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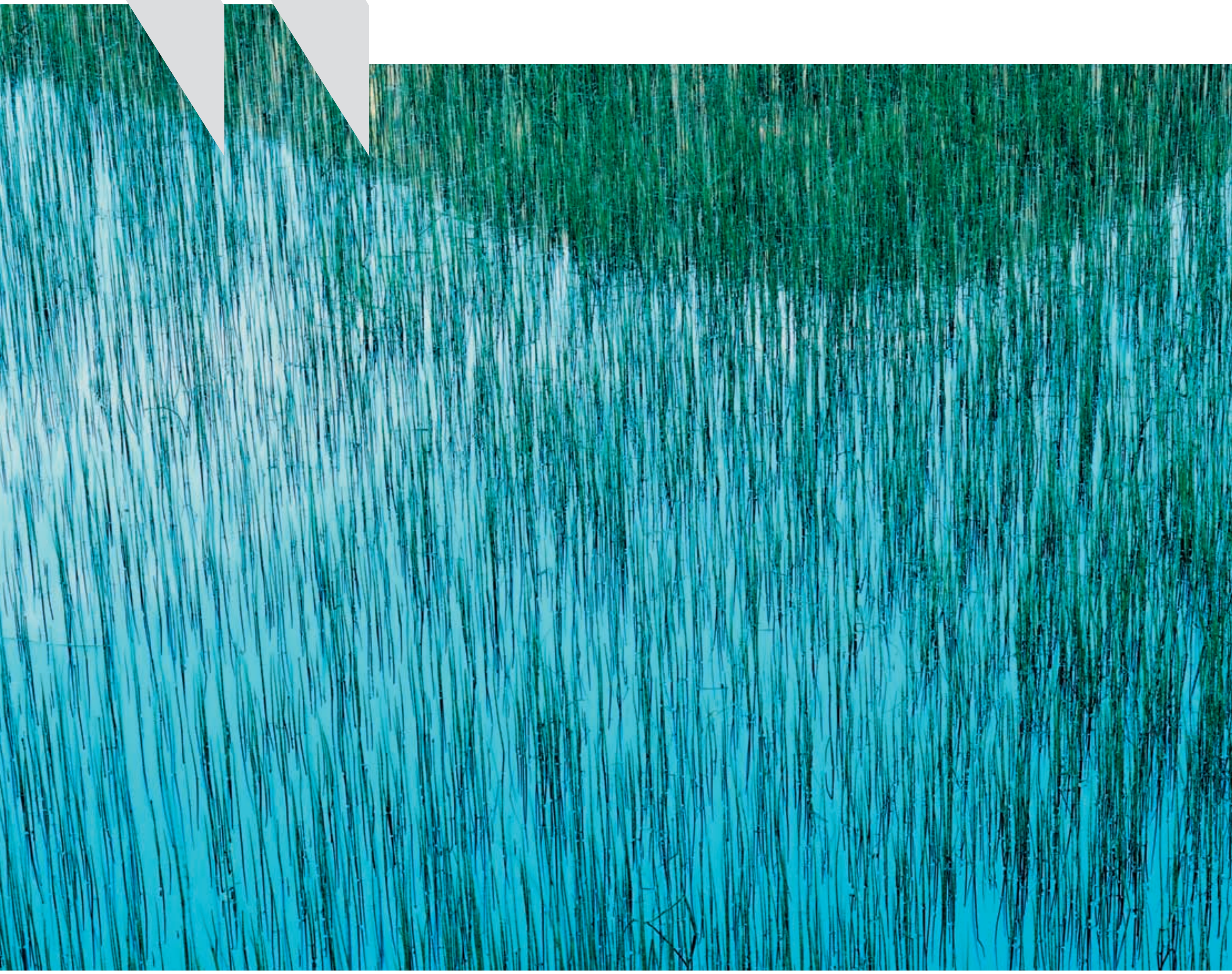
FRANCE



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France

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Table of contents

Boxes

Tables

Figures

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

The economic situation and policies of France were reviewed by the Committee on 16 March 2009. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 3 April 2009.

The Secretariat's draft report was prepared for the Committee by Alain de Serres and Rafal Kierzenkowski under the supervision of Peter Jarrett. Research assistance was provided by Patrizio Sicari.

The previous Survey of France was issued in June 2007.

BASIC STATISTICS OF FRANCE

THE LAND

Area (1 000 km^2)	632.8	Major cities (thousand inhabitants), 2005	
Agricultural area, excl. Overseas departments (1 000 km^2)	302.8	Paris	2 125
		Marseille	807
		Lyon	453

THE PEOPLE (2006)

Population (thousands)	63 382	Total labour force, excl. overseas departments (thousands)	27 607
Number of inhabitants per km^2	100	Percentage of employment in:	
Average annual increase (thousands) 1991-2006	316	Agriculture	3.5
		Industry and construction	20.3
		Services	76.3

PRODUCTION (2007)

Gross domestic product at market prices (Euros billion)	1 892	Gross value-added by activity, at basic prices (per cent):	
Gross domestic product per capita (Euros)	28 050	Agriculture	2.1
Gross fixed investment as a per cent of GDP (current prices)	21.5	Industry	14.1
		Construction	6.5
		Services (excl. FISIM)	76.7

GENERAL GOVERNMENT (2007)

ESA95 concept, as per cent of GDP:	
Total expenditure	52.4
Total revenue	49.7
Gross fixed investment	3.3

FOREIGN TRADE (2007)

Exports of goods and services (% of GDP)	26.6	Imports of goods and services (% of GDP)	28.5
Main exports as a percentage of total exports (SITC):		Main imports as a percentage of total imports (SITC):	
Food, beverages and tobacco (0+1)	10.5	Food, beverages and tobacco (0+1)	7.3
Chemical products (5)	16.3	Chemical products (5)	13.2
Manufactured products (6+8+9)	27.1	Manufactured products (6+8+9)	28.5
Machinery and transport equipment (7)	39.8	Machinery and transport equipment (7)	35.0

THE CURRENCY

Monetary unit: Euro		Currency unit per $	
		Year 2008	0.681
		First quarter of 2009	0.769

Executive summary

The French economy has not escaped the severe recession gripping all developed countries. After ending the year 2008 with a sharp decline, output is likely to contract further during the rest of this year, and prospects for 2010 remain highly uncertain, despite the many stimulus plans at home and abroad. The recession should be less deep than elsewhere, due inter alia *to powerful automatic stabilisers. However, while the finances of big banks and households do not appear to be in as bad shape as they are in several other countries, the capacity of the French private sector to revive activity in advance of a global recovery is limited. Moreover, given the already high deficit and debt levels, the crisis will leave public finances in a serious condition.*

In this context, the principal short-term challenge is to pull the economy out of recession, *while avoiding as far as possible recourse to budgetary measures that would be difficult to undo later. The recovery plan adopted at the beginning of the year meets many of these conditions, although the impact of certain measures will not be felt until the second half of 2009, at the earliest. If a further series of actions is deemed necessary, however, it will be more difficult to employ the same kind of self-reversing provisions targeted at business investment and cash flow.*

Once the recovery is well underway, it will be necessary to urgently implement a programme for reducing the public deficit, *consistent with obligations under the Stability and Growth Pact. A credible consolidation strategy will be especially important because of ongoing pressures on the Social Security accounts, which, in light of demographic trends, are likely to intensify. Given the already very high level of taxes and compulsory contributions, the effort to clean up public finances will have to rely essentially on government spending cuts. In order to control public spending more effectively, the General Policy Review (RGPP) applied to central government outlays will need to strive for more ambitious results. There are substantial potential savings in fields that the Review has not yet fully explored,* i.e. *Social Security and local government.*

On the structural front, numerous reforms have been undertaken since the last *Survey*, but a continuing priority must be to increase the employment rate *(which is still one of the lowest in the OECD). Such an increase would serve both to boost potential growth (temporarily) and to ease pressures on public finances significantly. To achieve this, further labour-market reforms will have to be pursued, in particular by cutting the cost of work for the less skilled and increasing the participation rate for older workers.*

A second priority is to render French firms more competitive in order to halt the steady erosion of their market share in world trade. *Restoring competitiveness will require, above all, efforts to achieve higher trend productivity growth and to reinforce its major determinants, such as research and innovation, while at the same time lowering the fiscal, social and administrative burdens that hamper business growth.*

If productivity is to grow faster, domestic competition will have to be strengthened, especially in the services sector. *While the legal and regulatory framework is clearly moving towards greater competition, there are still numerous barriers to entry in many sectors, particularly* *in regulated professions, due in part to the self-regulation mechanisms in place. When it comes to the electricity sector, one of the biggest obstacles to competition in retail markets is the persistence of regulated prices that reflect the low costs of production of French nuclear power plants and which are therefore below the supply costs facing any new distributor.*

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Assessment and recommendations

France is bound to experience a deep recession in 2009

Like other industrialised countries, France is facing the deepest economic recession of the post-war period. After the severe contraction recorded in the last quarter of 2008, activity seems to have slowed further in early 2009. Yet with financial-market turbulence a persistent threat and the risk of an even larger shrinkage in world trade, there is great uncertainty as to the timing and strength of the recovery. In any case, the decline in economic activity is likely to be very significant, even if less pronounced than elsewhere, with some likelihood of a gradual easing of the recession over the course of the year, supported by budgetary stimulus and interest-rate reductions in France and abroad. The resulting job losses are set to drive the unemployment rate steadily higher throughout the year; at the same time, the inflation rate will probably approach zero.

But bank and household balance sheets are not as shaky as elsewhere

The financial system remains the primary source of major risks. Those risks will persist as long as there are doubts about bank balance sheets, and until the risk revaluation process reaches a stage where markets can regain the level of liquidity needed to function normally. French banks are, on the whole, in a somewhat better position than their counterparts in many other countries, primarily because they have diversified their activities and adopted more defensive prudential lending standards. This helps explain why household indebtedness has remained lower than in other countries heavily hit by the crisis. Moreover, the measures taken by the government in October 2008 to boost the liquidity and solvency of the big banks have allowed the bank credit market to keep on functioning, thus offsetting to some extent the drying-up of the new-issues market. In this regard, the recession may lead directly to further deterioration in banks' assets, just at the time when their financial health is particularly vulnerable. *The financial authorities will need to keep paying close attention to developments throughout the year.*

The government is counting on investment to restart the economy

In this context, the authorities' essential challenge is to keep the recession as short as possible without letting the public deficit and debt mount to unsustainable proportions. The economic stimulus package adopted at the beginning of the year – equivalent to

1½ per cent of GDP – largely respects these conditions, to the extent that most of the planned actions focus on investment and on business cash flow, and they involve bringing forward to 2009 expenditures that were previously to be spread over the next two or three years. Not only do they appear sustainable, but the actions taken to date seem fairly well targeted: they are aimed primarily at the productive apparatus and are designed, on the one hand, to relieve the liquidity constraints that suddenly confronted SMEs and, on the other, to speed investment in various infrastructure projects. At first glance, given the primary objective of shoring up the economy in the very short term, the choice of promoting infrastructure investment might appear questionable, in light of the long gestation periods associated with such investments and the risk of waste through haste. In practice, however, these drawbacks may not be as important as they seem: it is quite possible to favour programmes that have already been assessed in terms of their costs and benefits but that have been held up for want of financing. *The government will need to take great care, however, to keep an eye on the expeditious and efficient implementation of the plan by ensuring the best possible co-ordination among the players involved in distributing the additional resources*. Since the deficit grew again already in 2007, at a time when the economy was still in a favourable cyclical position, the budgetary scope for dealing with the crisis is limited, especially as the public debt is nearly 70% of GDP. Nevertheless, if the recession proves to be more severe than expected, the government could consider additional measures, preferably transitory or automatically reversible (such as the temporary dispensations from income tax payments announced in February 2009) so as to safeguard the sustainability of the public finances.

Once recovery comes, priority must again be given to budgetary consolidation

Once the recovery is well underway, *priority will have to be given to resolutely enforcing a general-government deficit-reduction plan*, consistent with the obligations imposed by the Stability and Growth Pact and the government's own objectives. Since publishing its Stability Programme at the end of 2008, the government has had to revise downwards the growth outlook for 2009 and 2010, and to revise upwards the projected deficits for those years, to 5.6 and 5.2% of GDP, respectively. *A credible consolidation strategy will be all the more urgent*, as the starting point will be a much larger imbalance than before the crisis, and pressures on the Social Security accounts will continue and could even intensify, given demographic trends. As in 1993, the recession will be accompanied by a jump in social transfers and, hence, in overall public expenditures, which in that year reached a historic high as a share of GDP (nearly 55%). While that proportion has declined somewhat in the meantime, it is still well above its 1990 level. That episode highlights the importance of *steering away, as much as possible, from any supplementary measures involving expenditure increases that cannot be readily reversed as soon as the economy turns around.*

The credibility of the budget process needs to be strengthened

Despite improvements to the budgetary framework contained in the 2001 Organic Law on Budgets, government expectations for reducing the public deficit have hardly ever been achieved, especially those set for two or more years out. Repeated commitments to restore

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budget balance have failed to bring the deficit below 2% of GDP since 2001. The budget framework was recently bolstered by Parliament's adoption of a "balanced general-government accounts objective" in conjunction with the new public budgeting act. *In the light of these perpetual postponements of achieving the balanced budget goal, it seems necessary to take advantage of the implementation of this legislation to restore the credibility of the process as soon as possible*. Unless this is done, efforts to win public acceptance of the need to clean up public finances will be undermined by an impression that any sacrifices are made in vain. One of the factors contributing to the discrepancy between budget deficit commitments and outcomes is the failure to achieve the short- and medium-term growth rates assumed, even if these had been fairly close to the consensus view at the moment of their setting. To restore credibility, *the authorities could consider an approach whereby their spending and revenue forecasts would be made deliberately and openly conservative for any given growth scenario, so as to maximise the probability that the objectives will be achieved, year after year*.

A return to balanced budgets will require better control over spending

Many other countries will emerge from the crisis with heavy public deficits and rapidly mounting debt – France will not be alone in this regard. Yet, given the already very high tax burden in France, and the need to eventually lower it, *the drive to restore health to the public finances will have to focus essentially on reducing outlays*. While several other countries in the throes of budgetary problems have succeeded in reducing the expenditure-to-GDP ratio, the French ratio has increased steadily from cycle to cycle. Experience abroad shows that making meaningful spending cuts requires extensive rethinking of the role and the forms of State intervention in various fields. In this connection, *the initiative taken with the General Policy Review (RGPP) deserves to be highlighted and encouraged, in particular for its highly methodical approach to evaluating government programmes and services and identifying reform tracks that would make public services more efficient*. Nevertheless, the savings it has yielded to date seem modest indeed – less than 1% of public expenditure – especially since the RGPP was supposed to take a critical look at the boundaries of State action and the effectiveness of all its interventions. One reason for this is that the approach was confined primarily to central government outlays, which account for around one-third of total public spending. Thus, *there remains considerable potential for savings in fields that the RGPP has not fully explored, namely social security and local government spending*.

The efficiency of local taxation should be enhanced and the structure of government rationalised

When it comes to sub-national government, incentives to exert better control over expenditures could be reinforced by shedding greater light on the cost, in terms of taxes and compulsory contributions, of measures taken by each level of local government. To achieve this, *it would be advisable to reverse the tendency of recent years and to fund a growing share of local government resources from local taxes rather than from State transfers*. Over the longer term, however, the greatest potential for savings must probably be sought in the plethora of local government levels, which is a source of duplication in services and programmes. In particular, the establishment of the *intercommunalités* (groupings of municipalities) as an administrative level seems to have failed to produce the expected economies of scale in procurement and facilities management. On this point, *the authorities would be well advised to follow up on the report of the commission that examined this question so as to clarify responsibilities and enhance expenditure control*. As for the Social Security, to make really significant savings will surely require a critical reappraisal of certain social benefits that have not demonstrated their effectiveness. *Introduction of the new provision boosting incentives to seek work for those with low earnings potential (the* Revenu de solidarité active, RSA) *should have led to a greater refocusing of the existing provision (the earned income tax credit,* prime pour l'emploi), whose effectiveness has been reduced by the fact that it is too broadly targeted. More generally, as called for by the new budgeting act, all *tax exemptions and loopholes, which have mushroomed in recent years, should be subjected to a review similar to the RGPP.*

But the low employment rate is still one of the main reasons for the government deficit, which militates for continued labour-market reforms

Over time, a very significant rise in the employment rate (still one of the lowest in the OECD) would do much to balance the public accounts while allowing contribution rates to be cut. Once the crisis is over, *the government should refocus on boosting the employment rate. The well-known priorities for doing so can be summarised in three points: i) maintain efforts to reduce the minimum labour cost of low-skilled workers (relying henceforth more directly on moderation of the minimum wage but without undoing the reductions in social contributions for low-wage earners) and increase their financial incentives to work; ii) take further steps to relax legislation governing dismissals and layoffs, while making the unemployment insurance system more effective; and iii) enhance the incentives to continue working beyond 60 years of age (let alone after age 55), while ensuring that businesses cannot abuse the new mutual-consent termination provisions by foisting older workers onto the unemployment insurance system*. Reforms have been introduced in each of these areas, but additional efforts will be needed if they are to produce significant changes.

