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Franco-German Conference

Frankreich – ein Vorbild für Deutschland?
Allemagne – un exemple pour la France?

Berlin, 19-20 June 2008

French fiscal policy under pressure?

Catherine Mathieu, Mathieu Plane, Henri Sterdyniak
Observatoire Français des Conjonctures Economiques

OFCE
69, quai d'Orsay
75007 Paris
catherine.mathieu@ofce.sciences-po.fr
mathieu.plane@ofce.sciences-po.fr
sterdyniak@ofce.sciences-po.fr

1. **Introduction**

2. **Is fiscal policy still a regulation tool?**

3. **Public spending composition and trends**

4. **What taxation?**

5. **Conclusion**

1. Introduction

- At mid-2008, France is the only large country in the euro area keeping a government deficit still close to 3% of GDP and looks hence as the only 'sinner'. In Germany and Italy, government deficits have been substantially reduced in recent years.
- France looks like the only country resisting the prevailing anti-Keynesian view in Europe. The latter inspires euro area economic policies, the independence of the ECB and the Stability and Growth Pact.
- This framework seems unable to support growth in Europe and this is a reason why France has some reasons for departing from this view.
- However, France does not explain its policy and does not seem to try to impulse a change in economic policy in Europe. France regularly promises to bring the government deficit back to 0 and hence seems more like being unable to change EU economic policy than trying and implementing another policy.

1. Introduction

- Most EU countries have abandoned the objective of Keynesian demand stabilisation policies, have agreed to implement fiscal consolidation strategies. This choice is the choice of EU and national leading classes, it is in line with a specific strategy to adapt Europe to globalisation.
- But this strategy requires deep changes in EU societies. Until now France has been unable to find a social consensus to implement such a strategy. Therefore, France seems to lag behind in terms of implementation of liberal reforms.
- France needs to choose between accelerating the pace of reforms in France and setting a group with other countries in Europe in order to implement another policy. It is difficult to do both at the same time.

1. Introduction

- The weight of public spending has remained especially high in France: 53.2% of GDP as compared to 43.8% in Germany.
- Contrary to the vast majority of euro area countries, France had made few efforts to cut the weight of public spending in GDP.
- In 1990, public spending amounted to 49.5% of GDP i.e. 1 percentage below the euro area average.
- In 2007, the ratio is 6.5 percentage points above the euro area (46.5%).
- France ranks second just behind Sweden in terms of public spending levels.
- Same question here also: does France try and resist the liberal wave of public spending cuts or is it unable to control public spending? Is France lagging behind in terms of reforms (as compared to Germany for instance)?
- Recently, the government and leading classes have tried to make France become in line with the mainstream liberal approach (Pébereau's report, Attali's Commission, General revision of public spending) through advocating for large public spending cuts, but they were unsuccessful at least up to now. The Stability programme submitted by the French government is more moderate. What is the credibility of large public spending cuts?

1. Introduction

- France currently ranks 4th among OECD countries in terms of tax to GDP ratio.
- A French specificity is that taxation has remained relatively redistributive, with some specific taxes like wealth taxation and business tax (*taxe professionnelle*) which make France an isolated example in Europe.
- The French government is tempted to implement liberal reforms in order to adapt to globalisation, in lowering the tax burden on the most mobile factors: companies, capital and the wealthiest.

  But as the same time the government says it will cut labour taxation, although there is no budgetary room for manoeuvre and no strategy of massive public spending cuts is introduced.

2.The SGP growth Pact and its implementation

- The institutional framework:
- The 3% of GDP deficit threshold (sanctions to apply if the threshold is breached)
- Debt to GDP ratios below 60%

The Stability and Growth Pact (1997)

- Stability programmes: 4-year budgetary plans
- Medium-term objective: budgetary positions 'close-to-balance or in surplus'.

1997-2000: favourable economic conditions

- 2 interpretations: fiscal leniency or return to equilibrium

2001-2005: the difficult years

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
General government balance(1)	-2.7	-2.3	-1.4	-1	-1.8	-2.6	-3.1	-2.9	-2.5	-1.6	-0.7
Cyclical component	-0.5	-0.2	0.1	1	0.9	0.1	-0.4	-0.7	-0.8	-0.4	-0.1
Interest payments	4.4	4.1	3.6	3.4	3.3	3.0	2.9	2.7	2.6	2.5	2.5
Cyclically-adjusted primary balance	2.2	2	2.1	1.4	0.6	0.3	0.2	0.5	0.9	1.3	1.9

(1) Excluding proceeds relative to UMTS licences. Source: *OECD Economic Outlook*, No 78, Dec. 2005.

Fiscal developments in France and Germany

France

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
General government balance	-3,3	-2,6	-1,8	-1,5	-1,6	-3,2	-4,1	-3,6	-3,0	-2,6	-2,5
Cyclical component	-0,5	-0,1	0,5	1,2	1,3	0,6	0	-0,2	-0,4	-0,4	-0,2
Interest payments	3,0	2,9	2,7	2,6	2,6	2,6	2,5	2,5	2,4	2,3	2,3
Cyclically-adjusted primary balance	0,2	0,4	0,4	-0,1	-0,3	-1,2	-1,6	-0,9	-0,2	0,1	0,0

Germany

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
General government balance	-2,6	-2,2	-1,5	-1,2	-2,8	-3,6	-4	-3,8	-3,4	-1,6	0
Cyclical component	-0,9	-0,7	0,5	2,7	1,2	-0,3	-1,2	-1,6	-2,4	-1,5	0,2
Interest payments	2,9	2,9	2,7	2,7	2,6	2,5	2,6	2,5	2,4	2,4	2,4
Cyclically-adjusted primary balance	1,2	1,4	0,7	-1,2	-1,4	-0,8	-0,2	0,3	1,4	2,3	2,2

A fiscal framework lacking economic rationale

- ***Objective of the institutional framework?***

  – Preventing negative externalities
  – Economic policy co-ordination
  – Setting a common economic policy

  Rationale for the 3% of GDP reference value?

  – Stabilising the debt level at 60% of GDP?
  – Share of public investment in GDP?

  A country hit by a specific shock may need a higher than 3% of GDP deficit, with monetary policy less reactive to growth and possibly not adequate for this country. No negative spillover effects will occur.

  Rationale for medium term budgetary positions in balance?

- The myth of the number 'zero'
- Private savings may be excessive or insufficient
- Public investment may be financed through borrowing
- Budgets in balance will lead public debt to disappear
- And may require a too low interest rate

March 2005: A renovated Pact

- The SGP target: bringing structural government balances to 0 before allowing automatic stabilisers to play – without any discretionary policy allowed -, was not implemented in larger economies. This lead to a crisis in 2003

  Proposals made by France, Germany and Italy to automatically withdraw some categories of expenditure not accepted. Among these proposals:

- Gerhard Schröder: the judgement on excessive deficits should account for several criteria: introduction of reforms costly in the short run but boosting growth in the long term; R&D expenditure; country's contribution to price stability in Europe; economic situation; net contribution to the EU budget and, as concerns Germany, transfers to new Länder. Each country should have a right to decide their fiscal consolidation strategy and domestic fiscal prerogatives to be maintained.
- French government: suggested the exclusion of military spending and aid in favour of developing countries.
- These suggestions require defining the expenditures having a positive impact on potential growth. In any case, neither military expenditure nor all contributions to the European budget can be taken into account. These proposals define a target for structural balances, but do not consider the stabilisation role of fiscal policy.

