France

1. Introduction

This chapter discusses the current issues of the French economy. It is obviously beyond the scope of this report to discuss all aspects. Our approach is therefore focussed on a central question: What is the current government trying to achieve economically and will it succeed?

In order to address this question, we first provide some macroeconomic background and discuss it in connection with the main economic policy debates that have dominated French circles in the last two decades. We then describe and analyse the main reforms implemented by the Sarkozy administration.

Our overall assessment is mixed. On the one hand, the administration has managed to get through many reforms that had failed or were not even attempted during previous conservative governments. In particular, there is an ongoing, potentially important reform of the public sector. On the other hand, the government is well in the tradition of engineering small adjustments within a well-established framework, rather than changing that framework. Thus reforms are remarkable much more by their number than by their depth, and we cast doubt on their economic efficiency especially in light of some existing contradictions.

Finally we suggest that it is time for the government to abandon this catch-all approach and use its political capital to implement a few major, vital reforms. We suggest that more care be given to the reform of government. This reform is underway and promising but it would be improved were it not for the obstacle of a constant flow of new policy measures that interfere with it. Our other suggestion is a reduction of the minimum wage, which however has never been considered except in 1994[1] and remains a major taboo. Yet with more than 15 percent of workers at the minimum wage, this is becoming a huge burden that calls for action. As we discuss below, an opportunity to reduce the minimum wage was lost when the *Revenu de Solidarité Active* (RSA) was introduced.

2. Macroeconomic developments

This section provides some macroeconomic background for the recent evolution of the French economy and discusses it in light of the ongoing policy debates that in turn have shaped the reforms we discuss in Section 3. We start by analysing the French economy's growth and competitiveness, then discuss developments on the employment front and finally discuss the evolution of the public finances.

2.1 Growth and Competitiveness

Table 4.1 shows the growth rates of the French economy since 1992, with a comparison to France's main neighbours and the euro area. Over a long period, France's performance is very similar to that of the euro area as a whole. It has avoided the stagnation of Italy and Germany (the latter having been reversed in 2006), while remaining substantially below the best

[1] The Balladur government tried at the time to introduce a sub-minimum wage for younger workers which was met with very violent protests and eventually withdrawn.

Table 4.1
The annual growth rate of the French economy in PPP terms

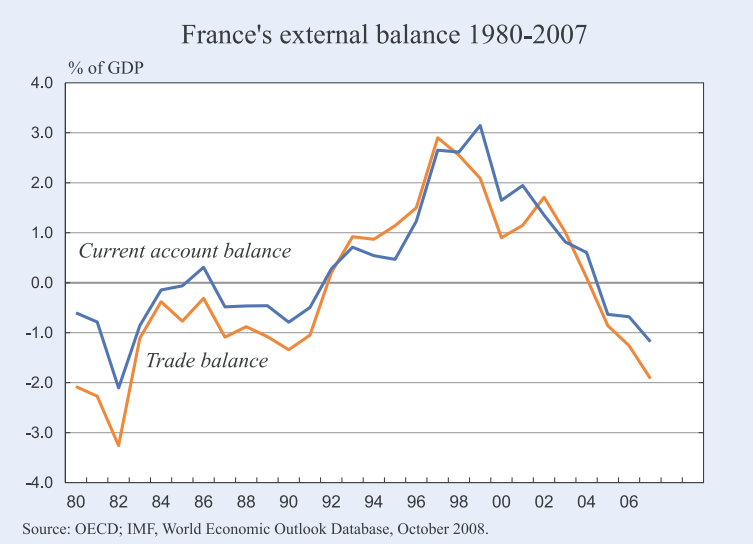
Time period	France	Germany	Italy	UK	Spain	Euro area
1992–96	1.2	1.4	1.1	2.5	1.5	1.4
1997–2001	3.0	2.1	2.1	3.1	4.4	2.8
2002	1.1	0.0	0.3	2.1	2.7	0.9
2003	1.1	– 0.2	0.1	2.8	3.1	0.8
2004	2.2	0.6	1.4	3.3	3.3	1.8
2005	1.9	1.0	0.7	1.8	3.6	1.7
2006	2.4	3.1	1.9	2.9	3.9	2.9
2007	2.1	2.6	1.4	3.0	3.8	2.6
2002–2007	1.8	1.2	1.0	2.6	3.4	1.8

Source: OECD Economic Outlook 84 (2008).

performers (Ireland, Spain, or, outside the euro area, the UK).

The 1980s and the 1990s were characterized by a slow economic decline in relative terms: the growth performance of France was below that of most other advanced economies. While most of the decline could be explained by the fall in employment and hours worked per employee, the country was also lagging in some technological indicators like information technology penetration (see Saint-Paul 2003). This pattern was overcome in the late 1990s when France's growth rate caught up with the European average. Thus France's growth performance can be summarised as "average European", which means rather modest.

Figure 4.1



Source: OECD; IMF, World Economic Outlook Database, October 2008.

However, one can see that France's performance in the last two or three years – boom years in the euro area – was again below average. It may be due to France being less cyclical than the rest of the zone – doing better in slumps and worse in booms. This is consistent with the view that its labour market is comparatively more rigid, so that employment adjusts less, both upwards and downwards. Or it may be that its relative decline had fortuitously stopped and has recently resumed, since the underlying structural weaknesses have not been addressed. Clearly, there are too few observations to support (or reject) such a statement. A third hypothesis is that it is slowing down in relative terms because it is losing competitiveness and therefore exporting less. This is especially plausible in light of the spectacular recovery of the German economy in 2006–2007, which was partly due to its internal devaluation. Clearly, any reduction in the price of German exports harms French exporters.

Traditionally, policy in France has always been somewhat mercantilist, keeping a watchful eye on the trade balance. While one should not ascribe too much importance to this statistic in the short run, we also know that protracted overvaluations of the real exchange rate can lead to significant competitiveness problems, permanent loss of the industrial base,[2] mounting external deficits and in the end an excess downward correction of the real exchange rate associated with a brutal fall in living standards (this is arguably the current US scenario). In the context of the European Monetary Union such a correction cannot take place through a depreciation of the nominal exchange rate, which means that a real overvaluation can be even more long-lived than if the exchange rate were flexible and consequently that the subsequent correction must be brought about by downward pressure on prices which can only be achieved if output is below potential.[3] Furthermore, the longer the overvaluation period, the larger the correction in the real exchange rate needed to restore the external balance in the long run, which makes overvaluation even more problematic under fixed exchange rates arrangements. There are reasons to believe that a number of euro area countries, most notably Greece, Portugal and Spain, are in such painful overvaluation situations.[4]

In the 1980s and early 1990s, French macroeconomic policy was chiefly driven by the so-called *désinflation competitive,* which aimed at reducing the trade deficit while maintaining a fixed parity vis-à-vis the Deutsch Mark. This policy was eventually successful in eliminating trade deficits but came at the cost of high unemployment over a number of years. Since then, France eventually accumulated surpluses but, as Figure 4.1 shows, its trade balance has slowly deteriorated since it entered the EMU. The most recent data

[2] See, for example, Baldwin and Krugman (1989).

[3] These issues are discussed in our 2002 EEAG report, Ch. 4.

[4] According to the OECD data that we use, the trade deficit in Greece, Portugal and Spain in 2007 was 13, 7.5 and 7 percent of GDP, respectively. In terms of relative prices Italy is also overvalued but the consequences for trade deficits seem milder than in these three countries.

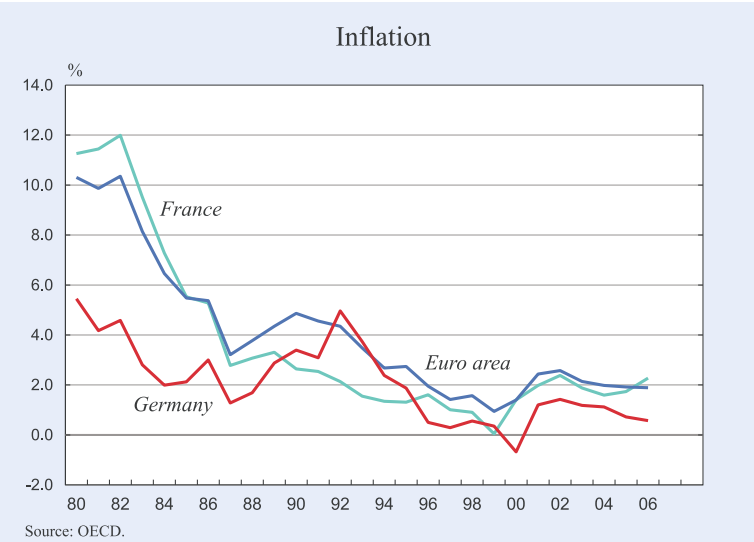
confirm this development and suggest a trade deficit in 2008 of around 3 percent of GDP.

Of course, this trend is in large part due to the euro's appreciation. However, it is compounded by the fact that while France's inflation rate is comparable to that of the euro area, it is higher than in Germany, as can be seen in Figure 4.2. And Germany is probably more of a competitor to France than the euro area countries that have high inflation rates such as Spain or Ireland.[5]

That being said, price developments are not the sole explanation for the recent adverse evolution of France's external accounts. A report by Fontagné et Gaulier (2008) highlights the fact that France, unlike Germany, has not been able to use outsourcing to concentrate on the skill-intensive segments of the value chain (see Sinn's "Bazaar Economy"; 2005). As a result, France has suffered a huge loss of market shares in exports in favour of Germany. According to Fontagné and Gaulier, France's market share in total world exports in 2007 is only 70 percent of its 1995 level, while Germany has almost maintained its market share over that period.[6]

If France's export performance is structurally weaker than Germany's, that suggests its real exchange rate should be depreciated, which in the context of the euro can only take place through lower inflation than in Germany. But as Figure 4.2 shows, the trend is in the opposite direction, suggesting a painful adjustment lies ahead, with a risk of returning to the painful years of *désinflation compétitive* and the associated high unemployment rates.

Figure 4.2



Source: OECD.

2.2 Trends in employment

A. Working time

The popular vision of the French economy is that there are many unemployed people and that the employed work very few hours. We argue that this is changing. Figure 4.3 shows the evolution of the annual number of hours worked per employee since 1990. We can see that in France, as in other European countries, there is a downward trend. Furthermore, among major European countries France clearly is in the bottom league, topping Germany only. In particular, one can see a sharp drop in hours between 1998 and 2002, when the 35 hour week was implemented by the Jospin government. Interestingly, though, hours per employee then reached a trough and have increased slightly, contrary to other countries where the downward trend has continued. This is a sign that France is perhaps leaving the "bottom league", and this may be reinforced by recent reforms described below that promote the use of overtime.

