Reforming France: Supply-side "Macronomics" strengthen growth potential

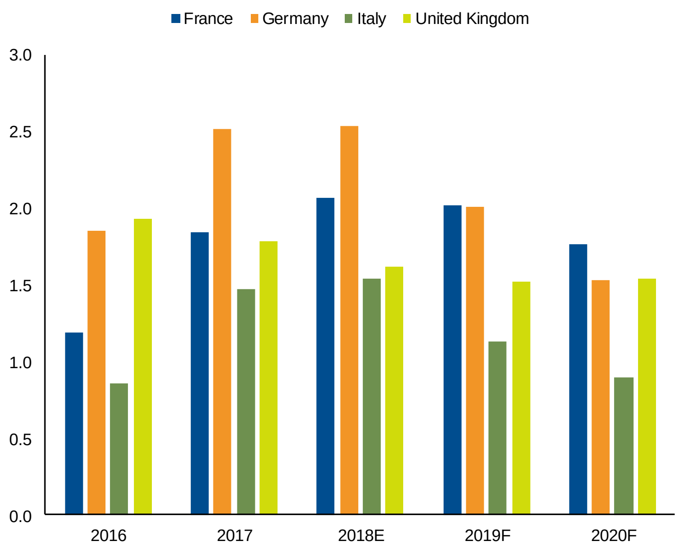
At the start of its second year in office, the French government continues to enact structural reforms, which Scope expects to enhance the economy's growth potential and help strengthen external competitiveness by reducing payroll costs and lower corporate taxes. Higher growth potential also contributes to more sustainable job creation. However, Scope recognises that high fiscal expenditures prevent France from quickly reducing public debt of 97% of GDP.

After higher than expected growth of 2.2% in 2017, France might have the fastest growing economy in 2019 and 2020 of the large European Union (EU) states, ahead of Germany, Italy and the UK, according to latest EU and IMF forecasts (see Figure 1). Even if the government does not manage to get through its entire programme, the reforms to date should raise the economy's growth potential by 0.1-0.2%, which compares with the IMF's optimistic baseline scenario of 0.5% (IMF, 2018). The current reform efforts coincide with stronger-than-expected economic expansion alongside a constructive outlook for 2018 (of 1.8-2.0% from the IMF and European Commission (EC)).

Following Macron's success on the privatization of the SNCF railway network, Scope expects that the government will continue to get public backing for the largely supply-side reforms, supporting economic growth. At the same time, Scope believes that over the medium-term, growth will depend on continuing to implement structural reforms to improve skills, reduce labour market duality and increase services-sector competition strengthening the longer-term effects of these reforms.

Thanks to stronger growth, France's fiscal consolidation is expected to continue as the government meets its fiscal targets with the headline deficit falling below the 3% threshold in 2018 for the first time since 2007. The limited improvement in the structural deficit is still a source of concern, however, and over the medium-term, high public debt burden and persistent structural unemployment will weigh on France's sovereign rating (AA/Stable).

Figure 1: Forecasts on real economic growth among peers, % change yoy



Source: IMF, World Economic Outlook, April 2018

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Major tax reforms

Numerous tax reforms in place

In Scope's view, the government's tax reforms will affect French GDP via three channels: (1) A lower burden on wage costs stimulates employment, hence domestic consumption, (2) the corporate tax reform raises investment and (3) both together strengthen external competitiveness and thereby net exports.

As part of its plans to a balanced budget over the medium-term, the government has introduced wide-ranging tax reforms. Scope notes that tax measures are aimed at broadening the tax base. Employment-related taxes have also been reduced. Recently completed measures include:

- Reform of the CICE (social contributions scheme) with lower employer contributions and extra relief for minimum wage earners
- Replacement of the solidarity wealth tax with a tax on real estate
- Flat tax on capital income (30%)
- Exemption from the housing tax (80% of the population)
- Reduction of the corporate tax rate from 33% to 25% (by 2022)
- Increase in the CSG solidarity tax (average 1.7 percentage points)
- Higher taxes on tobacco products and petrol

