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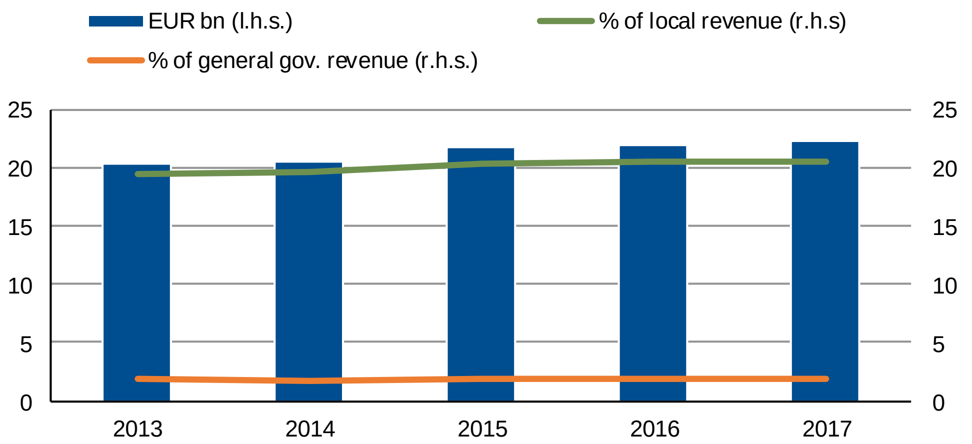
France's residency tax reform poses fiscal risks at the local and national levels

Scope Ratings

One of the pillars of President Emmanuel Macron's political platform during the 2017 elections was the strengthening of public finances, which are structurally constrained by low budgetary flexibility. The elimination of the residency tax (*taxe d'habitation*), a crucial tax revenue source for local governments, was one of the key presidential campaign promises. However, compensation mechanisms for local authorities who will lose out on local tax revenue due to this reform remain unclear at this stage.

The French government is facing a trade-off between pursuing its fiscal consolidation goals and providing social compensation to appease mounting discontent over previous supply-side policies and a persistently high tax burden. The elimination of the residency tax, a key tax source for French local authorities, was one of Macron's key campaign promises in order to raise disposable incomes. However, it has been met with pushback from local authorities who view the tax as crucial to their financial autonomy. Averaging more than EUR 21bn over the past five years, the tax has represented around a fifth of local operating revenues and 2% of general government revenue (**Figure 1**).

Figure 1: Residency tax revenues, 2013-17
EUR bn, %



Source: INSEE, Observatoire des finances et de la gestion publique locales, Scope Ratings GmbH

The government is following through on its campaign commitment by progressively eliminating the tax for 80% of the population by 2020 and is planning to abandon it entirely by 2022. For the 2019-2020 period, we foresee French local authorities continuing to benefit from dynamic operating revenue growth, driven by favourable economic trends, in line with the central government's targets. French local and regional authorities also benefit from relatively high operating surpluses that absorb higher capital expenditure and limit their recourse to debt for investment financing. However, we have identified three credit rating-relevant areas for the country and its local authorities over the medium term:

1. The local tax reform poses financial risks for the most vulnerable French local authorities by eroding local governments' tax authority and revenue flexibility;
2. At the current stage, the reform generates higher revenue uncertainty for municipalities and could therefore cause a deterioration in the local public investment climate;
3. As the reform will come at a cost and result in heavier local government dependency on revenue streams from the central government, increased conflicts between government levels over resources may become more likely.

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The French government is pursuing a fiscal consolidation strategy that affects local and regional budgets

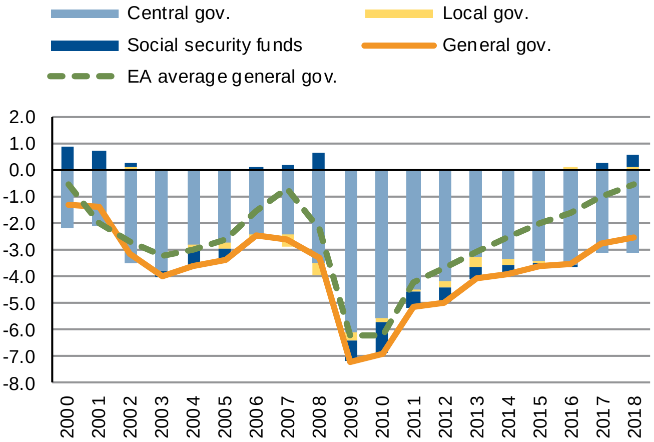
Persistent deficits weigh on budgetary performance