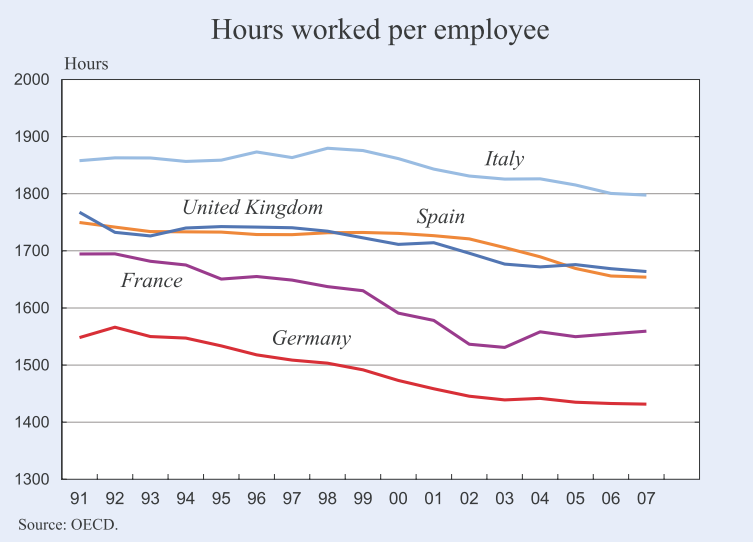
While the normal workweek has been shortened, the proportion of workers who do not work a "normal" workweek has been going up in recent years, and hours have gone up among these workers. Hence, according to OECD data, the proportion of workers working between 35 and 39 hours a week has fallen by two percentage points, from 49.8 percent to 47.5 percent between 2003 and 2007. Meanwhile, the proportion of workers working more than 40 hours a week has increased from 31.0 to 33.1 percent. So, despite the legal workweek of 35 hours, a large fraction of the workforce works more than 40 hours, and that fraction is increasing.

[5] Furthermore, comparing French inflation to euro area inflation is somewhat misleading as the euro area includes poorer countries which can have more inflation because of non-traded goods by virtue of the Balassa-Samuelson effect (see Balassa 1964 and Samuelson 1964): the price of tradables is equalized across countries, and convergence in living standards implies that non tradables become relatively more expensive. Consequently, poorer regions in a currency area must have higher CPI inflation.

[6] Intuitively, we expect both market shares to fall over time since world trade and the world economy are outpacing growth in France and Germany.

[7] A slightly different picture emerges if one uses OECD data instead of Eurostat data, because the gap disappears in the early two thousands.

Figure 4.3



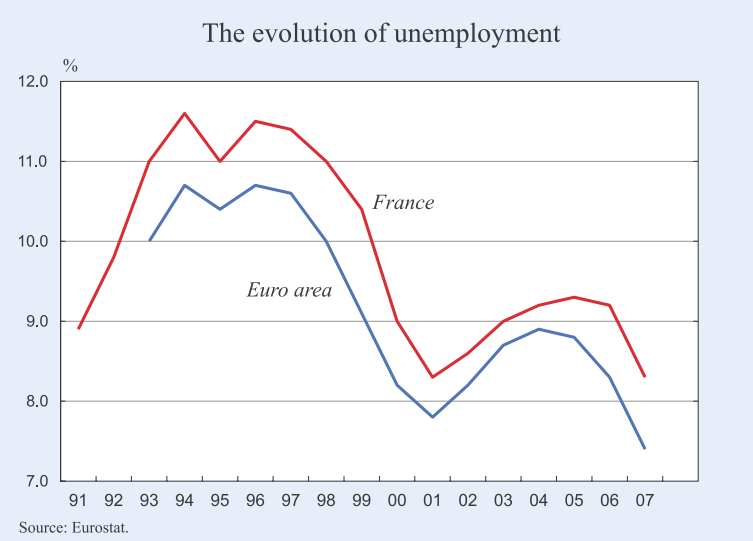
B. The evolution of unemployment and the policy debate

As far as unemployment is concerned, the record shows that France closely follows the euro area's experience but at a somewhat higher rate. This difference is fairly constant over time.[7]

The unemployment problem has been at the forefront of the policy debate for decades. It has motivated a large array of policies – including passive support to the unemployed, employment protection, job creation schemes in the public sector, deregulation of temporary contracts and reductions in employers' social security contributions. These policies have typically replaced each other at a dizzying pace and represent a large cumulative cost on the budget. Yet they do not seem to have had a large impact. France is now emerging from its third major episode of a substantial decline in unemployment. The first of these episodes was in the late 1980s, and the second one from 1997 to 2001. None of these episodes is explained by a substantial labour market reform; rather they reflect international business cycles. With the coming recession it is likely that the current episode will end and that unemployment will again reach some 9 percent. So far, though, recent data show that unemployment bottomed at 7.6 percent in March 2008, to increase again in November to 7.9 percent.

Thus, while a number of European countries seem to have returned to permanently lower levels of unemployment,[8] France is in the club of those countries where it remains high. We believe that this is for lack of substantial labour reforms; although it should be pointed out that the last two episodes of falling unemployment have not triggered inflationary tensions. This is somewhat paradoxical because in the absence of structural reforms we expect the equilibrium unemployment rate to stay constant. In principle, this means that inflation should accelerate when unemployment falls. One possible answer to this puzzle is that the natural rate has fallen despite the lack of reforms, say because the underlying trend of productivity growth is more favourable, or because the composition of the workforce gives a great weight to groups with structurally lower unemployment (e.g., the middle-aged vs. the young). If so, we should expect unemployment to stabilise at say 7.5–8 percent instead of returning to 9 percent. Another possibility is that the mechanism by which unemployment returns to its long-run level is no longer accelerating inflation. One reason why this may be so is that increased international competition makes it more costly for firms to increase their prices as this would entail a

Figure 4.4



[8] See the discussion in Saint-Paul (2004).

severe loss of competitiveness; on the other hand, it makes it easier for them to outsource activities and substitute imported intermediate inputs for domestic workers. If this is true, an incipient fall of unemployment below the natural rate does not result in more CPI inflation but rather in a direct fall in labour demand, coupled with more outsourcing and greater imports.

The recent evolution of unemployment looks less favourable if one looks at its duration rather than its level. This is reported in Figure 4.5. Over 25 years the average duration of unemployment has never fallen below 12 months. While the first two episodes of falling unemployment were associated with a reduction in the average duration from an admittedly very high initial level (16 months) to slightly above 12 months, the recent fall in unemployment is not associated with a reduction in average duration. This confirms the view that the labour market remains sclerotic and unfriendly to new entrants and suggests that most of the decline comes from a fall in the rate at which workers leave their jobs.

C. The issue of labour contracts

As in a number of other countries, France has attempted to make its labour market more flexible by reforming employment protection. This has been faced with substantial political opposition, and like Spain, Italy and Portugal, France has gradually reduced employment protection "at the margin" by liberalising the use of temporary contracts while not reducing the protection level associated with permanent ones. As a result, temporary contracts now account for some 70 percent of new hires. But because there are severe restrictions on their duration and how frequently they can be renewed, they only account for 15 percent of the stock of employment. To summarise, most workers are now in one of two situations:

- A "determined duration contract" (CDD), which cannot exceed 18 months and can only be used for tasks that are "temporary in nature" (e.g., replacing an absent employee, seasonal work, etc.)
- An "undetermined duration contract" (CDI), which makes it quite difficult to lay off workers for economic reasons, due to procedural difficulties (obligation to prove the economic difficulties to a judge; obligation to propose a plan for relocating the workers into other jobs, etc.), litigation and uncertainties (legal precedents of firms being forced to rehire workers that it had laid off, etc.)

There has been a debate on the role of temporary contracts in France. Some claim that they reinforce labour market dualism by creating a class of have-nots who move constantly between temporary jobs and unemployment spells. If anything, this evidence is not accurate. A large fraction of temporary job holders end up in permanent contracts and the probability of getting a permanent contract is much larger for temporary workers than for the unemployed. Some also fear that despite this "happy ending" of labour market trajectories, they are plagued by increased precariousness, and that this has costs in terms of say, ability of workers to get loans, investment in human capital, and so on. Despite much talk about it in the media, increased precariousness is largely a myth. Table 4.2 shows the evolution over time of two variables. One is the proportion of workers employed for less than a year, which is a measure of precariousness. The other is the proportion of workers employed for more than 10 years. While we expect these variables to be driven in part by changes in the demographic composition of the population as well as the economic cycle, we would expect a substantial trend toward shorter durations if precariousness increased over time. Over a period of 15 years the proportion of workers having worked less than a year in their current job is

Figure 4.5

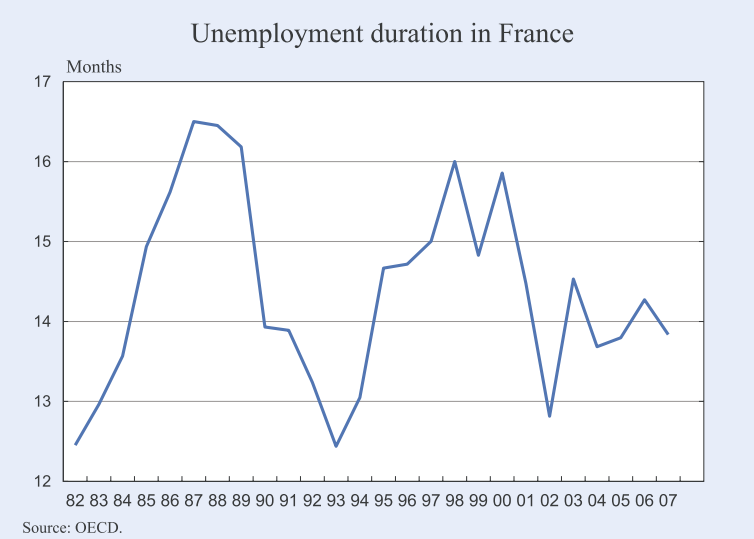


Table 4.2
Proportion of the employed in short and long employment spells

Year	% employed less than a year	% employed more than 10 years
1992	13.7	43.0
1996	12.9	43.4
2000	15.7	45.0
2004	13.5	45.4
2007	14.9	43.3

Source: OECD online data.

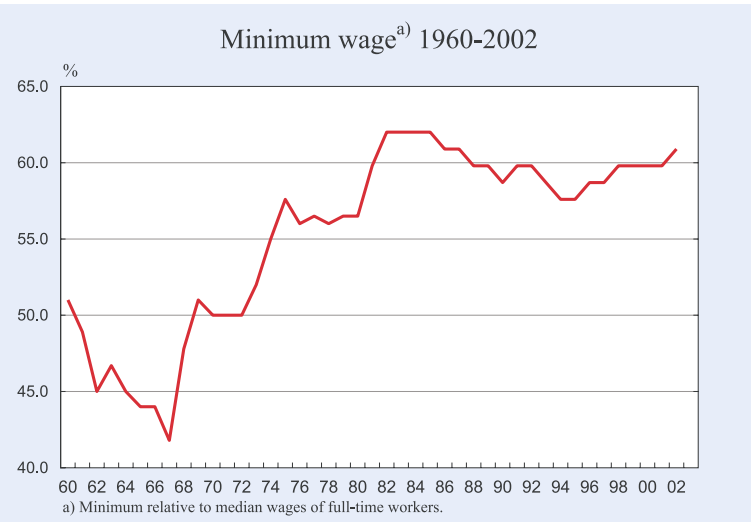
essentially unchanged. The same is true for the proportion of workers employed for more than 10 years. Thus there is no sign of increased precariousness.