March 2005: A renovated Pact

- **SGP remains essential**

  Nothing said on the reasons why the SGP did not work –

  3% and 60% remain the centrepiece of multilateral surveillance

- **Strengthening the preventive arm**

  Medium term objectives (MTO) differentiated for each MS.

  But range varies only from -1% of GDP for low debt/high potential growth countries to balance or surplus for high debt/low potential growth countries

  Why these limits? No rationale

  Why not consider a golden rule or deficit stabilising the debt to GDP ratio?

- MS having not reached their MTO to make a budgetary effort of 0.5% of GDP per year (in cyclically adjusted and excluding one-off measures balances), independently of the current economic context.

  But potential output and economic cycle are difficult to assess.

March 2005: A renovated Pact

- However, the Commission's report will account for 'all other relevant factors': policies implemented in line with the Lisbon agenda, R&D spending, public investment, economic situation or debt sustainability, efforts for international solidarity, European goals or European unification, costs of the introduction of a compulsory, fully funded pension pillar. These elements may prevent the launch of an EDP, and could also allow for longer adjustment paths to bringing deficits below 3%.
- The Council will take account of the speed of reduction in the debt to GDP ratio, for countries where they are above 60% of GDP.
- The acceleration of growth since 2004 a reduced tensions among EMU countries. However, this does not imply that EMU is able to run a coordinated fiscal policy if necessary. This is what we observe in 2008.

Table 1. Euro area GDP growth and general government balances according to the stability programmes

	GDP growth assumptions (per cent)											General government balance (per cent of GDP)										
	Stability Programmes										Actual	Stability Programmes										Actual
	J99	J00	J01	J02	J03	J04	J05	J06	J07	J08		J99	J00	J01	J02	J03	J04	J05	J06	J07	J08	
98	2.8										2.7	-2.1	-1.9									-2.3
99	2.5	2.2									2.9	-1.7	-1.4	-1.2								-1.4
00	2.6	2.8	3.3								4.0	-1.5	-1.1	-0.7	-0.8							-1.0
01	2.6	2.5	3.1	1.7	1.5						1.9	-1.0	-0.8	-0.6	-1.2	-1.6						-1.8
02		2.5	2.9	1.9	1.0						0.9		-0.6	-0.3	-0.9	-2.2						-2.5
03		2.5	2.8	2.6	2.1	0.6					0.8		-0.2	0.0	-0.5	-1.8	-2.7					-3.0
04			2.8	2.6	2.6	1.9	2.0				2.1			0.4	0.1	-1.1	-2.4	-2.7				-2.9
05				2.6	2.6	2.5	2.3	1.4	1.3		1.6				0.3	-0.6	-1.8	-2.3	-2.6	-2.4		-2.5
06					2.6	2.5	2.4	2.1	2.5	2.8	2.8					-0.2	-1.3	-1.8	-2.4	-2.0	-1.6	-1.3[1]
07						2.5	2.4	2.0	2.1	2.6	2.6[1]						-0.9	-1.3	-1.9	-1.4	-0.9	-0.6[1]
08							2.4	2.2	2.2	2.2	1.7[1]							-1.0	-1.4	-1.1	-0.9	-1.0[1]
09								2.2	2.2	2.2	1.5[1]								-0.9	-0.6	-0.6	-1.1[1]
10									2.2	2.1	–									-0.1	-0.2	–
11										2.1											0.3	

1. European Commission Spring 2008 forecast
Sources: European Commission, Stability programmes, Eurostat, own calculations.

Table 2. French GDP growth and general government balances according to the stability programmes

	GDP growth assumptions (per cent)											General government balance (per cent of GDP)										
	Stability Programmes										Actual	Stability Programmes										Actual
	J99	J00	J01	J02	J03	J04	J05	J06	J07	J08		J99	J00	J01	J02	J03	J04	J05	J06	J07	J08	
98												-2.9										
99												-2.3	-2.1									
00	2.5	2.5											-1.7									
01	2.5	2.5	3	2.5	1.2									-1								
02		2.5	3	2.5	2.5	0.5						-1.2		-0.6	-1.4	-2.8						
03			3	2.5	2.5	1.7	2.5	2.3			1.1		-0.5	-0.4	-1.3	-2.6	-4					-4.1
04				2.5	2.5	2.5	2.5	1.75			2.5			0.2	-0.5	-2.1	-3.55					-3.6
05					2.5	2.5	2.5	2.25	2.25		1.7				0	-1.6	-2.9	-2.9	-3.0			-2.9
06						2.5	2.5	2.25	2.25	2.25	2.0					-1	-2.2	-2.2	-2.9	-2.7		-2.4
07							2.5	2.25	2.25	2.25	1.9[1]						-1.5	-1.6	-2.6	-2.5	-2.4	-2.7[1]
08								2.25	2.25	2.5	1.6[1]							-0.9	-1.9	-1.8	-2.3	-2.9[1]
09									2.25	2.5	1.4[1]								-1	-0.9	-1.7	-3.0[1]
10										2.5										0.0	-1.2	–
11										2.5											-0.6	
12										2.5											0	

1. European Commission Spring 2008 forecast.
Sources: European Commission, Stability programmes, Eurostat, own calculations.

The 'new anti-Keynesian view of public finances' (NAK view)

Widespread among the Commission and European economists

- Public spending would reduce long-run output growth and spending cuts would positively affect short-run growth, short-term stabilisation would negatively affect output.

  This contrasts with the US, where monetary and Keynesian fiscal tools have been simultaneously and widely used to stabilise output since 2000.

- The NAK view suffers several scientific weaknesses. First, public spending is assumed to be always useless, meaning that public spending cuts (through the expectation of future lower taxes) necessarily raise households' permanent income.

  But public spending is generally useful, either for production purposes (public investment) or for households (old-age pensions, health, education, unemployment benefits).

- Second, the NAK view only applies in an economy operating at full capacity (or being supply-constrained), where useless public expenditure could be cut.

  But in a Keynesian unemployment regime, in a situation where short-term stabilisation policy could be run, public spending increases remain expansionary.

The 'new anti-Keynesian view of public finances' (NAK view)

- Third, most NAK view related empirical papers assume that agents consider public spending shocks as permanent shocks, although they may result from stabilisation (transitory) purposes. Private agents anticipate that governments will be unable to cut public spending when needed, which will raise interest rates or tax rates and will thus reduce output. Agents are assumed to consider that current and future output is determined by supply constraints.

  Contrary to these models' predictions, real long-term interest rates have been particularly low in periods of high public deficits and rising debts, like in Japan since 1997 or in the US from 2002 to 2005.

- Fourth, the empirical evidence of so-called 'NAK effects' rests mainly on time episodes when fiscal policy was tightened and had no significant output costs, thanks to expansionary monetary policies (often allowed by EMU membership prospects), exchange rate depreciation (in particular for small economies), rising equity prices or financial liberalisation.

  These 'NAK effects' can neither be generalised to large EMU economies, nor to stabilisation policies.

