Box 13 summarises its principal recommendations. The clearest message is that given the relatively small size of the State Budget in total spending, the challenge cannot be met by the State sector alone. Social security, as the principal source of spending pressure, must play a role, but so too must subnational government - especially if current plans to transfer additional responsibilities to the local level go through. If policy-makers are to succeed in directing public expenditure so as to create this room, they will have to clarify governance structures so that those who administer programmes face appropriate incentives to control costs and maximise programme efficiency. Too often financial responsibility and administrative responsibility are not held by the same body so that resulting conflicts contribute to policy inertia and blocked reforms. The authorities' decentralisation programme is a clear and important step towards clarifying roles. However, it does not address the second major difficulty, the lack of mechanisms to moderate the growth of public spending so as to create the fiscal room necessary to cushion forthcoming spending pressures.

To meet this challenge – both as concerns sub-national and social service expenditures – the authorities should consider expanding both the scope and the duration of the budget process to include the social security and sub-national sectors. A more integrated and multiyear budget would help expose all spending to the same degree of oversight and competition, while confronting decision-makers with the medium-term consequences of their actions. To be effective, such a reform would require that Parliament increase its influence over the revenues of the social security funds and introduce mechanisms that make their budgets more

Box 13. Summary of recommendations

Aggregate fiscal discipline

- In order to improve the information available to policymakers and to prevent expenditures from rising permanently, measures should systematically include, at all levels of government, evaluations of their medium-term impacts on the general government.
- In order to increase the authorities capacity to reallocate resources, the State and Social Security Budgets should be more clearly integrated into a medium term framework.
- It is important that the macroeconomic framework underlying budgetary assumptions be more closely in line with economic potential.
- Concerning specific programmes, information about individual Budget missions and social security programmes should be precisely displayed as a way to better isolate the influence of different spending programmes.

Ensuring the effectiveness of the new State budget framework law

- Letting spending Ministries and departments participate actively in the preparation of missions objective and evaluation strategies will be key to ensuring that those who are called upon to implement such objectives see them as fully legitimate.
- In order for new public-expenditure management techniques to improve the quality and cost-effectiveness of programmes, the policy evaluation process needs to be reinforced.
- The resources allocated to evaluation might need to be increased, something that can be achieved through reallocation of posts.
- As a means to combating spending inertia, the authorities could consider making greater use of sunset clauses that require specific task-spending programmes to be abandoned after a set period of time.
- Although the new budgetary framework only applies to the State Budget, the authorities should envisage measures requiring a more regular reporting of the impacts of social security programmes and incorporating a discussion of these into the parliamentary debate on the PLFSS held each year. The benefits of output based budgeting should also be extended to sub-national governments.

Local governments

- Bringing forward the preparation of local government budgets would help improve co-ordination and the preparation of the general government budget.
- The ongoing reform to rationalise the roles of different sub governmental actors should be phased in as planned. If its spirit is preserved during its realisation, it would go a long way towards generating important efficiency gains.

Box 13. **Summary of recommendations** (cont.)

Mandatory expenditures

- Transforming into direct transfers the aid the State currently provides the social security system in the form of earmarked taxes would go a long way towards reducing presently observed rigidities in budgetary allocations.
- Making the budgets of the social security regimes more binding would help bring healthcare expenditure under control.
- In order to make individuals and their private insurance schemes more interested in controlling costs, access to basic coverage should be made more universal, consistent with current government's plans, while also conferring more of the overall costs to complementary regimes.
- Specific recommendations concerning the reform of the pension system are outlined at the end of Chapter II.

binding. Furthermore, the additional autonomy and expanded spending responsibilities that decentralisation will bring to sub-national governments need to be combined with a responsibility to respect national spending norms. Finally, if the medium-term features of such a programme are to help guide policymakers, projections need to be based on prudent macroeconomic assumptions and the sources of future savings need to be identified.

Of course, such institutional changes cannot in and of themselves generate the savings necessary to ensure fiscal sustainability. Here, the ongoing reform of the pension and healthcare systems will play critical roles. As the simulations in Chapter I make clear, failure to generate the kinds of savings proposed by the authorities between now and 2020 will place serious strain on the economy. Moreover, notwithstanding the ambition of current proposals, this is just a beginning and much more needs to be done to restore equilibrium to the pension regimes.