One of the pillars of Macron's political platform during the 2017 presidential elections was the promotion of fiscal responsibility to strengthen the country's public finances. France has not had a balanced general government budget (including regions and cities) in over three decades and public debt levels have increased steadily since the financial crisis, reaching 98.4% of GDP in 2018. The central government balance remains the main contributor to the deficit, at -3.1% of GDP in 2018, while the subnational government reached a fiscal balance of 0.1% of GDP on an aggregated level (**Figure 2**).

Budget flexibility is constrained by high public expenditure and revenues

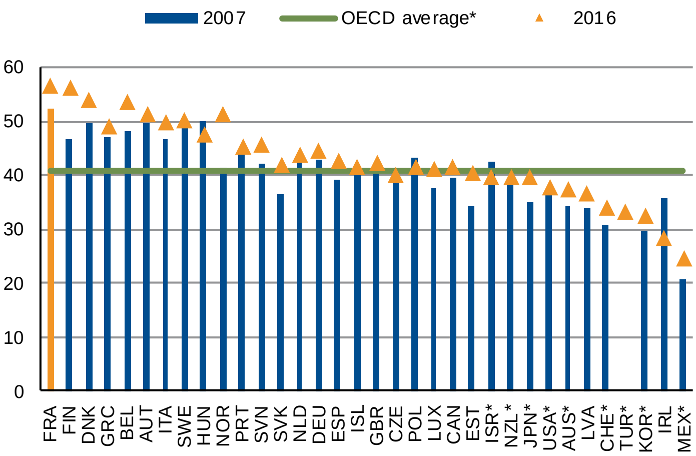
In our opinion, the French general government has limited budgetary room for manoeuvre given high and rigid expenditure levels. France has the highest proportion of public spending as a percentage of GDP among OECD countries, standing at 56.5% in 2016 compared with the OECD average of 40.9% (**Figure 3**). Accordingly, high revenue requirements make France the country with the fourth highest levels of government revenue among OECD countries (at 53.2% of GDP) after only Finland (54.2%), Norway (54.8) and Iceland (56.9%). As a result of the comparatively large tax burden in France, potential revenue increases are limited in our view.

Figure 2: Budget balances by government tier
% of GDP



Source: ECB, Eurostat, Scope Ratings

Figure 3: General government expenditure
% of GDP, by country, 2007 and 2016



* 2015 figures due to issues with data availability
Source: OECD, Scope Ratings

Low expenditure flexibility given rigid expenditure structure

Expenditure flexibility is low given a rigid overall expenditure structure owing to legislative requirements and the social sensitivity of some expenditure items. For example, social protection represented around 43% of government expenditures in France in 2015, 10 percentage points above the OECD average, followed by health care at 14%, which is below the OECD average by 4 percentage points. Moreover, the high public expenditure level in France vis-à-vis other OECD countries is partly explained by the high employment in the general government, which amounted to 21.4% of total employment in 2015, above the OECD average of 18.1%. As a result of these high and rigid expenditure levels, the French general government deficit, which reached 2.5% of GDP in 2018, represents a structural constraint on public debt sustainability.

Stronger focus on local consolidation in recent years

In recent years, governmental efforts to reduce the deficit have focused on local government budgets. A strategy to reduce the level of transfers granted to municipalities was initiated in 2014 in a bid to decrease central government expenditure and contain local spending growth. As a result, central government transfers to local governments declined by over 22% from 2014 to 2017, which led municipalities to curb spending in several areas.

Although the decline in transfers has abated recently, the current government has continued to pursue a reduction in local-level spending, calling for EUR 13bn in local-government savings by 2022.