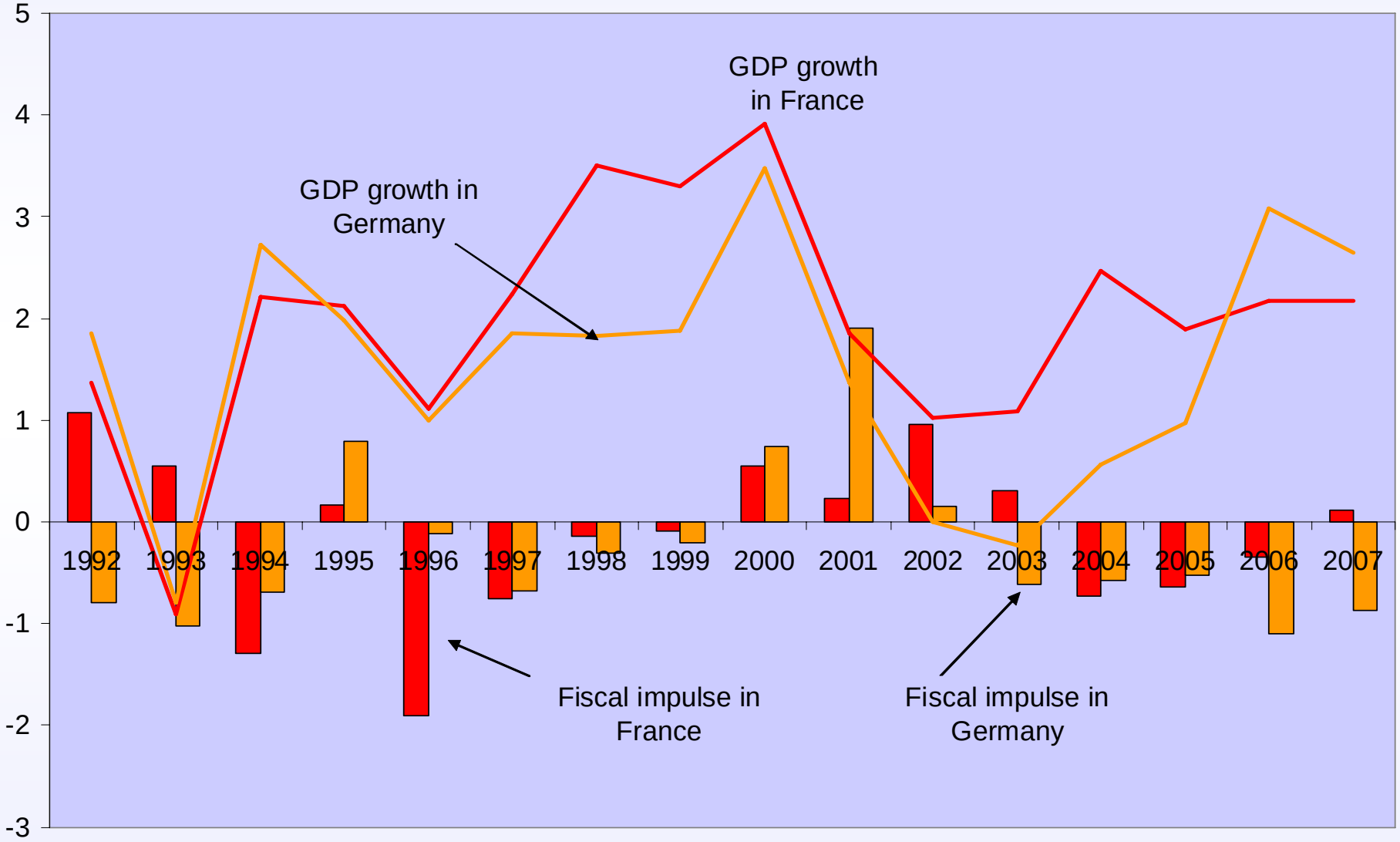
2. GDP growth and fiscal policies in France and Germany

- From 1998 to 2000, the fiscal stance is close to neutral: the two countries deny to implement restrictive policies, in order not to put at risk the acceleration of growth. In 2000, fiscal deficits reach 1.5% of GDP in France, 1.2% in Germany. Both countries are far from the 3% of GDP limit, but have not cumulated rooms for manoeuvre.
- In 2001-2003, in a context of world economic slowdown, both countries run expansionary policies (1.5 percentage point of GDP in France and Germany) which to the cyclical deficit and consequently deficits reach 4% of GDP in 2003, initiating a crisis of the SGP in November 2003. At the whole euro area level, the fiscal impulse reached 1.2 percentage point of GDP during these years, as compared to 6 percentage points in the US and 5.4 percentage points in the UK
- From 2004 to 2007, restrictive fiscal policies have been run in the two countries; much more in Germany (3.1 percentage points of GDP) than in France (1.6 percentage point).
- In the two countries, fiscal policy has therefore been pro-cyclical between 1994 and 1997 (due to the convergence to the Maastricht criteria) and from 2004 to 2007 (due to the lack of rooms of manoeuvre). Conversely, fiscal policies were indeed stabilising in 1992-1993 and in 2001-2003 although probably not sufficiently in the latter period.

GDP growth and fiscal policies in France and Germany

- Two explanations can be given to explain the poor performances of France and Germany
- First explanation (EU Commission): it is governments' responsibility: they have overestimated potential growth, and hence run in permanence structural deficits, they do not implement the needed restrictive policies when economies are at the peak of the cycle, like for instance in 1990-2000. According the Commission, France and Germany should have run restrictive fiscal policies even though they had unemployment rates close to 10% and inflation rate close to 1.5%
- Second explanation: the 3% of GDP limit for deficits does not leave sufficient rooms for manoeuvre in countries, constraining them to implement restrictive fiscal policies too early in the cycle. If one considers that countries like France and Germany can have output gaps of around 2.4% of GDP, that the stabilising discretionary deficit can amount to 50% of the output gap, the deficit should be allowed to reach 5% of GDP in recession troughs. This is the figure observed in France in 1993-1995, in the UK in 1992-1995 and in the US in 1991-1993 and in 2003-2004