Health reform will also be important. Several propositions currently on the table, including decentralisation, an extended role for complementary coverage, and perhaps a reduction in the range of services covered, would serve to reduce health insurance costs and contribute to their slower progression. However, they do little to make the budget constraint of the system more binding and in this regard the 1999 Economic Survey made a number of suggestions, which remain relevant. For the State Budget, the new budgetary framework may help contribute to a slower and more effective expenditure growth. To maximise the chances that this reform will be successful, the high level of support that it has

enjoyed so far will need to be maintained, both at the political level and on the part of all of those responsible for public spending.

The fiscal challenges facing France in the coming years are enormous and will require important fiscal adjustments. While the path ultimately chosen will doubtless be different from the one outlined here, it will necessarily address the same problems. Whatever form they take, reforms along these lines could go a long way to helping ensure that France is able to meet its future challenges with a minimum of disruption and while maintaining a high level of public services.

Glossary of acronyms

ACCORD New State's mission oriented data system

ACOSS Central fund for social security
ARHs Regional hospital agencies

ARPE Employment replacement allowance

ASFNE (an early retirement scheme)

APA Personalised assistance allowances to the elderly

APE State ownership agency

BAPSA Separate annex budget for the agriculture social fund

CADES Fund for the amortisation of the social debt CAE Prime Minister's Economic Analysis Council

CEC Consolidated employment contract
CES Solidarity employment contract
CGP General Planning Commission

CIT Corporate income tax

CNAF Family social security regime
CNAMTS Healthcare social security regime
CNAVTS Old age social security regime

COG Management target and management conventions between the

State and the social security regimes

COR Retirement Advisory Council
CSG Generalised social contribution
EDF French Electricity Company
EPICs French Public Companies

EPCIs Public Companies for municipal cooperation

EU European Union

FCATA Asbestos workers early retirement fund

FCAATA Agriculture work accident fund

FIP Local investment funds

FOREC Fund for the financing of the reform of the enterprises' social

charges

FRR Retirement reserve fund
FSV Old age solidarity fund
GDP Gross Domestic Product
GIAT Armament Company
GDF French Gas Company
GHG Greenhouse gas

IGF General Finance inspectorate

ISF Wealth tax

INSEE National Institute for Statistics and Economic Studies

IPO Initial public offering

LOLF New framework law for the State Budget
MINEFI Ministry of Industry, economy and finance

ONDAM National health spending target

PARE Return to employment assistance scheme

PEE Enterprise saving plan
PES Public employment service
PIT Personal income tax
PLF State draft budget

PLFSS Draft social security budget
PPE An earned-income tax credit
PPES Voluntary saving partnership plan
R&D Research and development

RFF French railways infrastructure company

RMA Minimum activity revenue
RMI Guaranteed minimum revenue
RRIT Research and technology network
SEMs Local public service companies

SIFE Insertion and training stage programme
SNCF French railways Service Company
SMEs Small and medium seized enterprises

SMIC Minimum insertion wage

SNECMA Aeronautical manufacturing firm

TIPP Petrol tax

TRACE Access to employment programme

UNEDIC Organisation in charge of the management of the unemployment

insurance scheme

URSAFFs Regional agencies in charge for collecting social security

contributions

WHO World Health Organisation

- These other general government organisms includes special funds put into place to transfer money from the State Budget to the social security system, notably the retirement reserve fund and a special fund designed to deal with the debts incurred by the bailout of Credit Lyonnais in the 1980s.
- 2. Perhaps, the first time ever such credits have been cancelled outright, without an offsetting increase elsewhere.
- 3. The reform also included a 0.6 percentage point hike in social security charges, but these come into effect in 2003 and therefore do not explain the projected improvement in the accounts in 2004.
- 4. Based on OECD estimates (2000) of a 1.9 per cent of GDP funding gap for the health system and, at one end of the range, the COR's (2001) baseline scenario (deficit of 4.5 per cent), which comprises a substantial improvement in various structural policies, notably unemployment (down to 4.5 per cent). The upper end of the range is based on the same OECD estimates and a "no-policy change" scenario, the COR "gris" scenario, which nevertheless incorporates a fall in the unemployment rate to 7 per cent. All scenarios incorporate a regular full in private-sector replacement rates as the 1993 pension reform continues to come on stream (see Annex I for more details).
- 5. This is strictly true for the private-sector scheme only as under the public-sector scheme benefit levels are based on one's final salary not a weighted average of the previous 25 year's salary.
- 6. For more details on assumptions underlying these simulations, see Annex I.
- 7. In the reference scenario, it is fixed at 2 per cent per year, which is higher than during the recent period of relatively job-rich growth, but approximately equal to the rate observed during the 1980s.
- 8. Youth employment rates at about 50 per cent were much higher in the 1970s. Their fall to less than half that level in 2001 (23 per cent) coincides with the increase in joblessness in France. While other OECD countries saw youth employment rates decline, none did so to the extent that they did in France. In Sweden which has the second largest drop in employment rates, the fall was much less marked and youth employment rates there are twice French levels.
- 9. All told six of ten of the 30 per cent of individuals who left the *emploi-jeunes* programme before the end of their contract found employment. However, only one third of these (6 per cent in total) found employment in the private sector. Most participants continued on to the expiration of their contract without finding unaided work or another *emploi-jeunes* (Bellamy, 2002a).