For example, the fact that the minimum wage (SMIC) has been raised more slowly than median income over the last few years is noteworthy, as is the planned creation of a group of independent experts to advise on appropriate changes to the SMIC. These decisions should reinforce the trend decline in the share of workers paid the SMIC. As well, with the introduction of the RSA, the social insurance system has been significantly reformed to increase the incentives to work for those least attached to the labour market, helping to reduce poverty and social exclusion. At the same time, numerous changes have relaxed the rules governing working time, *but retention of the legally mandated 35-hour week has been made costly to the treasury in terms of foregone tax revenues from work in excess of that limit; its effectiveness should be closely assessed.*

When it comes to dismissals and layoffs, the regulations governing indefinite-term labour contracts have been relaxed slightly, with the introduction of termination by mutual consent of employer and employee (*rupture conventionnelle*). Yet, in its current form, this type of agreement poses the risk of abuse of the unemployment insurance system. Moreover, while the various other changes introduced under the agreement between the unions and management on "modernising the labour market" have marginally improved flexibility in hiring and firing procedures, they have done nothing to overcome the dualism that exists in that market. As the notion of a "single contract" was rejected outright by both

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sides, there is nothing in the accord that will serve to narrow the gap, even partly, between workers who benefit from significant protection and those in a much more precarious situation. In addition, the public employment service has also been reformed through the creation of the "*Pôle emploi*", a one-stop shop, as the OECD recommended in its last *Survey*, resulting from the merger of the ANPE and UNEDIC. However, the reform could go further by ending the two organisations' distinct systems of governance. At the same time, the recently approved definition of what constitutes a "reasonable job offer" will strengthen the incentive to look for work and thereby help shorten the duration of unemployment spells.

Work incentives for seniors have improved, but further progress is needed

Finally, a number of appropriate measures have raised the incentives for older workers to pursue employment: these include the progressive lengthening of the pension contribution period, an increased *surcote* (the additional pension given to those who contribute for more than the normal number of years), withdrawal of the waiver of job-search requirements, the possibility of combining employment income and pensions, an increase in the mandatory retirement age and reform of the special pension regimes. Yet an increase in the employment rate for seniors is also hostage to the legal retirement age, which is still below the level prevailing in many other OECD countries. Consequently, *one of the best options for enhancing the sustainability of the pay-as-you-go pension system would be for the coming negotiations to yield an agreement to raise the legal retirement age.*

Heavy social charges are detrimental to innovation and business growth

Because the employment rate is low, the contributions needed to finance Social Security are high, and they add considerably to the tax burden on business, which hampers innovation and thus firms competitiveness. In spite of their well targeted sectoral and geographic specialisation and favourable relative price and cost trends, French exporters have been losing market share since early this decade, with a steadily worsening trade balance. In particular, the technological innovation content of French products seems to be declining, while the search for lower costs has no doubt driven several large firms to shift part of their production offshore. With the appearance of highly export-oriented emerging-market economies on the world scene, firms in the more advanced countries must constantly innovate, upgrade their product quality and burnish their brand names in order to preserve existing markets and conquer new ones. While French firms have on the whole succeeded in remaining fairly price-competitive, this has been done to some extent at the expense of their margins. Lacking the means to invest, they have been obliged to sustain their competitiveness by restructuring, *i.e.* shedding workers and abandoning the least profitable activities, rather than looking to technological innovation and product differentiation for productivity gains. In this context, apart from horizontal policies to bolster French competitiveness (such as support for R&D), the authorities have introduced a number of measures to encourage firms to look for international opportunities and to assist them in export markets. *Targeted sectoral policies that could distort resource allocation between the tradeables and non-tradeables sectors should be avoided.* The best way to restore competitiveness is to *reduce the fiscal, social and administrative burdens that are hobbling business growth, and more broadly to take action on the main determinants of productivity, in particular research, innovation and SME growth*.

The governance of public research has been improved

A number of significant reforms have been launched recently to breathe new life into public research by increasing its funding, but also by strengthening its organisation and governance. Creation of the Research and Higher Education Evaluation Agency (AERES) has laid the foundation for evaluating universities and research laboratories more systematically against criteria such as publications and patents. *It is important that this principle be reinforced*. Indeed, the recent decision to upgrade university career profiles is an opportunity to raise the performance bar for the entire teaching-research profession. The reform underway at the CNRS, designed to enhance its co-operation with universities and other national research organisations, is a welcome step and should also help improve the productivity of public research. As well, *the newly created National Research Agency should be supported and its role expanded inasmuch as it promotes project-oriented public research*, which will make for a more balanced allocation of resources in comparison with a situation where funds are awarded essentially on an institutional basis.

The universities need still more autonomy

France is in fact the leader among G7 countries for the share of higher education institutions in the total number of patents filed by inventors living in the country, but few of them are actually brought to market. *The spillover effects of public research could be enhanced by creating technology transfer and licensing offices in the universities,* as a useful supplement to the "business incubators" policy. Finally, the "Universities Freedom and Responsibility Act" has laid the initial groundwork for autonomy in the French universities, which should boost the quality and efficiency of higher education. Notwithstanding the many helpful measures taken to date, however, *the effort to reinforce university autonomy should be pursued further, particularly in the areas of budgeting and hiring and remuneration of personnel*. *This goal would be well served by allowing the universities greater freedom to select incoming students and to set tuition fees*. Higher fees should be paired with an expansion of the system of students loans recently introduced.

Government funding should target the most successful "competitiveness clusters", and the new research tax credit mechanism needs to be assessed

When it comes to public financing of investment in innovation, there are several issues at stake. Various studies of the clusters policy have highlighted the useful role that such policies can play in forging closer linkages between scientific research and industry, especially by co-ordinating multi-disciplinary research around specific economic and financial challenges (health, environment, etc.). But the potential pitfalls should not be overlooked: these include the difficulty of having the State pick winners in the context of

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rapidly evolving, globalised markets; the temptation to spread funds too thinly; and the danger that the authorities will be captured by firms with a large stake in the programme. To minimise these risks, *it is essential that government financing for competitiveness clusters be made conditional upon results, and funding should be terminated for those that miss their pre-established performance goals*. For clusters that prove successful, *it would be better over the longer run to gradually replace public subsidies with private financing,* recognising that a mix of funding sources is especially critical for sparking innovative activities. As to the other major tool of public support for private research, the research tax credit, it is true that the 2008 reform simplified its use considerably and increased its visibility, but at the same time it made it one of the most generous incentives anywhere in the OECD. *It will be important, therefore, to monitor its impact closely so as to measure its effectiveness in terms of increasing research effort.*

The taxes that weigh most heavily on jobs and investment should be cut and targeted measures for business restructured

One of the main obstacles to business growth is the burden of various levies, foremost of which being social security contributions, the *taxe professionnelle* and the tax on wages. Because they tax production factors directly, levies of this kind penalise investment and growth. *It is therefore important that the government's recent commitment to make permanent the suspension of the* taxe professionnelle *in 2010 be implemented, preferably as part of a more comprehensive overhaul of local taxation that would raise the* taxe foncière *(property tax) and possibly share VAT proceeds*. Moreover, even if the effective corporate tax rate is not particularly high by international standards, the gap *vis-à-vis* the statutory rate is very wide, thanks to the many exemptions and deductions that narrow the tax base. Apart from reducing the distortions that multiple exemptions inevitably produce, lowering the statutory rate while broadening the tax base would render the tax system more transparent, thereby easing the administrative burden, and make France a more attractive location for investment. *A thorough restructuring of targeted support for businesses could help finance a reduction in the tax burden on the productive apparatus as a whole.*

Insufficient competition is holding back productivity growth

France enjoys one of the highest hourly productivity rates among OECD countries, but productivity growth has been relatively sluggish over the last 10 years. This disappointing performance has been particularly evident in various service sectors, not only in absolute terms but also in comparison with many other countries. There is still a lack of competition in several service sectors, and this is holding back innovation, productivity and job creation, especially for less-skilled workers, and severely impairing consumers' well-being by depriving them of quality goods and services at the lowest possible prices. Considerable progress has been made over the last decade in opening up various services that were previously completely or partly sheltered from competition. Yet there remain numerous barriers to entry in several sectors, including the regulated professions, due in part to self-regulation mechanisms. In the retail trade, real strides have been made, but further progress is needed in areas such as commercial zoning.

Competition will benefit from the Competition Council's transformation into a single Authority with expanded powers

The Economic Modernisation Act (LME) transformed the former Competition Council into an Authority with enough extended powers and increased resources to develop an authentic competition culture. For example, merger control will be placed solely under the aegis of the Authority, with the Minister of the Economy retaining the right to overrule it on grounds of public interest other than those related to competition. The Competition Authority will also have its own investigators, as well as heightened powers over staff of the Ministry who may be made available to it to assist in investigations. The Authority will also be able to issue opinions on any competition-related topic at its own initiative. The strengthening of the competition policy framework and the means given to the independent Authority raise the possibility that the good results obtained, for example, in certain telecommunications sub-markets be replicated in other sectors, including in the regulated professions that are still marked by formidable barriers to entry.

The Royer-Raffarin laws should be repealed to allow real competition in retail trade

In the retail sector, the LME relaxed the rules governing the negotiability of terms of sales between suppliers and distributors (the Galland law), in particular by removing the prohibition on discriminatory commercial practices. In addition, although the ban on "resale below cost" was maintained, its definition was amended to make it much less binding. Moreover, the LME amended the Royer-Raffarin laws by raising the floor-area threshold above which any new store must obtain special authorisation and by changing the composition of the licensing commission to exclude the applicant's competitors. While these reforms represent progress, *the best policy in the realm of commercial zoning would be to abolish the Royer-Raffarin laws outright*. To the extent that these laws have heightened concentration among large-scale retailers at the national level, their repeal would seem a necessary step if the reform to the Galland law is to bear fruit in terms of increasing consumer purchasing power. *Applications to open large-scale retail outlets should in this case be examined and decided on the basis of criteria established in the overall zoning plans without distinction as to size.*

Barriers to entry in several regulated professions are still too high

In most OECD countries, many professions are subject to a broad range of regulations (in the form of self-regulation and/or of regulation imposed by the State), and some of these have a direct impact on competition. In France, barriers to entry and restrictions on professional practice most likely exceed what is necessary to protect the consumer. A number of reports based on international comparisons show that barriers to entry are needlessly high in several regulated professions related to health and beauty treatments (physiotherapists, veterinarians, pharmacists and hairdressers), as are obstacles to competition between partially substitutable professions (conventional physicians, practitioners of alternative medicine) and more generally in services to businesses and/or

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individuals (accountants, architects, lawyers). Greater competition in health-related sectors could potentially help reduce public outlays with equivalent service quality.

While it can be difficult to pursue reforms that would do away with long-entrenched entitlements, the government has in fact taken steps to foster competition in specific sectors, especially legal services. In addition, the LME introduced the status of "independent entrepreneur" (*auto-entrepreneur*), greatly simplifying the formalities involved in creating a micro-enterprise, and this could in time favour competition, especially in various personal services. Similarly, the principles of freedom of establishment and freedom to offer services that underlie the European Union's Services Directive could make it easier for foreigners to set up operations in France. For this to be the case, however, *the government will have to agree with its European partners to apply the Directive as broadly as possible so as to reduce to a minimum the sectors excluded from its scope*. In several areas, these changes alone will not be enough to stimulate competition as long as regulatory barriers to entry or practice are maintained. Thus, *more flexible rules (e.g. minimum geographic quotas) should be substituted for the overly strict quota mechanisms currently in force in specific legal services (notaries and bailiffs), as well as in health care (pharmacists)*. For other professions, *entry conditions should be relaxed* by reconsidering the required years of study (architects, veterinarians, hairdressers). Competition could also be strengthened by *facilitating access by legal and accounting firms and pharmacies to outside sources of financing*.

A fourth mobile telephone operator should mean lower prices, benefitting consumers

Among the major network industries, telecommunications was the first whose retail markets were opened to competition (nearly 10 years ago). While there has been relatively solid progress in the development of fixed-line services (telephony and broadband Internet access), within a highly competitive market, the situation is more worrisome in mobile telephone service, primarily because of the very limited success of virtual mobile network operators (VMNOs). In this context, the advent of a fourth operator will boost competition by weakening the current situation of oligopoly. Indeed, given its initially small market share, it will have an interest in making its network more profitable by offering better terms of access to the VMNOs. *In that regard, awards of new frequencies should be based* inter alia *on a criterion of the quality of access terms offered. More generally, the regulatory authority could intervene to relax the conditions operators impose on the VMNOs, in particular as they relate to contract length, exclusivity clauses and ownership rights.*

Regulated retail prices for electricity, which are below any new entrant's cost of supply, limit competition

In the energy sector, an important step for competition was struck in 2007 with the complete opening of the gas and electricity markets, in compliance with European directives. Yet the historic operators still hold dominant market shares. Among the major obstacles to real competition in the retail electricity market, the greatest is no doubt the maintenance of regulated prices which reflect the low costs of French nuclear power plants and are therefore below the supply costs of any new entrant. The government introduced a new provision in 2005 whereby customers who had previously opted for market prices were allowed to revert to administered rates (the *Tartam*), which have been kept below market prices. It may be quite legitimate for the government to let French society enjoy the economic benefits from the "nuclear option", but to maintain a rate below the market price – particularly for electricity-intensive industrial customers – is surely not the most efficient and equitable way of doing so. This practice could in fact skew the industrial structure towards more electricity-intensive production. If there is to be real competition, *the Tartam should not be renewed beyond 2010*. More generally, *it would be well to reconsider the scope of application of regulated retail prices, at least for the non-residential sector*. At the same time, it will be important *to pursue efforts to integrate European energy markets by facilitating the interconnection of gas and electricity networks,* so as to promote the development of liquid and efficient wholesale markets.

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Chapter 1

Coping with recession and preserving fiscal sustainability

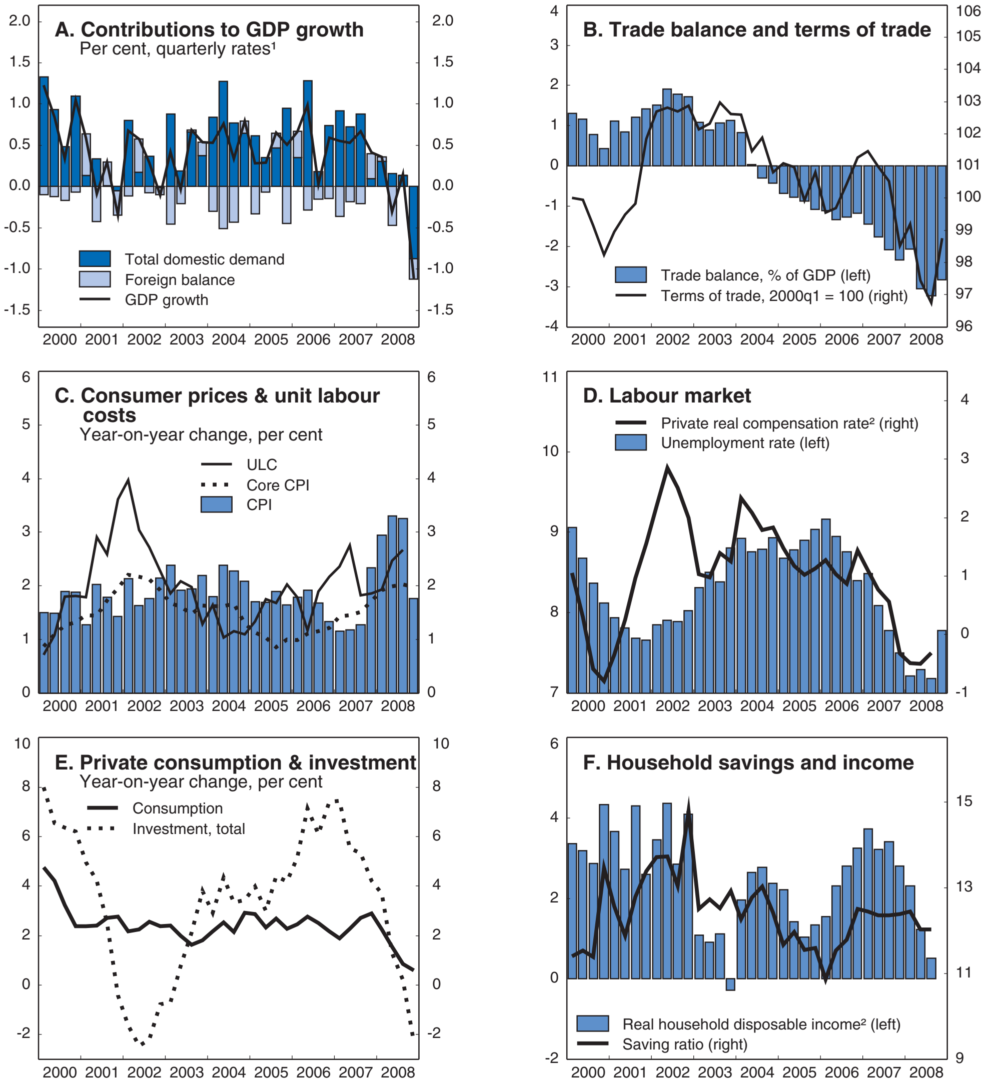
The financial crisis did not spare the French economy, which is facing a deep recession in 2009, even if the situation is less severe than elsewhere. After a clear drop in the fourth quarter of 2008, economic activity will most likely continue to contract throughout this year. Both the timing and the strength of recovery remain uncertain, primarily because of the risks surrounding the balance sheets of financial institutions. While French banks have been weakened by the crisis, they are not as shaky as their counterparts in many other countries. Moreover, the risk that the real estate market correction now underway will accentuate the decline in economic activity is attenuated to some extent by the low rate of household indebtedness and the weakness of the wealth effect on consumption. The crisis will leave public finances in poor shape, and once the recovery begins, a priority will be to phase out the general government budget deficit. Given the already very heavy burden of taxes and compulsory contributions, public finance consolidation will require strict control over expenditures. This chapter reviews the latest macroeconomic developments, including those on the fiscal policy front, and discusses priorities for restoring health to public finances.