While many economists call for uniform labour contracts, in practice the use of temporary contracts has proved to be the only politically viable way of making the labour market more flexible. The reason is that it gives firms a margin to manage their workforce while preserving the interests of incumbent insiders. Thus, recent hints at introducing a unique contract was met with resistance from both the unions and employers: while the former feared that the new contract would be more flexible than permanent ones, the latter were concerned that they would have less freedom if they could not use temporary ones. As a result, reform of employment protection has so far boiled down to a limited agreement between the social partners (see section 3.1B).

D. The minimum wage

One cornerstone of French redistributive policy is the minimum wage. While in most countries the minimum wage is sufficiently low to be considered as a minor distortion, this is not the case in France. Figure 4.6 documents the secular rise of the minimum wage in relative terms since the late 1960s. While there was a downward trend in the 1960s, following the 1968 *accords de Grenelle* the minimum wage jumped upwards by almost 20 percent. It was followed by two successive hikes following the election of Giscard d'Estaing in 1974 and that of Mitterand in 1981. Since then the minimum wage has remained stable at around 60 percent of the median wage.

Figure 4.6



a) Minimum relative to median wages of full-time workers.
Source: OECD.

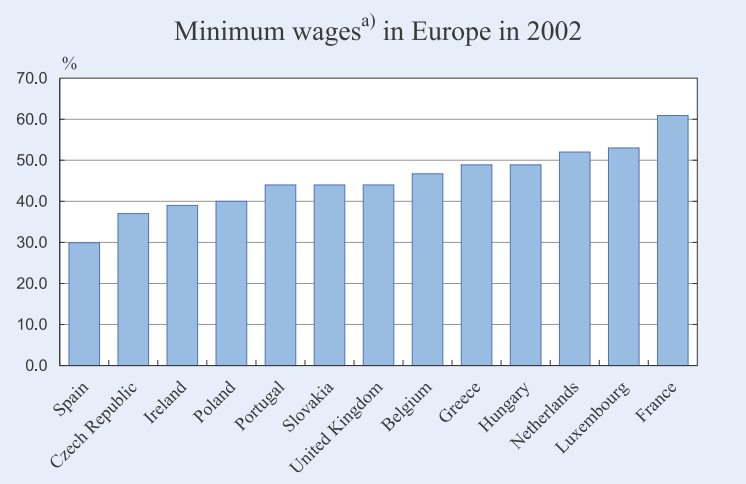
How high is this by international standards? This is shown on Figure 4.7, which confirms that the French minimum wage is the highest in Europe in relative terms.

The French minimum wage exerts a strong compression effect of wages at the bottom of the distribution of income. The proportion of workers paid the minimum wage has substantially increased over time.

Figure 4.8 is taken from a working paper of the French Ministry of Finance (2007) and depicts the evolution of the proportion of workers paid the minimum wage over the last two decades. We note a sharp increase in this proportion since the mid-1990s, peaking at over 16 percent in 2005 (the corresponding number for the United States is 2.5 percent). This is the result of policies aimed at reducing the cost of labour by reducing employer's social security contributions for low wage earners. As a result, these contributions have become quite progressive as wages go up beyond the minimum wage, which creates disincentives for employers to increase wages above the minimum. Furthermore, these policies have mostly opened the door for discretionary increases of the take-home minimum wage, and thus had in the end little negative impact on the total labour cost of the minimum wage, except in their very first years. This induced effect, of course, further increases the proportion of minimum wage workers.

The current minimum wage trap is worrisome for a number of reasons. First, the large number of workers paid the minimum wage suggests that it is binding for a large segment of the labour market and therefore

Figure 4.7



a) Minimum relative to median wages of full-time workers.

Source: OECD.

that it destroys many jobs. In a well-known study, Laroque and Salanié (2000) have found that a 10 percent increase in the minimum wage in France would destroy around 300,000 jobs, which means an increase in the unemployment rate of 15 percent.[9]

Second, unskilled workers are discouraged from acquiring skills: they now need a larger productivity improvement than in the past to increase their take-home wage by the same amount, due to the progressivity of social security contributions. And those at the very bottom of the distribution of earnings face the additional problem that should they move up a full decile, they would still be paid the minimum wage. To grasp how big these effects are, note that according to the OECD in the United States the second decile of the distribution of wages earns a third more than the bottom decile. This suggests that to move to the second decile, an unskilled worker would have to increase his productivity by a third on average, which with estimated returns to education is equivalent to at least three extra years of schooling. In France the incentives to do so are virtually non existent, since with 15 percent minimum wage earners the second decile is barely richer than the first (it earns 11 percent more on average).

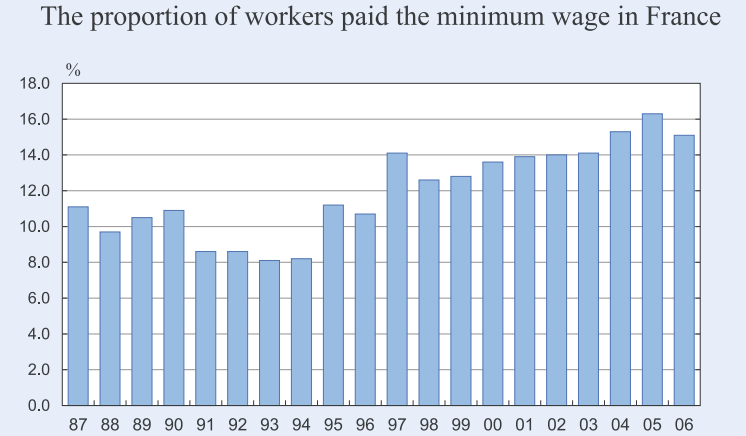
2.3 Fiscal policy

Having discussed the evolution of employment in France, we now turn to an important dimension of its macroeconomic developments: fiscal policy and the size of government. A stylized characterisation of France's fiscal policy could be as follows:

- A will to use budget deficits in slumps to stimulate the economy
- An incapacity to run surpluses and re-balance the budget during booms

The latter aspect is certainly due to political factors. There is considerable temptation for politicians to spend any incipient budget surplus in exchange for political benefits. Furthermore, this is aggravated by the fact that an increase in public spending is often the outcome of distributive conflicts between special interest groups.[10]

Figure 4.8



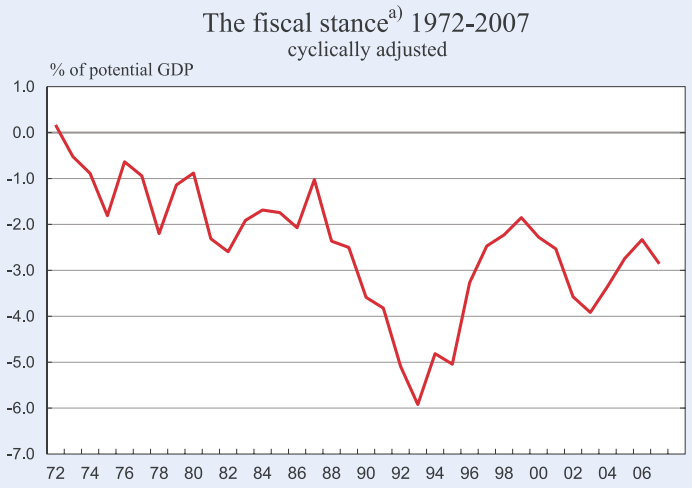
Note: Share of employees in the non-agricultural service sectors affected by the increase of the minimum wage between 1987 and 2006.

Source: French Ministry of Economics, available at: http://www.minefe.gouv.fr/directions_services/sircom/emploi/conf071023/smic.pdf.

The result of this process, summarized in Figure 4.9, is that France has run a deficit every single year since 1973 and remains close to the 3 percent Maastricht limit since the implementation of EMU (which, along with German deficits, has led to the de-facto repudiation of the Growth and Stability Pact). The deficit is bound to deteriorate sharply with the current

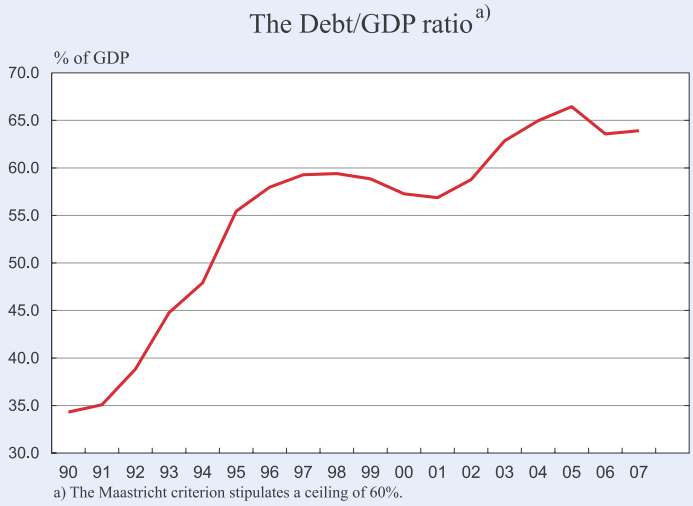
[9] That is, if it were implemented now, unemployment as a share of the workforce would increase from some 8 percent to 8 x 1.15 = 9.2 percent.
[10] See Alesina and Drazen (1991).

Figure 4.9



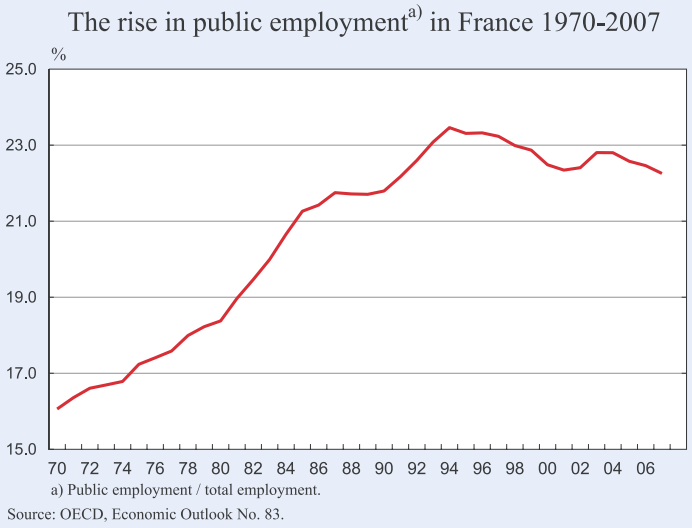
a) Government net lending.
Source: OECD, Economic Outlook No. 83.

Figure 4.10



a) The Maastricht criterion stipulates a ceiling of 60%.
Source: OECD, Economic Outlook No. 83.

Figure 4.11



a) Public employment / total employment.
Source: OECD, Economic Outlook No. 83.

recession and the expensive stimulus package that was launched in December 2008.