10. Approximately 40 per cent of participants fail to find a job before the programme ends (nominally after 18 months), some of these have the programme extended while others jump to a training programme presumably to prolong access to State aids.

- 11. 56 per cent of youth awarded these contracts were working previously, 33 per cent in a normal job and 23 per cent under an apprenticeship contract. A further 30 per cent were unemployed while the remainder were mostly in school.
- 12. The programme is restricted to youth (< 26 years of age) with poor qualifications, older workers (> 50 years of age) without work, the long-term unemployed and handicapped persons.
- 13. Twenty-five per cent of interim workers have a permanent contract a year later, as compared with one-third with a fixed-term contract and only 13 per cent unemployed.
- 14. The law stipulates both "normal" working time (35 hours per week) and the maximum number of overtime hours that may be worked, the total being referred to as the contingent. This problem for small- and medium-sized firms was discussed in the 2001 Economic Survey.
- 15. Dares, www.travail.gouv.fr/dossiers/dossiers_f.html
- 16. Virginie Malingre "L'UNEDIC dresse un constant alarmant du régime d'assurance chômage des intermittents du spectacle", Le Monde, August 22, 2002.
- 17. McKinsey (2002) reports that fully 10 per cent of the workforce in the US earns less than the French SMIC.
- 18. A significant proportion of this rise is due to increases in the SMIC, which all other things equal raises the number of individuals with a salary close to the SMIC. Nevertheless INSEE (2001) concludes that the post 1993 period saw the number of low-qualified workers rise substantially, reflecting lower social charges for both full-time and part-time workers.
- 19. Approximately 46 per cent of employees earning the SMIC work for firms that have not yet entered into a 35 hour workweek agreement.
- 20. The end to compulsory military service was progressive, applying to young men born after 1978. This meant that as of 1997, the year the reform was introduced, the potential population of conscripts began falling. Moreover, young men in school or at work were permitted to delay their military service to avoid interrupting their careers. In the past this had the effect of reducing youth unemployment as such individuals would enter military service (and therefore exit the labour force) when they lost their jobs. As of January 1st 2002, no more conscripts were received, effectively exonerating those who had yet to undergo their military service because of various delays even if they were born before 1978 (Minni and Poulet-Coulibando, 2003).
- 21. Such studies are necessarily much more complex as they have to take into consideration problems such as selection bias (individuals selected or qualifying for a programme may be more likely to succeed) and require a close follow up on the population that did not participate in the programme individuals who are more difficult to identify than those that did.
- 22. Givard (2002). The rise in unemployment also plays a small role, while for women the trend rise in their labour force participation has a small opposite effect.
- 23. Zaidman *et al.* (2000) cite a number of studies attesting to the limited or even negative impact of early retirement on unemployment over the long term.
- 24. Zaidman et al. (2000), p. 103.