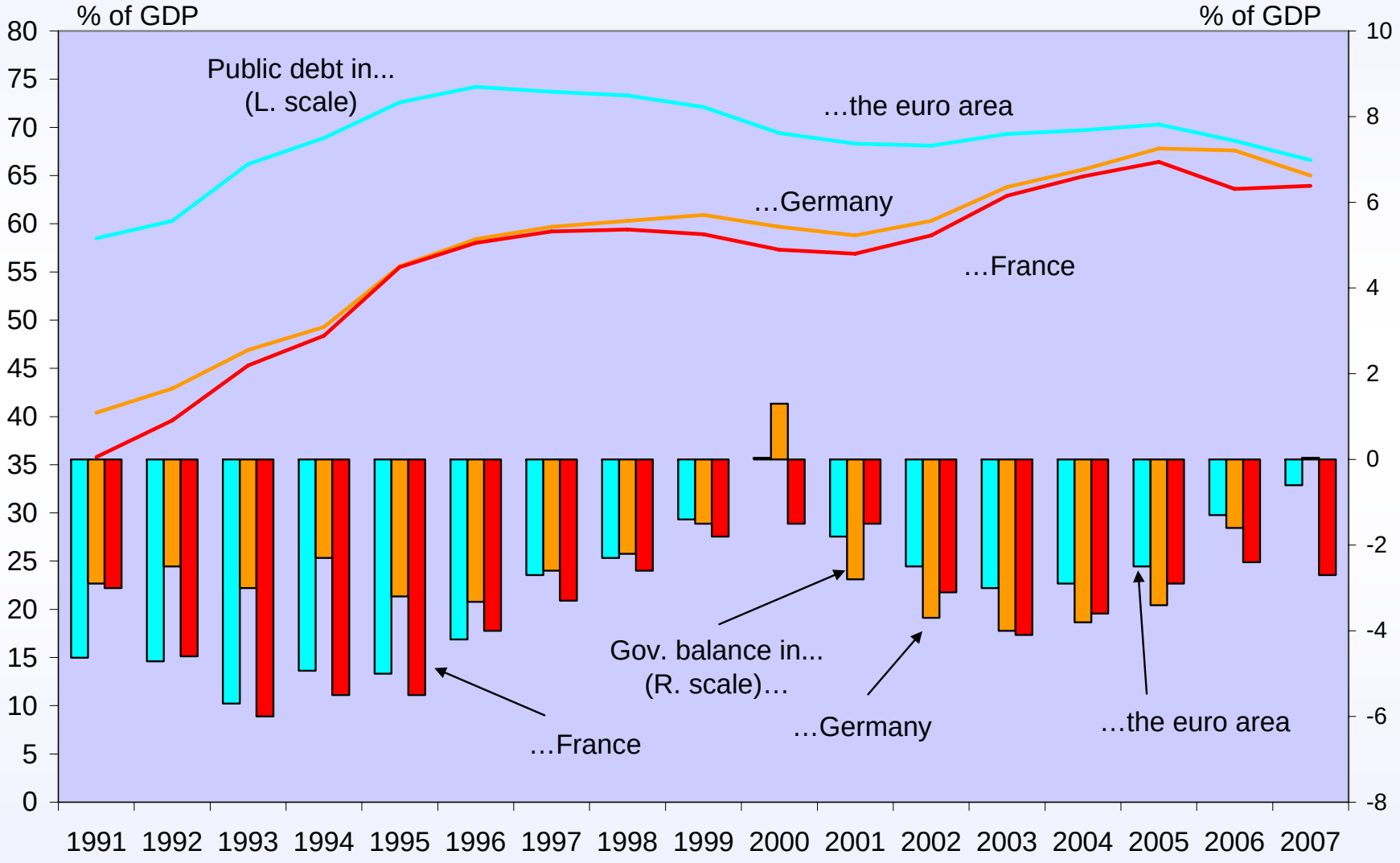
Figure 1. GDP growth and fiscal impulse



Are French and German public debts sustainable?

- Public debt (Maastricht definition) was: 64.2% of GDP in France in 2007 and 65% of GDP in Germany (see Figure 3).
- Since 1991, public debt rose by 28 percentage points of GDP in France and 25 in Germany, as compared to 8 percentage points for the euro area as a whole.
- Although in terms of debt trends, France and Germany have performed less well than the average, French and German debt levels do not depart from most EU countries and even show a more favourable position.
- French and German debt levels are below the EA average (66.6%) and close to the US level (65%), well below Belgium (85%), Italy (104%) and Japan (181%). There is therefore no specifically high debt level in France and Germany.

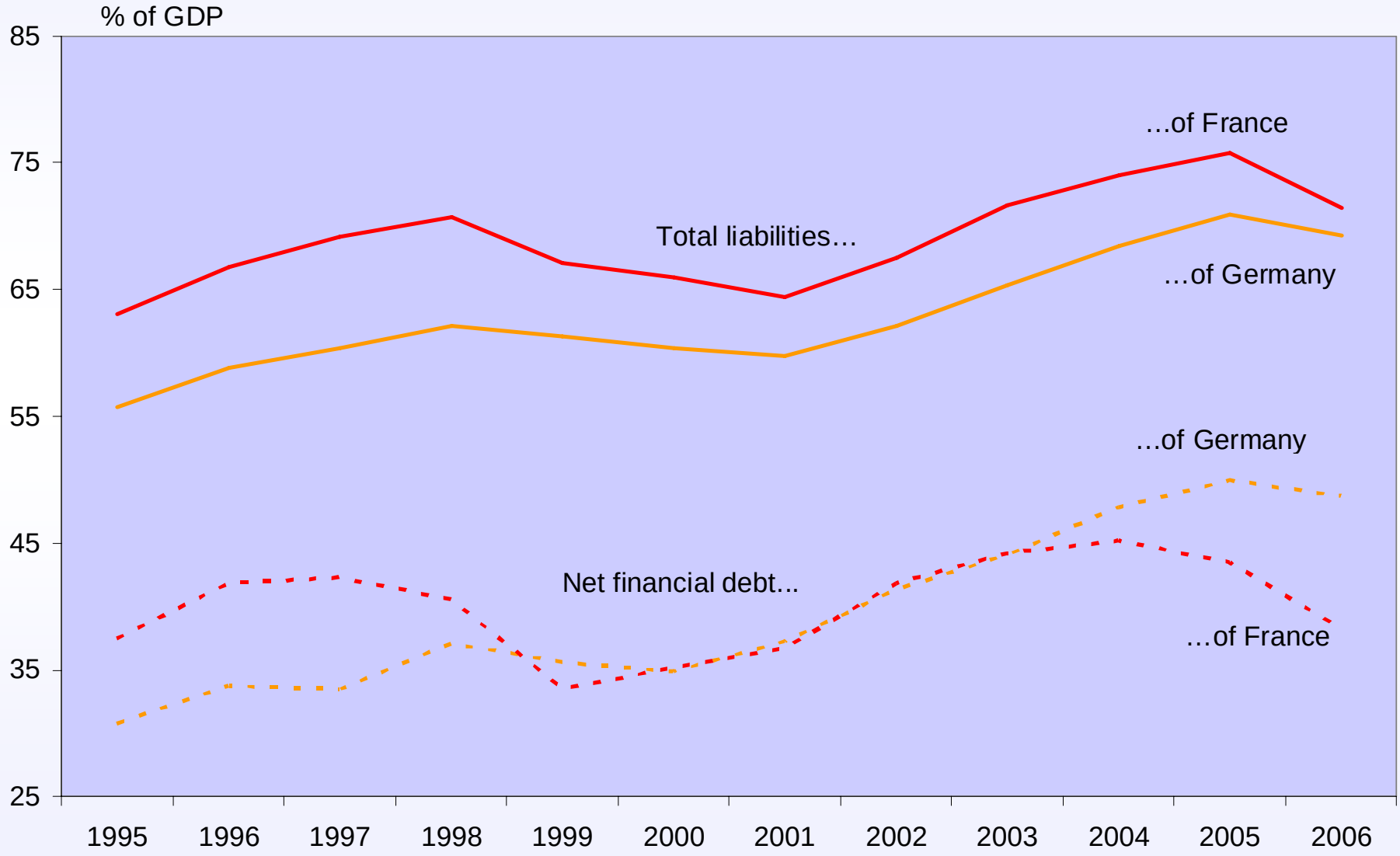
Figure 3. Government balance and debt



Are French and German public debts sustainable?

- The Maastricht definition for government debt does not account for assets owned by the general government sector and among them financial assets.
- The Maastricht debt is very similar in France and Germany, but there are substantial differences between the two countries in terms of net financial debt levels and trends.
- The net financial debt was 41.2% of GDP in France and 50.2% in Germany in 2007 (see Figure 4).
- The general government sector owns more assets in France (23% of GDP) than in Germany (15% of GDP). The French net public debt is well below the euro area average (48.5%), the US (44%) and Japan (86%).