Because of this apparent inability to run surpluses, the sustainability of French fiscal policy ultimately depends on the economy's growth rate: the debt/gdp ratio improves somewhat in good times and deteriorates quickly during recessions.

As Figure 4.10 shows, public debt has drifted upward. The data show no implicit target for the debt/GDP ratio that policy makers would aim at. In particular, episodes of rapid increases in national debt, such as the sharp recession of the mid-1990s, have left a large and apparently permanent increase in public debt of some 25 percent of GDP. If a similar episode were to occur again, we would expect an increase of the same order of magnitude and the debt/GDP ratio would reach 90 percent, which might become more and more problematic. Indeed, the current crisis suggests that there is every reason to be worried about such a possibility.

Of similar concern is the upward drift in public employment, the causes of which are further discussed below.

As shown on Figure 4.11, public employment as a share of total employment experienced an upward trend in the 1970s, with two accelerations after 1981 and 1988 (i.e., after socialist victories in elections). It peaked in 1994, and has decreased somewhat since then, but that is essentially because its denominator, employment, has started growing. As a result public employment is now 22.5 percent of the workforce,

and reaches 25 percent if one takes into account atypical public entities such as the social security administration and the post office. This is very high by international standards.

Box 4.1

The Fiscal Package

The Fiscal Package was the first series of economic measures of the Sarkozy administration. The general philosophy is to enhance people's incentives to work and accumulate. The four key measures of the Fiscal Package are:

- Introducing a ceiling of 50 percent on the total taxes paid by any household (the so-called fiscal shield or *bouclier fiscal*): Fiscal authorities now collate all the taxes paid by a household and send a refund for all taxes paid in excess of 50 percent of their income.
- A full-income tax credit for all overtime hours, coupled with a reduction in payroll taxes for these hours.
- An income tax credit for interest payments on mortgages.
- Suppression of inheritance taxes whenever the beneficiary is the spouse.

Summary

The preceding analysis highlights the three main challenges that economic reform should address:

- A dismal long-term growth performance
- An unemployment rate that remains high compared to those countries that have escaped the European unemployment dilemma
- An overbloated public sector

3. Economic reforms

Since the election of President Sarkozy in 2007, the country has been engaged in an unprecedented wave of reforms, especially in contrast to Chirac's last term (2002–2007) where little was achieved on the economic front except the 2003 partial pension reform and the ill-fated new targeted flexible labour contracts introduce by the Villepin government in 2006.

3.1 What reforms?

The reforms that have been implemented are broad and eclectic and are based on different philosophies and paradigms. They are so numerous that the sheer task of presenting them is itself a challenge. We choose to group them into five main blocks: tax policy, labour markets, goods markets, the welfare state and the government.

A. The Fiscal Package

The so-called Fiscal Package *(paquet fiscal),* part of Sarkozy's electoral platform, was implemented immediately after the presidential and parliamentary elections of 2007. Its stated philosophy is "work more to earn more". The package is eclectic and includes tax breaks on overtime work, subsidisation of mortgage payments as well as the elimination of (some) taxes on bequests. It is clearly meant to appeal to the middle class/upper middle class voters, who are highly represented among the Sarkozy electorate. Overall, these reforms (described in Box 4.1) should increase the incentives to work and accumulate wealth – which should translate into a greater stock of capital. But the inspiration and economic rationale of these reforms is not totally clear. In particular, they have not been carefully designed on the basis of cost/benefit considerations.

The tax cuts for overtime increase incentives to work on the intensive margin.[11] Many analysts have criticised them on the grounds that the real problem is low employment, not low hours per person, so that acting on the extensive margin would have been more appropriate. However, it makes economic sense to tax marginal hours at a lower rate than inframarginal hours, since it is the latter that matter when workers and firms are setting their working time optimally. But the extensive margin matters too when it comes to the arbitrage between working and not working, which is key to the determination of the employment rate. Thus we think that the fiscal effort should have been more balanced, i.e,. one should have lowered payroll taxes on non-overtime work instead of having a very large subsidy on overtime only; the effects on employment would have been more favourable. Also, many economists think that firms can "cheat" on the scheme by giving wage increases in the form of fictitious overtime. If these concerns are true, then the scheme would involve a substantial deadweight loss (although a good side effect is that it then becomes an employment subsidy and acts on the extensive margin).

[11] One typically distinguishes the margins of adjustment: the "intensive" margin, where the intensity of activity goes up and the "extensive" one, where inactive units become active. This distinction applies to all sorts of contexts. In the employment context, the intensive margin means more hours by employed workers, and the extensive margin means more employed workers.

Similarly, the tax cut on mortgage payments is likely to be largely dissipated in the form of higher house prices: it is a poor idea to subsidize the demand for housing, especially in areas that are densely populated and highly regulated, where the response of construction to an increase in house prices is not very strong. The main effect of the reform is to transfer money from taxpayers to those who initially own real estate. Worse, because the subsidy is in the form of a tax deduction, the poorest households (who pay a zero income tax) cannot access them, despite suffering from the higher house prices induced by the policy. Therefore, this policy is not only ineffective in solving the housing problem, it is also increases inequality. Instead of subsidising mortgage payments, it would have been better to reduce the taxes on transactions that amount to around 10 percent of the value of the good being sold. Such a reduction would have favoured increased turnover on housing markets, hence reducing the average delay for selling or buying a home, and it would have made housing genuinely cheaper for buyers (and more profitable for sellers).

B. Labour market reforms

In France, labour contracts are heavily regulated. The law that governs industrial relations, the *code du travail,* has tens of thousands of pages. De-regulating the labour market, especially in the area of termination, has long been a centre-piece of the public debate. Yet it has proved quite difficult. The history of right-wing governments in France is that of violent street protests against reforms that increased labour market flexibility and were subsequently withdrawn (the other two traditional triggers of such protests being pension reforms and reforms of the educational system).

In the aftermath of yet another failure to make the labour market more flexible by the preceding Villepin government, the Sarkozy administration has relied on collective bargaining to reach an agreement on labour market reforms. It has given a deadline to employers' associations and trade unions with the threat that if no agreement was reached by that deadline, it would impose its own law. The result is the 11 January 2008 agreement, which is described in Box 4.2.

Overall, the agreement reduces the legal uncertainties associated with termination of the employment relationship. This makes it somewhat easier for firms to lay off workers. At the same time, statutory severance payments are increased and some employer-based benefits are made more portable. The reform moves a small step in the direction of substituting protection of people for protection of jobs, in accordance with the very fashionable "flexicurity" philosophy.

But the move is not revolutionary and should only have a moderate effect on job creation. Its caution is exemplified by one of the items of the agreement, the "determined object contract". As in Italy and Spain, firms try to achieve flexibility by hiring under fixed-

Box 4.2

The labour market agreement of 11 January 2008

In January 2008, French employers and union representatives signed an agreement about reforming the laws governing labour contracts, in particular with respect to the conditions of termination. The social partners were under strong pressure by the government to bargain over these issues, as the government had threatened to impose a law and ignore them should they fail to reach an agreement by a given deadline.
The key points of the agreement that was signed on 11 January 2008 are as follows:

Introduction of a severance procedure "by mutual agreement". Under this procedure, the employee is entitled to unemployment benefits as if he had been involuntarily laid off, as well as to a severance payment. On the other hand, the scope for litigation after the separation has occurred is severely restricted. The mandated level of severance payment used to be equal to 10 percent of the monthly wage per year of tenure. It was small by European standards even though dismissals were made quite difficult for the firm due to many restrictions. The agreement doubles that level. The new mandated severance payment also applies to separation by mutual agreements.

Portability of fringe benefits into periods of unemployment: laid-off workers can now continue to draw fringe benefits (like supplementary health insurance) associated with their previous job during part of their unemployment spell. The motivation for that measure is to eliminate a disincentive for mobility associated with the automatic loss of these benefits when one loses one's job.

The new "determined mission contract" (CMD), which can last between 18 months and 36 months. It is however limited to executives and engineers. The approximate duration of the mission must be written in the contract, and the employee must be informed about the termination of the mission at least two months in advance.

term contracts as much as they can. The impossibility to renew a fixed term contract beyond 18 months implies that, to obtain such flexibility, firms must get rid of valuable employees after 18 months or else convert their contract into a CDI and bear a much higher level of employment protection. For that reason, for years employers' associations have lobbied for a "project contract", which allows firms to hire workers for the entire duration of a given project. This would conciliate flexibility with better consistency in the firm's recruitment policy and better opportunities for the workers hired under temporary contracts to accumulate valuable human capital, which in turn would improve their career opportunities and the likelihood that they get a permanent contract. While the original plan by employers was a 5-year contract, the agreement only allows for a 3-year contract which only applies to fairly skilled workers. This is more like a super CDD for the skilled than a genuine project contract.

On the downside, the reform tends to increase the incentives for workers to be unemployed. As Box 4.2 shows, it involves greater portability of a number of social benefits when people lose their jobs. Portability generally makes it easier for workers to change jobs and should be commended. But here the counterpart of greater portability is an increase in both the effective severance payment and the effective unemployment benefit replacement ratio. For example, laid off workers can keep supplementary health insurance for 7 months. But both parties, the employer and the employee, have to pay their share. This is unfortunate: the employer's share acts as an additional severance payment, but it is paid only as long as the worker does not find another job. This cumulates the negative effects of severance payment on job creation with the negative effects of unemployment benefits on job search. Ideally, employer-based benefits should be abolished; they have no economic rationale, workers could get higher wages instead and purchase whatever benefit they want on the market. The distortions associated with portability problems would then disappear. To summarize, while reducing non-wage labour costs, the agreement has increased the incentives by firms and workers to inefficiently rely on the unemployment benefit system in terminating employment when they would not want to do so if unemployment benefits did not exist.

Another intervention in the labour market took place in October 2008. The government put together a package to fight the incipient rise in unemployment triggered by the slowdown in the world economy. These hasty measures contradict to some extent the structural approach underlying the process for reforming labour contracts.

The package involves a variety of measures of different quantitative significance. The most salient ones are the introduction of 100,000 subsidised jobs in the non-business sector and the generalisation of the so-called *contrat de transition professionnelle* (CTP), which is a kind of super-unemployment benefit scheme reserved for workers who lose their jobs in large firms and involves generous benefits along with special counselling and training.

The first measure is a revamping of old policies that were especially popular with the Left (in 1997 the Jospin government created the so-called *emploi jeunes,* which offered low-paid temporary public sector jobs to recent school leavers), and it is in contradiction with the Right's usual stance that one should refrain from creating jobs in the non-business sector (The *emploi jeunes* was discontinued after the Right assumed power in 2002.) In general, there is much scepticism about the scheme's efficacy.

The second measure, the extension of the CTP, is consistent with the general "flexicurity" philosophy, but by its very nature this scheme benefits "insiders" and does nothing to increase competition from outsiders in the labour market – indeed, the same can be said of the subsidised jobs, which withdraw outsiders from active job search while locking them in jobs of little productive value.