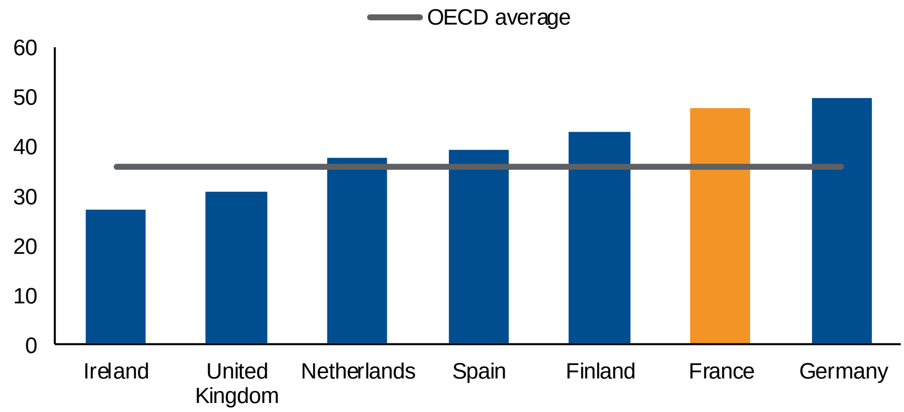
Flat tax replaces solidarity wealth tax

Scope expects that the measures will lead to a broader tax base with fewer exemptions while eliminating ineffective though symbolically important levies such as the solidarity wealth tax. Instead, fiscal authorities have introduced a flat tax of 30% on capital income effective January 2018[1]. Although the change may lead to a temporary decline in tax income due to the reduction in the tax's earlier progressivity, Scope expects that the overall impact will be neutral to positive over the medium-term due to greater incentives to report capital income alongside the indirect impact on higher growth rates.

Relief on ancillary wage costs

Another important tax reform targets the labour market by lowering wage costs. Currently, France ranks among the top five countries with the largest tax wedge (see **Figure 2**). The tax wedge measures the ratio of taxes paid by a worker (single worker without children) as a share of total wage costs for the employer.

Figure 2: Tax wedge across OECD countries in 2017% of labour cost



Source: OECD database 2018

[1] The new tax applies to interest and dividends, capital gains, life insurance and shares (http://www.wfw.com/wp-content/uploads/2018/01/WFWBriefing-France-Tax2018.pdf).

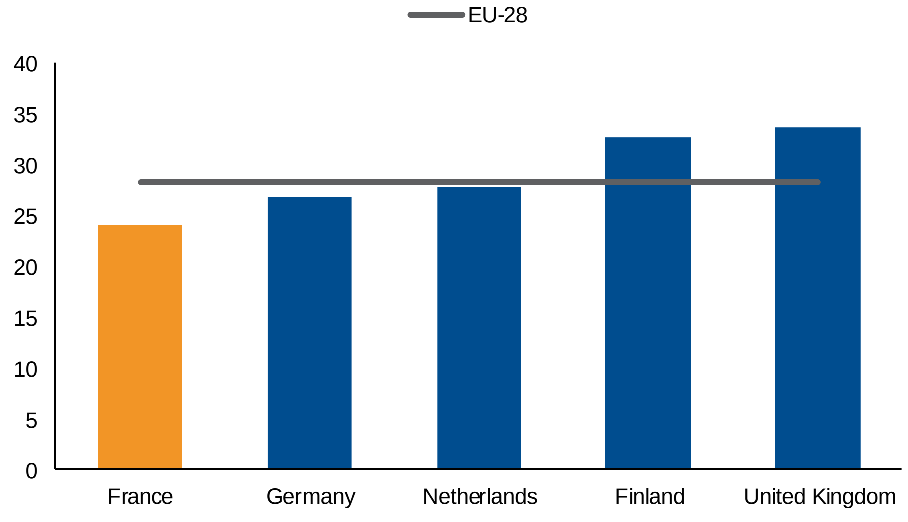
In Scope's opinion, the large burden on labour costs, which accounted for 23.9% of GDP in 2015, poses a major barrier on job creation in France and weakens the external competitiveness of exporters[2]. From 2019 on, employers' contributions will be cut by between 3.9 and 6 percentage points on low income earners (up to 2.5 times the minimum wage)[3]. A further reform was recently launched to lower employees' contributions for both unemployment and health insurance. In Scope's view, these measures should support a continuous, if gradual, decline in the unemployment rate in France (which stood at 9.2% in April 2018) over the medium term.

Additional taxes on consumption and higher CSG to balance fiscal impact

Aside from the tax reforms' growth-enhancing impact, the government plans to keep fiscal revenues up by tax increases in two areas: Higher taxes on tobacco and petrol, intended to change the behaviour of consumers, when successful, bring a drop in revenues as consumers change consumption patterns. The increase in the General Social Security Contribution (CSG) tax, levied on virtually every income source and thus constituting a very wide tax base should, however, compensates for revenue losses from tax eliminations and reductions[4].