Historically weak enforcement of expenditure rules for local government

An expenditure norm (*l'objectif d'évolution de la dépense publique locale*, ODEDEL), which sets a non-binding limit on yearly expenditure growth, has been in place since 2014. But the enforcement of expenditure rules at the local level has been historically weak in France. This was an issue in 2017 when local spending growth exceeded the target laid out by the ODEDEL. To increase compliance with fiscal rules, the central government has signed legally binding contracts with 230 local authorities (out of 322) whose operating expenditure exceeds EUR 60 million. In exchange for their commitment to containing operating expenditure growth to no more than 1.2% on average annually, local authorities were given guarantees that there would be no sharp decreases in transfers from the state in the future[1]. Central government oversight of local public finances has increased overall as well. Nevertheless, the European Commission still views the evolution of expenditure by local authorities as a key risk to French budgetary targets for 2019[2].

Supply-side reforms and the yellow vests protests

Several policies implemented by the current government have been perceived by French citizens as mostly benefitting the supply side, e.g. the reduction of the tax burden and provision of social contributions by the corporate sector, at the expense of vulnerable segments of the population. These supply-side reforms have contributed to a significant decline in the president's popularity, which has crystallised in the yellow vests protests.

Pro-inclusivity agenda as social compensation for distortional reform effects…

To ensure the social acceptability of the reform process, the government has pursued a pro-inclusiveness agenda to compensate for the initially negative impacts of its policies in terms of labour market flexibilisation. Examples of pro-inclusiveness policy measures include the announcement of the government's EUR 8bn (0.3% of GDP) anti-poverty initiative in September 2018 or the increase in the minimum wage and tax exemptions for low-income retirees announced in December of the same year.

… whose budgetary impact undermines fiscal consolidation.

The budgetary impact of concessions such as these has undermined the government's efforts to reduce the deficit, which is expected to exceed the 3% of GDP EU threshold in 2019. This highlights the dilemma that the French president faces: how to strike a balance between fiscal consolidation and pro-growth policies, while maintaining popular support for his reform programme. These considerations are particularly important in the current context as the great national debate (*grand débat national*) revealed a consensus among French citizens that measures must be taken to reduce the high tax burden.

Ratings implications for French municipalities: loss of tax authority, increased revenue uncertainty, hampered investments

Campaign commitment to eliminate the residency tax…

The government has adopted several policies aimed at increasing purchasing power for households as part of its strategy of delivering social compensation on the demand side. One of the government's most prominent and controversial measures to address this issue is the reduction and planned elimination of the residency tax, a key campaign promise of Macron. In 2016, the residency tax represented an average annual cost of EUR 662 per household, amounting to 1.4% of disposable income[3]. The tax has been criticised for its lack of transparency and inefficient redistributive effects that motivated the government's desire to eliminate it (see **Annex**).

[1] For a list of signatory municipalities, see: https://www.collectivites-locales.gouv.fr/files/files/dgcl_v2/FLAE/liste_signataires_contrats-etat.pdf
[2] European Commission, Analysis of the draft budgetary plan of France
[3] OFCE, Evaluation de la réforme de la taxe d'habitation d'Emmanuel Macron, June 2017

… with significant effect on the local tax structure.

The residency tax is one of the main components of tax revenues for French municipalities. In 2017, the French municipalities raised over EUR 22.3bn via the residency tax[4]. This amounted to around 40% of local tax revenue and 20% of total operating revenue[5]. The French municipalities have direct control over the residency tax and three other local taxes. These four taxes combined amounted to 46% of total operating revenues for local governments in 2017, granting French municipalities a relatively high degree of revenue flexibility compared to international peers. In OECD countries, local governments retain discretion over the rates of 10.4% of revenues on average[6]. In our view, the high level of tax authority that French municipalities possess, underpinned by the current framework, constitutes a key credit strength for these municipalities.