- 25. Naturally, conditions apply. Workers older than 50 having worked 6 of the last 22 months are entitled to 7 months benefit, those having worked 14 of the last 24 are entitled to 23 months benefit, while those having worked 27 months in the previous 36 are entitled to a benefit of 36 months duration. In addition, those over 57 years of age and having 25 years professional experience are entitled to a total of 42 months of benefits.
- 26. The classification of certain categories of jobs as difficult and deserving of special treatment is necessarily a hazardous exercise, leaving some individuals working in truly onerous conditions uncovered, while others whose jobs are not nevertheless meet the criteria of the programme and qualify. Moreover, in practice these programmes tend to favour (and implicitly subsidise) the labour management issues of certain kinds of firms. Thus, employees of large unionised firms tend to be over-represented in these programmes, both because of the definitions retained for onerous work, but also because larger firms are better able to amortise the cost of gaining admittance to these programmes across a larger number of workers (Anglaret and Massin, 2002).
- 27. A survey conducted by the CSA indicates that 59 per cent of the population would be willing to accept a smaller pension in exchange for an earlier retirement, while 37 per cent indicated a preference for working longer in exchange for a larger pension (Les Echos, 21 January, 2002).
- 28. Récépissé de Création d'Entreprise.
- 29. Some sectors may, due to the nature of their activity, require a larger capitalisation.
- 30. Among OECD countries in 2001-02, five provide tax credits on incremental R&D expenditures only, four on the level and two on both the level and increment.
- 31. Principally via the Ministry of research; the fund for research and technology; the Ministry of Industry, Finance and Economy; and the Environmental and Energy Agency.
- 32. The authorities estimate that in 2001 only 15 such angels operated in France in contrast to several hundred in the United Kingdom.
- 33. See, for instance, the special section "Aujourd'hui: Sciences" of Le Monde 12 March 2003, pp. 24-25.
- 34. These include: King and Rebelo (1990), Englander and Gurney (1994), Slemrod (1995), Leibrfritz et al. (1997) and Bleaney, M. et al. (2001).
- 35. Generally France does poorly in terms of international comparisons of corporate income tax burdens. Indeed, only in *ex post* calculations of corporate tax burdens does it appear within the average range. Rather than be comforting, this likely reflects a combination of selection bias and the operation of market forces. Firms operating in France are either those that are less impinged upon by the tax system or those that have succeeded through tax optimisation strategies in lowering their tax burden down to the average.
- 36. The bias in favour of large firms reflects the influence of a favourable amortisation scheme for manufacturing companies, which is particularly evident for large firms in the construction, transportation and energy sectors.
- 37. EC (2000) provides more details on these developments.
- 38. See for example, World Economic Forum (2002) which ranks France as a country where such rules and regulations are particularly onerous.

39. Cross subsidisation of services and various implicit and or explicit transfers from the State Budget have served to shift these costs either to other users – or to taxes. Such practices have been greatly curtailed in recent years, although the SNCF still benefits from a substantial subsidy in so far as the management fees it charges the *Réseau Ferré de France*, the owner of France's rail system, greatly exceed the fees it pays for using the system – thereby transferring the operating losses of SNCF to RFF whose shortfalls are covered by transfers from the central government.

- 40. Paul Questiaux, "La privatisation d'EDF et la concurrence", Les Echos, 13 February 2003.
- 41. Minister of Transport, Gilles Robien, cited in Samuel Coulon, "Gilles de Robien défend la nécessité de privatiser la compagnie", Les Echos, 13 February, 2003.
- 42. Other major recipients were Etablissement Public de Financement de Restructuration, BULL, (the beleagured state-owned computer manufacturer) and Charbonnage de France (the State Coal company).
- 43. For instance, the authorities appear to have used their position in State-owned firms to help support a privately owned French firm resist a takeover attempt by a foreign company. In this particular instance, state-owned or firms with a state representation on their boards helped the French firm overcome cash-flow difficulties by purchasing some 10 billion euros worth of shares in a subsidiary that it was selling.
- 44. Similar operations have been conducted in the Czech and Slovak Republics and Hungary.
- 45. A detailed analysis of French climate policies can be found in the chapter on Environmentally sustainable growth in the previous Economic Survey of France.
- 46. Eight new nuclear reactors came online during that period.
- 47. Such growth would be somewhat below potential economic growth in this period, as estimated by the OECD.
- 48. A provision equal to 0.3 cents per kilowatt hour is placed on EDF's balance sheet. The total of the reserves for waste treatment and decommissioning amount to 29 billion euros.
- 49. Comprising employee and employer social security contributions, personal income tax and the generalised social contribution (CSG).
- 50. The authorised concentration in drinking water of individual pesticides was set at the lowest level detectable, when the law was put in place. The levels in the United States and those set by the WHO are different for each chemical and much higher.
- 51. Farmers were offered subsidies covering 60 per cent of investment, primarily for manure storage, at a likely cost of 2 285 million euros between 1994 and 2006.
- 52. Marginal costs may be estimated at 0.75 euros per kilogram of nitrogen.
- 53. The tax varies from 71 euros per tonne for detergents without phosphate to 87 euros for those with high phosphate content.
- 54. Polluters can opt to pay the tax based on actual discharges. Polluters with above average emission intensities have no incentive to opt for this system and so have no incentive to reduce discharges.
- 55. Overall, government expenditures increased by more than 200 per cent in volume terms between 1970 and the beginning of the new millennium, 30 per cent more quickly than GDP itself.
- 56. This compares with 52 per cent in the European Union considered a whole.
- 57. Calculations based on UN demographic projections, Commissariat Général du Plan (2002).