The effects of the financial and economic crisis and the authorities' response

The recession that has gripped the French economy since the last quarter of 2008 marks the end of a virtually uninterrupted cycle of growth that began in early 2002 (Figure 1.1). While the initial problems sparked by the subprime crisis date back to May 2007, their adverse impact on the real economy did not really make itself felt until about a year later. During the 12 months that preceded the sudden seizing-up of the financial system in September 2008, growth was already losing steam, initially under the combined effect of sharply slowing housing investment and the increasingly negative contribution of external trade (in the second half of 2007), and then under the impact that the commodities price shock had on inflation and on household purchasing power (in the first half of 2008). At the same time, with the slide in stock market indices and the downturn in the housing market, households began to see the value of their equity slide, particularly from early 2008 on. To the slowing of real disposable income was thus added a negative wealth effect, the impact of which on consumption is still hard to measure. In this context, while households were able to dip into their savings, this fell far short of offsetting the inflationary shock-related effect of lost purchasing power, and they preferred to rein in their pace of consumption, even though employment held up well until summer 2008. At the same time, the steady drop in unemployment led to a marked slowing of productivity growth. This in turn was reflected in a faster rise in unit labour costs, thereby exacerbating the competitiveness problems that French firms have faced for several years (see Chapter 3).

While some of these forces were still operating in mid-2008, it was the worsening of the financial crisis in September 2008 that brought about an abrupt fall in activity during the fourth quarter and thus heightened the risk of a deep and prolonged recession. The impact of the financial crisis was surprising not only for its scope but also for the speed at which the economy deteriorated in the fourth quarter. While growth was slightly positive in the third quarter, signs of an abrupt downturn were coming in rapid succession with the collapse of confidence indices, followed by shutdowns in certain industries (the whole automobile industry, in particular), a retreat in corporate investment and fast-swelling unemployment. Moreover, production dropped much more quickly than demand, resulting in a very significant rundown in inventories during the fourth quarter. The speed at which firms adjusted output no doubt reflects cash flow problems and the credit crunch they were facing. Apart from the decline in inventories, the domestic demand components that depressed activity the most in the last quarter of 2008 were business and residential investment. By contrast, household consumption proved much more resilient than expected, growing by near 0.4%. After declining to 7.2% in midyear, unemployment jumped sharply in the fourth quarter, to close the year at 7.8%. In addition, one of the channels that carried the crisis so swiftly to France was the collapse of external trade: exports and imports fell by 3.5% and 2.3% in volume (Q/Q) in the fourth quarter, resulting in a negative net contribution to growth of 0.3 percentage point.

Figure 1.1. **Macroeconomic indicators**



1. Chain-linked data.
2. Year-on-year growth, percentage.

Source: OECD, *Economic Outlook database*.

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As in most countries, the economy in France was directly affected by the financial and real estate crises, even if to a lesser extent, by some measures, than in more exposed countries such as the United States, the United Kingdom, Spain, Ireland and Iceland. The financial crisis had overall the same short-term effects as elsewhere: temporary suspension of the interbank market, drying up of the securities market and severe jolts to the credit market. Faced with a crisis of confidence that was paralysing the financial system and threatening the survival of banking institutions, the government took an initial series of measures in mid-October 2008 to prevent financing for the economy from coming to a halt and to restore confidence in the banking system. The key measures of that plan involved setting up two vehicles, one that would allow the banks to refinance themselves with a State guarantee, and another that would inject equity into the banks in order to bolster their solvency (Box 1.1).

Box 1.1. **The plan for rescuing the banks and financing the economy**

Like the plans introduced in other European countries, the French rescue plan had the dual objectives of reinforcing the banks' solvency and easing their access to credit. To bolster solvency, the government has created a new agency, the *Société des prises de participation de l'État* (SPPE), with funding of EUR 40 billion, which can be used to increase the capitalisation of banks that request injections. By the end of January 2009, two tranches of EUR 10.5 billion each had been extended to the six biggest French banks: the first tranche was announced in mid-October (and approved at mid-December by the European Commission), and the second was announced in mid-January. Both cases involved the SPPE's acquisition of super-subordinated securities of indefinite term issued by the banks concerned. While these are not equity as such, the banks can count these hybrid instruments as part of their Tier 1 capital ratios. At the same time, the government earns annual interest averaging 8.2% on these instruments. By choosing this way of injecting funds, the government has sought to ensure that its buy-in into the banks' capital does not dilute the interest of common shareholders and thereby discourage them from taking up future securities issues. SPPE itself is 100% owned by the State. A few weeks earlier, in concert with the governments of Belgium and Luxembourg, the French State had already participated in a EUR 1 billion bailout of the Dexia banking group: in this case, the intervention involved the acquisition of voting shares.

To boost bank liquidity and thus compensate for the dysfunctional interbank market, the government set up a second vehicle, the *Société de Financement de l'Économie Française* (SFEF), which is owned 66% by the banks and 34% by the State (with a blocking minority interest and a veto right). With the government's guarantee, SFEF can raise up to EUR 320 billion for lending to the banks. However, the guarantee is confined to loans contracted up to 31 December 2009, for a period of five years. Loan conditions include the posting of collateral that meets certain requirements in terms of quality, and an interest rate that represents a margin of 180 basis points over the rate SFEF pays for its borrowings. What distinguishes this approach from that followed in many other European countries is that the State guarantee applies to the banks' medium-term financing, rather than directly to interbank loans. By mid-march 2009, the banks had taken up some EUR 40 billion in loans through the SFEF.

Along with these measures, the government has instituted a lending programme for businesses (those with up to 5 000 employees are eligible), totalling EUR 22 billion, or around 1% of GDP. The funds used for this purpose are taken from cumulative deposits in "administered" savings accounts managed by the principal institutional investor acting on behalf of the State (the *Caisse des Dépôts et Consignations,* CDC).* Finally, the government has created a strategic investment fund to provide venture capital to innovative firms and, more importantly, to forestall foreign takeovers of French firms in sectors that are deemed "strategic". The fund has been established as a subsidiary of the CDC and is financed by loans from the State and from the CDC, amounting to EUR 3 billion each, topped up by securities or equity interests that the State and CDC hold in various French enterprises, to the amount of EUR 14 billion.

The direct and immediate impact of these measures on public finances is fairly modest. In the case of capital invested in bank equity, this will simultaneously raise debt and assets in an amount equal to the second tranche (EUR 10.5 billion or around 0.5% of GDP), as the first tranche was funded from CDC cash holdings. Refinancing poses a threat to public finances only in the event that the State guarantee were to be called, which is rather unlikely. At the same time, the State earns net interest from the margin the banks must pay it in return for its guarantee and its capital injection. Moreover, even if CDC activities do not appear in the government accounts, that agency is nevertheless a public financial institution that is being heavily solicited in the current crisis. These moves by the CDC will have an impact on the central government budget if the yield from these operations is so low that returns to the State are substantially reduced.

* In addition to managing a number of public pension regimes, the CDC takes the amounts collected in savings accounts at private banks, where remuneration is fixed by the State, and invests them, mainly in social housing.

These measures fall within the context of a European Union-wide rescue plan, and they have been accompanied by cuts to the European Central Bank's key interest rate and an easing of the conditions under which it provides funds to financial institutions. As a result, money market and interbank rates have subsided somewhat after spiking to around 180 basis points above expectations for the ECB key rate in mid-October. This has been followed by a moderate recovery of activity on the interbank market, although in both cases the situation is far from returning to normal. The French banks have come out of these financial and real estate crises with their balance sheets in better shape than those of their counterparts in many other countries. Only two banks have suffered losses from their subprime or Lehman exposures that were heavy enough to threaten their solvency.[1] Most of the other French banks, including the biggest ones, posted profits in 2008. Their exposure to toxic assets is still difficult to assess, however.

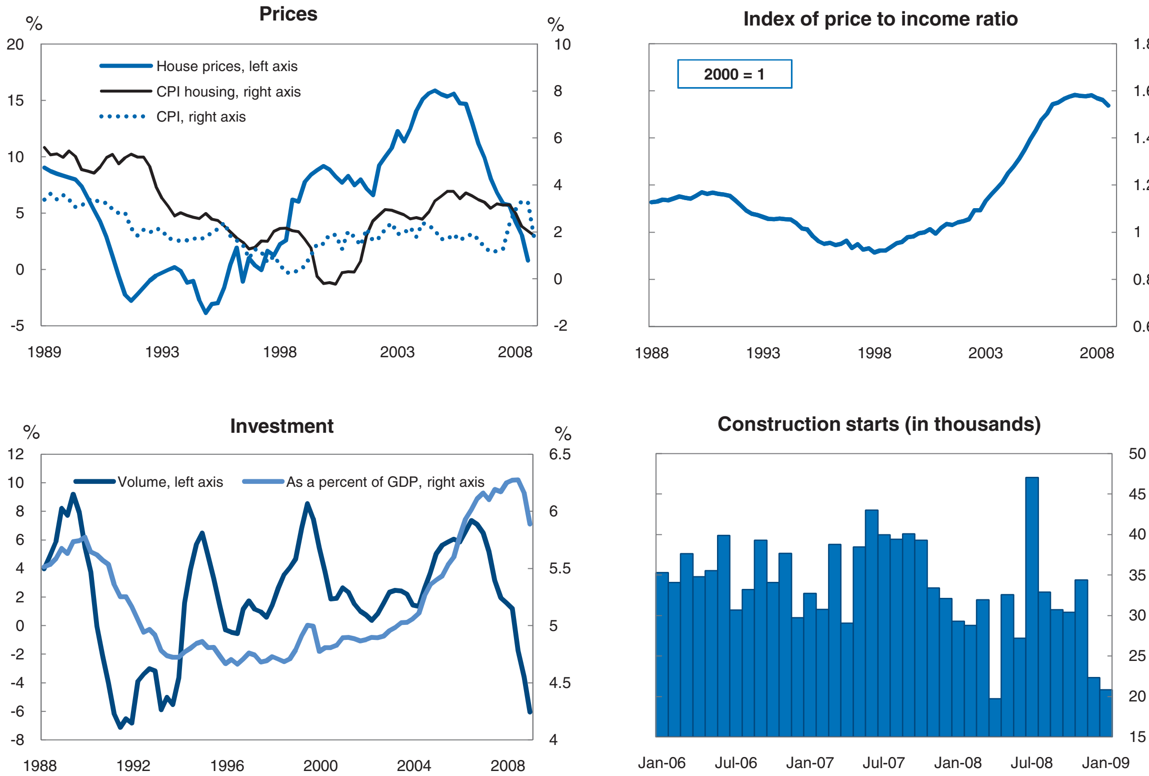
In this context, the real impact of these measures on lending to businesses and households is still unclear. In fact, although financial institutions certainly need to clean up their balance sheets, there are no obvious signs as yet of a credit crunch. In terms of lending to businesses, the appointment of a credit mediator has revealed numerous cases where companies have faced severe tightening on their overdraft privileges or a suspension of credit insurance. However, the number of cases handled since the mediation service was instituted in October 2008 represents barely 0.3% of all firms with fewer than 20 employees.[2] Moreover, after a significant jump in the first weeks of the programme, the flow of new cases has stabilised at around 450 per week, and three-quarters of these relate to firms with fewer than 10 employees. As well, surveys of banking institutions show that the tightening trend in credit to businesses, which began in the third quarter of 2007, continued in the last quarter of 2008, but that at the same time credit institutions were anticipating even lower demand in the first quarter of 2009.

When it comes to the cost of bank credit to non-financial companies, this has indeed risen, from 5.2% at the outset of 2008 to 5.6% in September, but after an easing that began in October those costs had fallen back by December to 4.9%.[3] Finally, while the latest available statistics on outstanding credit to nonfinancial companies show a clear slowdown, the annualised quarterly growth rate has remained significantly positive (dropping from 13.0% in December 2007 to 7.7% in December 2008 and to 6.9% in January 2009). This deceleration may, however, signal a real constraint, in that bank credit is being relied on, in part, to replace bonds as a source of corporate finance, given that the primary market for securities has dried up. After two months of net negative issuance in September and October (in both of which net redemptions amounted to EUR 1 billion), new issues recovered in November and December, at net flows of EUR 4.6 and EUR 9.4 billion, respectively (the December figure represents about 5% of the outstanding stock of securities). On the other hand, net share issues by nonfinancial companies remained slightly negative in November and December (EUR -0.5 billion).

Credit to households has tended to track developments in the housing market closely. Several indicators suggest that a housing-market correction was inevitable, although it may have been precipitated by the crisis. Not only had housing prices ballooned during the years since 2000, especially when compared to household disposable income, but the ratio of residential investment to GDP was higher than during the real estate boom of the late 1980s (Figure 1.2). Moreover, recent data on housing starts show that the decline in residential investment could well persist for several months longer.[4] As to house prices, it was only in the third quarter that they began to come down, at least in a generalised

Figure 1.2. **Housing sector indicators**

Year-on-year growth rate (except as indicated)



Source: OECD, *Economic Outlook database* and Ministry of Environment, Energy and Sustainable Development.

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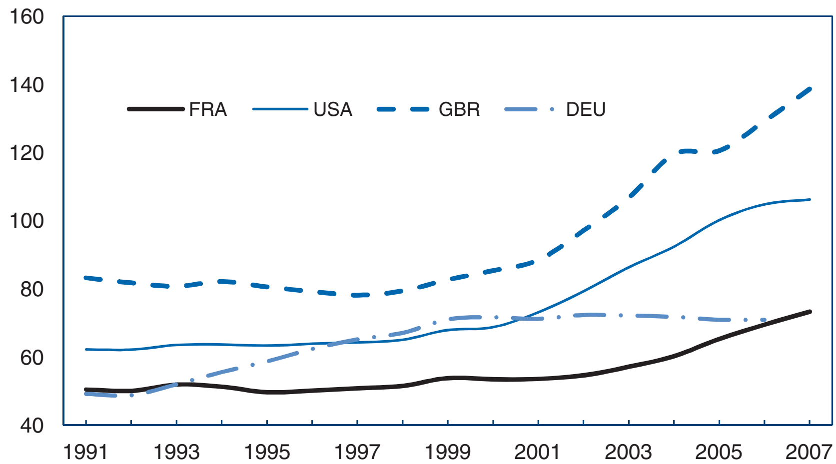
manner. Until now, their decline has been fairly moderate (1.1% since the peak), especially in light of the 150% nominal hike over the previous 10 years. Yet the sharp fall in the number of transactions suggests that the price slide could accelerate in the months to come. In this context, potential buyers have taken a wait-and-see attitude, which may explain why the demand for mortgages has slowed beyond what could be attributed to the tightening of credit conditions alone. In fact, the pace of growth in the volume of household mortgages granted by the banks has dropped, from an annualised quarterly growth of 6.5% in October 2008 to 4.5% in January 2009. This trend is confirmed by a decline of nearly 26% in new mortgages to households for the year 2008 as a whole, compared to 2007. While the banks may be assessing risk more strictly, there are good reasons to believe that this decline in lending has more to do with a reduction in demand than with shrinkage in the supply of credit.