Figure 4. Financial accounts of the general government sector



Are French and German public debts sustainable?

- From 1995 to 2007, the net financial debt remained roughly stable in France (+4 percentage point of GDP) while it rose by 18 percentage points in Germany.
- The rise in the French gross public debt was to a large extent offset by the rise in the value of financial assets owned by the general government sector. Conversely, in Germany, the rise in the gross public debt was not offset by a rise in the valuation of the government sector's assets – the latter decreased by 9 percentage points of GDP.

Are French and German public debts sustainable?

- Even if government owned assets' valuations have differed over the last ten years, the French and German government debts are ranked AAA by notation agencies (Standard and Poor's, Fitch ratings). Financial markets consider that there is no risk of default on the French and German governments and this is the reason why government bonds' interest rates are so low (around 4% in May 2008): government bonds are considered non risky assets

- This market's confidence is at odds with the gloomy prospects of the Pébereau's report, according to which the continuation of current trends would lead to public debt levels of 130% in 2020, 200% in 2030, 300% in 2040 and close to 400% in 2050. But such a scenario is unrealistic: lenders would react well before such high debt levels can be reached. The most likely scenario in case of a persisting rising debt would be a rise in interest rates that would lead the government sector to lose the control of their financial situation. Financial markets, observing this, would request a higher risk premium which would fragilise further the government sector and would affect the whole economy.

- According the Attali's report: "If nothing is done, the public debt will amount to 80% of GDP in 2012 and 130% in 2020. Even if the weight of interest payments needs to be compared to assets' value, the interest payment burden will be three times as much as today for tomorrow's taxpayers''. But it is difficult to see the reimbursement burden on today's taxpayers.

How to define public expenditure sustainability?

- If the objective is public debt stability, then the primary structural balance should be in surplus (if the nominal interest rate is close to nominal GDP growth).
- If we consider that a stabilising discretionary fiscal policy may represent half of the output gap, then the primary structural balance should be higher than half of the output gap.
- Table 3 shows that the judgement on deficit sustainability depends strongly on the estimation of the output gap.
- According to OECD estimates from June 2007, French fiscal policy was sustainable over the last ten years.
- but the OECD revised estimates in December 2007 lead to conclude that French fiscal policy became unsustainable from 2000 to 2004 and this comes in line with the Commission's figures. The problem therefore stands in the output gap estimates

3. Primary structural government balance, France

As a % of GDP

	Commission		OECD June 2007		OECD Dec. 2007	
	PSB	PSB–0.5y	PSB	PSB–0.5y	PSB	PSB–0.5y
1997	1.1	2.0	1.4	2.7	0.2	0.3
1998	0.9	1.1	1.3	2.1	0.4	0.3
1999	0.9	0.6	1.5	1.9	0.4	-0.1
2000	0.3	-0.8	0.9	0.5	-0.1	-1.4
2001	0.6	-0.3	0.6	0.4	-0.3	-1.4
2002	-0.6	-0.9	-0.5	-0.2	-1.3	-1.6
2003	-1.2	-1.1	-0.9	-0.2	-1.6	-1.4
2004	-1.0	-0.8	-0.3	0.4	-0.9	-0.8
2005	-0.3	-0.3	0.4	1.4	-0.2	0.1
2006	0.1	0.0	0.6	1.4	0.1	0.2

How to define public expenditure sustainability?

- If the objective is that net public debt equals general government assets, then the structural deficit should be higher than:

  net investment + government debt depreciation due to inflation + capital gains on owned financials assets.

  The maximal structural deficit for France is thus at around 2.8% of GDP, i.e.: net investment (1% of GDP) + debt depreciation (1.2%) + capital gains on financial assets (0.6%)

  Public finances need to be managed seriously, but as regards these different indicators, the French and German government debts do not currently raise any sustainability problem.

3. Public spending composition and trends

Since 1999, the EU authorities have stressed in the successive BEPG (Broad economic Policy guidelines) the need to lower public spending in order to ensure public finance sustainability, to avoid a rise in taxation, to prepare for future rises in spending resulting from the ageing of populations.

On the contrary, the Lisbon agenda was expecting substantial increases in spending on education, research, innovation and infrastructure.' Thus, the member states should reallocate public spending towards expenditure supporting GDP growth'. The fulfilment of this programme would request a substantial reduction in public spending directly benefiting to the Population (health, pensions, etc) which raises a problem both from a social (should inequalities be increased in terms of access to basic needs), an economic (what spending will be rewarding in the future) and a democratic point of view (the choice between public and private spending must be made by the Peoples).

3. Public spending composition and trends

As a matter of fact, the weight of public spending in GDP has been stable since 1990 in the EU-15 taken as a whole.

There have been significant cuts in some countries: the Netherlands (7 percentage points), Sweden and Spain (4 percentage points), Austria and Ireland (2.5 percentage points) either because of social protection privatisation or because of rapid GDP growth.

Public spending as a percentage of GDP has risen in some other countries: Portugal (9 percentage points), UK (3.5), Belgium (3), France and Greece (2.5).

4. Primary public spending in EU countries

	Primary public spending, as a % of potential GDP		
	1990	2000	2006
Germany	42.6	45.2	42.2
Austria	48.5	49.2	45.9
Belgium	41.0	43.0	44.0
Finland	48.4	46.3	48.1
France	47.5	49.1	50.0
Greece	36.1	39.5	38.5
Ireland	36.2	31.1	33.6
Italy	43.4	41.7	44.7
Spain	41.2	36.4	36.7
Netherlands	50.5	42.5	42.8
Portugal	33.0	41.3	42.1
Denmark	48.5	51.3	50.1
UK	38.8	38.0	42.4
Sweden	56.4	53.7	52.3
EU-15	43.4	43.2	43.9

Source :

3. Public spending composition and trends

The level of public spending has always been higher in France than in Germany (5.7 percentage point of GDP on average from 1991 to 2007). However, the gap was more or less wide over time depending on different GDP growth rates and fiscal policies.

From 1993 to 2001, public spending growth was similar in the two countries (1.7% for France, 1.9% for Germany), see Table 5. But GDP grew more rapidly in France (2.5%) than in Germany (2%) and this led the difference between public spending levels to be cut by 2.6 percentage points (from 6.7 percentage points of GDP in 1993 to 4.1% in 2001 (see Figure 5).

From 2001 to 2007, the trend was reversed: there was a drastic cut in public spending in Germany (-0.2% per year), bringing public spending to 44.3% of GDP in 2007 down from 47.5% in 2001. On the contrary, in France public spending growth accelerated slightly (2.1% per year) and public spending increased from 51.6% of GDP in 2001 to 52.4% in 2007. The gap between France and Germany widened: in 2007, public spending was 8.1 percentage point higher as a share of GDP in France than in Germany. The gap also increased between France and the euro area: from 4.3 percentage points of GDP in 2001 to 6 percentage points in 2007.