- 58. Excluding public works employment and employees of State-owned enterprises. Calculations based on INSEE (2002) and Commissariat Général du Plan (2002).
- 59. This compares with an average of 30 per cent for OECD unitary states (OECD, 2003).
- 60. The share of social security contributions levied from payrolls represents about 50 per cent of the funding of the health system, 59 per cent of that of the family and social assistance regime and 71 per cent of the old age pension system.
- 61. The CSG represents 34.5 per cent of healthcare revenues and 20.7 per cent of those destined for the social assistance system. The old-age pension system does not receive revenues from the CSG.
- 62. The relatively healthy budgetary balance of the social security system does not reflect expenditure restraint but efforts to reinforce its revenues by increasing its share in tax revenues and State transfers.
- 63. Although a 50 per cent cut in State expenditures represents about 9.5 per cent of GDP, pre-existing state employee pension obligations (which are financed from general revenues) are projected to grow from about 2 per cent of GDP to some 6 per cent of DGP in 2050, reducing considerably the public savings.
- 64. The authorities justified this difference by the presumption that there existed a significant negative output gap that could be absorbed. While OECD estimates of potential growth are broadly in line with those of the authorities (see Chapter II), they suggest that the gap in 2002 was significantly smaller than the one outlined in the PLF.
- 65. For instance, rather than reacting counter-cyclically, labour market policy spending appears to have increased structurally over the past decade (IMF, 2002). In particular, expenditures for subsidised state-sector employment did not diminish towards the end of the last decade, notwithstanding reports of widespread hiring difficulties in the private sector and indications that these programmes were having limited impact on the long-term employability of participants.
- 66. The share of social security spending in GDP has risen by 50 per cent since 1970, from 12 to 18 per cent.
- 67. Specific examples in recent years include the introduction of a universal healthcare coverage, a programme of in home assistance for the aged and in large measure the cuts to social security contributions to offset the costs of firms from moving to the 35 hour work. Indeed, it should leave open the possibility for a reversal in trends.
- 68. Based on the assumption of a person having contributed 40 years, aged 62 years of age and with a real rate of return of 3 per cent.
- 69. Currently hospital-based care is budgeted, giving individual hospitals little financial interest in reducing costs.
- 70. Indeed, it is largely because the rigidities implicit in earmarking that the constitution explicitly prohibits earmarking of funds within the Budget of the State.
- 71. The expenditures of the unemployment insurance system, which should normally be strongly counter-cyclical, have been pro-cyclical on a structurally adjusted basis. Rather than paying down its debt or building up reserves during up-turns, the UNEDIC has reacted, on more than one occasion, by reducing contributions and increasing benefits only to reverse itself during the downturn.
- 72. This is perhaps most obvious in the case of the pension schemes, where, barring reform, the tax payer is being asked to pay the deficits of the most generous special and complementary regimes.

73. Administrative and management costs are estimated to represent 10 per cent of non-hospital medical expenditures (*Commission de comptes de la Sécurité Sociale*, 2000). This falls to 6 per cent if hospital grants are included in the denominator but State contributions to hospital administration excluded.

- 74. The degree to which such responsibility will be delegated in practice remains to be seen. Both the political and social sensitivity of staffing decisions, may seriously constrain managerial freedom in this regard, while ceilings on expenditure appropriations will limit the fungeability of resources.
- 75. To date these powers have not been exercised, perhaps reflecting the early stages of the transition.
- 76. The system is being brought into play in two phases. Overall, it seeks to equip the central administration with a common expenditure management and accounting software application for the stockage and retrieval of indicators, accounting information both at the macro- and micro-budgetary levels. Already eight ministries have been linked to ACCORD I and the remaining three large ministries (Agriculture, Foreign Affairs and Defence) are scheduled for a link by the end of 2003. During 2005 and 2006, ACCORD II will be launched to encompass other minor central services and the local administrations.
- 77. The responsibilities of the EPCI are defined by the municipalities whose elected members form their managing assemblies.