Also, there is some confusion in the whole approach between structural measures aimed at reducing the long-term equilibrium rate of unemployment and cyclical ones that are supposed to combat a recession. Structural measures exert their effects only after a while and are an inappropriate tool for stabilising business cycles.[12]

C. Goods markets : The Attali Commission and the Loi de modernisation économique

Immediately after being elected, President Sarkozy appointed Jacques Attali, a former EBRD CEO and special advisor to Mitterand to head a commission with the goal of proposing reforms to boost the coun-

[12] Furthermore, it is arguably politically easier to introduce them in booms, although that is debatable. See Saint-Paul (2002).

try's growth and competitiveness.[13] The appointment took place in the context of the debate on France's relative economic decline. The commission, with a very eclectic membership that included economists, top civil servants, sociologists, historians, philosophers, and so on, built on previous reports that pointed out rigidities in many different areas such as regulations of good markets and retail trade, rigidities of the educational system, lack of access of small firms to credit markets, and so on. The outcome of the commission was the *loi de modernisation économique,* a catalogue of measures of various importance (Box 4.3). It should be noted that in the context of the debates associated with the law, the government suffered a setback as taxi drivers mobilised against one of the most advertised propositions of the Attali Commission, namely the elimination of the quotas for taxi licenses (See Box 4.4).

[13] The Attali (2008) Report is available online at http://lesrapports.ladocumentationfrancaise.fr/BRP/084000041/0000.pdf

D. Welfare reform: Pensions and the revenu de solidarité active

The problem of financing pensions in France is not as large as in other European countries thanks to more favourable demographics. Nevertheless, the accounts are far from balanced and the problem has been aggravated by a reduction of the retirement age to 60 in the early 1980s as well as an excessive reliance on pre-retirement schemes to cope with the unemployment problem. As illustrated in Table 4.3, this meant that the labour supply of elderly workers was quite low by international standards.

Box 4.3

The Attali Commission and the *loi de modernisation économique*

In the spring of 2008 the so-called *loi de modernisation de l'économie* was enacted. Its goal is to enhance the country's growth and competitiveness by lifting a number of barriers to economic activity. The law is broad and encompassing and can be summarised by 10 key items:

Creation of the status of *auto-entrepreneur*: this measure is targeted at people who want to start their own business. The auto-entrepreneur is spared all the red tape and pays a flat tax that replaces all social security contributions and income tax. He or she does not pay corporate taxes and does not pay the so-called *taxe professionnelle* (yet another tax on businesses) during the first three years. Pension rights are accumulated automatically, although it is unclear at what rate. An individual is eligible to that status only with a yearly turnover below 80,000 Euros for commercial activities and 32,000 Euros for services. The income tax deductibility only applies to the bottom three tax brackets.

Easing the life of small businesses: this allows entrepreneurs to shelter a greater fraction of their personal assets from creditors in case of bankruptcy (while letting them opt out from such protection for some assets if they want to improve their access to credit). Also, some threshold effects in payroll taxes are smoothed, although this is "experimental" and will be reviewed in 2010.

Granting preferential access to public procurement for "innovating" small- and medium-sized enterprises (SMEs). Reducing payment deadlines between firms. Important tax reductions for the inheritance of businesses, whenever the beneficiaries are family members and/or employees.

Easing regulation on retail trade. While administrative approval was needed to open a retail outlet of more than 300m^2, the threshold is now 1000m^2. Furthermore, representatives of competitors can no longer be members of the administrative commissions that are granting the approvals. Also, those commissions can no longer deny the permits on the grounds of "lack of economic need" but can only do so on environmental and urbanistic criteria. Finally, "back margins" are declared illegal. Back margins are a practice by which a supplier pays a retail outlet for the right to have its product sold at that outlet. The difference between back margins and lower supply prices is that the law prohibits selling below cost. Thus, back margins allow supermarkets to buy at a low effective cost while tying their own hands to charge high prices by maintaining high theoretical costs: it is an indirect way of sustaining collusion among the leading supermarket brands. The abolition of back margins forces supermarkets to negotiate price reductions with their suppliers, thereby eliminating the collusion technology.

Liberalising sales: the new law involves a marginal liberalization of sales. While in the past sales could take place 10 weeks a year, and these 10 weeks were uniformly set by the government's representative, (the *préfet*), there are now only 8 such weeks, but each business can have sales during two extra weeks of its choice. While this is surely marginal, it could nevertheless have a large impact on competition. In a way, restricting sales enforced collusion in the retail sector. A seller could not lower its price except during the sales season. Now, sellers have an incentive to "deviate" from such collusion since they can boost their turnover considerably by having a sale at a time when others do not have it. As a result it is hoped that the level of prices sustained by collusion will be lowered more than suggested by the modest size of the move.

Box 4.4

The French Taxi conundrum

In France, the profession of independent taxi driver is heavily regulated. To operate, one needs to take an exam which is relatively complex compared to the actual task of driving a taxi, and involves the French language, the regulation of the taxi industry, traffic rules and driving (which is redundant with the requirements for simply having a driver's license), rescue techniques, management and local topography. Furthermore, one needs to purchase a license, and the total number of licenses is fixed by the government. The number of taxis in Paris in 1992 was only 15,000, as opposed to 20,000 in 1931 and 25,000 in 1925. That number did not increase until 2003, when 1,500 new licenses were issued. New licenses are given for free to candidates who are on the waiting list. The others must purchase a license on the secondary market. The value of a license in Paris is 120,000 euros. Last but not least, each license restricts operations to a specific zone. Taxis are not allowed to accept fares that do not start in their zone. Thus, for example, a *taxi parisien* is allowed to operate in central Paris plus the immediate suburbs, but not in more remote suburbs. A taxi that transports a customer from Paris to Fontainebleau is obliged by law to return to Paris empty.

In 2008, French taxi drivers mobilised against proposals by the Attali Commission to deregulate the market for taxis, even before any attempt by the Parliament to write it into the law. Perhaps because taxi drivers are a traditional constituency for the Right, the government has given in, and taxis have been left out of the *loi de modernisation de l'économie*.

Pension reform was initiated in 1994 and then proceeded at a slow pace amidst strong opposition by organized interests.

The French pension system is segmented in a way that involves large inequalities between groups of workers. The "general regime" involves dependent employees of the private sector and is the less generous. Civil servants have a more generous regime of their own, for the same rate of contribution – meaning the regime is more insolvent than the general regime. Finally, so-called "special regimes" are even more generous and involve an earlier retirement age. These typically involve a number of large public firms, like Electricité de France, the train company SNCF and the Banque de France. As of 2008 the ratio between contributors and pensioners in these regimes is 1:2 meaning they are actually bankrupt and that the pensions are paid by the taxpayer.

In 1994, the required duration of contributions to be eligible for retirement was increased for the "general regime" – i.e., dependent employees of the private sector – from 37.5 years to 40 years. Furthermore, the pension level was now a proportion of the average wage in the past 25 years rather than the past 10 years. Finally, pensions were indexed on prices, not on wages. However, the regime of civil servants as well as the "special regimes" were left untouched. In that respect, the reform increased the inequality between civil servants and special regimes and the general regime: all the burden of the adjustment was borne by the general regime, which was already disadvantaged compared to the other two regimes. A key political issue was the alignment of the two privileged regimes with the general regime. In 1995, the Juppé government tried to reform the special regimes and align them with the civil service regime. This reform touched off violent protests and was withdrawn. Two years later, the Right lost the election. The new socialist government did not attempt any pension

Table 4.3
Employment/population ratio for the 55 to 64 years old, 1994 and 2007

Country	1994	2007	(2007)–(1994)
Austria	28.4	38.6	+ 10.2
Belgium	22.4	33.8	+ 11.4
Czech Republic	32.3	46.0	+ 13.7
Denmark	50.2	58.7	+ 8.5
Finland	33.5	55.0	+ 21.5
France	33.4	37.9	+ 4.5
Germany	35.9	52.0	+ 16.1
Greece	39.5	42.1	+ 2.6
Hungary	31.1	33.1	+ 2.0
Ireland	39.5	54.1	+ 14.6
Italy	29.4	33.8	+ 4.4
Netherlands	29.0	50.1	+ 21.1
Norway	61.6	69.0	+ 7.4
Poland	34.4	29.7	– 4.7
Portugal	45.9	50.9	+ 5.0
Slovakia	21.3	35.7	+ 14.4
Spain	32.7	44.6	+ 11.9
Sweden	61.9	70.1	+ 8.2
Switzerland	61.1	67.2	+ 6.1
United Kingdom	47.4	57.4	+ 10.0
United States	54.4	61.8	+ 7.4

Source: OECD Employment Outlook (2008).

reform. In 2003, after the 2002 victory of the Right, the Raffarin government successfully implemented (despite violent opposition) the so-called "Fillon reform", which set the required duration of contribution for civil servants equal to that of the general regime, while planning a gradual increase over time of the duration of contributions, which was now indexed on the average life expectancy.[14] The reform is probably insufficient to guarantee the financing of the pension system, and further increases in the level and/or duration of contributions are to be expected. While the increase in the duration of contributions for civil servants is commendable on equity grounds, it is not clear how long it will continue from a budgetary perspective. After all, civil servants are paid by the government and the net savings generated by the measure depends on the ability to substitute elderly workers for younger workers in the public sector. If the level of substitutability is low, one may well observe an increase in the number of civil servants, which will eliminate the gains of the reform to the (consolidated) public sector, especially since a working civil servant is more costly to the budget than a retired one.

As Table 4.3 shows, despite the reform the labour participation rate of older workers has only increased modestly in France as compared with other countries and it remains far below 50 percent.

Against that background, the Sarkozy government managed against all odds to implement a reform of the fearsome special regimes that had inflicted so much damage on the Juppé government. The reform plans to align the required duration of contributions with those of other regimes to 40 years by 2012, although a provision says that if that duration were to increase – which is very likely – the special regimes will follow with a 4-year lag.[15]

Introducing incentives in welfare

More recently, and borrowing ideas from the Left, the government has moved to replace the basic assistance income (RMI), which creates an inactivity trap by making it unprofitable to work half-time at the minimum wage compared to being on welfare by a new system called RSA (See Box 4.5). The new system eliminates the inactivity trap by introducing a gradual reduction in welfare payments as hours worked go up. As a result there is (almost) no zone at the bottom of the distribution of income with confiscatory marginal tax rates.

The reduction in the trap involves an increase in the amounts redistributed and therefore a cost to the budget. As a result, the government has created a new tax on capital income which has been much criticised by employers' associations and the parliamentary Right. The new system could hardly have been better designed as it is based on the goals of increasing incentives to work while not reducing the level of income support granted to those out of work. But it has created a new concern about an excess use of part-time work, as discussed in section 3.2. Politically, it has added to the confusion about the actual stance of the government, which had been already generated by the appointment of socialist ministers and the delegation of policy design to a prominent socialist advisor to Mitterand.