Residency tax to be eliminated in three steps by 2022

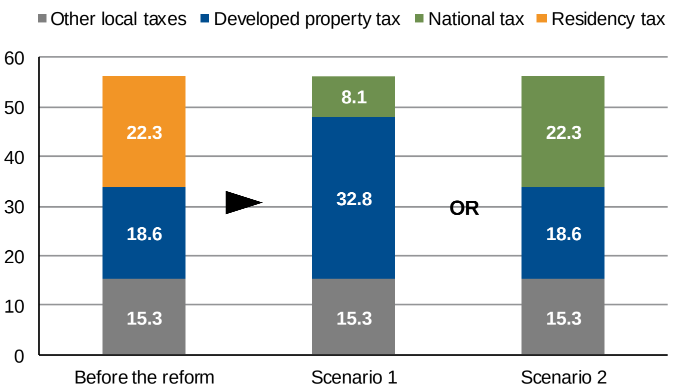
The government has justified the elimination of the tax by highlighting the positive impact the reform will have on disposable incomes. The initial reform provided for a gradual alleviation of the tax over the 2018-20 period for 80% of households based on taxable income and household composition criteria. A rebate of 30%, 68% and 100% was to be granted to eligible households in 2018, 2019 and 2020 respectively. More recently, the government announced its intention to remove the tax altogether for the remaining 20% of households by 2022.

Central government intends to compensate local authorities

The central government has committed to compensate local authorities for the loss of revenue in its entirety. This commitment was initially estimated to cost EUR 3bn, EUR 6.6bn and EUR 10.1bn for 2018, 2019 and 2020 respectively[7]. After 2020, the government intends to change the tax arrangements between the central government and municipalities to compensate for the lost proceeds from the residency tax (projected to equal EUR 26.3bn in 2020). Two scenarios are being considered with differing impacts on French municipalities' tax structures (**Figure**):

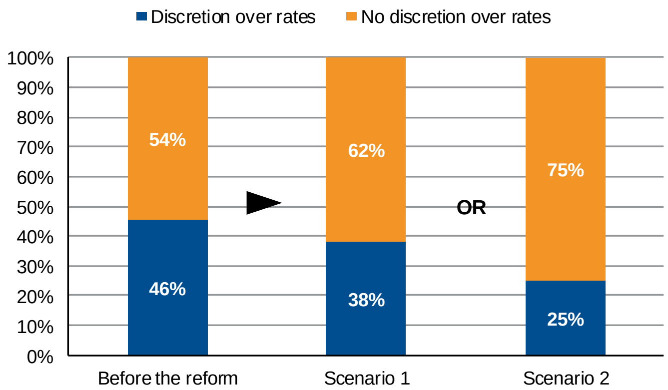
- **Scenario 1:** The share of the developed property tax that was previously allocated to the *départements*, totalling EUR 15.1bn (or 57% of the lost revenue), will be transferred to the municipalities. The central government would complement this with the transfer of a share of the proceeds of a national tax, such as the value added tax.
- **Scenario 2:** The loss of revenue will be entirely compensated for by the transfer of a national tax with the *départements* retaining their share of the developed property tax.

Figure 4: Municipal tax structure (2017 figures)
EUR bn



Source: Observatoire des finances et de la gestion publique locales, Scope Ratings

Figure 5: Local tax authority (2017 figures)
% of total operating revenue



Source: Observatoire des finances et de la gestion publique locales, Scope Ratings

[4] This includes revenues from the residency tax on secondary residences as well as state compensation for existing exonerations and rebates.
[5] Observatoire des finances et de la gestion publique locales, Les finances des collectivités locales en 2018, July 2018
[6] OECD fiscal decentralisation database: https://stats.oecd.org/Index.aspx?DataSetCode=TAXAUTO
[7] Dominique Bur and Alain Richard report on local taxation, May 2018

Loss of local tax authority and revenue flexibility

In our opinion, replacing the residency tax with transfers from the central government or a national tax (with the rate decided at the national level), either partially or entirely, would result in a lower degree of local tax authority (**Figure *5*5**). Using the revenue figures for 2017 as a baseline, we estimate that the implementation of Scenario 1 would result in a decrease of the share of operating revenue over which local authorities have full discretion to 38% from 46%. This would constrain the implementation of budgetary measures at the discretion of French local governments, thus weighing on local government's budgetary flexibility. The figure declines further to 25% in a scenario in which the residency tax is entirely replaced by a national tax (Scenario 2). As a result, the elimination of the residency tax, regardless of the scenario chosen by the government, will lead to the erosion of revenue flexibility for French municipalities. These concerns have been raised by French mayors who view the reform as an attack on their financial autonomy and their constitutional right to self-govern.