In any event, there are some factors that could help stimulate demand for housing loans in the months to come. *First*, after rising by some 200 basis points between the end of 2005 and December 2008 to a peak of slightly over 5.3%, average interest rates on new housing loans began to ease slightly, by nearly 20 basis points, in January. The fact that the banks have finally begun to pass on the ECB's cuts to its key rate may be taken as a sign that their own access to financing is improving. *Second*, the easing of interest rates combined with lower selling prices is opening homeownership to new buyers by enhancing their repayment capacity (for a given amount of borrowing).[5] *Third*, in contrast to the situation in many other countries, France has not amassed a surplus stock of new housing, although the situation varies from one region or locality to another. In fact, estimates for the country as a whole suggest that there is something of a housing shortage.

Moreover, there are several reasons not to over-estimate the negative fallout on real activity and the financial system resulting from the housing-market correction. First of all, in contrast to the situation in the United States and the United Kingdom, the linkage between falling house prices and household consumption *via* the wealth effect is much more tenuous in France, mainly because lending conditions are generally stricter. As a result, household indebtedness levels are much lower than in countries that have been more exposed to the real estate crisis (Figure 1.3). The fact that households are in sounder shape financially may explain in part why the bankruptcy rate to date has remained fairly low, and consumption has remained stable while elsewhere it has fallen.[6] At the same time, tougher lending rules have allowed the banks to limit their vulnerability to the housing-market downturn. The main effect on global demand is confined essentially to the collapse of activity in the construction industry. But that shrinkage looks like it may have further to go: for example, the early 1990s recession saw residential investment as a share of GDP decline by some 1.1 percentage points, while the drop thus far in the current episode has been only 0.4 percentage point.

Figure 1.3. **Household mortgage debt as a percentage of disposable income**



Source: OECD, *Economic Outlook database.*

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In any case, with obvious signs of a severe retreat in economic activity and evidence that the bank bailout plan will not alone suffice to stave off the expected decline in demand, the government adopted an economic recovery plan amounting to 1.3% of GDP. One characteristic of that plan was that it relied essentially on bringing forward to 2009 expenditures that were already planned, but scheduled over several years (Box 1.2). This was certainly the case with infrastructure development projects, but also with accelerated payment of amounts owed by the State to businesses, in order to cushion their cash flow difficulties. Hence, for the most part, these were “self-reversing” expenditures that will cause only a temporary bump in the fiscal deficit. Another characteristic was that the plan focused mainly on measures affecting business investment and cash flow, thereby boosting directly production rather than consumption. Since the plan was approved only

Box 1.2. **Key aspects of the economic recovery plan**

The economic recovery plan announced at the beginning of December 2008 contained a series of measures totalling EUR 26 billion, or around 1.3% of GDP, including 0.8% of GDP having an impact on public finances in 2009. Those measures can be classified as follows:

- Measures to stimulate public investment: EUR 10.5 billion (0.5% of GDP):
  - Directly by the State: EUR 4 billion for investment in infrastructure other than network industries (sustainable development, tertiary education and research, defence equipment, maintenance of cultural heritage).
  - *Via* public enterprises: EUR 4 billion for the development of network industries (rail, postal services, energy).
  - *Via* local governments: EUR 2.5 billion to finance new investments.
- Measures to support SMEs (primarily for cash flow): EUR 11.5 billion (slightly more than 0.5% of GDP):
  - Accelerated payment of amounts due from the State (EUR 9.7 billion).
  - Accelerated depreciation of investments (EUR 0.7 billion).
  - Higher initial payments on government procurement contracts (EUR 1 billion).
- Measures to support the automotive and construction industries: EUR 2 billion (0.1% of GDP):
  - A combination of measures to help first-time homebuyers finance purchases of new homes (a doubling of interest-free loans, subsidised loans for low-income families under the "Pass Foncier" scheme) and a construction stimulus package (additional construction of social and intermediate housing units, acceleration of the urban renewal programme) (EUR 1.5 billion).
  - A cash bonus of EUR 1 000 for sending a 10 year-old (or older) car to the wreckers against purchase of a new one that meets environmental standards (EUR 0.2 billion).
  - Additional funding for SMEs through the public support agency OSEO (EUR 0.2 billion).
- Enhanced job-creation policies and employment incentives for micro enterprises: EUR 2 billion (0.1% of GDP):
  - Firms with 10 employees or fewer are exempt from all social contributions for persons hired at the minimum wage (EUR 0.7 billion).
  - Funding for supplementary measures to support employees and job-seekers (occupational transmission contracts) (EUR 0.5 billion).
  - EUR 200 bonus for future beneficiaries of the *Revenu de solidarité active* (income benefit for low-wage workers, RSA) programme that is to be launched in July 2009 (EUR 0.8 billion).

These measures come on top of previously announced actions, including temporary suspension of the local business tax (*taxe professionnelle*) for new investments made between November 2008 and December 2009 (EUR 1.1 billion); and maintenance of 100 000 "assisted contracts" that were to be eliminated (EUR 0.3 billion). For the automotive industry, the government had already announced in October 2008 a plan to develop a zero-carbon-emissions vehicle, including R&D support (EUR 0.4 billion) and establishment of a network of recharging stations for electric cars.

Since the recovery plan was announced, additional aid has been promised to the automotive and aviation industries, amounting to EUR 5 to 7 billion each, mainly in the form of loans and guarantees. Furthermore, additional measures amounting to EUR 2.6 billion (0.15% of GDP) were announced on 18 February 2009, including a one-time exoneration from income tax for low-income households, a payment to families with children who are eligible for the annual back-to-school benefit, vouchers usable for various household services and an increase in compensation for part-time unemployment.

at the beginning of January 2009, its economic impact is likely to become apparent only in the third quarter of the year. While the effect of the cash flow support measures could be felt sooner, some months are bound to go by before the investment projects really get underway.

The outlook for 2009 and 2010

Recent indicators suggest that the pace of decline in production may have intensified in the first quarter of 2009, as firms continue to run down their inventories and reduce investment in the face of weak orders and low confidence. In contrast, private consumption has shown some resilience so far this year, following a relatively strong outcome in the fourth quarter of 2008. However, the crisis has now hit the labour market severely, with a sharp increase in unemployment in the first months of 2009. After falling late last year, headline CPI inflation has been near zero in the first quarter, reflecting lagged effects of the earlier decline in energy and commodity prices. Stripped of the energy component, underlying inflation remains well above zero even if the rate has fallen.

Relatively tight borrowing conditions, combined with widespread declines in profits and little sign of recovery in order books, will likely lead to further inventory decumulation in the first half and falling business investment through most of 2009, as firms seek to bolster their balance sheets. In the case of households, uncertainty related to the sharp increase in unemployment in the first quarter and ongoing declines in asset prices are projected to result in a retrenchment of private consumption and residential investment in coming quarters, despite a modest increase in real disposable income. The fiscal stimulus package, along with substantial monetary easing and the additional measures to strengthen the banking system, will contribute to limiting the recession and support the recovery in 2010.

Real GDP growth is thus expected to remain negative throughout 2009, but at a steadily diminishing rate (Table 1.1). The recovery projected for 2010 will be weak, with growth remaining below potential rates until the end of the year. This is due in part to persistently weak demand abroad. Unemployment is projected to return to double-digit rates for the first time since 1999. Headline CPI inflation is likely to bounce back to positive rates fairly soon as the impact of past energy and commodity price declines tails off. However, the build-up of substantial excess supply gaps on product and labour markets will maintain downward pressures on wages and prices across the board, contributing to a gradual decline in underlying inflation to close to zero by the end of 2010.

Given the poor job-market prospects and falling wealth, households are likely to raise their saving rate in the next few quarters, despite only very modest gains in real disposable income and a moderate level of indebtedness. The projected increase in domestic private-sector saving will be more than offset by public-sector dissaving, as the combination of automatic stabiliser effects, discretionary stimulus and the loss of buoyant revenues associated with the bursting of financial and housing market bubbles will push the general government deficit to above 6½ and 8% of GDP, respectively, in 2009 and 2010. Even though this is largely cyclical, the structural deficit is also expected to widen by nearly one percentage point of GDP over the period, to around 4.5%. With a less severe decline in domestic demand than in large neighbouring countries, import weakness will be more moderate than in trading partners and net exports will continue to act as a drag on growth, leading to a widening of the current-account deficit, despite much lower imported energy prices.

Table 1.1. **Recent macroeconomic developments**

	2005	2006	2007	2008	2009	2010
	Current prices in [euro] billion	Percentage changes, volume (2000 prices)				
Private consumption	980.4	2.5	2.4	1.3	–0.3	0.2
Government consumption	408.4	1.4	1.4	1.5	1.4	1.3
Gross fixed investment	343.8	5.0	4.9	0.3	–7.1	–1.8
Public	56.9	–2.1	1.7	–1.2	–1.6	1.7
Residential	96.3	6.9	2.9	–1.1	–6.2	–2.4
Non-residential	190.6	6.3	6.8	1.5	–9.1	–2.6
Final domestic demand	1 732.7	2.7	2.7	1.2	–1.3	0.0
Stockbuilding[1]	5.9	–0.1	0.2	–0.2	–1.1	0.1
Total domestic demand	1 738.5	2.6	2.9	1.0	–2.4	0.1
Exports of goods and services	448.8	5.6	3.2	1.1	–11.4	–2.3
Imports of goods and services	463.5	6.5	5.9	2.0	–7.6	–1.0
Net exports[1]	–14.7	–0.3	–0.8	–0.3	–0.8	–0.3
GDP at market prices	1 723.8	2.4	2.1	0.7	–3.3	–0.1
Memorandum items:						
Employment		0.6	1.8	1.4	–1.9	–0.9
Unemployment rate[2]		8.8	8.0	7.4	9.9	10.9
GDP deflator		2.5	2.5	2.2	1.2	0.6
Harmonised index of consumer prices		1.9	1.6	3.2	0.4	0.6
Core harmonised index of consumer prices[3]		1.5	1.6	1.8	1.3	0.6
Household saving ratio[4]		11.7	12.4	12.4	13.2	12.9
General government financial balance[5]		–2.4	–2.7	–3.4	–6.7	–8.3
Current account balance[5]		–0.7	–1.2	–2.0	–2.3	–2.4

Note: National accounts are based on chain-linked data.
1. Contribution to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of labour force.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
4. As a percentage of disposable income.
5. As a percentage of GDP.
Source: OECD, *Economic Outlook database.*

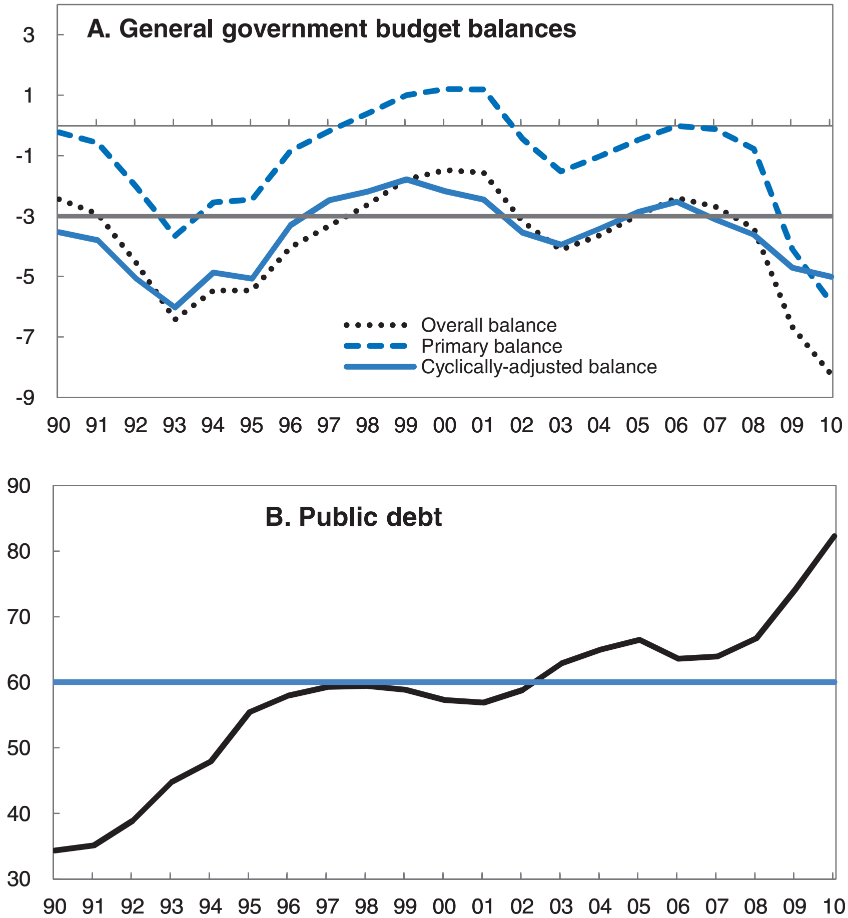
Returning public finances quickly to a more sustainable path

After shrinking from 4.1% to 2.4% of GDP between 2003 and 2006, the general government deficit widened again in 2007, despite relatively favourable economic conditions, with excess demand estimated at nearly 1% of potential GDP. Then, with the rapidly deteriorating economic situation in the second half of 2008, the deficit once again passed the 3% threshold, pushing the debt (Maastricht definition) to 67% of GDP. In 2009, the combined impact of the recession and the recovery plan is likely to drive the deficit to its highest level (relative to GDP) since the mid-1990s, which was the last time France saw a year (1993) of negative growth (Figure 1.4).

The loosening of fiscal policy in 2007-08 was induced by a drop in revenues rather than by any acceleration in expenditures, in contrast to previous episodes of fiscal stimulus. In fact, a number of measures adopted in 2006 had the effect of reducing combined personal and corporate income tax revenues by some 0.6-0.8% of GDP in 2007. Those measures included reducing the number of tax brackets for households (from 7 to 5), along with lower rates, a more generous PPE (earned-income tax credit), and an enriched research tax credit for corporations. Further income tax cuts were voted in August 2007 with adoption of the TEPA (Work, Employment and Purchasing Power Act), the annual impact of which in

Figure 1.4. **Budget balance and public debt**

Per cent of GDP



Note: Public debt is based on Maastricht definition. The data for 2009 and 2010 are based on OECD projections.

Source: OECD, *Economic Outlook database*.

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terms of lower revenues was felt primarily in 2008 (Projet de Loi de finances pour 2009, 2008a). The principal measures involved the exemption of overtime working hours (leading in particular to a significant decline in social contributions), the lowering of gift taxes on property transfers, and the reform to the "*bouclier fiscal*" (overall tax ceiling). Taken together, the tax and social contribution cuts contained in the TEPA amounted to the equivalent of around 0.4% of GDP in 2008, and this was only partially offset by increases in the funding of Social Security. While several of these measures adopted in 2007 will result in further relief for taxpayers over the years 2009-12, their annual impact in terms of stimulus will be fairly weak (less than 0.1% of GDP).

Despite tighter control over public expenditures in the last few years, relative to GDP they did not fall sufficiently in 2007 and 2008 to offset the tax cuts, and the general government deficit consequently rose. In fact, after two years of sharp declines in 2006 and 2007, the ratio of government spending went up again in 2008, although this could largely be attributed to cyclical factors. Whereas the inflation spike in the first half brought about a significant jump in debt service charges (mainly because of the heavy proportion of indexed bonds), the swiftly deteriorating economic situation in the second half was reflected in higher social transfers. In structural terms, the measures taken to limit public expenditure growth to around 1% by volume – including the only partial replacement of retiring civil servants – produced a slight decline in the total expenditure ratio.

In the 2009-12 stability programme submitted to the European Commission at the end of 2008, the government forecasted that the recovery plan announced in December would drive the overall public deficit to nearly 4% of GDP in 2009, but that the macroeconomic impact of the stimulus (estimated at 0.6% of GDP) would allow the economy to average slightly positive growth rates over the year. However, the sharp decline in economic activity recorded in the fourth quarter and lower-than-expected tax and social security revenue in 2008 prompted the government to revise its growth and deficit forecasts for the period 2009-2012. With activity expected to shrink by 1.5% in 2009, and a weak recovery expected in 2010, the authorities now foresee a deficit of close to 5.6% of GDP for 2009 and 5.2% of GDP for 2010, and they still hope to bring it below the 3% bar in 2012. Given the outlook for only sluggish recovery in 2010 and the possibility that new measures will be introduced, it is difficult to foresee a marked improvement in the deficit before 2011, if by then, unless further tightening measures are taken.

On this point, it has been a chronic feature of stability programmes and their underlying budget laws to spell out a profile for restoring fiscal balance that is subsequently never achieved. A review of past programmes reveals a quasi-systematic bias in budgetary forecasts, with the expected deficits nearly always underestimating the actual outcomes, even for the year immediately following publication (Table 1.2, Panel A). Since fiscal year 2001, the government has underestimated the deficit for the following year in five out of seven budgets, while its forecasts were correct or overestimated in only two cases (the end-2003 and end-2005 programmes). As of the second year out, the bias is systematic, even if it has kept below 0.2 point of GDP for three out of the six programmes, and it increases as the time horizon is extended. This perpetual postponement of the return to equilibrium tends to tarnish the credibility of multiyear budget planning. One of the factors contributing to this discrepancy is the relative optimism that colours growth assumptions for future years (Table 1.2, Panel B). First, the medium-term growth rate predicted in the programmes (2¼ or 2½ per cent, depending on the year) has almost never been achieved in the course of this decade (with growth averaging only around 1.7%). Moreover, the growth forecast for the immediately following year has hit the mark in only two out of seven cases, even though the government's prediction was generally close to the consensus outlook.