While we do not dispute the positive incentive effects of RSA on non-working welfare recipients, it has two economic shortcomings.

First, full-time workers at the minimum wage may take advantage of it to work part-time. This would result in an overall reduction in hours worked and in a strong pressure on the budget. At face value, one might be tempted to dismiss this claim: at a marginal tax rate of 38 percent a reduction in pre-tax income of around 500 euros would entail a loss of 0.62 x 500 = 310 euros per month, which is far from negligible at such low incomes. However, the picture changes considerably if one brings other dimensions of the redistributive system back into the picture. First, like the RMI before it, the RSA part of an individual's income will not be subject to (most of) employees' social security contributions. However, the wage part will remain subject to those taxes. If one takes that into account, the marginal tax rate for RSA recipients is no longer 0.38 but the sum of the employee's social security contribution rate (about 20 percent) and the marginal tax rate of the RSA system, i.e., 0.38 + 0.20 = 0.58. The loss from a 500 euros income loss is now 0.42 x 500 = 210 euros per month. This is not the end of the story, though, because being on welfare is associated with a number of other fringe benefits. The most important one is the CMU *(couverture maladie universelle)*, which grants free and total medical coverage for any person whose monthly income is below a certain threshold (621 euros for a single person). In

[14] Contrary to reforms in other countries, a funded pillar was not introduced, and the degree of individual choice remains quite modest.
[15] See http://archives.lesechos.fr/archives/2008/lesechos.fr/01/16/300234200.htm

Box 4.5

Changes in social protection: the RSA (*revenu de solidarité active*)

A key reform of social protection is the introduction of a scheme called *revenu de solidarité active*, which is a form of earned income tax credit for low earners. The scheme is meant to replace an important inactivity trap that made it unprofitable for those on welfare to take a part-time job at the minimum wage. The reason is that any hour worked eliminated eligibility to the RMI (*revenu minimum d'insertion*), a basic assistance programme which pays around 500 euros per month if one includes a related housing benefit called APL.

The new scheme eliminates the inactivity trap by smoothing the amount transferred to the worker as hours increase instead of brutally eliminating the transfer at the first hour worked. Figure 4.12 illustrates how the system works. In the initial situation there is an infinite marginal tax rate at zero income, followed by a zero marginal tax rate up to the minimum wage (depending on the family situation). Of course, in effect that means that nobody has an incentive to work for a monthly amount that is below the RMI, i.e. to be a part-timer at the hourly minimum wage. The new system leaves the income floor untouched and smoothes marginal tax rates by increasing the generosity of welfare payments. As a result there is a uniform marginal tax rate of 38 percent for all incomes below 1.04 times the minimum wage, after which the supplementary income vanishes and the worker faces the regular income tax schedule, which means a substantial drop in the marginal tax rate as one passes above the threshold.[1]

As Figure 4.12 makes clear, the RSA increases the overall level of redistribution and is costly to the budget. Estimates are around 10 billion euros per year and a new tax on capital income has been introduced to finance these costs.

Clearly, the incentives to take a part-time job instead of remaining unemployed are now much larger than in the past. To be sure, the blue line in Figure 4.12 is only a stylized representation of the previous system. Preceding governments had already implemented modest, partial solutions to the inactivity trap by means of the so-called *prime à l'emploi* (a small income tax deduction for workers) and *ristourne* (a scheme that allowed the unemployed to cumulate RMI with their wages for 12months, but denied this to those who took employment without having been through welfare). While one may argue that the new system is merely consolidating and simplifying these preceding schemes, and will therefore have little effect, it is in fact far more transparent, not prone to discretionary manipulation (unlike the *ristourne*) and involves greater monetary incentives.

[1] These marginal tax rates are only partial in that they ignore social security contributions. Of course, when all taxes including VAT and payroll taxes are taken into account, marginal tax rates are very high in France.

itself, the CMU creates a big poverty trap. But the RSA reform makes the situation worse because it is affordable to live below the threshold, since the RSA income is not taken into account when determining eligibility to CMU. While there is no way to purchase complete coverage of all expenses on the market, good health insurance for a single person is worth around 100 euros per month. That is therefore the value of the CMU, implying that an increase in earnings from 621 to 622 euros amounts to a 100 euro fall in net income.

Another aspect is that the RSA part of the income is non-taxable, while wages are taxable. Finally, welfare recipients are eligible to a host of in-kind benefits, not least because local administrations typically add their own layer of redistribution to that of the central level. These in-kind advantages include exoneration of taxes on dwellings *(taxe d'habitation)*, TV sets *(redevance)*, subsidised rates for phone calls, free public transportation, and, last but not least, the "Christmas bonus", which amounts to 150 euros for a single individual and is topped-up by local authorities – e.g., the department of Bouches-du-Rhône adds another 115 euros to the state Christmas premium. It is unclear how these benefits will be transformed when the new RSA comes into place; the most likely

Figure 4.12

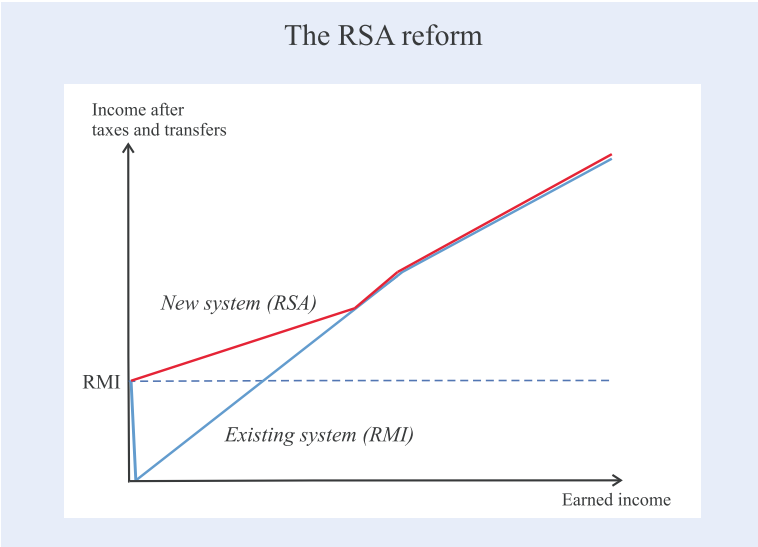


Table 4.4
The part-time option in the RSA system

Hours worked per week	20	35
Gross wage	755	1321
Net wage (1)	593	1037
RSA (2)	235	0
CMU (3)	100	0
Personal Income tax (4)	3	30
Total (1)+(2)+(3)-(4)	925	1007

outcome is that they will be conditional on some income cap, thus becoming similar to the CMU.

Let us illustrate how serious the problem can become with a simple numerical example. Table 4.4 provides a back-of-the-envelope computation of the effects of the new system on the incentives to work part-time. It takes into account the employee's social security contributions, the RSA, the CMU valued at 100 euros per month, and the personal income tax. Other benefits such as the Christmas premium, etc., are ignored; our computations therefore understate the incentives to move from full-time to part-time work – i.e., they overstate the marginal hourly wage associated with such a move.

We consider a minimum wage earner who reduces his working time from 35 hours a week to 20 hours a week. The reduction in net income puts him below the threshold for eligibility to full medical coverage (CMU), which is 621 euros per month; he is thus eligible for CMU as well as for RSA, which is non-taxable and does not overturn eligibility to CMU. We find a total post-tax, monthly income for part-timers equal to 925 euros, versus 1007 euros for the full timer. The difference is only 82 euros[16] per month, for a difference in hours worked of about 4*15 = 60. The actual net marginal wage is therefore only equal to 82/60 = 1.37 euros per hour. These computations suggest that it makes economic sense for full-time minimum wage earners to reduce their working time to 20 hours a week.

Given that a full 15 percent of French employees work at the minimum wage, this would lead to a considerable loss of total hours worked on the order of magnitude of 3 to 4 percent.[17] Of course, this will be compensated by an increase in the hours worked of those who will move from unemployment to part-time work. But, ironically, the net effect looks much like the infamous 35-hour week: a work-sharing scheme which induces stagnation or a fall in total hours worked, at a large cost to the taxpayer!

Second, the RSA ignores the demand side. Most of these workers will have minimum wage jobs and should the RSA increase the total supply of hours of the low-skilled, employers have no interest to absorb them unless the cost of labour falls. This suggests that a lot of the benefit of the RSA is going to be lost because of the minimum wage. This negative consequence would have been avoided if the government had used the RSA as an opportunity to reduce the minimum wage, replacing a distortionary and job-destroying form of support (the RSA) by another one with much better incentive properties. But this would have substantially increased the cost to the taxpayer, as part of the burden of redistribution will be redistributed from employers to the budget, although that argument has little economic meaning since the minimum wage is in fact a disguised form of tax on the employed.

E. Reforming the public sector

Finally, measures are being implemented to reduce or at least contain the size of the public sector and ensure the financing of the welfare state in the long run.

The size of government

In terms of the overall burden of public expenditure, France consistently ranks within the top 3 among developed countries, along with Sweden and Denmark. Over time, the size of the public sector has grown due to several factors:

- The development of a lavish welfare state (basic minimum income, complete universal health care for the poor, early retirement, working time reduction, in-kind subsidies, etc.).
- The decentralisation reform of the 1980s which transferred power to local governments. This led to an increase in the number of local civil servants which was not matched by an equal fall in civil servants at the central level.
- The lengthening of the time spent in the educational system and the uniformity of state-imposed degree requirements for many professions.

[16] This would fall to some 62 euros if the move involved the gain of a Christmas bonus, some 40 euros if in addition one were to be spared the *taxe d'habitation and the redevance,* and would end up well below zero if one also takes into account free public transportation.
[17] Assume that out of these 15 percent of employees, two-third moves to the part-time option. They reduce their working time by a fraction (35-20)/35 = 3/7. The total reduction in hours worked will be 3/7 times 10 percent, i.e., some 4.2 percent.

– The incrementality of reforms, which tends to add layers of administration on top of existing layers.
– The resolution of political stalemates through subsidy schemes.
– Policies that reduced unemployment statistics through job creation schemes in state and local administrations.

With total government expenditures around 54 percent of GDP, there seems to be no room for further public-sector growth. This has led to timid attempts to reduce the number of civil servants, which stands at about 25 percent of total employment if all administrations are taken into account. Because these enjoy employment security, and because voluntary flows to the private sector are very small (not least because for almost all skill levels the public sector has higher wages and better pensions), the only way to reduce public employment is by using retirement flows. That is what the government has started doing, with about 30 percent to 50 percent of retirees not being replaced (also, monetary incentives to leave the public sector have been introduced). The implied order of magnitude is 20,000 to 30,000 per year, i.e., some 0.4 to 0.6 percent per year. This means that it would take 20 years to reduce public employment by some 10 percent. That would reduce it to say 22 percent of total employment, which remains very high by international standards. Furthermore, this is the best case scenario, since local authorities may offset part of the downsizing by increasing their workforce.