Compensation for losses remains unclear at this stage

In our view, the elimination of the residency tax reduces the predictability of future revenue streams due to increased local-government dependence on nationally shared taxes that will be more difficult to anticipate despite the likelihood of a future tax-sharing mechanism being enshrined in law. For example, future central governments may revise the share of national taxes allocated to municipalities, which may pose a risk to the stability of local public finances in years to come.

Additionally, it remains unclear how the level of compensation for individual municipalities will be determined and how compensation will evolve over time. The practical complexity associated with the transfer of the departmental share of the property tax could lead to municipalities being under- or over-compensated for the loss of revenue. In our view, this highlights the need for a complementary equalising mechanism. This could, for example, take the form of a 'guaranteed' resource for municipalities that would be used for redistributive purposes to avoid over- or under-compensating municipalities. Similarly, if the mechanism freezes current tax rates, the level of compensation would be higher for municipalities that have historically had above-average residency tax rates at the expense of those who have made a budgetary effort to keep rates low.

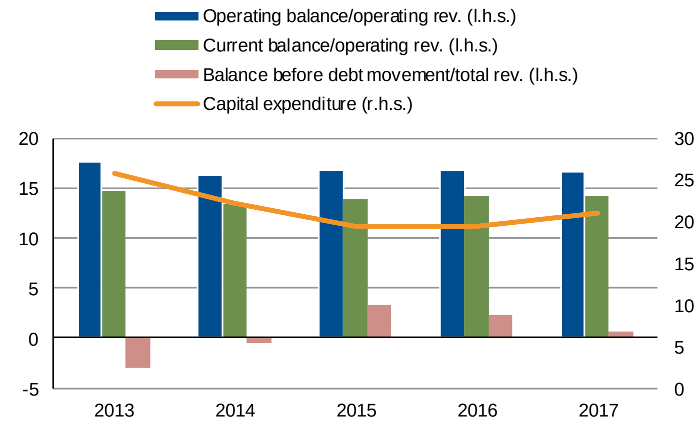
Local public investment has declined since 2015

One positive development is that, in the current benign economic environment, French municipalities have maintained solid budgetary surpluses (after interest expenses and investment activities and before debt repayments) on an aggregate level since 2015, reflecting their ability to cushion potential reductions in revenue without incurring new debt (**Figure**). However, we note that, in response to the previous government's policy of reducing state transfers, local authorities had to reduce capital expenditure in order to maintain budgetary performance[8]. From 2013 to 2017, local public investment decreased by 18.4% while operating expenditure increased by 1.6% over the same period. This assessment is underpinned by a review of local investment trends conducted by the French *Observatoire des finances et de la gestion publique locales,* highlighting that more budget-constrained municipalities tended to reduce capital expenditure and adopt more conservative investment strategies[9]. This highlights the fact that any increase in revenue uncertainty moving forward could be met by a similar reaction on the part of French municipalities (i.e. a reduction in local investment). We note, however, that, more recently, investments have picked up at the local level helped in part by a stabilisation of state transfers.

[8] Cour des comptes, Les finances publiques locales, September 2018

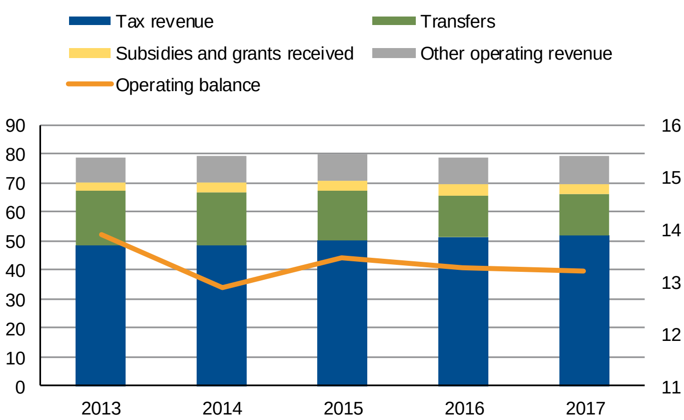
[9] Observatoire des finances et de la gestion publique locales, L'investissement des communes et intercommunalités depuis 2014, January 2019.

Figure 6: Municipal budget performance
% (l.h.s.), EUR bn (r.h.s.)