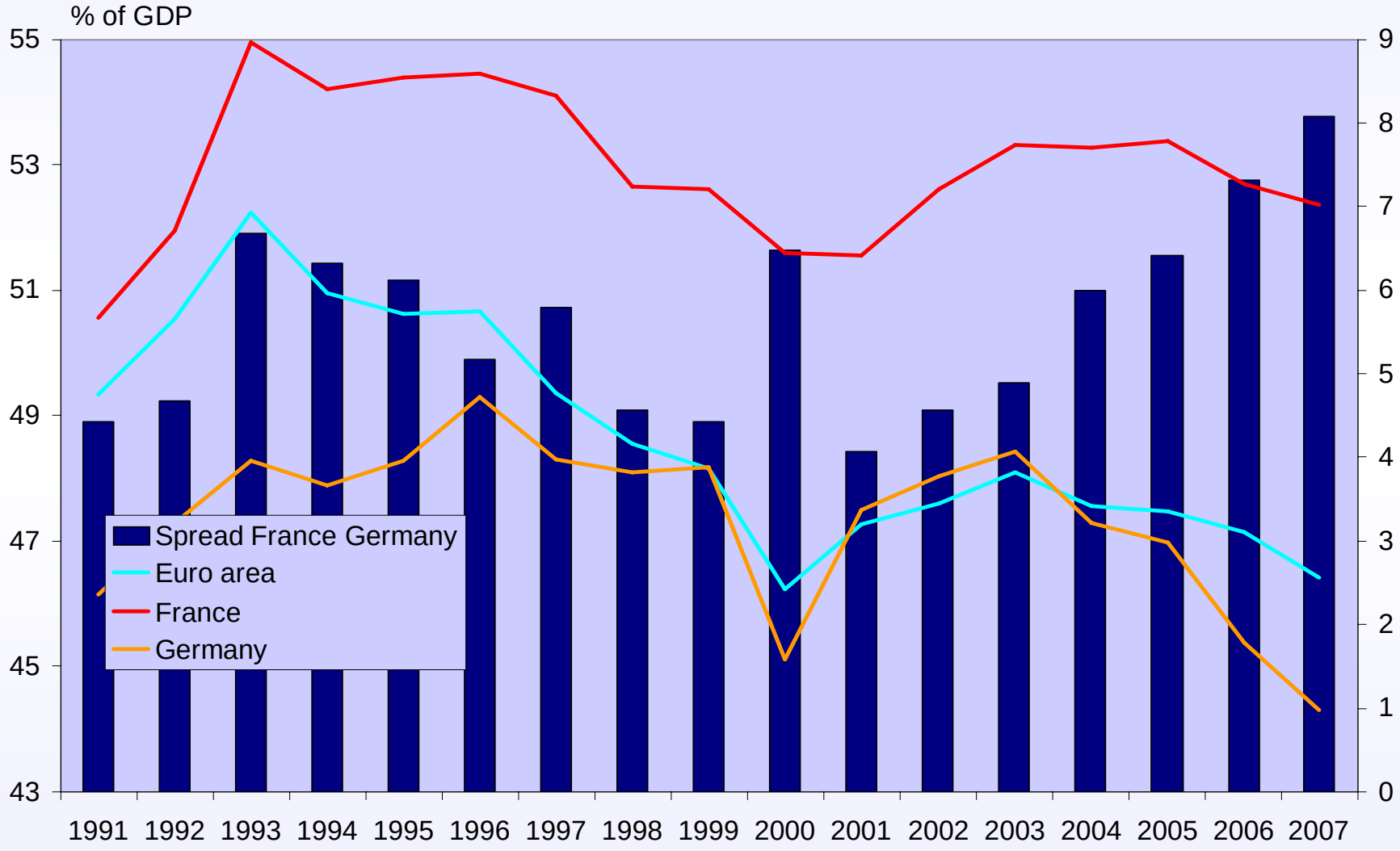
5. Public spending growth (in real terms)

In %

	1994-2001	2002-2007	1994-2007
Germany	1.9	-0.2	1.0
France	1.7	2.1	1.9
Euro area	1.3	1.4	1.4

Sources: OCDE, INSEE, OFCE's estimates.

Figure 5. Public expenditure



Public spending composition and trends

- The gap between public spending in France and the rest of the EU is particularly substantial in the social protection (including health) area where the public spending level is almost 4 percentage points higher in France than in the euro area average. Public spending in education is 1 percentage point higher in France than in the euro area, due to a higher share of young people in the population and to the low level of private spending in education. Public spending is slightly higher in France in collective infrastructure (0.8 percentage point), culture (0.5 percentage point), defence (0.5), and slightly below for economic affairs (0.7).
- the differences in terms of public spending weight between France and Germany amounted to 6.5 percent of GDP. The difference in terms of public spending (1.9 percent of GDP), housing and collective infrastructure (0.8) result mainly from demographic reasons. The fertility rate is much higher in France than in Germany, the ratio of young people (under 20) to working age population (20-59) stood at 36% in Germany and 46% in France in 2007. Of course education and collective equipment (nurseries, schools) depend on the number of children and young people. Also, the share of private spending in total education spending is higher in Germany than in France (17% versus 8% according to the OECD in 2005). Military spending are 0.8 percentage point of GDP higher in France than in Germany. Finally, health spending are 1.2 percentage point higher, general services 1.2 percentage point higher and leisure-culture spending 0.9 percentage point higher.

6. Government expenditure by function

As a % of GDP

	1995			*2001*			**2005**		
	GE	FR	EA	GE	FR	EA	GE	FR	EA
General public services	6.7	8.2	9.0	6.2	7.5	7.4	6.1	7.3	7.0
Defence	1.3	2.6	1.6	1.2	2.1	1.4	1.1	1.9	1.4
Public order and safety	1.6	1.3	1.6	1.7	1.2	1.6	1.6	1.4	1.6
Economic affairs	4.6	3.9	4.4	4.2	3.1	4.2	3.5	3.0	3.9
Environment protection	1.0	0.6	0.8	0.6	0.7	0.7	0.5	0.9	0.7
Housing and community amenities	0.8	1.5	1.3	1.0	1.7	1.1	1.0	1.8	1.0
Recreation, culture and religion	0.8	1.1	0.9	0.7	1.2	1.0	0.6	1.5	1.0
Education	4.4	6.6	5.2	4.2	6.3	5.0	4.2	6.1	5.0
Health	6.3	6.5	5.9	6.3	6.7	6.1	6.2	7.4	6.5
Social Protection	20.8	22.2	19.9	21.5	21.1	18.8	21.9	22 .3	19.3
Total	**48.3**	**54.4**	**50.6**	**47.5**	**51.6**	**47.2**	**46.9**	**53.4**	**47.4**

Sources: Eurostat, OECD.

3. Recent projects for large cuts in public spending in France

Public spending rose by 2.9% per year in real terms from 1980 to 1990, by 2.4% from 1990 to 1997, 2.3% from 1997 to 2002, 2.2% from 2002 to 2007. Since 1990, public spending has not been growing more rapidly than potential output. However, this does not allow for a reduction of public spending as a share of GDP. Would such a reduction be possible?

Since 1998, all stability programmes submitted by France have announced a significant slowing of public spending growth. But this never occurred (see Table 7). In 2007, the Stability programme announced an almost stabilisation of central government spending (+0.3% per year), under the effect of not replacing one over two civil servants retiring; health spending growth of 2%, retirement spending growth of 2.7%, and only +0.6% for family and housing benefits, a 6% per year cut in unemployment spending; local administration spending expected to rise by 1.4% per year.