While lower income groups are exempted from the CSG tax increase, it still creates an – albeit small – additional burden on employee income. In Scope's view, the better alternative to an increase of the CSG tax would be higher consumption taxes, which are ranked the second lowest in the European Union, and contributed to less than a quarter of overall revenues[5]. Low consumption tax revenues are mainly related to tax exemptions and low rates on certain spending items and have helped create market distortions. Since a higher tax on consumption usually creates a larger burden on financially constrained households, a better balance might be achieved through lower social contributions to benefit the same households.

Figure 3: Taxes on consumption in 2014, % of total tax revenue



Source: EC. "Taxation trends in the European Union", 2016

[2] European Commission. "The economic effects of a tax shift from direct to indirect taxation in France", Discussion Paper 077, March 2018.
[3] Baudchon, H. "France: A year of Macronomics", May 2018.
[4] Ministère de L'économie. "Overview of the French tax system", December 2016. https://www.impots.gouv.fr/portail/files/media/1_metier/5_international/french_tax_system.pdf

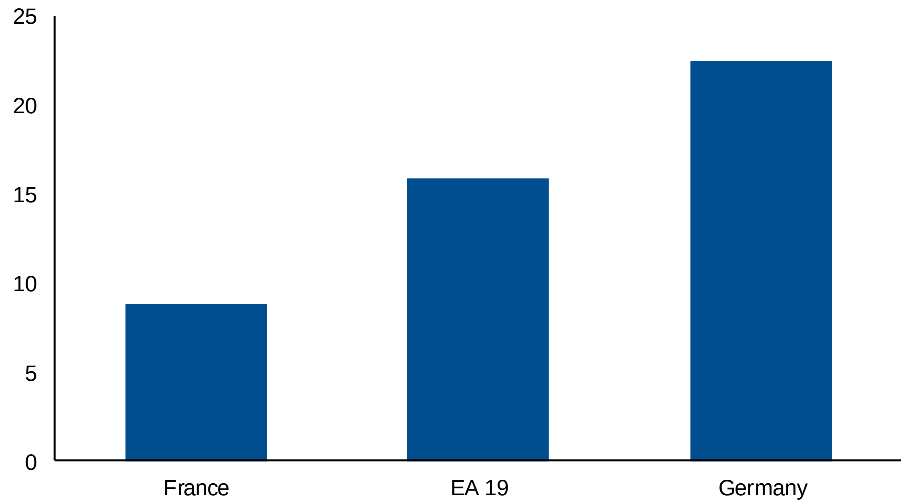
5 European Commission. "Taxation Trends in the European Union", 2016. https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2016/econ_analysis_report_2016.pdf

Structural shift in the French labour market

A mix of rights and obligations, liberation and protection

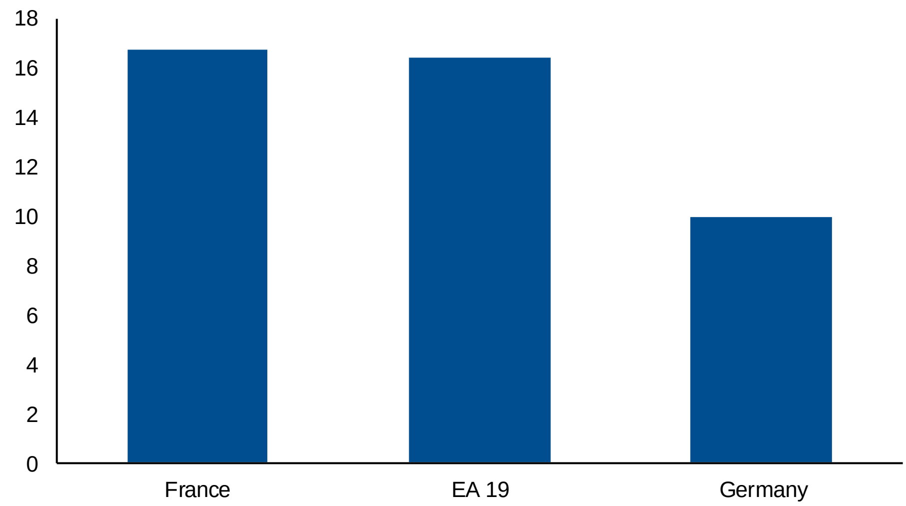
A comparison of the French and German labour markets shows that the sector of low-skilled, low-wage employees is considerably larger in Germany than in France (see **Figures 4 and 5**). The government’s reform programme (PNR) published in April 2018 seeks to combine the merits of higher employment without creating a large low-wage sector as in Germany. In addition to the tax reforms, aimed at lowering the tax burden for employees and firms, the government has put into places a set of measures to facilitate the emergence and development of small- and medium-sized enterprises (SMEs) and medium-sized corporates with a focus on higher profit sharing by employees and involvement in decision-making processes (“*liberation”*). At the same time, the government wants to regulate the use of very short-term contracts by using sectoral agreements, which will be replaced by an incentive system with variable unemployment insurance contributions (depending on the number of short-term contracts) (“*protection*”).