This ongoing damage to credibility does little to win public acceptance of the need to clean up public finances. For one thing, it can give the impression that the sacrifices people are being asked to make – be they perceived or real – will be for naught. At the same time, it can sow doubt about the government's capacity to wield the levers needed to attain its objectives. Finally, besides tarnishing credibility, the systematic shortfall between objectives and performance leaves France exposed to sanctions under the Stability and Growth Pact every time there is a cyclical downturn, thus undermining the preventive role of the Pact (Senate, 2007). Faced with a similar problem of keeping its budget planning process credible in the early 1990s (when its fiscal deficit was out of control), the Canadian government reacted by adopting the opposite approach, *i.e.* choosing deliberately conservative macroeconomic assumptions. More specifically, the government of the day made it a rule to assume a growth rate that was systematically lower than the prevailing consensus, thereby introducing a bias into its planning forecasts and ensuring that its

Table 1.2. **Budget balance and growth rate forecasts included in stability programmes**

Publication	Date	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
		A. General government budget balance (% of GDP)											
Stability programme:													
2003-05	End 2001	–1.4	–1.4	–1.3	–0.5	0.0							
2004-06	End 2002		–2.8	–2.6	–2.1	–1.6	–1.0						
2005-07	End 2003			–4.0	–3.6	–2.9	–2.2	–1.5					
2006-08	End 2004				–3.6	–2.9	–2.2	–1.6	–0.9				
2007-09	End 2005					–3.0	–2.9	–2.6	–1.9	–1.0			
2008-10	End 2006						–2.7	–2.5	–1.8	–0.9	0.0		
2009-12	End 2007							–2.4	–2.3	–1.7	–1.2	–0.6	–1.1
2009-12	End 2008								–2.9	–3.9	–2.7	–1.9	–1.1
Budget balance outcome (OECD projections for 2009 and 2010)		–1.56	–3.16	–4.11	–3.63	–2.97	–2.40	–2.68	–3.40	–6.67	–8.28		
		B. Real GDP growth (%)											
Stability programme:													
2003-05	End 2001	2.1	2.5	2.5	2.5	2.5							
2004-06	End 2002		1.2	2.5	2.5	2.5	2.5						
2005-07	End 2003			0.5	1.7	2.5	2.5	2.5					
2006-08	End 2004				2.5	2.5	2.5	2.5	2.5				
2007-09	End 2005					1.8	2.3	2.3	2.3	2.3			
2008-10	End 2006						2.3	2.3	2.3	2.3	2.3		
2009-12	End 2007							2.1	2.3	2.3	2.3	2.3	
2009-12	End 2008								1.0	1.0	2.0	2.5	2.5
GDP growth outcome (OECD projections for 2009 and 2010)		1.76	1.10	1.09	2.22	1.92	2.36	2.11	0.70	–3.25	–0.15		

Note: The stability programmes published at the end of 2007 and 2008 refer to the same horizon. When programmes included more than one scenario, the low-growth one was chosen. When growth assumptions were set as an interval, the figure taken as the reference for public finance projections was chosen.

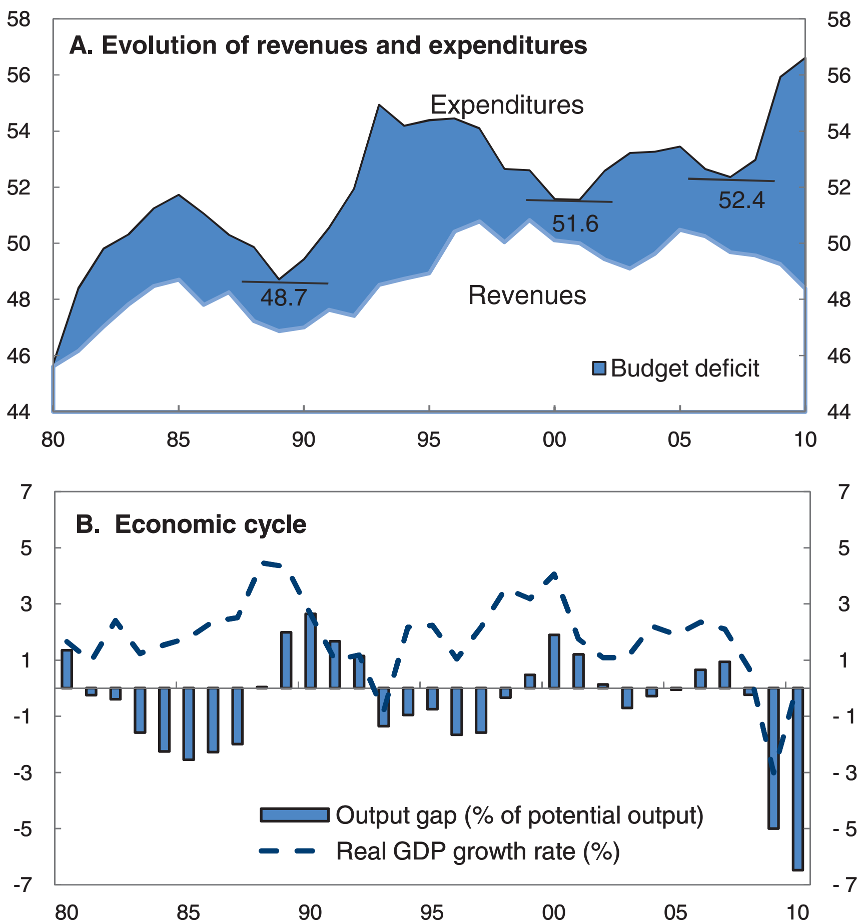
Source: OECD based on successive French stability programmes and *OECD Economic Outlook database*.

targets would be met or exceeded year after year (OECD, 1996).[7] There is no doubt that this was one of the measures that contributed to the success of the policy for restoring Canada's fiscal health. Without necessarily following an identical approach, the French government could draw inspiration from that success, for example, by setting its revenue and spending forecasts in a deliberately and openly conservative fashion relative to the real growth assumption, so as to maximise the probability that the objective for the budget balance would be achieved.

In any case, when it emerges from the crisis the government will find itself in a greatly weakened financial position, with a deficit similar to that of 1993 but now combined with a debt that is bigger by at least 30 percentage points of GDP. France is far from alone in this regard: many countries will be facing deficits that are just as high or even higher in some cases. The difference is that expenditure levels and the fiscal burden in France are already very high by international comparison, and the possibilities of eliminating the deficit through discretionary revenue increases are very limited. Past experience shows how difficult it can be to bring about a sustainable reduction in spending, particularly as rising indebtedness translates automatically into steeper interest payments. In this context, there are grounds to wonder whether the fiscal framework that has been in place in recent years is sufficiently constraining to guarantee a return to balance, and whether there are particular measures that could be considered for tightening expenditure control.

The trend of the revenue and expenditure profile over the last 30 years reveals that each time the budget has approached equilibrium – whether in 1980, 1988 or 2000 – it was followed by an acceleration in expenditure that inevitably pushed the restoration of balance several years into the future (Figure 1.5). The early years of the 1990s and of this decade were both marked by an economic downturn that weighed heavily on expenditures. Yet the recovery, when it came, was never strong enough to bring spending back to the initial level relative to GDP, and outlays reached a new plateau at the end of each cycle. Thus, between the cyclical peaks of 1988 and 2000, spending rose by nearly 3 percentage points of GDP, reflecting higher social transfers and greater central and local government operating expenses as well as a heavier debt service burden (Table 1.3). On the other hand, public investment retreated over the same period. The overall expenditure level as a share of GDP rose again in the course of the next cycle, between 2000 and 2007, although the increase this time was much more modest (0.8 percentage points of GDP). Once again, transfers accounted for a good part of this increase, while operating expenses were under better control, and lower interest rates meant a reduction in debt service charges.

Figure 1.5. **The influence of the business cycle on public spending and revenues**



Note: The data for 2009 and 2010 are based on OECD projections.

Source: OECD, *Economic Outlook database*.

StatLink http://dx.doi.org/10.1787/603474350635

Table 1.3. **Main components of general government expenditures**

Per cent of GDP

	1979	1989	2000	2007	Change over 1979-2007
Total expenditures	44.6	48.7	51.6	52.4	7.7
Final consumption expenditures					
Wage consumption	12.5	12.2	13.3	12.9	0.4
Non-wage consumption	8.2	9.4	9.5	10.3	2.0
Expenditures on transfers					
Social benefits[1]	18.8	20.7	22.7	23.5	4.7
Subsidies	2.0	1.8	1.5	1.4	–0.7
Debt charges	1.1	2.5	2.9	2.7	1.6
Gross fixed capital formation	3.0	3.4	3.1	3.3	0.2
Capital transfers and payments	–1.1	–1.3	–1.5	–1.7	–0.6

1. Including various other transfers such as payments for museums and national parks.

Source: OECD, *Economic Outlook database*.

Among the factors that have served to dampen the increase in expenditure in comparison with the previous cycle has been a certain strengthening in the budgetary framework with adoption in 2001 of the State Finance Framework Law (*Loi organique relative aux lois de finances*, LOLF). The main contribution of the LOLF was to introduce mechanisms to improve the utilisation of budgeted resources. Among the main changes: expenditures are now classified by policy objective or "mission", rather than by administrative unit; managers have greater discretion in their use of budget envelopes, in exchange for more accountability; there is more systematic use of precise objectives and performance indicators; and budget transparency has been enhanced. The LOLF first came into full force in 2006, and some of its impacts have been felt only more recently.

The setting of multiyear fiscal targets, including the anticipated trend of the budget balance, is now anchored in a legislative framework that allows Parliament to approve appropriations ceilings for the next three years, and for each "mission" in the budget.[8] Among other provisions of the 2008 Multiyear Budget Planning Law are some rules designed to contain the growth of general government expenditure by volume within an annual range averaging between 1 and 1¼ per cent over the period 2009-12. On this point, this law incorporates several rules or objectives set during recent years that affect the different levels of government but that were not anchored in a legal framework and introduces some new ones (Box 1.3). Thus, zero growth in central government volume outlays is an objective that dates back to 2002 but has been only partially achieved to date. In fact, with the exception of 2006, government volume outlays have risen steadily since 2002, although the upward trend slowed slightly over that period. In any event, even if the government had achieved its objective, the growth of outlays at all levels of government would still have exceeded by far the 1-1¼ per cent target set for the following years, because of the large contributions accounted for by local governments and the Social Security system (Table 1.4).[9]

To achieve this target, the rate at which total outlays have been growing in real terms since 2002 will have to be cut in half over the period 2009-12. Apart from the fact that this is unlikely to be attainable in a recession (2009) and a period of weak growth (2010), the target would seem ambitious even in normal economic times, since the growth rate of local government spending would have to be cut by two-thirds. The difficulty is illustrated by the

Box 1.3. Budgetary rules at different levels of government

The French budgetary framework contains three types of rules, applicable respectively to expenditures, revenues and the balance.

Rules governing expenditures

The rule set forth in the Programming Law includes growth targets for the volume of spending by central government and all public administrations. These are set, respectively, at zero and 1-1¼ per cent, until such time as budgetary balance is achieved. Those targets are now enshrined in law, but there is no corrective mechanism in case they are missed. A similar rule applies to a specific category of Social Security spending, namely sickness insurance, where the annual growth rate by value must not exceed 3.3% in 2008 and future years. This rule was already part of the legal framework before it was included in the Programming Law and is in principle somewhat more constraining in the sense that breaching the rule triggers corrective measures proposed by an independent committee, the *Comité d'alerte indépendant*. Despite making it more binding during the 2000s, the national objective for health-care spending voted annually by the parliament has nearly never been achieved since 1997, and the cumulative overspending has been over EUR 50 billion.

Rules governing revenues

Since 2006 (when although the budget was in deficit the government faced political pressure to spend the unexpected surplus in revenues), the central government has been bound by law to decide in advance how it will allocate any revenues in excess of those foreseen in the budget. In such a case, the decision is to be taken on the basis of discussions with the National Assembly and the Court of Accounts (the independent audit body). There is, however, no sanction mechanism if the rule is violated. In addition, the Multiyear Budget Planning Law introduces a new rule whereby the creation or expansion of any tax or social expenditure must be offset by deleting or cutting existing ones. It also incorporates the setting of annual objectives for containing the cost of existing mechanisms. It further stipulates that evaluation of measures in the realm of taxation or social security that are instituted as from the presentation of the Budget Planning Law should be made systematic, three years after they enter into force. The government has also pledged to conduct a thorough evaluation of all tax and social security loopholes by the end of its current mandate. Lastly, the Law stipulates that new measures resulting in a reduction in the level of tax revenues and/or social security fees or contributions will be offset, over the entire programming period, by an equivalent increase in revenue (State and social security), as long as the revenue level set by the Budget Planning Law has not been met.

Rules governing the budget balance

The main constraint on the level and profile of the budget balance comes from the Stability and Growth Pact, according to which a general government deficit beyond 3% of GDP triggers an "excessive budget deficit procedure". In addition, local governments are required by law to observe a "golden rule" based on budget accounting and overseen by the regional and territorial chambers of accounts, which have a responsibility to propose corrective measures if the rule is not adhered to.

fact that local spending accelerated in 2007 when the economy was still healthy, even if that hike may be attributable in part to the electoral cycle.[10]

In this context, the strengthening of the budgetary framework implied by the Multiyear Budget Planning Law represents an important step forward, but it will not be

Table 1.4. **Contributions to growth in total public expenditures**

	2002	2003	2004	2005	2006	2007
Growth in total public expenditures						
(% growth in volume)	3.8	2.3	2.2	2.6	1.6	2.5
Contribution from the State	0.9	0.2	0.5	0.5	0.0	0.2
Contribution from the ODAC[1]	0.0	0.2	–0.4	0.1	0.3	0.1
Contribution from the APUL[2]	1.0	0.8	0.7	0.7	0.7	0.9
Contribution from the ASSO[3]	1.0	1.3	1.1	1.1	0.8	1.2

1. Various organisms affiliated to the State.
2. Local governments.
3. Social security system.

Source: Projet de Loi de finances pour 2009 (2008b).

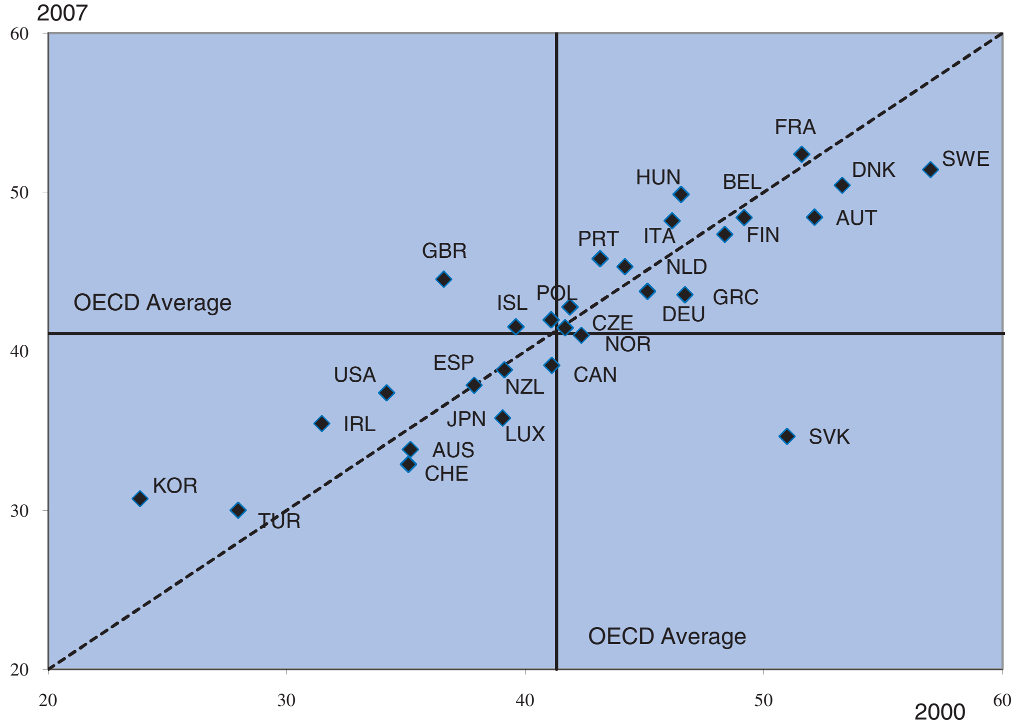
enough to ensure that ambitious targets can be met. On the one hand, the multiyear dimension of the law makes it easier to manage appropriations for each "mission", given that the proportion of annual outlays subject to discretionary adjustment does not exceed 5%. On the other hand, despite a somewhat tougher political commitment, the constraining power of the budgetary rules is still limited, as the government can override them by legislation. For example, the rule requiring balance in the Social Security accounts has not prevented rising deficits (let alone eliminated them), although it was originally more constraining than other rules. More generally, the many rules introduced in the last several years and the oft-declared intention to control outlays more effectively have led to only a slight decline of spending, in structural terms as a proportion of GDP.