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Annex I

Annex I

Long-term fiscal simulations

This appendix provides detail on the fiscal simulations discussed in Chapters I. Crucial to all of the simulations are the assumptions employed to project potential output over the next 50 years and these are discussed first, followed by descriptions of the modelling of alternative measures that might taken to improved long-term fiscal positions.

Potential output

Potential output is calculated using the production function approach described in Giorno *et al.* (1995). In brief, trend business sector employment, hours worked, total factor productivity (TFP) and the business sector capital stock are combined using Cobb-Douglas production technology to calculate trend business sector output, to which the relevant government outputs (real public sector wages and consumption of fixed capital) are added to define total economy potential output. The path for potential output until the end of 2008 is taken from the latest OECD forecast (EO 73) and medium-term reference Scenario (MTRS). Beyond 2008, for the base case "no policy change" scenario it is assumed that:

- Business investment will grow at a rate that keeps the business sector capital-to-output ratio stable:
- Trend hours worked will continue their estimated trend decline in the MTRS of -0.3 per annum until 2020 at which point the level of hours worked is constant;
- Population growth will turn negative in around 2011 and remain so until 2050 as per the latest "medium variant" of the United Nations population projections.
- Trend unemployment (the NAIRU) will remain constant at the MTRS level of 8.8 per cent;
- Trend employment rates will increase slightly at around 0.5 percentage points per decade reflecting the assumption that the general increases seen in recent trend female participation rates will continue forward, outweighing the "population ageing effect" that occurs from lower levels of participation in older age cohorts.¹
- Trend labour productivity growth will remain constant at around 2 per cent per annum, the trend rate estimated for France over the recent past, and;
- Government sector outputs will grow at the same rate as business sector potential output.
- 1. Detailed quinquennial data of labour force participation rates and population levels differentiated by sex are used to calculate the aggregate participation rate. In particular, the average increase in female participation rates seen in the 1990s are used to project female participation rates forward subject to the constraint that they do not exceed 95 per cent of current male participation rates. In turn, male participation rates are assumed to remain constant in each cohort. The participation rates are then combined with projections of population shares in each cohort to calculate the aggregate participation rate.

The alternative potential output scenarios shown in Tables 3 and 4 of Chapter I maintain the same assumptions as the base case with respect to trend hours worked, population growth, and the government sector. Unemployment in the reference scenario is assumed to fall to 4.5 per cent in line with the simulations done by the COR. To examine the impact of increasing employment rates, male labour force participation rates are arbitrarily converged by around 2030 to average OECD levels for cohorts where current participation rates are below OECD levels (i.e. youths, 20-24 year olds and older workers). Together with the assumed catch-up process of female participation rates described in the base case, this implies the aggregate participation rate rises significantly above current average OECD levels. For this reason, in the fiscal consolidation scenarios present in Table 4 a more conservative process of catch-up is posited such that the aggregate participation rate increases by half the magnitude to a still high 76 per cent.

To examine the impact of increases in trend labour productivity two sources are looked at: a permanent increase in the capital-to-output ratio of 0.2 (and investment growth) and a permanent increase in TFP growth of around 0.22 per cent *per annum*. Both sources serve to increase labour productivity, however, the increase in TFP growth is more profound as it requires even more investment in order to keep the capital-to-output ratio stable. As an intermediate case, in the fiscal consolidation scenarios the increase in labour productivity growth is halved and is driven by a more moderate increase in TFP growth of around 0.1 per cent *per annum*, while the capital-to-output ratio still increases by 0.2.

Projection of fiscal positions

Fiscal scenarios are projected from 2009, taking the recent MTRS ending in 2008 as the starting point. In the base case fiscal projections all government expenditures excepting those related to ageing are kept constant relative to potential output, while in the fiscal consolidation scenarios seen in Table 4. decreases in non-ageing expenditures are built in. In all scenarios, health care costs are project to increase by 1.9 per cent of GDP by 2050, as per the OECD (2000) long-term health care projections.

Due to data constraints a detailed construction of pensions costs was not undertaken, instead, the COR (2001) reference scenario is used to infer pension costs. That is, the absolute real pension costs as per the COR study are taken as given, although the costs relative to GDP differ reflecting alternative potential output assumptions. For example, in the base case scenario pension costs relative to GDP by the end of 2040 are around 15.2 per cent of GDP, some 0.5 per cent lower than the COR gris scenario, reflecting the cumulative impact of marginally higher potential output growth.