The révision générale des politiques publiques (RGPP)

In parallel, the government is implementing a long-term, potentially far-reaching reform of the entire internal organisation of the public sector. These changes could pave the way for much larger reductions in its size in the future than the modest steps that are being taken right now. It is beyond the scope of this report to describe the RGPP in its entirety since all dimensions of the administration are involved.[18] Two key ideas driving the reforms are:

– Introducing incentives in the management of the public sector,
– Merging administrations whenever synergies or duplication of tasks appear.

[18] Description and monitoring of the whole RGPP is available on the following government website: http://www.rgpp.modernisation.gouv.fr/

Some of the aspects of RGPP are easy to understand, like the planned reduction in military personnel by 54,000 soldiers, the transition of 20 universities to a regime that will allow them to manage their budget in an autonomous fashion and recruit workers under private law contracts (although this reform fails on two key accounts: the ability of universities to select their students and their ability to charge tuition fees), or numerous mergers of services with similar goals in the central administration. For example, in April 2008 it was decided to merge the Ministry of Commerce's statistical service with INSEE, the national statistical institute.

Others are more complex and involve the creation of new agencies and committees to improve co-ordination and/or governance. It is not always clear that these committees are of any use. For example, in April 2008 an authority was created whose task is to "guarantee the independence of the statistical system". It is unclear how the authority will work and how independent it will be; nor has there been any obvious concern that the statistical system's lack of independence has led to unreliable numbers.

The sheer scope and complexity of the project makes it very difficult to evaluate. At this stage, the overall assessment made by the EEAG group is positive. The reason is that the majority of measures involve cost-cutting, simplifying and better incentives. But the devil is in the details and the details are very difficult to infer from official documents. The two main risks are that the new agencies will grow out of proportion and become sclerotic, which would render the whole exercise obsolete and that the efficiency gains generated by RGPP in the central administration are offset by an increase in size and slackness at the level of the local administrations.

In the longer run, RGPP has the potential to have quite positive effects on France's economic growth, through a mechanism which is seldom mentioned in the debate but is likely to be relevant: the allocation of talent. It has been recognised, in particular by authors such as Murphy et al. (1991), that the career choices of the most talented individuals in society have a profound impact on growth. Typically, we expect more growth if those individuals elect to be engineers, scientists and innovators than if they become politicians, lawyers or bureaucrats (or in the past "mandarins" or *fermiers generaux*). This choice in turn depends on the reward structure offered by society; if top level bureaucrats have a high status and/or pay then the

most talented individuals will select those careers instead of more innovative jobs. In France these positions are traditionally quite prestigious; while they are not particularly well paid they open the door to top-level careers in large firms, politics or international organizations. The RGPP, however, intends to substantially reduce the number of high-level executive positions in public service. As a result public service will be less attractive to young talented individuals because of deteriorated career prospects. This is because the alternative careers that they will choose good news probably have a greater social value, but this also means that the government itself will be more poorly managed, which will partly offset the direct efficiency gains induced by RGPP.[19]

3.2 Assessing the reforms

The sheer scope of the reforms makes it obviously difficult to assess them. It is natural to believe that there is radical change under way and that France is entering a now totally different policy regime. Yet closer scrutiny shows that many of the shortcomings of previous approaches are still there, which casts doubts on the efficiency of the reforms. In particular, the quantitative impact of the reforms will be reduced by three features that have always harmed French economic policy: incrementality, complexity and reversibility. Furthermore, the reforms follow contradictory motivations and principles that stem from conflicting paradigms—thus the reforms lack a clear direction and it is difficult for economic agents to form expectations about the future policy stance.

Three weaknesses

The catalogue of reforms that we have established is impressive in its breadth. Another question, though, is whether the reforms are far-reaching, taken individually.

Traditionally, French reforms have suffered from three flaws:

- Incrementality: Rather than aiming at a deep change of the existing system, most often reform intervenes at its margin, often by adding new limited schemes. The Sarkozy measures are no exception. The standard regime for labour contracts is unchanged – new restricted contracts are being introduced. Instead of eliminating the difficulties and ordeals of running a business, another category of business has been defined that escapes these rules but which is restricted in its composition and has a very restrictive cap in terms of turnover. Regulation and taxes of the housing sectors are unchanged but only marginally offset by an additional tax deduction (which adds to the complexity of the income tax).
- Complexity: the French legal system is one of the most complex in the world. French labour law, for example, has tens of thousands of pages. Complexity is evident in the number of different taxes, the proliferation of competing jurisdictional levels, the number of targeted subsidies to various activities, etc. The more complex the system, the more difficult it is to operate. This means that policies do not have their intended effect, either because their interaction with the pre-existing system is neglected, or because lower levels of authority have considerable discretion in applying the law, as it is practically impossible to apply it entirely. Thus, a complex environment makes reform more problematic. One may even go as far as to claim that a prerequisite for reform would be to eliminate this complexity. Yet the recent reform waves consist of incremental add-ons. This makes them difficult to evaluate and more likely to have perverse effects or be cancelled by discretionary behaviour at lower levels.
- Reversals: reforms have often been reversed in the face of political opposition, political changes or subsequent renegotiations. The problem is made worse by the fact that each government prefers to have its own scheme rather than using those introduced by the preceding ones. The problem is particularly salient in the area of labour policy. Specific targeted support for hiring a given category of worker under given conditions, either in the form of a special kind of labour contract or some tax deductibility, abound and have a high birth and death rate: according to the French ministry of labour, about 80 such measures were introduced between 1974 and 1993, i.e., about 4 per year. Of the two new flexible labour contracts introduced by the Villepin government, one (the CPE) was withdrawn after having been voted by Parliament in the face of violent protest, the other (the CNE) was quietly eliminated by the Sarkozy/Fillon administration in the context of the 2008 labour negotiations. With the current administration, there are signs that the reversibil-

[19] This also raises the problem of evaluating the RGPP, since this negative productivity effect may be considered as a shortcoming (which is true if one considers the public sector in isolation) whereas it is actually one of the benefits of RGPP.

ity syndrome is present once again. There have been hints that some measures have been introduced on an "experimental" basis, implying that they could easily be cancelled. The taxi reform was abandoned in the face of protests, as described in Box 4.4. The RSA is being financed by a tax on capital income, which amounts to a partial reversal of the fiscal package.

If reforms are highly reversible, economic agents will ignore them when setting their strategy but be happy to cash-in whatever benefits are available. The end result is that policy is ineffective, and can even have perverse effects in some cases.[20] For example, a firm will not invest the resources to hire an additional worker in response to some subsidy if it expects that in the near future the subsidy will vanish and will be replaced by some other scheme that does not apply to that worker. But it will be happy to earn the subsidy on any worker it would have hired absent the subsidy. In other words the deadweight loss associated with a given policy – the part of the cost of the policy which has no impact on economic outcome – is greater, the less credible the policy, i.e., the more short-lived it is expected to be. The uncertainty created by the possibility of reversal also impedes investment since a rational investor has an incentive to "wait-and-see" if the reforms will last.

To conclude, the Sarkozy administration has done more than previous administrations and has displayed a general will to boost economic activity. But it has done so in the same way as preceding governments: small reversible steps that add to the complexity of a costly and hard to control policy apparatus. This raises doubts about the effectiveness of the reforms.

Four paradigms

A key prerequisite for a successful transformation of society is an overall reform plan with clearly stated goals and measurable intermediate targets. This can create synergy effects between reforms instead of inconsistencies that reduce or nullify the overall reform effect. Unlike the Thatcher and Reagan governments or indeed Sarkozy's socialist predecessors, there is no central organising principle to guide the reform other than the political will to act quickly and to engage in thorough and massive action. This lack of structure explains the apparent lack of consistency of the reforms. They reflect various strands of the public debate and ideological stances. This diversity can be summarised by four distinct paradigms which often conflict with one another:

Paradigm 1: Free markets

This category includes all the reforms that are in accordance with the general prescription of eliminating barriers to entry in labour and product markets and freeing competition. Economists believe that deregulation and competition are good because they favour mutually profitable transactions, which inherently increase welfare. But this view is mostly absent from the French public debate. Instead, freeing markets is most often motivated on grounds that are dubious to economists:

First, a common argument is that free markets are conducive to economic growth and employment. While few economists would disagree, this view is fundamentally flawed. There are policies that increase growth and employment and have little to do with liberalisation; quite often they are associated with a poor allocation of resources and their positive aggregate effects do not justify them. This will be the case of any tax-funded increase in public investment that disregards the true value of that investment to consumers. Conversely, many deregulations benefit consumers despite having few aggregate effects. Thus, recent moves to liberalise shopping hours on Sunday have been criticised on the grounds that they would create few jobs, and that argument has played some role in the government's reluctance to go ahead with that. Yet a simpler argument is that it makes perfect sense to allow people to buy and sell whenever they want. Indeed no one has contemplated commissioning a study on the employment effects of the reverse reform of restricting shopping hours.

Second, free markets have been motivated by the politicians' concern to redistribute in favour of their own constituency. Right-wing governments have historically engaged much more in labour market reforms than product market ones. (In fact, rigidities in product markets and the retail sector were reinforced by the 1996 law, under a right-wing administration.) Conversely, left-wing governments have historically been less averse to deregulating goods markets while they were making labour markets more rigid. Relative to this historical record, the Sarkozy administration seems keen on deregulating both goods markets and labour markets, which is unusual

[20] In particular, as pointed out by Bertola and Ichino (1995), shrinking firms may use labour flexibility to reduce their workforce now, while growing ones fail to increase hirings as they expect the reform to be overturned.

and commendable, despite the Taxi hiccup discussed above.

Third, deregulation has often been used by right-wing politicians to buttress their political capital. As it is typically associated with conflict with special interest groups, it provides them with an opportunity to "flex their muscles" and signal their strength to their electorate. Of course such a strategy may backfire if the battle is lost, which has happened quite often. In that respect, the Sarkozy/Fillon government has been unusually successful. The level of protest has been quite low given the number of reforms, perhaps because labour unions have been exposed to such a high number of reforms that designing a strategy has proved problematic for them.

Therefore, the "free market" paradigm in France is quite fragile. In some sense, it could be even less influential, given the lack of support for the idea of free markets in France. As documented in Table 4.5, based on the world values survey, France is the only country where a majority of people oppose free markets. Historically, Gaullist administrations were quite dirigistic, following de Gaulle's view, reported in his memoirs, that markets are valuable only to allocate goods such as groceries. The Right gradually became more favourable to the market economy in the 1970s, and attempted its first wave of free-market reforms during Chirac's last term as prime minister in 1986–1988. This was associated with considerable street protest and led to a socialist victory in 1988. Since then, pro-market reforms have proceeded at a cautious pace and politicians have typically justified them as a constraint imposed by the European Union – rhetoric that backlashed in 2005 when France rejected the European constitutional treaty.

This background explains why even when the government wants to improve the efficiency of the economy, it typically relies on taxes and subsidies or special programmes rather than a mere scrapping of existing regulations.

Paradigm 2: France Inc.