Figure 4: Low-wage workforce in 2014, as a % of total employees



Source: Eurostat, 2018

Figure 5: Low-skilled unemployment in 2017, as a % of the labour force



Source: Eurostat, 2018

In addition, authorities plan to increase spending by EUR 15bn for vocational training for the young uneducated and untrained unemployed (NEETs). This measure is linked to improvements in the education system, including a doubling of the number of first classes for students[6].

The unemployment insurance reform entails a universal extension of the insurance duration and a broadening of eligibility for workers who quit their jobs and the self-employed (*"rights"*). At the same time, unemployed workers will be monitored more closely in their job-searching efforts (*"obligation"*).

In Scope's opinion, France has taken important steps towards a more flexible labour market, combining a lower tax wedge with better training of the unemployed workforce to return the unemployed back to work. However, its efforts to improve educational outcomes will only become visible over the medium-term and it is not yet clear if labour productivity matches wage demands and thus allows for a sustainable revival in the skills-demanding labour market.

Strengthening international competitiveness

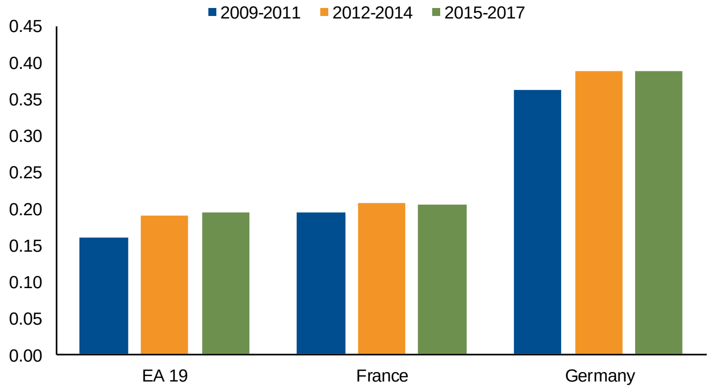
Lower production cost strengthens exports

In Scope's opinion, the above measures should have a positive impact going forward on France's trade balance. Lower wage costs and lower corporate taxes can help stimulate exports, which have faced strong external price competition for several years (see **Figure 6**). The loss of competitiveness was mainly driven by price increases in the non-tradable sector relative to tradable goods and the labour cost differential (in particular relative to Germany) before the crisis[7].

Remove of regulatory barriers to SMEs

The current policy mix of (1) lower labour costs, (2) more favourable corporate taxation, (3) active labour market policies and (4) simplified business regulation for SMEs can help the export industry to increase. The government has launched a programme, which removes regulatory barriers to SMEs, including lower staff, social charges and tax thresholds, easier auditing and improved bankruptcy processes. This should help to bridge the large gap to German small enterprises who are more than twice as likely to export than French SMEs[8]. However, Scope expects that the current account remains negative over the forecast horizon, because the large decline of French manufacturing over a prolonged period is unlikely to be turned around quickly[9].

Figure 6: Exports of goods, as a % of GDP



Source: Haver Analytics

[6] Baudchon, H. "France: A year of Macronomics", May 2018. http://economic-research.bnpparibas.com/Views/DisplayPublication.aspx?type=document&IdPdf=31003
[7] International Monetary Fund. France: 2017 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for France, September 21, 2017
[8] Financial Times, 18th of June 2018
[9] see ibid.