Yet, many countries have succeeded in reducing expenditures as a proportion of GDP over the last 10 years (Figure 1.6), in some cases quite significantly (in particular the Nordic countries, but also Germany, Austria and Canada). Their experience shows, however, that ambitious objectives demand a thorough rethinking of the role and the forms of State intervention in various fields, and call for actions that go beyond the budgetary framework. In the case of France, a significant and sustainable reduction in the spending-to-GDP ratio is quite feasible, especially in light of the potential savings to be found in each of the major components of public expenditure, *i.e.* central government, local governments and Social Security. Achieving these savings, however, will require vigorous pursuit of the reforms now underway, and additional efforts as well.

With the launch of the General Policy Review (*Révision générales des politiques publiques,* RGPP), the government adopted a more methodical approach to reforming the State. The declared objective is to provide a framework to identify ways for making government more efficient, by auditing all government programmes and services. As part of this exercise, various teams of auditors from the ministries and from the private sector set out to answer questions about the nature and justification of State policies in every field, and about the ways to make those policies more effective.[11] What this amounts to is a re-examination of the way the State intervenes, and this is indeed a positive move. In the wake of audits to date, more than 300 measures have been identified and approved by the government for gradual implementation between 2008 and 2011. In principle these measures are to be monitored by teams created within each ministry. The anticipated savings from these reforms are estimated at some EUR 7 billion over three years, including EUR 3 billion in payroll costs, EUR 2 billion in subsidies and investments, and slightly over EUR 2 billion in other operating costs. On the payroll front, the savings will come entirely from reduced

Figure 1.6. **General government public expenditure levels**

As a percentage of GDP



Source: OECD, *Economic Outlook database.*

StatLink http://dx.doi.org/10.1787/603475538284

staffing levels in the civil service, and will be achieved through attrition (*i.e.* by replacing only a portion of those retiring).

In light of the expectations that an exercise of this kind might elicit, the forecast savings of EUR 7 billion are certainly modest in comparison with the global amount of public spending, which is nearly EUR 1 trillion. Moreover, it is far less than the savings necessary to achieve the 1-1¼ per cent spending growth target (which is around EUR 50 billion), (Cour des Comptes, 2009). One reason for the lack of the savings is that, while the RGPP was supposed to be general in its scope, it was in the end confined essentially to central government outlays (around 30% of the total), while Social Security and local government spending were largely excluded. But even in terms of central government spending alone, these savings fall far short of the potential estimated by the Institut de l'entreprise in 2006 in its *Observatoire de la dépense publique*.[12] Without going that far, however, it is to be hoped that the State will persevere in implementing the measures identified by the RGPP and at the same time avoid as far as possible any expansion of its scope of intervention. This objective has indeed been largely respected in the first recovery plan where, apart from the extension of "occupational transition contracts", few of the measures will be hard to reverse.

While the issue of local government spending was not explored in the RGPP, the Institut de l'entreprise study found that considerable savings can be achieved in this area, especially insofar as local governments' share in total spending has been rising steadily, and not only because of the transfer of responsibilities to the local level.[13] This can be explained in part by the structure of financing between the different levels of government.

Together with the transfer of responsibilities, the share of their own tax revenues in local government budgets has steadily declined in favour of transfers from the State. The sometimes tenuous link between the locus of resource management and the source of funds does little to foster local governments' accountability for their expenditure choices (OECD, 2007). Moreover, local governments may have considered that the transfer of powers was not sufficiently accompanied by a proportionate transfer of human resources, even though Act II of the 2003 decentralisation had called for comprehensive transfers of the staff needed to administer those powers. What in fact was observed was an increase in staffing levels above and beyond the transfers. Finally, the plethora of overlapping territorial structures is itself a source of duplication in services and programmes. Co-operation between groups of small municipalities has not produced the economies of scale that might have been expected, particularly when it comes to procurement and facilities management. On this point, and in the wake of the debate unleashed by the Attali Commission Report – recommending, *inter alia*, the elimination of one of the administrative levels (the *département*) – the government created a "Committee for Local Government Reform", chaired by former Prime Minister Édouard Balladur, to examine ways to simplify the administrative structure. The recommendations of this committee include the merger of certain regions or *départements* on a voluntary basis. The government has pledged that in the months ahead it will prepare draft legislation inspired by these proposals.

Recognising that social transfers are the items that have contributed most to the increase in overall expenditures, it would also be desirable to subject them to an RGPP-type exercise. Efforts at rationalisation have already been made, indeed. For example, the two main institutions responsible for compensating the unemployed (UNEDIC) and the public employment service (ANPE) have been merged, and user (co-insurance) charges have been introduced for drugs and certain paramedical services, leading to savings in health insurance costs. Yet, while productivity gains can no doubt be found by re-organising the management of social programmes, really significant savings on the social benefits' side will surely require a critical reappraisal of certain services and programmes that have not demonstrated their effectiveness. Unfortunately, since the least efficient programmes are often those with the greatest number of beneficiaries, such a reappraisal, even if partial, is bound to be politically difficult.

On this point, it is quite revealing that to complete the financing of the *Revenu de solidarité active* (the new incentive to work for those with low earnings potential), a new tax has had to be introduced (see Chapter 2). This is regrettable, all the more so because introduction of this new measure could have provided the occasion to withdraw, or at least to refocus more significantly, another existing measure (the earned-income tax credit, PPE), which has similar objectives but is of questionable effectiveness because there are too many beneficiaries receiving too little benefit in relation to their income. Similarly, substantial economies could be achieved by reconsidering the universality of certain benefits – in particular the family allowances – and either subjecting them to a means test or bringing them into the income tax base. More generally, "tax expenditures" should be subjected to the tests of effectiveness and legitimacy, as stipulated in the Budget Planning Law and as the government has pledged do to, since they often amount to transfers even if they are not treated as such from a national accounts or budget viewpoint. The number of tax loopholes has increased by more than 200 since 2002, and their total cost in terms of forgone revenue is officially estimated at EUR 70 billion per year (3.5% of GDP).

Over the longer run, only with a very significant increase in the employment rate will it be possible to restore the financial health of the Social Security accounts without a thorough rethinking or at least an important change in the parameters governing numerous social benefits. By way of example, the steady decline in unemployment (until its abrupt reversal in 2008) had allowed the unemployment insurance fund to post a surplus as of 2007. There is especially great potential for raising the employment rate in France, which is now one of the lowest in OECD countries. Indeed, the nearly 5 percentage point gap in employment rates between France and Germany explains in part the difference of eight percentage points of GDP in the overall level of expenditures. A higher employment rate is all the more necessary as demographic ageing is bound to have a non-negligible fiscal impact, even if it will be smaller than in other European countries.[14] Clearly, the current crisis makes it difficult to envision such an increase in the next two or three years, but even over the longer term a significantly higher employment rate, especially among youth and seniors, will be hard to achieve unless current and future efforts to reform the labour market are successful (see Chapter 2).

Box 1.4. **Summary of recommendations relating to public finances**

- Implement the recovery plan swiftly and effectively by ensuring the greatest possible coordination among different players involved in distributing the additional resources. If the recession lasts longer than expected, consider adopting additional measures, preferably of a temporary or self-reversing nature, in order to safeguard the sustainability of public finances.
- Once the recovery is underway, move decisively to implement a strategy for reducing the deficit at all levels of government over the medium term, according to an explicit path.
- Restore credibility to the budget process by adopting an approach whereby revenue and expenditure forecasts associated with growth scenarios are deliberately and openly conservative, to ensure that the objectives are likely to be achieved year after year.
- Focus the public finance consolidation effort on reducing expenditures, in particular through complete coverage of Social Security accounts by the General Policy Review and by encouraging local governments to undertake a similar process.
- Strengthen the incentives to better expenditure control by giving greater visibility to the cost, in terms of taxes and compulsory contributions, of measures taken at each level of local government, and by eliminating duplication of programmes and services among the different levels.
- Take advantage of the new provision offering incentives for those with low potential earnings to seek work (the *Revenu de solidarité active* or RSA) to refocus completely the existing provision (the earned income tax credit, *prime pour l'emploi* or PPE).
- Examine all tax loopholes to reconsider their effectiveness and legitimacy.

Notes

1. These are Natixis and the Banques Populaires. The Société Générale also constituted provisions at the beginning of 2008 following the loss of EUR 5 billion as a result of unlawful transactions by one of its traders. The bank nevertheless reported a profit for the year.
2. By excluding from the number of firms those reporting no employees. Of the 5 000 cases filed since the mediator began work in October 2008, some 40% had been settled by the end of January 2009. About two-thirds of those had a positive outcome, *i.e.* a situation that allowed the firms to remain in business. About 10% of the cases submitted were rejected at the outset.
3. These are the rates charged by French banks on loans of less than one year to non-financial companies for amounts below EUR 1 million; for higher amounts, the rates are lower but have followed a similar profile.
4. After a record year in 2007, housing starts dropped 16% on average in 2008, returning to their 2004 level.
5. In this sense, the solvency index of new borrowers has improved since November 2008.
6. The latest available data on household over-indebtedness show that the total number of cases filed in September 2008 was slightly down (by 0.4%) from September 2007.
7. In addition, the deficit projections incorporated generous contingency reserves in order to confront possible future negative shocks.
8. This new feature was made possible by the constitutional amendment of 21 July 2008, one objective of which was to bolster Parliament's powers.
9. Even though the contributions presented in Table 1.4 are calculated for fixed spending responsibilities across the different levels of government, it must be emphasised that some of the spending areas that the State transferred to local governments are growing quickly (for example, the guaranteed minimum income, which is becoming the *revenue de solidarité active*, RSA).
10. In 2007, growth in local government spending proved more dynamic than in 2006, due *inter alia* to rising investment by municipalities, attributable in part to the municipal elections of early 2008, and to the sharp rise in the total wage bill excluding transfers.
11. More precisely, the audit teams were to answer seven questions: What does government do? What are the public's needs and expectations? Should it continue to do the same things? Who should do it? Who should pay? How can things be done better and more economically? How should the transformation be handled?
12. That report offered 17 proposals for reducing State spending by between EUR 45 and EUR 52 billion (Institut de l'entreprise, 2006). Those proposals were in part inspired by the Camdessus (2004) and Pébereau (2006) reports. It should be noted, however, that some of them were implemented before the RGPP, thereby reducing the potential for further savings.
13. Of the 37 proposals contained in the *Observatoire de la dépense publique*, six concerned local governments and involved potential savings of nearly EUR 25 billion, more than half of which would come from greater cooperation (or amalgamation) between local governments in order to share and reduce management costs, and from relying more on private partners.
14. In its 2007 report, the *Conseil d'orientation des finances publiques* argued that ageing could raise public spending by slightly more than 3 percentage points of GDP, with unchanged policies.

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Chapter 2

Progress in labour market and other reforms

The authorities have undertaken numerous structural reforms since the last OECD Economic Survey *was published in June 2007. Many of those reforms go in the direction of the recommendations offered at that time, while other reforms conducive to social dialogue have also been put in place. This chapter reviews the progress that has been made in improving the functioning of the labour market, addressing the problem of demographic ageing and making the education system more effective. These efforts will have to be pursued and the momentum of reform maintained, pressing ahead even further in some fields while perhaps changing course in others. The greatest challenge is to raise the employment rate in order to restore the health of public finances and sustain rising living standards.*

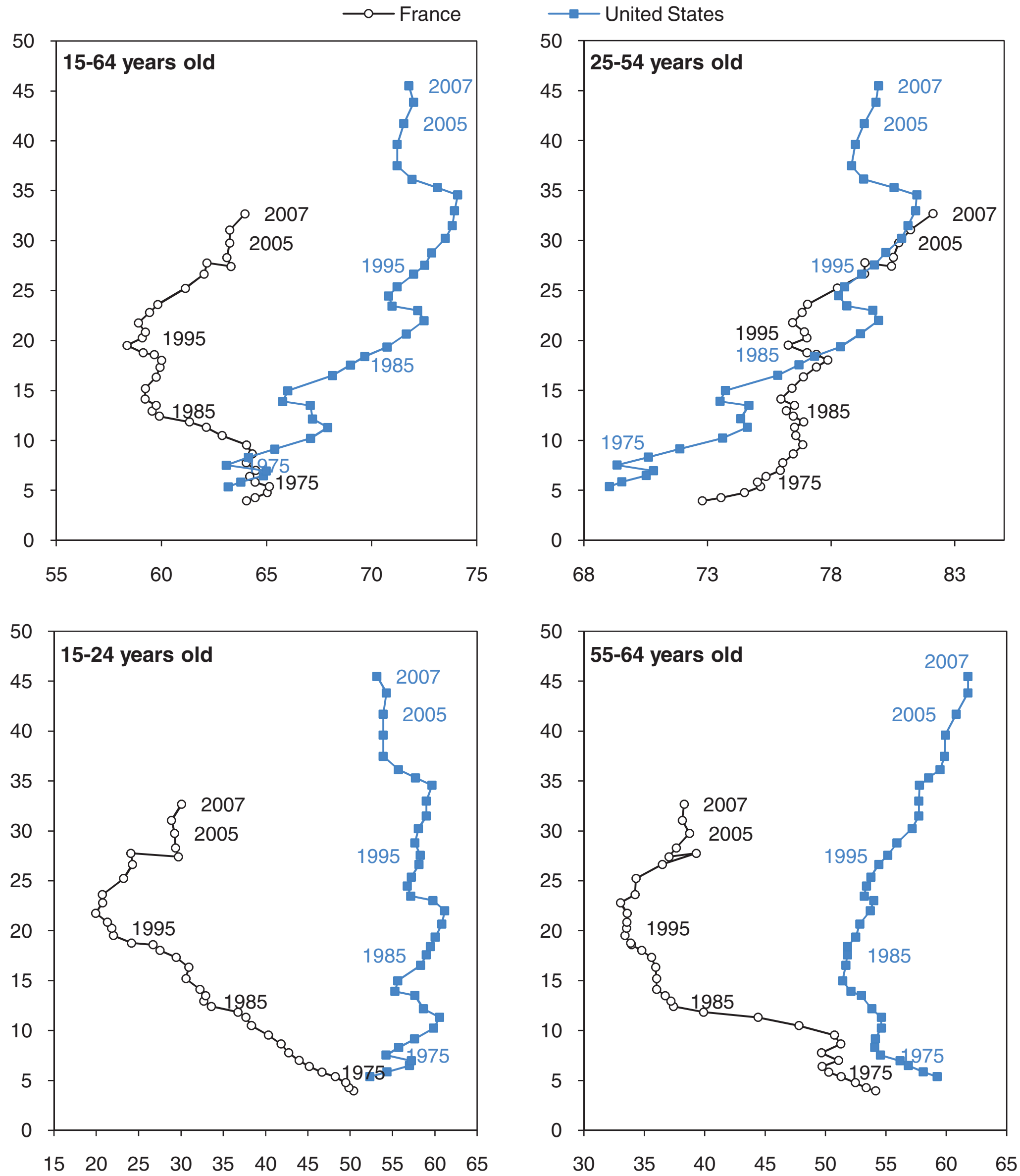
In the wake of the presidential elections of May 2007 and the installation a month later of a new government, numerous reforms have been launched to improve the functioning of the French economy. In this connection, the report of the "Commission to Liberate French Growth", chaired by Jacques Attali and published in January 2008, represented a relevant diagnosis of the actions needed to raise the country's growth potential, reduce poverty and unemployment and cut the public debt as a percentage of GDP (Attali Commission, 2008). The OECD in fact made a significant contribution to that report (OECD, 2008a). By the end of 2008, according to the Commission's members, more than two-thirds of the 316 measures proposed had been implemented wholly or partially or were under discussion, demonstrating that the report served to initiate new government plans or is at least consistent with them. While some measures have respected the spirit of the report rather than its letter, it certainly contributed to the debate and to the overall momentum of economic reform in France.