7. Public spending growth, per year, in real terms

	Stability programme	Observed
2000-2002	1.0	2.3
2001-2003	1.3	2.5
2002-2004	1.5	2.8
2003-2005	1.3	2.6
2004-2006	1.3	2.2
2005-2007	1.1	2.0
2006-2008	1.2	
2007-2009	0.6	
2008-2010	0.6	
2009-2012	1.1	

3. Recent projects for large cuts in public spending in France

The Attali's report (January 2008) considers that the government and other pubic administrations have to be substantially reformed

However, the Report suggests substantial programmes aiming at increasing infrastructure, supporting social housing, reducing the number of poor people from 7 to 3 million, improving pre-primary, primary and higher education, adapting France to innovation.

At the same time, the report advocates for cutting public expenditure by 1 percentage point per year during 5 years, which implies that public spending should grow by 0.5% per year only (the report even says 0).

Are these objectives consistent? Yes, according to the report, owing to reallocations of expenditure and private-public partnership. But is this credible?

3. Recent projects for large cuts in public spending in France

Attali's report (cont.)

Some cuts recommended by the report are arguable:

Family allowances according to incomes (but the government has refused this measure),

Introducing some non-refundable payment on medicine costs depending on incomes,

Abolishing the 'departements' (but who will manage social assistance?).

Abolishing some support to companies, employment and housing, supposed to be inefficient:

The Report recommends a change in civil servants wages' growth rules. However, the average real wage rose by 0.4% in the civil service from 2000 to 2007 (as compared to 5.7% in the private sector). Is it possible to do even less?

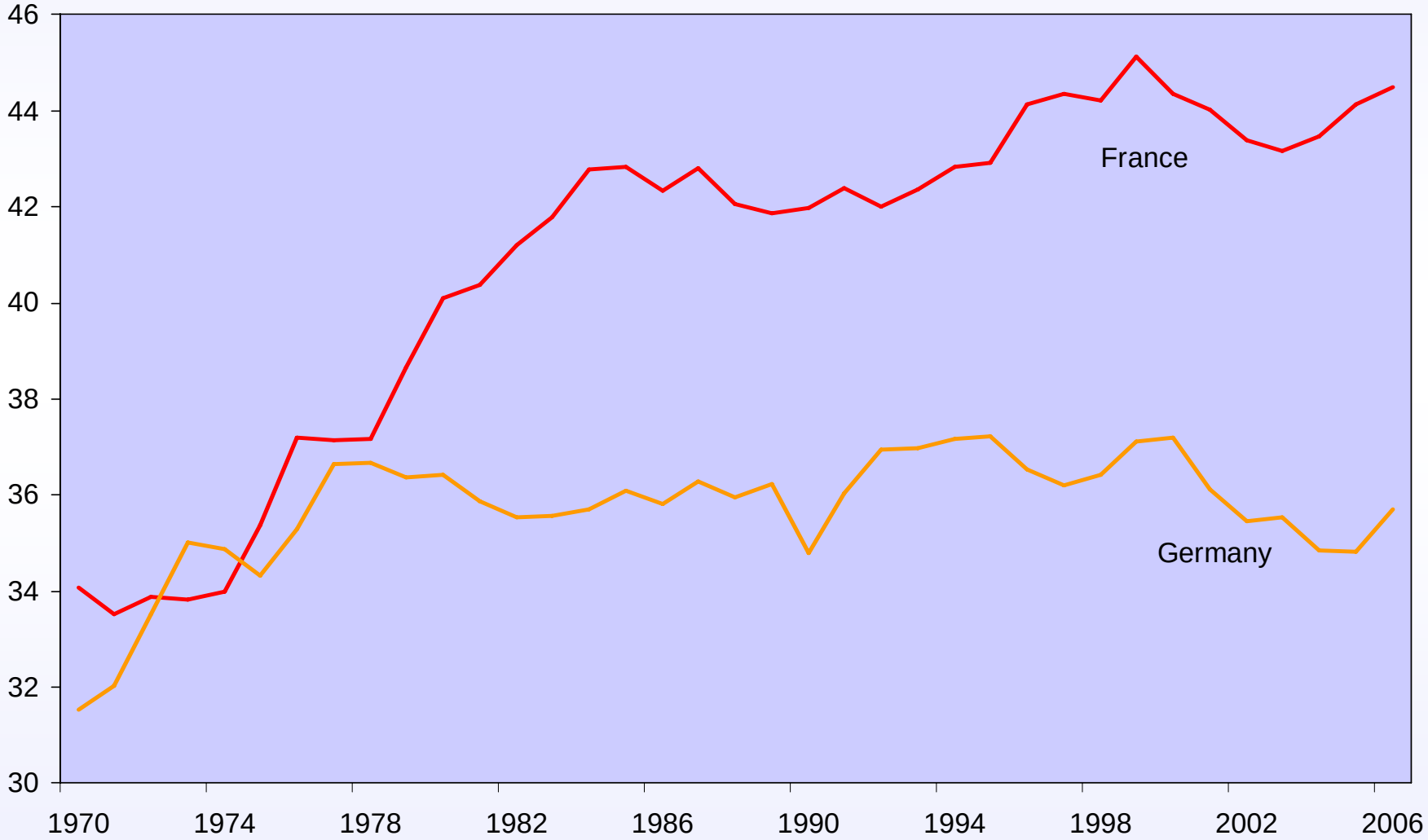
The report recommends not to replace 2 civil servants over 3 retiring, i.e. a 8.5% cut over 5 years in the number of civil servants and 5 billion euros savings (0.25% of GDP), the third of which would be allocated to civil servants' wage increases

4. What taxation?

- The French tax to GDP ratio increased significantly from 34% in 1974 to 42.5 in 1984 and remained stable at that level until 1993. It reached 44% in 1996 and remained at that level since then (see Figure 6). Since 1984, French governments have considered that the tax-to-GDP ratio had reached a maximum and that structural adjustment would be done through lowering spending. Since it is difficult to cut in a short period of time the level of spending, this choice explains the rapid rise of public deficits in 1992-1995 and later in 2002-2004. It is only because of the Maastricht binding rules that the government raised taxes in 1996-1997. Refusing to increase the tax-to-GDP ratio means that public spending must be managed more strictly: from 1993 to 1996 they rose at an annual 2.2% in real terms, i.e. almost like GDP (2.1%)

- Germany started from a slightly lower tax-to-GDP ratio in 1971 (32%), which rose to 35.5% in 1974-1990 and to 37% from the reunification to 2000. Since then, Germany has been able to cut its tax-to-GDP ratio down to 35%. The gap with France widened progressively from 2 percentage points in 1972 to 7 percentage points in 1984 and 9 in 2006.

Figure 6. Tax revenues as a percentage of GDP in France and Germany since 1970



Source: OECD.

4. Taxation

- The French taxation system has four main features:

- Income taxation is especially weak (even when including GSG). This is partly offset by a high local taxation.
- Employers' contributions are particularly high (esp. if taxes on wages are added).
- Business tax is high
- Property taxation is relatively high (wealth tax, estate and inheritance)

- This suggests that France should increase the weight of income taxation and reduce the weight of employers' contributions, through financing family and health allowances by general taxation.
- Besides, heavy taxation on property and business (*taxe professionnelle*) are difficult to maintain in world with free movements of capital.

4. Taxation

French taxation trends in France from 1980 to 2005 are characterised by a rise in CSG and in local taxes, while there were some reduction in income taxation together with some reduction in employers' contributions.