There is a traditional tendency in French economic policy to support French businesses in gaining market shares even at the cost of taxpayers' money and/or reducing economic efficiency. This includes state aid to "strategic" sectors, political involvement to obtain contracts abroad, etc. The 2007 EEAG

Table 4.5

The popular support for free markets in France

	Total Agree	Total Disagree	Strongly Agree	Somewhat Agree	Somewhat Disagree	Strongly Disagree	Depends/ Neither	DK/ Refused
Argentina	**42**	**29**	11	31	13	16	2	26
Brazil	**57**	**30**	18	40	19	11	4	9
Canada	**65**	**29**	22	43	19	10	2	3
China	**74**	**20**	25	49	16	4	3	4
France	**36**	**50**	10	26	27	29	3	11
Germany	**65**	**32**	29	36	24	9	2	1
Great Britain	**66**	**27**	26	39	17	10	2	5
India	**70**	**17**	34	35	12	6	3	11
Indonesia	**68**	**29**	22	46	25	4	1	3
Italy	**59**	**31**	21	38	20	12	4	5
Kenya	**59**	**28**	33	25	12	13	3	13
Mexico	**61**	**38**	21	40	27	11	0	1
Nigeria	**66**	**29**	34	31	13	16	2	4
Philippines	**73**	**22**	23	50	17	5	2	4
Poland	**63**	**19**	22	41	14	5	4	14
Russia	**43**	**34**	11	32	25	9	7	15
S. Korea	**70**	**19**	11	60	17	2	5	6
Spain	**63**	**28**	27	36	14	14	1	8
Turkey	**47**	**36**	5	42	31	6	4	12
USA	**71**	**24**	34	37	15	9	2	3
Average	**61**	**28**	**22**	**39**	**19**	**10**	**3**	**8**

Source: http://65.109.167.118/pipa/pdf/jan06/FreeMarkets_Jan06_quaire.pdf

report includes a chapter on economic nationalism that discusses these issues. The Sarkozy administration has not abandoned that approach; if anything it has reinforced it. For example, the *loi de modernisation de l'economie* grants preferential access for "innovating" small businesses to public procurement, up to 15 percent of the total amounts. It is not clear how one defines an "innovative" small business and such a measure will clearly open the door to favouritism and political quid pro quos in local public commitments. While foreign firms are not discriminated against by this measure – otherwise one would violate the rules of the European Union – restricting it to small businesses clearly gives an edge to French firms, as small firms typically lack the skills and expertise to extend their operations abroad. Finally, granting preferential access to public procurement is a very inefficient way to stimulate innovation. Instead, one should promote intellectual property rights and public investment in fundamental research. The measure sounds very much like the outcome of lobbying and is likely to reduce the efficiency of public investment as well as the degree of competition in French goods markets. It is therefore in contradiction with other measures of the same *loi de modernization de l'économie* which promote competition in other areas.

Recent developments, in particular associated with the financial crisis, suggest that economic nationalism is gathering momentum in France. Hence in late October 2008, the president announced a *grand fonds stratégique d'investissement national* (great strategic fund for national investment). The extent to which a country with soaring public debt and a trade deficit can run a sovereign fund on any significant basis is unclear. But it is likely that this fund will be managed so as to defend "strategic national interests", i.e., will favour national firms over foreign ones, for example, by taking on participations in national champions to block foreign takeovers. This will distort the allocation of resources in the ways we have analysed in our 2007 chapter. As an example, in early November 2007, the government partially nationalised a major shipbuilding firm, the Chantiers de l'Atlantique, by taking a 33 percent stake.

Paradigm 3: Reliance on social partners

Since 1950, the so-called "social partners" have played an increasing role in the design of policies. The agreements they sign apply to all the workers in the relevant economic sectors even if they are not affiliated with the unions that have signed these agreements. The legitimacy of this system of social partnership is based on the 1950 law which names five "representative" labour unions whose agreements are binding.[21] Thus these unions are representative de jure regardless of their actual membership, while other unions are non-representative de jure. Furthermore, for an agreement to be applicable to the whole sector, only one "representative" union and one "representative" employer association need to have signed the agreement.

There are two issues regarding this paradigm. One is that being called representative in a 1950 law and being currently representative are two different things. In effect, the inclusion of new unions is prohibited. This is the subject of much debate and is in the process of being reformed.

Another is that there is a broad agreement in the media, the public and policy circles that collective bargaining is a legitimate source of law. Yet, as economists, we know that collective bargaining (even if it were much more representative than in the French system) is not a democratic institution as it excludes the non-employed: students, retirees, the unemployed and so forth. This exclusion leads to inefficiencies in the agreements being reached, such as excess protection of the insiders at the expense of the outsiders and consequently a high level of unemployment.

The Sarkozy administration has not challenged such legitimacy except insofar as it is implementing a reform of the concept of representativeness, which was long overdue anyway. One illustration is the delegation to "social partners" of the reform of the labour contract discussed in the preceding section, instead of handing it to Parliament. As a result, the reform that comes out of this process suffers from two drawbacks:

- It is limited in scope because of the inevitable bias toward quid pro quo and consensus. Instead, a parliamentary majority does not have to make concessions to the minority to implement its reforms.
- It ignores the interests of the outsiders of the labour market (the non-employed), as well as those who are not represented by the organisations that signed the agreement.

[21] These unions are: CGT, CFDT, FO, CGC and CFTC.

Thus, the reform has merely exploited the margins of improvement that were not a matter of controversy between the social partners. One may expect that if the parliamentary majority had designed the reform instead, job creation and the competitiveness of firms would have played a bigger role and the welfare of incumbent employees a smaller one.

Another drawback of relying on negotiation is that it is not immune to renegotiation. Unions have a strategic interest to renegotiate because (by virtue of the "social progress" paradigm, which is discussed next) the concessions they get are far more irreversible than the concessions they make. It is much harder to abolish some benefit once it is considered as an "acquis" than to alter things like a provision for greater contractual freedom or for stronger monitoring of the unemployed. And there are precedents. The "PARE" agreement between social partners was implemented under the Jospin government and involved tighter monitoring of the unemployed's search activity in exchange for more generous unemployment benefits. The latter stayed but the former was quickly emptied of any real content. The *contrat nouvelle embauche* (CNE) was introduced by the Villepin government to allow firms to hire the long-term unemployed under a more flexible form of CDI. It had been widely used but was abolished by a stroke of pen in 2008 as part of the concession package to the unions in exchange for the January 11 agreement. While the CNE was not the outcome of collective bargaining (it had been designed by the office of the prime minister), its abolition came after much pressure by the unions and shows how labour market reforms can easily be cancelled. It would not be surprising if the new CMD had a similar fate.

Paradigm 4: Social progress

The paradigm that there should be social progress, meaning that there should be ever more redistribution and more social insurance, is highly influential in France. Historically, redistributive schemes have almost never been dismantled. Every form of "social progress" is therefore irreversible. For example, one can list a number of redistributive policies that have been implemented by the Left and that the Right considers as untouchable:

- The RMI assistance income for any individual above 25 years of age, established in 1988
- The CMU granting complete health coverage for people below a certain threshold, introduced in the late 1990s by the Jospin government
- The obligation for any municipality to have at least 20 percent of publicly subsidised "social housing", despite the inefficiencies and unfairness of this type of redistribution
- The wealth tax (ISF), which has been regularly proved to cost more money in the form of lost VAT receipts than it brings in tax revenues, because of the exodus of the very wealthy who escape its absurdly high marginal tax rates.

To date, this paradigm has not been challenged by the Sarkozy administration and has led to compromises and contradictions.

In the area of labour regulation, the paradigm has ruled out any overall reduction in the level of worker protection à la "Anglo-Saxon" model. Instead, the popular model is the Danish model of "flexicurity", which trades a reduction in employment protection for an increase in the generosity of unemployment benefits, associated with tighter monitoring of the unemployed's search activity.[22]

In the area of income support, the constraints imposed by the paradigm have led to the *revenu de solidarité active* (RSA) reform discussed above. Any reduction in the level of support at any income level has been ruled out, so that the smoothing of the marginal tax rates needed to eliminate the inactivity trap has been associated with an increase in the amounts that will be redistributed. This is clearly costly to the taxpayer and the reform has been hastily financed by a new tax on capital income, which is in direct contradiction with the fiscal package and has sent a very confusing signal to the public about the goals of the government. Also, reducing the minimum wage in exchange for the introduction of the RSA was not considered, despite our argument that it would have greatly enhanced its effect on job creation.

4. Conclusion

The current administration has claimed to have broken with past policy practices. This claim is validated by the sheer quantity of reforms that have been introduced in less than two years. Yet closer scrutiny reveals little novelty in the nature of these reforms. They remain incremental, complex and reversible as

[22] The "flexicurity" model was discussed in a preceding EEAG report (2007), with some critical conclusions. In particular, the PARE episode mentioned above suggests that flexicurity may be problematic or unfeasible in France because of the difficulty of imposing sanctions on the unemployed.

their predecessors, and exhibit contradictions because of the conflicting paradigms that motivate them. In that respect, the current administration has if anything aggravated the problem because it has vastly increased the number of policy reforms. Thus we are concerned that the overall effect on the economy will be quite small.

On the other hand, the approach seems to have generated political benefits by increasing the scope for action of a democratically elected government which faces entrenched special interests. Perhaps the complexity and number of reforms has helped, for example, by making it difficult for opponents to co-ordinate their agenda on a given item.[23] A natural course of action for the next three years would be to build on this political capital to elect a small number of far-reaching reforms and focus on them.

The most promising one is the RGPP because it may yield the largest long-term benefits. Furthermore, it has the merit of being quite sheltered from political opposition, because it lacks obvious distributive consequences. As we have argued, it is difficult to evaluate. But we believe random policy measures do not help it, both because they divert human resources that could be better used in the RGPP and because they interfere with it, for example by artificially boosting the need for administrative units that could otherwise be dismantled or shrunk.

Another untouched issue is the minimum wage, which is increasingly a burden. In this respect the government has lost a golden opportunity to bundle the RSA reform with a reduction in the minimum wage. This would have been politically difficult but worth the benefits: while the RSA itself would have been far more effective, the reform would have broken the taboo that redistribution can never go too far and helped to remove the low-skilled trap that we discussed above.

[23] This may explain why Sarkozy was successful with his reform of *régimes spéciaux* while Juppé was not.

List of abbreviations:

CDD	contrat à durée déterminée	determined duration contract
CDI	contrat à durée indéterminée	undetermined duration contract
CMD	contrat à durée déterminée	determined mission contract
CMU	couverture maladie universelle	universal health care coverage
CNE	contrat nouvelle ebauche	flexible labour contract
CPE	contrat première embauche	flexible labour contract
CTP	contrat de transition professionelle	supplementary unemployment benefits for some workers
ISF	impôt de solidarité sur la fortune	wealth tax
RGPP	révision générale des politiques publiques	general revision of public policy
RMI	revenue minimum d'insertion	basic assistance income
RSA	revenue de solidarité active	earned income tax credit

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