Source: DGFiP, DGCL, Scope Ratings

Figure 7: Municipal operating revenue and expenditure
EUR bn



Source: DGFiP, DGCL, Scope Ratings

Lower revenue predictability may hamper public investment

The residency tax reform could thus weigh on local public investment given the tendency of municipalities to prioritise reductions in investments when faced with decreasing revenues, coupled with the increased uncertainty regarding future tax sharing arrangements. Lower revenue predictability induced by the residency tax reform is mitigated by the favourable macroeconomic environment and high operating surpluses on an aggregate level, limiting the degree of recourse to debt for investments (**Figure 7**) to a certain degree. However, the increased uncertainty of tax revenue growth could be exacerbated in an economic slowdown scenario. A survey of French mayors found that 46% of respondents would favour delaying investments if the revenues they received from the state fell[10]. As French municipalities are responsible for investments in key areas, such as education, transport, housing and essential services, a decline in investments could lead to a deterioration in local infrastructure and lower the quality of public services.

Rating implications for the sovereign: GDP growth, fiscal balance and intergovernmental relations

Mixed impact on national GDP growth

The elimination of the residency tax will increase households' disposable income, supporting private consumption and helping offset the negative impacts of other fiscal policies such as the increase in environmental and other excise taxes. In its 2017 study of the reform, the OFCE estimated the average increase in disposable income, as a result of the elimination of the residency tax, to be EUR 325 per household per year[11]. This average income gain varies depending on the level of living standards, with the reform mostly benefitting the middle class. The average annual gain for households in the bottom income decile is estimated to be around EUR 100, while the figure rises to above EUR 500 for those in the fifth, sixth and seventh deciles.

On the other hand, a potential deterioration in the local public investment climate presents a downside risk to the country's economy. Capital expenditure by municipalities represented 27% of general government investment (0.9% of GDP) in 2017. These investments help support job creation in areas that are important to the country's overall growth outlook. Lower levels of investment at the local level could lead to lower growth in the short-to-medium run with implications for France's sovereign rating (AA/Stable).

[10] AMF-CEVIPOF/SciencesPo, Enquete 2018 – Les maires de France : entre résignation et incertitude, November 2018
[11] OFCE, Evaluation de la réforme de la taxe d'habitation d'Emmanuel Macron, June 2017

Increased pressure on public finances

In 2018, the French government estimated that the progressive suppression of the residency tax for 80% of households over 2018-20 would result in a total cost of almost EUR 20bn[12]. The recent announcement of the planned exoneration of the remaining 20% by 2022 could increase the total cost of the reform by between EUR 10.3bn and EUR 10.6bn (around 0.4% of GDP), a figure which was not included in previous budgets or the multiannual budget programme for 2018-22. This constitutes a significant loss of revenues for the central government in a context of reduced fiscal space. To finance the reform and avoid a deterioration in the budget balance, the government will have to decrease spending at a more rapid pace or implement measures to increase revenue from other taxes. This will be particularly difficult following the National Debate as French voters are expecting policy measures to address the country's high tax burden. Prime Minister Édouard Philippe has committed to lowering taxes, which further reduces the government's fiscal leeway.

Relations between central and local government have deteriorated

Finally, the reform has also led to a rise in political tensions between the central government and lower-tier governments. Mayors and other local officials have increasingly expressed their discontent with the residency tax reform, highlighting the threat to the relatively high levels of financial autonomy previously enjoyed by the French municipalities. Moreover, rising concerns over their public finances and a lack of voice in national policymaking have culminated in a deterioration of central-local relations. In October 2018, the French mayors' association pointed to an exacerbation 'of the crisis of faith' between central and lower tiers of government[13]. Consequently, the mayors' association has called for more state consultation with local authorities, legal guarantees of financial autonomy and, more generally, increased efforts towards decentralisation.

A lack of progress in this regard has led to increased weariness among local officials. A 2018 study found that 49% of mayors have already decided not to pursue re-election in the 2020 municipal elections. This contrasts with the situation in 2014 when 60% of incumbent mayors were reelected[14]. A third cited a lack of financial resources as the main cause for their desire not to pursue reelection. In our view, the tax reform falls within this context and has hampered the government's efforts to strengthen relations with local authorities. As a result, political support for fiscal consolidation at the local level, which is a key element of the government's holistic approach to strengthening its public finances, could weaken.