The previous OECD *Economic Survey* (OECD, 2007a) highlighted the fact that an increase in employment would have a favourable impact not only on poverty and social exclusion but also on public finances, through additional revenues from social contributions and income tax, and would at the same time reduce social expenditures (unemployment benefits, RMI, etc). It would also diminish the long-term risks to public finances posed by the ageing of the population (see Chapter 1), in a context where the efforts aiming at reforming the pension system must be continued not only in France, but also in many other OECD countries (OECD, 2007b). Finally, it would narrow the gap in living standards between France and the most advanced countries. While in the first half of the 1970s the overall employment rate in France was comparable to that in the United States and was associated with a similar per capita GDP, a persistent gap in living standards appeared thereafter, sparked by a severe drop in employment rates for youth and seniors in France (Figure 2.1). The employment rate stabilised during the 1990s and then improved between 1997 and 2003. But this progress has been largely halted since 2003.[1]

The last *Survey* stressed that the weakness of the employment rate has much to do with the characteristics of the labour market and the French system of social protection. Even if the system is successful in keeping the bulk of the population out of poverty, it is less effective in avoiding social exclusion and easing entry into the workforce. Simultaneously, older workers tend to stop working before they reach the age of 60, so that the employment rate for persons between 55 and 64 years is significantly lower than the Lisbon strategy's target of 50% for 2010. Given these issues, slower increases in the SMIC (the minimum monthly wage) and the introduction of a "single employment contract" were recommended, together with enhanced and better targeted in-work benefits. It was also recommended that the contribution period be lengthened further, that the financial incentives to keep working beyond the legal retirement age be strengthened, that older workers drawing unemployment benefits should no longer be exempt from active job-search requirements, and that the special retirement regimes be reformed. Finally, the previous *Survey* emphasised that employment prospects could be enhanced by offering

Figure 2.1. **Employment and per capita GDP trends: France *versus* the United States**

Per capita GDP in current PPP, in USD thousands: vertical axis
Employment rate, as a percentage: horizontal axis



StatLink http://dx.doi.org/10.1787/603478401186

greater performance incentives at all levels of the education system, notably through greater autonomy for secondary schools and universities.

The authorities have undertaken numerous structural reforms since the last *Survey* was published. Many of those reforms go in the direction of the recommendations offered then, and the progress achieved in the areas mentioned above is presented hereafter. Measures have also been taken to foster competition on markets for goods and services, and these are discussed in Chapter 4. These efforts will have to be pursued and the momentum of reform maintained, pressing ahead even further in some fields while perhaps changing course in others.

For years, one of the characteristic features of France has been a low level of co-operation in social dialogue. And yet a number of recent studies show that quality labour relations are in many cases associated with lower unemployment rates (Blanchard and Phlippon, 2004; Feldmann, 2008). Improving the quality of social dialogue in France is thus an important vector for raising the employment rate, especially insofar as the effectiveness of labour law would probably be enhanced if the law were more contractual and less regulatory (Barthélemy and Cette, 2008). Two major laws have expanded the role of the social partners in the French economy's dynamic of structural change launched two years ago and have laid the foundations for numerous initiatives affecting the functioning of the labour market. The January 2007 law modernising "social dialogue" established a reform strategy based on consultations and negotiation between labour and management organisations on the basis of prior proposals by the State. In addition, the August 2008 law on the "renewal of social democracy and working-time reform" introduced new rules for the validity of agreements stemming from inter-professional negotiations. The latter legislation is likely to make trade unions more accountable by making their respective showings in occupational elections a decisive factor in representativeness and validation of collective-bargaining agreements.

A reform strategy based on negotiations between social partners runs the risk of producing "insider" agreements, as shown by the rejection of the proposed single labour contract. Nevertheless, the government and Parliament ultimately have the final say on any decisions, insofar as the legislation adopted can differ significantly from agreements between social partners if the government deems those agreements insufficient. Furthermore, it is possible that social partners may sign agreements that improve conditions for "outsiders", as illustrated by the example of the new unemployment insurance scheme calling, *inter alia*, for a reduction from six to four months of the minimum affiliation period needed to qualify for benefits.

Improving the functioning of the labour market to combat poverty and social exclusion

Overcoming the dualism of the labour market

To reduce poverty and the sense of insecurity, the last *Survey* recommended that employment protection legislation should be amended to attack the dualism that prevails in the French labour market. On the one hand, there are workers with an indefinite labour contract (CDI) who benefit from rules that make dismissal or layoff complicated and costly (which may explain why such contracts are hard to get), and on the other hand there are others, often working under a fixed-term contract (CDD) or as temporary staff – arrangements that allow firms to adjust to shocks but that leave workers exposed to uncertainty. Given this reality, the recommendation of the previous *Survey* was to introduce a single labour contract, one that would offer progressively greater protection as seniority in the firm increases, while leaving the employer the scope to decide on economic grounds whether it is time to let one or more employees go, the idea being that the courts should intervene only to prevent abuse (such as discrimination) in layoffs.

A government proposal that moved in the direction of a single contact was in the end rejected by the social partners in negotiating the *Accord national interprofessionnel* (ANI) of January 2008 on modernising the labour market. Neither the unions nor the employers' organisations were willing to support it: the unions saw it as an attack on the regulations

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governing redundancy, while the employers likely felt that other available types of contact (CDDs, temporary contracts) offered a simpler way to achieve staffing flexibility (Fabre *et al.*, 2008). In particular, given uncertainty about the degree of detail with which the courts can interpret breach of contract, the employers might have feared that a single contract could lead to even greater rigidities. The labour market modernisation act of June 2008, which reflects the main provisions of the ANI, created, on an experimental basis for a period of five years, a special CDD which is reserved for engineers and management staff and is to be used for carrying out specific projects. Moreover, the length of the CDI probation period has been extended. Finally, the law reclassified all the *contrats nouvelle embauche* ("new recruitment contracts", CNEs) as CDIs. While the CNE introduced some easing of labour contract regulations for firms with fewer than 20 employees, the Paris Court of Appeals had ruled that the probationary period (two years) was too long, and the International Labour Organisation had judged that it failed to comply with a convention that prohibited the termination of employment without valid reason.

If a reform instituting a single contract were precluded, the previous *Survey* recommended easing the legislation on CDIs in other ways, such as broadening the definition of economic redundancy, simplifying layoff procedures and reducing firms' redeployment obligations. Once the crisis has been overcome, progress on the issue of economic redundancy would be advisable. However, the labour market modernisation act simplified the law governing layoffs by introducing the option of terminating a CDI by mutual consent of employer and employee (*rupture conventionnelle*). In fact, this move gives legal recognition to, regulates and expands a practice widely followed in the past for the departure of managerial personnel: "amicable termination for personal reasons" (*rupture amiable pour motif personnel*). As a result, in contrast to past practice, this form of termination confers entitlement to unemployment insurance benefits and to the tax and social treatment associated with severance pay, while at the same time providing employers with greater legal security. This does, however, pose certain risks and negative externalities, stemming in particular from the risk of abuse of the unemployment insurance system. In the case of workers who reach the age of 57, the risk, which already existed under the old system, stems above all from the rules for compensating seniors, given their entitlement to 36 months of unemployment benefits and the fact that the legal retirement age is still set at 60. The resulting effect could partly offset efforts to postpone the effective age of retirement and to increase the employment rate for seniors. Finally, while any agreement acquires legal force upon approval by the Departmental Director of Labour, Employment and Vocational Training, a disputed case can be referred to the *Conseil de prud'hommes* (the employment relations tribunal) – a provision that undermines the legal certainty of this form of termination.[2]

Reducing the counterproductive effects of a minimum wage that is set too high

The previous *Survey* stressed that the minimum wage in France, the SMIC, is not the most appropriate instrument for combating poverty. Relative to the median wage, it is one of the highest in the OECD, and, because of steep hikes in the past, it has risen faster than the productivity of unskilled workers. Because of this, the cost of hiring unskilled workers increased until 2006, despite cuts in employers' social contributions. In this context, to increase employment of the unskilled and to make for less compression in the structure of wages above the SMIC, it was recommended that the SMIC should grow at a much slower pace in coming years and that, at the very least, discretionary upward "nudges" should be avoided.

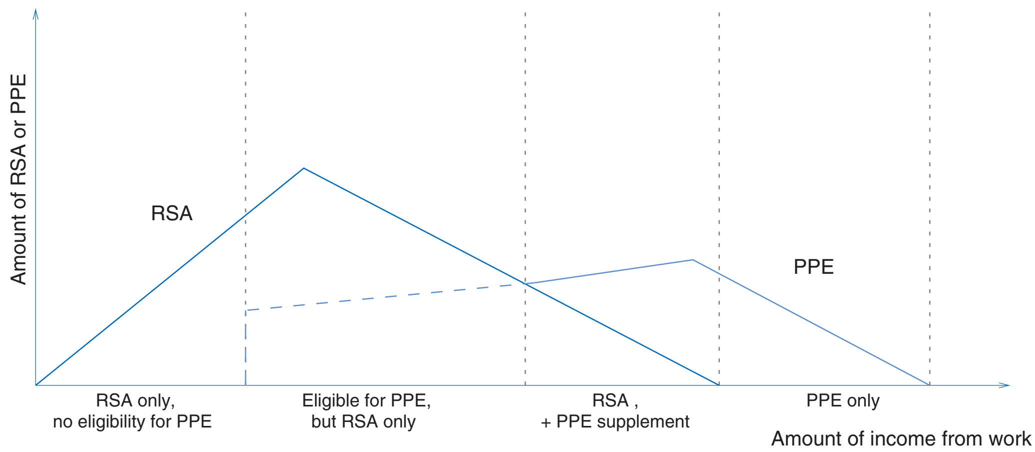
Over the last two years, the authorities have in fact avoided such "nudges", and the percentage of workers affected by SMIC adjustments dropped from slightly over 16% in 2005 to around 13% in 2007. Successive July 1 adjustments (amounting to an average of 1.5% per year) have corresponded to the minimum amount consistent with existing legislation.[3] Pursuant to that legislation, there was also an automatic increase of slightly over 2% on 1 May 2008, reflecting the fact that the benchmark price index had exceeded the 2% threshold on a year-over-year basis. More generally, the *Survey* recommended a more considered approach to setting the SMIC, relying on expert opinion and consultation, as is done in some other countries (for example, with the United Kingdom's Low Pay Commission). The December 2008 law to promote income from work calls for a change in the procedure for setting the SMIC as of 2010. A group of independent experts is to make proposals to the government and the *Commission nationale de la négociation collective* (National Collective Bargaining Commission, CNNC) on the appropriate changes in the SMIC, which represents a framework for setting up the SMIC that goes in the right direction. Finally, the adjustment date of the SMIC was moved forward from 1 July to 1 January. Such a change will make for a better fit with the timing of industry- and company-wide wage negotiations.

Better targeting of in-work benefits

The 2007 *Survey* also argued that there is a better way to combat poverty than through constant SMIC increases and continuous cuts in employers' social contributions. Instead, it recommended using the earned income tax credit (*prime pour l'emploi*, PPE), while focusing it more directly on poor families. At the same time, it suggested reviewing the benefits system to ensure that having a job, even if only for a short time, generates additional income beyond what benefits alone bring. The generalised introduction of a new social benefit, the *Revenu de solidarité active* (RSA), as of June 2009 will address several of these issues. More generally, it is intended to lift 700 000 people above the poverty line. Following introduction of the law on work, employment and purchasing power (TEPA), testing of the RSA has been underway in 34 departments since 2007. In these experimental zones, it is estimated that RMI beneficiaries returned to work at a rate 30% higher than in the "control" zones.

Technically speaking, the RSA serves three objectives. *First*, it will make the social benefits system less complex and boost the incentive for the unskilled to seek work (Cahuc *et al.*, 2008). The RSA will replace the benefits that top up income to a certain minimum level, *i.e.* the *revenu minimum d'insertion* (RMI, a benefit that provides a guaranteed income) and the single-parent allowance (API). It will also take the place of the PPE for beneficiaries who return to work at an income that falls within a certain range (see Figure 2.2). Finally, it will replace the one-time back-to-work bonus for persons working at least 78 hours a month and the temporary work incentive for persons taking part-time jobs. Consequently, it will help not only to do a better job of smoothing the effects of tax thresholds and effective marginal tax rates, but also to make permanent the incentive mechanism, which had been paid for one year only. *Second,* it will reduce the proportion of poor workers: 33% of poor people (defined as those with incomes at or below 60% of the median income) were working in 2004, representing 5% of the population (OECD, 2007). *Third*, it will boost incentives to work by guaranteeing that people who return to work will see an improvement in their incomes from the very first hour on the job. The

Figure 2.2. **How the RSA and the PPE mesh**



Source: Doligé (2008).

way the RSA is constructed, beyond what the RMI provides (income for inactivity), it supplements income from activity: one euro earned from work guarantees EUR 0.62 of additional income.

The RSA transfers resources to families with very low incomes. The additional cost of this provision beyond the benefits it replaces is EUR 1.5 billion per year. It is to be financed by a surcharge of 1.1 percentage points on the social charges levied on investment income (with the exception of certain regulated savings accounts), the level of which is raised from 11 to 12.1%.[4] It was initially planned to finance the RSA by redirecting the PPE to the poorest workers. That would have been in fact a desirable objective. Integrating the PPE into the RSA would correct some of the PPE's shortcomings: not only the fact that it is still hardly targeted at low-income people but also that its amount is relatively low, and there is a time lag between taking work and receiving the bonus, which is calculated on the basis of income from the previous year. Despite some improvements, this last element makes the PPE hard to understand, reducing its impact as an incentive to take up work, while the Social Security Offices will pay the RSA every month (with quarterly updating of the beneficiary's position). The difference, however, is that, in contrast to the PPE but as with the RMI, the RSA beneficiaries must be over 25 years of age. Overall, the desire not to create "losers" has kept a portion of the PPE in place, leading to a complicated blending with the RSA (see Figure 2.2). Thus, as of June 2009, it is expected that 300 000 families will receive the RSA and a PPE supplement, and 5.1 million families will be receiving the PPE only (Doligé, 2008). The number of families receiving the PPE will, however, decline by around 300 000 because of the decision not to raise the thresholds and the caps of the credit in 2009. This represents a budgetary saving of some EUR 400 million.

Devise more effective policies for helping the jobless and the excluded to find work

The OECD Jobs Strategy stresses that it is better to protect people rather than jobs and advocates the promotion of work opportunities. With a view to rationalising and making more efficient the various services for the unemployed – registration and interviewing, placement, delivery of allowances and ongoing support – the February 2008 law reforming the organisation of the public employment service (PES) provided for the merger of the organisation that delivers placement services for job seekers (ANPE, run by the State) and the unemployment insurance agency (UNEDIC, managed by the social partners). The creation of a one-stop shop, the "*Pôle emploi*", is in line with the recommendations of the previous *Survey*. It came into effect on 1 January 2009 and is to be in general service by the end of the year, but, should the merger be completed, it will be important to avoid the maintenance of two distinct entities in terms of governance.

This merger offers the chance to refocus the PES on registering the unemployed and helping them find employment with the aid of specialised external placement agents. However, in practice, the latter's effectiveness is uncertain (Cahuc and Kramarz, 2004; Cahuc, 2008). Their compensation should perhaps be tied more closely to an observable performance indicator, such as the rate of reemployment for the job seekers they take under wing. The cost of these services could be reduced, moreover, by selecting agents through competitive tender. The outsourcing of placement services does not necessarily diminish the influence of the PES in favour of private operators: in fact it retains a key role, through its profiling of job seekers, in providing direction and guidance towards reemployment (Georges, 2006). In order to optimise its range of services, the PES should learn from the trials that have been conducted as to the effectiveness of enhanced accompanying measures (Behaghel *et al.*, 2008). In general terms, it would be preferable to have the PES helping those made redundant to find new work, rather than requiring firms to implement social plans to assist those laid off, and to finance the corresponding costs with an experience-rating type mechanism (linking the level of an employer's contributions to unemployment insurance to the number of its redundancies).

The previous *Survey* stressed the need of harmonising the rights and obligations of the potentially active unemployed, and restoring the obligation to look for work. Reforms going in this direction have been started by the authorities. The August 2008 law on the rights and duties of job seekers proposes better support and encouragement for the unemployed. The PES will assist them in working out individualised employment plans in light of their personal characteristics (qualifications, working experience, personal situation, etc.) and those of the desired job (expected wage or salary, preferred geographic location, etc.). Those plans will serve to define a "reasonable offer of employment". The law stipulates that a job seeker may not turn down more than two such offers without having his or her benefits suspended for two months. Moreover, the new rules force job seekers to moderate their expectations as to pay and geographic location as time goes by without finding work. Finally, a new social agreement on unemployment insurance to broaden the conditions of access to unemployment benefits in return for a cut in employers' contributions if the unemployment insurance system is in surplus is in effect. The agreement features two major strides: *first*, it lowers to four months (instead of six) the qualifying period for entitlement to benefits, which is one way to reduce the dualism of the labour market and shows that labour/management negotiations can yield pacts that are not "insider agreements"; and *second*, the implementation of a single, uniform process, improves the transparency and fairness of the benefit system by eliminating a number of undesirable threshold effects.