In scenarios where employment rates are higher than the base case real pension costs are presumed to grow by 1/25 of the increase in productivity each year, reflecting private sector rules. This reflects the presumption that the increases in employment entailed will be entirely met by private sector employment where employees contribute to private pension plans. In contrast, in the scenarios where productivity growth is boosted real per capita pension costs (in absolute terms) are projected to increase. This reflects the standard assumption that higher productivity growth will be passed on into higher real wages, hence increasing the pension entitlement of each retiring cohort. Crucially, however, the retirement costs as a share of GDP are lower in the short run as a share of GDP, implying an improvement in the deficit and debt dynamics relative to the base case.

To project debt dynamics it is assumed that debt serving costs will remain constant as a share of the debt stock, or in other terms, that the interest rate on government debt will stay roughly constant. This is a relatively benign assumption – were debt servicing costs to rise as debt levels became unsustainable, deficits and debt would rise by substantially more.

Annex II

Annex II

Chronology of main economic events

2001

November

Electricity prices raised by 1 per cent for private individuals.

Adoption of the draft Social Security financing bill for 2002. Revenue is forecast to total FF2 076 5 billion

December

Parliament adopts a revised Budget for 2001, incorporating a budget deficit of 32.4 billion euros.

The Constitutional Council censures the government's plan to finance the 35-hour workweek via the Social Security system.

2002

January

Social benefits raised: subsistence benefits by 2 per cent, family allowances by 2.1 per cent, the basic pension by 2.2 per cent and the earned-income tax credit doubled. Introduction of special assistance allowances for the elderly (allocations personnalisées d'autonomie). The price of tobacco is raised by 9 per cent.

The regulatory authority fines France Télécom 5 million euros for failing to respect competition conditions vis-à-vis its Finnish counterpart Sonera.

An agreement is signed between the three health insurance funds and the doctors' union: consultation fees to go up to 18.5 euros on 1 February and time spent "on-call" will be remunerated.

February

The government revises its growth forecasts for 2002, from 1.6 per cent to 1.4 per cent.

The Ministry for Employment and Solidarity increases its estimate of the Social Security surplus for 2002 to 1.5 billion euros.

March

The State sells 13.6 per cent of the capital of Thomson Multimédia.

The Ministry of Finance limits the maximum penalty for bad cheques of less than 50 euros to 30 euros.

The State sells a 49 per cent stake in Autoroutes du Sud de la France.

April

The government sets up a commercial practices review commission to examine general purchasing conditions and the "back margins" system.

Following the results of the first round of the Presidential election, Lionel Jospin tenders his resignation to the President of the Republic. Jean-Pierre Raffarin is appointed Prime Minister.

May

Jacques Chirac re-elected President of the Republic. Jean-Pierre Raffarin makes no changes to his previous government.

Bouygues Télécom applies for a UMTS mobile telephony licence.

Iune

Doctors' consultation rates increased to 20 euros and home visit rates to 30 euros, on condition that more generic medicines are prescribed.

In the parliamentary elections, the Union pour la Majorité Présidentielle (UMP) wins 70 per cent of the seats in the National Assembly.

Unemployment insurance contributions for employers are raised by 3.7 per cent and by 2.1 per cent for employees.

France Télécom and Vivendi Universal shares fall spectacularly, by 16 and 23 per cent credit respectively. Moody's and Standard and Poor's each lower France Télécom's credit rating.

The government announces a 2.4 per cent increase in the SMIC as of 1 July, with no extra boost ("coup de pouce").

Iuly

The Paris Tribunal de grande instance ratifies the PARE unemployment insurance agreement (return to employment preparation scheme), but cancels provisions allowing the Assedic to suspend benefit payments to job-seekers.

The Ministry of the Interior presents an internal security Bill, creating 13 500 new police force posts.

The Health Ministry increases the budget of public hospitals by 700 million euros in 2002.

The Social Security audit committee forecasts a 2.4 billion euros deficit in 2002.

The government announces that it intends to privatise Air France.

Annex II 175

August

The National Assembly adopts a bill introducing the youth contracts (*contrats jeunes en entreprises*) programme for 16 to 22 year-olds with few qualifications.

September

A decree easing the restrictions on legal work time increases the overtime quota from 130 to 180 hours.

The Council of Ministers adopts the 2003-2008 defence bill (*projet de loi de programmation militaire*) which provides for spending of 89 billion euros on defence and the *gendarmerie*.