Meanwhile, in Germany the income tax was cut while contributions paid by households increased; capital taxation was abolished

These trends raise similar issues: should households' taxation be mainly income taxation, which has the advantage of being progressive and of accounting for the entire situation of the tax payer or should the global amount of tax revenues be hidden by the addition of several taxes? Should capital taxation be abolished (because of free movements of capital and wealthy people) ?

French taxation should be reviewed within the General Review of Taxation, but the project is still vague.

8. Tax revenue, Germany and France

	Germany			France		
	1980	1990	2005	1980	1990	2005
Total	36.4	36.0	34.8	40.1	42.4	44.1
Taxes on incomes, individuals	10.8	9.6	8.1	4.7	4.5	7.6
Of which: personal income tax						*2.9*
CRDS-CSG						*4.7*
Corporate	2.0	1.7	1.7	2.1	2.2	2.8
Social security contributions						
Employees	5.6	5.6	6.1	4.5	5.6	4.1
Employers	6.6	6.7	6.6	11.4	11.4	11.0
Other	0.3	0.7	1.2	1.2	1.5	1.2
Taxes on wages	-	-	-	0.9	0.8	1.2
Taxes on goods and services	9.9	9.3	10.1	12.2	11.9	11.2
Other taxes, companies*	-	-	-	1.2	1.4	1.5
Taxes on property	1.2	1.2	0.9	1.9	2.7	3.5
*Housing tax***				*0.6*	*0.6*	*0.9*
Real estate households	*0.2*	*0.1*	*0.2*	*0.4*	*0.5*	*0.7*
Real estate companies	*0.2*	*0.2*	*0.3*	*0.2*	*0.3*	*0.5*
Wealth households	*0.1*	*0.1*	-	-	*0.1*	*0.2*
Wealth comanies	*0.4*	*0.4*	-	-	*0.1*	-
Inheritance	*0.1*	*0.1*	*0.2*	*0.2*	*0.4*	*0.5*
Transactions	*0.2*	*0.2*	*0.2*	*0.5*	*0.6*	*0.6*

*Taxe professionnelle. ** Taxe d'habitation.
Source: OECD, *Revenue Statistics, 2006*

9. Implicit tax rates, 2005

According to Eurostat classification, taxation is slightly heavier on labour in France than in Germany, this is much more true for capital, which may be justified both from fairness and economic efficiency view points in a context of mass unemployment, but raises today a problem because of free movements of capital

	France	Germany
Consumption	20.2	18.1
Labour	42.1	38.7
Capital	38.9	23.3

Source: Taxation trends in the EU, Eurostat (2007).

4. Taxation: VAT

In January 2007, the 3 percentage point rise in German VAT was used to cut by 2 percentage points unemployment insurance contributions (other contributions having been risen by 0.9 percentage point) and to reduce the government deficit.

In France, the German VAT rate rise has been singled out by the proponents of a 'social VAT' who consider that France could improve its competitiveness at no cost, in replacing employers' contributions rates by VAT percentage points. According to them, social protection financing through VAT explains the good economic performances of Denmark.

Competitiveness gains, either permanent or transitory would be welcome by many EU States, such fiscal reforms could be a substitute for a devaluation no longer possible in the EA. This would progressively bring VAT rats to their maximum (25%), each country would in turn be a victim or guilty. This would not ensure competitiveness gains vis-à-vis non euro area countries, where the exchange rate plays an important role. This would not be a substitute for a reform of the economic policy framework in the euro area. The VAT rise in Germany is not a model for EU partner countries and France among them.

4. Environmental taxation

Both in France and Germany, environmental taxation has a limited weight: 2.4% of GDP in France and 2.5 on Germany;
Taxes on transport: 0.6% in France, 0.4 in Germany,
Taxes on polluting activities and natural resources: 0.2% in France and do not exist in Germany.
Both countries stand slightly below the EU average (2.6%)

4. Company taxation

The French corporate taxation rate was 50% in 1985, declined to 33.3% in 1993. In order to fulfil the Maastricht constraints, corporate taxation rates increased to 41.66% in 1997 and decreased afterwards progressively down to 34.3%. But relatively high local taxes, real estate taxes (0.5% of GDP in 2005) and even more the business tax (1.5% of GDP in 2005) are paid by French companies

In Germany: global tax rate of 60% in the 1980's, including local company taxation, 56% in 1998 and 39% in 2001 (nominal corporate tax of 25% + 5.5% extra-tax +local tax). Germany decided to cut the nominal corporate tax rate to 15% (i.e. 29.8% for the effective rate in 2008), thus taking part to tax competition. German companies are therefore less heavily taxed than French ones. Total company taxation declined from 2.6% of GDP in 2980 to 2% in 2005 in Germany while company taxation was increasing from 3.5% to 5.3%

4. Company taxation

Two difficult choices for France:

- Taking part to tax competition and progressively cut corporate tax rates. Lower corporate tax rates could be offset by heavier taxations on dividend incomes and plus-values paid by residents ..
- advocate at the EU level for tax coordination: An agreement should be reached on a common tax base and minimum tax rates (higher for more developed countries.
- But are EU countries able to reach such an agreement?

4. Households income taxation

The income tax rate is difficult to reform

French governments have introduced CSG, a flat tax paid-as-you earn; with a large base.
In 2005, German households paid a direct tax of 8.3% of GDP (8.1% in income tax,0.2 in local taxes),
French households 9.4% (2.9% in income tax 4.7% en CSG, 1.6% local taxes et 0,2% in wealth tax (ISF).

4. Households income taxation

Taxes are less heavy than in Germany on low wages (due to social contributions exemptions) but heavier on high wages (due the absence of ceiling for social contributions)

Table 7: Average tax rate, in 2005, married couple, two children, two wage earners, spouse earning 70% of husband's wage

Wage level/ Average wage	0.7		1		2		3		5	
	a	b	a	b	a	b	a	b	a	b
Germany**	6.5	38.9	16.0	45.2	30.8	49.9	36.3	46.8	39.4	47.2
France*	9.6	34.4	12.3	42.9	18.8	48.3	23.0	51.2	27.0	53.7

Inequalities in the EU

According to EUROSTAT statistics , which are however fragile, France and Germany are in an intermediate position between liberal and Scandinavian countries in terms of poverty rates and social inequalities. In recent years, it seems that poverty rates have slightly declined in both countries while the performance of Scandinavian countries have deteriorated noticeably

	Poverty rate		D80/D20	
	1995	2005	1995	2005
Germany	15	13	4.6	4.1
France	15	13	4.5	4.0
Sweden	8	12	3.0	3.5
UK	20	19	5.2	5.4

4. Conclusion

Germany is more adapted than France to globalisation constraints. In France, a social-democrat taxation has been maintained: taxation on companies, high incomes and wealth.

France can therefore choose between two strategies:

- **moving towards a more liberal model, where public spending cuts and privatisation of social spending will allow for tax rates cuts.**
- **Looking for allies in the EU (but where?), in order to preserve the European social model, characterised by a high level of transfers and public spending and therefore by a high level of tax-to-GDP ratio.**
- **This system will have to be protected from tax competition through domestic harmonisation measures in the EU which will have to involve forbidding unfair competition, introducing minimum tax rates in some cases and strong measures against tax heavens at a worldwide scale. Moreover, it will have to include competitive advantages (free education and health for all, public infrastructure, social benefits) in order to remain competitive despite globalisation. Can Germany join France on such a strategy?**