[12] Sum of the 2018, 2019 and 2020 figures presented Dominique Bur and Alain Richard report on local taxation
[13] AMF, Taxe d'habitation: un dénigrement irresponsable des maires de France, October 2018, https://www.amf.asso.fr/documents-taxe-dhabitation-un-denigrement-irresponsable-maires-france/39004
[14] AMF-CEVIPOF/SciencesPo, Enquete 2018 – Les maires de France : entre résignation et incertitude, November 2018

Annex: Issues with the residency tax

The residency tax is a key local tax source…

The residency tax (40% of local tax revenue) is one of the four main French local taxes that also include: the developed property tax (33%), the commercial property tax (14%) and the undeveloped property tax (2%). It is levied on all primary residents[15], regardless of ownership, and depends on the value and condition of their residences as well as the local tax rate. Rates are set by city councils without the intervention of the state and municipalities receive 100% of the proceeds.

… with an outdated tax base, …

The amount owners and tenants must pay is calculated based on the cadastral rental values of their residence. These were last updated in 1980 and are re-evaluated on a yearly basis at the national level[16]. The resulting rental values used in the calculation of the residency tax do not reflect differences in regional real estate markets.

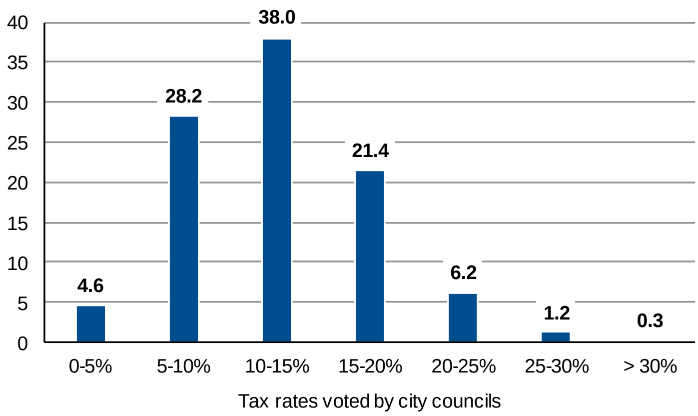
… divergence in tax rates, …

There is a strong divergence in local tax rates that ranged from 0% to over 30% in 2018 (see **Figure 8**). This results in an uneven burden for households depending on the place of residence. For instance, the average residency tax paid by households in Cognac (EUR 592) and Poitiers (EUR 1,099) differs greatly despite both cities having a comparable median income of around EUR 18,000.

… and limited redistributive effect.

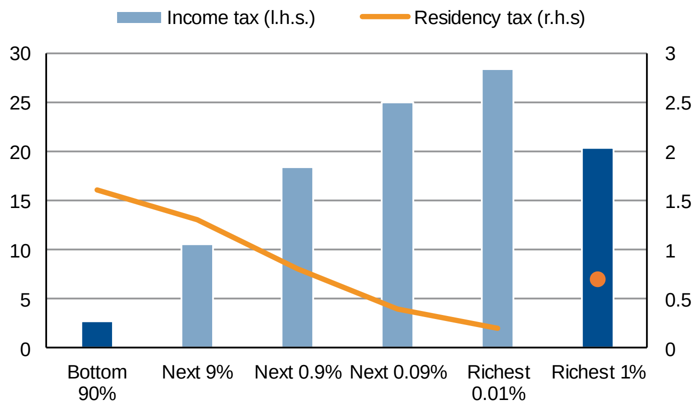
The tax base and rates associated with the residency tax have led to a de-correlation of the tax burden from the level of income. In 2015, relative to taxable income, the residency tax for the richest 1% of the population represented 0.7% while it amounted to 2.7% for bottom 90% (**Figure**).

Figure 8: Distribution of residential tax rates in France (2017)
%



Source: DGFiP, Scope Ratings

Figure 9: Tax burden by income level group (2015)
% of taxable income



Source: INSEE, Scope Ratings

[15] The residency tax applies for both the primary and secondary residences although the reform only concerns the former.
[16] See: http://bofip.impots.gouv.fr/bofip/1537-PGP

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