Presentation of the draft 2003 State Budget (growth assumption: 2.5 per cent); three major items receive increases: justice (+7.4 per cent), defence (+6.4 per cent), the interior (+2.2 per cent), while the culture and research budgets are reduced (by 5.2 and 0.8 per cent respectively). Employment credits fall by 6.2 per cent. 1 089 civil service jobs are abolished. 3 412 school teachers' jobs are cut (mainly supervisers) and 1 864 jobs are created in the Ministry of the Interior. The number of subsidised public-sector jobs is revised downwards (160 000 instead of 260 000), as is the number of *emplois-jeunes* contracts (160 000 instead of 213 000). Tax cuts total 3.9 billion euros.

October

The Ministry of Finance announces its intention to reduce the budget deficit by 0.5 per cent of GDP in 2004.

The European Commission examines the possibility that the status of EDF-GDF as an EPIC (établissement public d'intérêt commercial), which allows it to borrow at favourable rates, constitutes State Aid.

The price of crude oil exceeds \$31 per barrel, the highest level for nineteen months.

November

Parliament votes for the gradual phasing out, as of 2003, of an early retirement scheme for civil servants (congé de fin d'activité).

December

Parliament votes to open the gas market up to competition; implementing decrees to be adopted before the end-2003.

The Air France privatisation bill is discussed by the Council of Ministers.

2003

January

Signing of the agreement on easing the reduction of work time for public sector hospital workers (800 000 people): payment of a maximum of ten days' working time reduction in 2003, recourse to overtime and a 10 per cent bonus on the time savings account. A similar agreement is signed for hospital doctors.

EDF-GDF employees reject the summary conclusions on the reform of their pension scheme.

Agreement between doctors' unions and sickness insurance funds, raising specialists' consultation fees and providing for a new medical agreement.

February

The Minister for Economic Affairs and the Justice Minister submit the financial security bill to the Council of Ministers, the object being to reform the financial activities supervisory authorities, to enhance the protection of savers and the insured and to overhaul corporate accounting and governance.

In accordance with the government's pledge, the *Groupe confédéral sur la réforme des retraites* held its first meeting.

March

The government notifies the European Commission that the public deficit reached 3.04 per cent of GDP in 2002.

France Télécom announces historic losses of 20.7 billion euros for 2002. The announcement is followed by that of Vivendi Universal, which posts a new record loss of 23.3 billion euros

The national rail network is opened up to foreign rail freight companies.

The merger between Crédit Lyonnais and Crédit Agricole is authorised by the regulatory authority (Comité des établissements de crédit et des entreprises d'investissement).

France Télécom launches a 15 billion euro equity issue.

The European Central Bank lowers its main reference rate by \(\frac{1}{2}\)-point to 2\(\frac{1}{2}\) per cent.

April

The Pension Reserve Fund decides to invest 55 per cent of its assets, or 6 billion euros, in equities (38 per cent in the euro area and 17 per cent outside) and 45 per cent in bonds.

Public enterprise GIAT Industries announces a restructuring plan involving 3 750 job losses and the complete shut-down of two sites by 2006.

France Télécom ends its 15 billion euros new equity issue: 9.2 billion euros is subscribed by the State, 4.5 billion by investors and 1.3 billion by 21 underwriting banks.

The Minister of Health announces a cut in the reimbursement rate, from 65 to 35 per cent, of 617 drugs whose medical effectiveness is deemed moderate.

May

Strikes and employee demonstrations against decentralisation and pension reforms.

The Council of Ministers approves the pension bill submitted by the Minister for Social Affairs.

European Finance Ministers adopt a law allowing private pension fund companies to sell their products to businesses throughout the European Union.

The European Commission issues a warning about the size of deficits and rejects the idea of removing certain investment outlays from the deficit calculation formula.

Annex II

The US Congress adopts a ten-year, \$350 billion tax cut plan.

The European currency hits an all-time high of \$1.19 per euro.

Iune

The European Commission begins an extensive inquiry into the acquisition of Vivendi Universal Publishing by the Lagardère group.

Third day of strikes and demonstrations against the proposed pension reforms.

Signature by employers' organisations and three trade unions of a memorandum of understanding amending the unemployment insurance scheme for contract TV, film and stage workers.

The British Minister of Finance delivers a thumbs-down verdict on the economy's readiness to adopt the euro.

European summit in Thessaloniki, during which the draft Constitution prepared by the Convention is presented.

The US Federal Reserve cuts its key interest rate by ¼-point to 1 per cent.

Adoption of Common Agricultural Policy reform, introducing partial decoupling of direct subsidies and production levels.

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