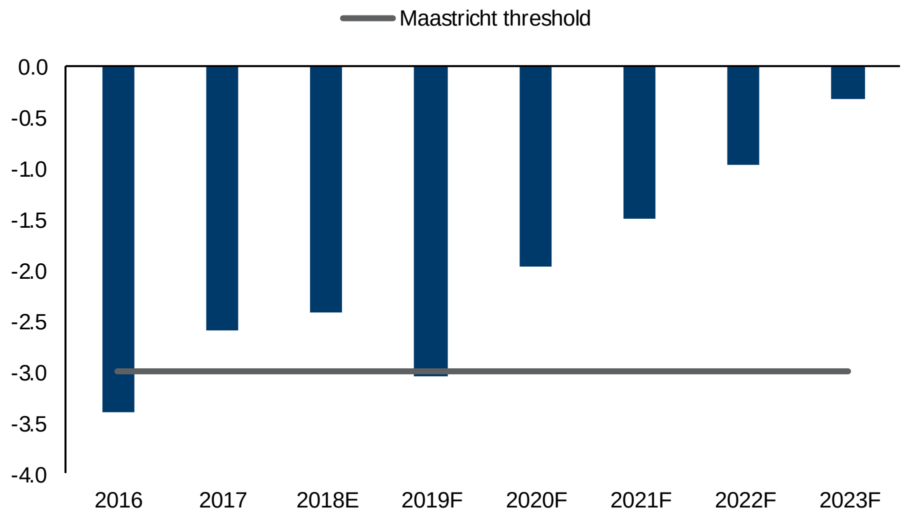
The legacy of a high debt burden

Remaining uncertainties on the fiscal side

The European Council initiated an Excessive Deficit Procedure (EDP) for France in April 2009 with a call to correct the deficit within three years. The deadline was extended three times since then to give France more time to adjust during an extended period of stagnant growth. In June 2018, the Council recommended that the EDP on France be ended following an improvement in the fiscal deficit to below the 3% of GDP limit (to 2.6% in 2017) for the first year since 2008.

In Scope’s opinion, France will move towards a more sustainable level of public debt, albeit very gradually and strongly dependent on growth prospects (see **Figure 7**). In a research comment from 7 March 2018, Scope noted expectations that French debt could decline towards 90% of GDP in the coming years supported by labour market reforms[10]. In Scope’s view, the latest tax reforms are more likely to worsen public finances over the short-term before contributing to higher revenues later due to the broader tax base.

Figure 7: Headline deficit projection in France, as a % of GDP



Source: IMF, Haver Analytics

Progress on privatisations

In addition, the government has made progress on the privatisation of state-owned enterprises: The railway network SNCF is being turned into a private corporation comparable to the German Deutsche Bahn AG, with the government as a single owner but with a corporate structure and private management. In return, the public sector is officially taking over a large part of SNCF’s debt, which shall facilitate any refinancing on capital markets for the new company. The government has announced further planned privatisations for major airports (with government holdings valued at EUR 15bn), including Charles-de-Gaulle in Paris with the aim of privatising all public-sector companies to improve their efficiency.

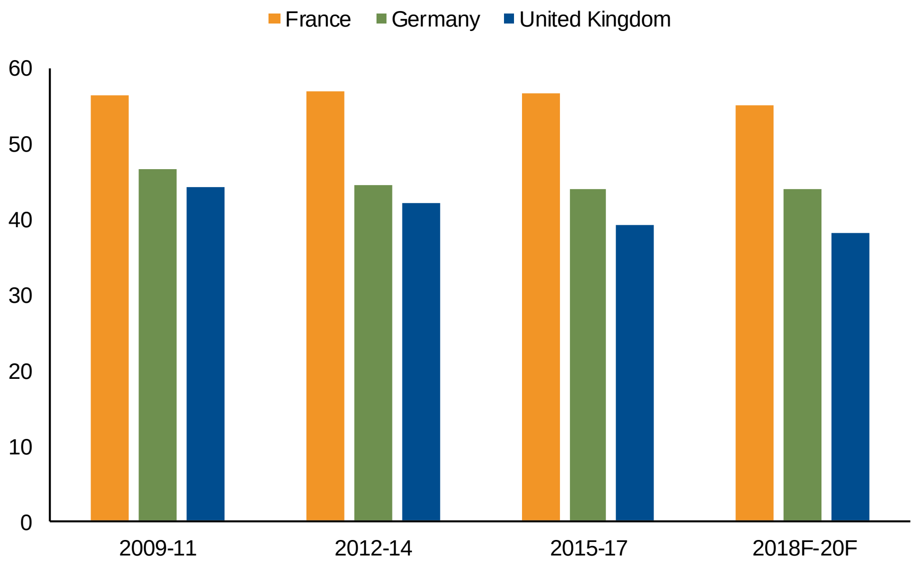
High government expenditures remain an area to target

Government expenditures in France remain high and will need to be targeted to regain fiscal space over the medium-term. According to the government’s economic programme, employment should fall by 120,000 and a public-sector wage freeze will be re-introduced. Moreover, the government plans to further increase the retirement age as part of a major reform of the pension system to ensure more uniform access and benefits for all retirees.

[10] See Scope’s research comment: “France: Macron’s labour market measures are likely to boost structural reform momentum”, published on 7 March 2018.

Taken together, Scope expects a gradual improvement of public finances as these measures are finally implemented. However, high fiscal expenditures to soften the negative impact of the supply-side reforms still inhibit the government from quickly reducing its high debt burden.

Figure 8: General government total expenditure, as a % of GDP



Source: IMF, Haver Analytics

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