One outcome of the April 2008 employment insertion summit was the *contrat unique d'insertion*, a new standard work contract for persons furthest removed from the labour market. This contract simplifies the various types of assisted work contracts for groups facing the greatest difficulty in finding a job, while allowing greater flexibility in respect of renewal or changes in the length of the work week. Employers' actions in promoting employment will be assessed to avoid windfall effects or possible impasses. The new contract is supplemented by other provisions, such as priority attention given by the PES to workers under these contracts (individualised coaching, training, etc.). Finally, consistent with the recommendations of the previous *Survey* to limit "inactivity traps" by not tying related entitlements to the recipient's status, some benefits are to be subject only to a means test (*e.g.* exemption from the local property tax and universal basic medical coverage). However, care should also be taken to try to keep marginal effective tax rates as moderate as possible over the range of income where benefits are phased out.

Measures have also been taken to raise the youth employment rate, with a special focus on young people in the most disadvantaged locations. Employment promotion programmes for 16 to 25 year-olds include personalised interviews at local employment offices and support through the "social integration contract". The *Espoir banlieues* ("Hope for the suburbs") programme, announced in February 2008, contains several measures to boost employment for young people in sensitive urban areas, who often suffer from unemployment, poverty and discrimination. *First*, a new type of contract is being tested: a young person enters into a "*contrat d'autonomie*" ("contract for independence") with a placement agency, which is paid according to results. The beneficiary receives individualised training and coaching for a total of one year (six months before and after signing a work contract). *Second*, it provides support for creating an enterprise, offering a package that combines and adapts financial assistance from all available programmes. *Third*, it encourages large companies to sign a "national commitment to employ youth from the *quartiers*" (low-income neighbourhoods) under which they offer recruitments and/or training. A year into this plan, however, there are still delays in getting it up and running. *Finally*, the TEPA law on work, employment and purchasing power raised the tax exemption ceiling on earned income for students from two to three months worth of SMIC over the year. This tax benefit has been extended to all those under the age of 25.

Encouraging increased working time

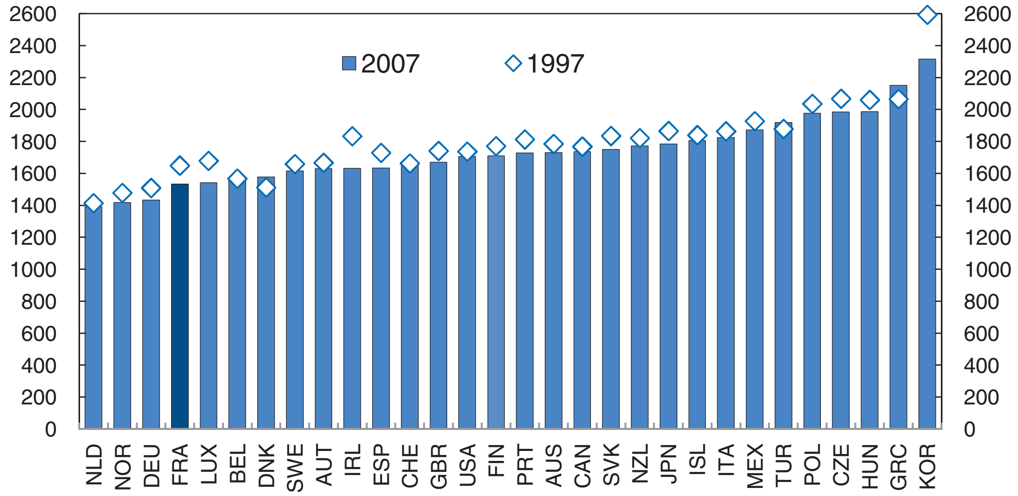
Against a backdrop of decomposing growth, the downward trend in hours worked per employee has continued to have an adverse impact (Table 2.1). The annual number of hours worked per employee is in fact among the lowest in the OECD (Figure 2.3), although there has long been a downward trend in most developed countries (OECD, 2008b). Nevertheless, steps have been taken to encourage longer working hours. While the legal

Table 2.1. **The components of real GDP growth**

	Average 88-97	Average 98-07
GDP growth	2.0	2.3
Labour productivity (per hour)	2.3	1.8
Capital intensity	0.9	0.8
Multifactor productivity	1.4	1.0
Total hours worked	–0.2	0.5
Hours worked per employee	–0.4	–0.5
Working-age population	0.3	0.6
Labour force participation rate[1]	0.0	0.2
Employment rate[2]	–0.2	0.3

1. Ratio of labour force to working-age population.
2. Ratio of employment to labour force.
Source: OECD, *Economic Outlook No. 84 database.*

Figure 2.3. **Annual hours worked per employee**



Source: OECD, *Economic Outlook No. 84 database.*

StatLink http://dx.doi.org/10.1787/603552774556

workweek remains at 35 hours, the TEPA law of August 2007 raised overtime pay for work beyond that threshold. Additional hours worked are now exempt from employee contributions and income tax, and the legally mandated overtime premium has been raised from 10 to 25% in firms with fewer than 20 employees. Employers also benefit from a lump-sum reduction in their contributions.

The implementation of the TEPA law has been accompanied by a significant increase in reported overtime hours, though the number of hours actually generated by the law is statistically difficult to evaluate, mainly because of low declaration rates by businesses in comparison with the pre-August 2007 situation (DARES, 2008). As well, overtime has been subjected to a complex set of rules designed to prevent fraud (such as declaring one-time bonuses as overtime pay for tax-exemption purposes or cutting the hourly wage and simultaneously lengthening reported work time). This has generated additional administrative costs for firms and additional supervisory costs for government without completely eliminating the risk of opportunistic behaviour, it would appear. Moreover, the possibility that overtime has substituted for new recruitment cannot be discarded, at least in the short term, even if beneficiaries' purchasing power may have boosted activity and employment and the lower cost of labour has perhaps sustained the demand for labour. In any case, financing the cost of these tax relief measures, which amounted to EUR 3.5 billion in 2008, will mean greater tax pressure over time, and this will tend to depress activity (Artus *et al.*, 2007; Blanchard *et al.*, 2007). Lastly, the August 2008 law on the "renewal of social democracy and working-time reform" introduced additional instruments for managing working times within firms without calling the statutory and maximum working times into question (Box 2.1).

Promoting appropriate housing policies

To combat poverty and exclusion, it was recommended that efforts to support poor families and to make the supply of private housing more elastic should be expanded, in particular by reviewing regulations governing the security of rental tenure. The February 2008 law on purchasing power changed the rules governing residential building leases. The new provisions are intended to favour tenants, but they could have the effect of

Box 2.1. **Recent changes to ease working-time management**

The "chosen hours" (*heures choisies*) scheme repealed by the new law had already enabled a worker, at the employer's initiative, to work beyond the firm's standard overtime quota, but without exceeding the statutory maximum working hours. Now a business is free to set the level of overtime that its employees can work with no need for prior industry-level authorisation. Since exceeding the quota is no longer subject to control by labour inspectors, the quota is no longer a ceiling for the volume of hours worked, but merely a threshold above which mandatory compensatory leave (the length of which is still governed by law, but the terms and conditions of which may be set forth in a company-wide agreement) is triggered.

This freedom for individual firms also applies to the maximum number of days worked by employees subject to "annual working days" (*forfait en jours sur l'année*) agreements: mutual agreements between employers and employees to exceed the statutory 218 days no longer require prior group approval. The law stipulates an annual limit of 235 days, but this can be extended to up to 282 days through a company- or industry-wide agreement. Pay for these additional days' work is at least 10% higher. Until year-end 2009, pursuant to the "purchasing power law" of 8 February 2008, these extra days also qualify for exemptions under the TEPA law (exemption from income tax and employee-paid social security contributions and flat-rate exemptions for employer contributions).

Lastly, the terms for converting earned extra leave (RTT)[1] into pay, either immediate or deferred, when employees deposit leave entitlements to a leave-time savings account (*compte épargne-temps*, CET),[2] as well as the frequency for assessing working cycles at the collective level, may also be negotiated freely by businesses.

1. RTT days are additional leave days awarded to an employee in compensation for work time in excess of the 35-hour week.
2. Pursuant to the "purchasing power law" of 8 February 2008, these days also qualify until year-end 2009 for exemptions under the TEPA law (exemption from income tax and employee-paid social security contributions and flat-rate exemptions for employer contributions).

depressing the supply of housing. In order to contain rent hikes, therefore, the benchmark index has been changed.[5] The law also reduces the lease security deposit by half and limits it to one month's rent excluding maintenance charges. However, the February 2009 Law on Mobilisation for Housing and Combatting Exclusion includes a number of measures likely to bolster the supply of housing. Among them is a temporary easing of zoning rules authorising builders, within stipulated limits, to exceed construction standards (height, floor area ratios, etc.) and a refocusing of support for investment in rental housing to areas where supply is tight. In addition, the amount of time a jurisdiction may grant to suspend execution of an expulsion decision was cut from three years to one.

The government has also tried to promote home ownership. The TEPA law revised and lowered succession and donation duties and instituted a mortgage interest tax credit (during the first five years) for the purchase or construction of a principal residence. While a tax break on mortgage interest for real estate purchases does not in itself lead to sharp inequalities of wealth, it can exacerbate them if the motivation is to bequeath the property (Cho and Francis, 2008). In fact, cutting taxes on the transfer of property would have been a better way to promote ownership and would do more for labour mobility as well. The reduction in such duties could, however, be expected to be very costly for the local governments that collect them. Acquiring ownership has also been made easier in the HLM (geared-to-income rental housing) market. The proceeds from sales should go to financing new construction. Those proceeds could be supplemented by the funds that will flow from the extension of the "*livret A*", a highly popular regulated savings product that has been offered by all banks since January 2009. New constructions appear to be necessary: the practical impact of adoption of the legal right to housing for the poorest families has been uneven, mainly because of a shortage of social housing in certain cities (Bellan and Chauveau, 2008). The mobilisation for housing law delivers a response to this strong demand, *inter alia* by imposing a levy on the financial resources of social landlords who fail to meet their construction targets. Such a levy effectively pools resources between social housing bodies owning rental properties so that resources untapped by some might help assist landlords faced with substantial investment requirements in especially tight sectors. Finally, a socially assisted ownership plan has been introduced for couples who are purchasing a home for the first time: the plan is to produce 30 000 dwellings in 2009, for which buyers would pay EUR 15 per day for up to 40 years.

One move called for in the economic recovery plan adopted at the beginning of 2009 (see Chapter 1) is to begin construction on 70 000 social housing units, of which 30 000 would be reserved for renting to households with the lowest incomes and 40 000 would be rented to middle-class families, with an option to buy. This programme comes in addition to the purchase by subsidised housing bodies (HLM) of 30 000 dwellings from developers who have been unable to begin construction because of the market downturn. The application of this programme was made possible by an easing of the conditions for such purchases by HLM. The "design" phase of the projects having already been completed, the purchase option should ensure that some of these construction projects can be resumed soon. The recovery plan also seeks to support construction of new private dwellings for first-time home-buyers (in the modest and medium income ranges) via zero-cost financing. This involves a State-subsidised interest-free loan, the amount of which has been doubled (up to 30% of the cost of the dwelling), and higher ceilings on the price of eligible units.

In all, social housing is an important component of efforts to address the problem of poverty and social exclusion. Measures and incentives that favour tenants and promote homeownership may also serve important economic policy objectives. However, they may have counterproductive effects on property prices and rents, especially if the price elasticity of supply is low, making it less likely that the desired objectives can be achieved cost effectively.

Table 2.2. **Progress in structural reform: labour market and anti-poverty policies**

Recommendations from previous *Surveys*	Actions taken since the June 2007 *Survey*
REFORM OF THE LABOUR MARKET AND POLICIES TO COMBAT POVERTY AND EXCLUSION	
Review employment protection legislation to reduce the disparity between fixed- (CDD) and indefinite-term (CDI) contracts, preferably moving to a single employment contract with lower protection, increasing with length of service.	The government proposal to introduce a single employment contract was rejected by the social partners, and has not been made law.
If a single employment contract is precluded, find other ways to ease the legislation on CDIs, such as widening the definition of economic redundancy, simplifying layoff procedures and reducing firms' redeployment obligations.	Layoff law has been simplified by introducing the possibility of mutually agreed termination (*rupture conventionnelle*) of the CDI, but this poses a risk of abuse of the unemployment insurance system, especially in the case of older workers.
Ensure that the SMIC grows more slowly than the median wage, by at least avoiding discretionary increases.	Discretionary hikes beyond the legally mandated increase have been avoided. An advisory group of independent experts is to determine the appropriate changes in the SMIC as of 2010.

Table 2.2. **Progress in structural reform: labour market and anti-poverty policies** *(cont.)*

Recommendations from previous *Surveys*	Actions taken since the June 2007 *Survey*
To reduce the risk of unemployment and poverty traps, use the earned income tax credit (PPE) and focus it more closely on poor families, and review the benefits system to ensure that having a job, even if only for a short time, generates more income than benefits alone.	As of June 2009, there will be a new social benefit – the *Revenu de solidarité active* (RSA) – which is designed to smooth out effective marginal tax rates, reduce the proportion of poor workers and increase incentives to work. It would have been better, however, to finance the RSA by refocusing more significantly the PPE on low-income workers, rather than by raising taxes on investment income.
REFORM OF THE LABOUR MARKET AND POLICIES TO COMBAT POVERTY AND EXCLUSION	
Limit inactivity traps by de-linking related entitlements from the recipient's status.	The local housing tax exemption and access to universal basic medical coverage are now awarded according to a means test, which is preferable to using status.
Make the public employment service (PSE) more efficient by setting up a one-stop shop through a merger of ANPE and UNEDIC, by harmonising the rights and obligations of those without work, by imposing a job-search requirement, and by assessing the effectiveness of programmes specifically targeted at the unemployed.	A one-stop shop (*Pôle emploi*) has been created through the merger of ANPE and UNEDIC. What constitutes a "reasonable job offer" has been defined; a person on unemployment insurance may not turn down more than two such offers without incurring financial penalties. Over time, the jobless are expected to trim their pay expectations and expand the scope of their job search.
Target specific measures on those furthest removed from the labour market and use profiling techniques to make targeting more effective.	The "*contrat unique d'insertion*" simplifies the various types of assisted work contracts for the most vulnerable population groups and is complemented by priority attention from the PES.
Give priority to making young people employable.	Labour market entry programmes for 16 to 25-year-olds are continuing; the "*Espoir Banlieues*" plan has been launched for youth in sensitive urban zones to help them join the workforce; tax advantages have been increased on employment income for students under 25 years of age.
Make working-time regulations more flexible.	The legal workweek remains at 35 hours, but, with the TEPA law of August 2007, exemptions from social contributions and income tax have been granted for overtime hours; this is costly to the treasury and runs the risk of fraud. Additional instruments for easing the 35-hour rule were incorporated into the law on "renewal of social democracy and working time reform" of August 2008.
Expand efforts to support poor families and make the supply of private housing more elastic, in particular by reviewing regulations governing the security of rental tenure.	The rent indexation rules have been revised to rein in increases, and the security deposit has been cut in half, which could well have an adverse impact on supply, although the temporary easing of zoning laws moves in the opposite direction. Introduction of a legal "right to housing" has faced the supply constraint, but the effort to expand the stock of social housing will be pursued, thanks to the extension of the *Livret A*, the home ownership plan (housing at EUR 15 a day) and the economic recovery plan.

Raising employment rates for seniors in a context of demographic ageing

Consistent with the 2003 law making provision for an indexation of the public pension contribution period to life expectancy, the lengthening of the contribution period to 40 years was officially confirmed in 2008, in accordance with the recommendation made in the previous *Survey*. That period will now be increased gradually by three months per year, starting in 2009, until it reaches 41 years in 2012. However, there has been no change in the legal retirement age. It remains fixed at 60 years and is still below the legal age in many Western countries of the European Union (65 years) or in the Scandinavian countries (67 or 68 years). Hairault *et al.* (2006) have shown that distance to retirement is one factor that explains the employment rate of seniors in France.[6] The lower legal retirement age conferring entitlement to a full pension (with no penalty) can indeed reduce the employment rate of older persons for several reasons. For one thing, it may reduce the incentive for firms to invest in training them once they reach the age of 50 or 55, insofar as they will be seen as approaching the end of their career. Second, the legal age not only influences individual behaviour but also sets a benchmark in negotiating early retirement. Finally, there is no empirical evidence to suggest that the reasons for low employer demand for older workers is that their productivity slips relative to their pay. Nevertheless, a low legal retirement age may lead employers to think, wrongly, that there is such slippage, particularly when productivity is not readily measurable. For all these reasons, it is to be hoped that the new round of negotiations, planned for 2010, on improving the employment rate of seniors and making the retirement system sustainable will lead to an increase in the legal retirement age.

To boost the incentives for a longer working life, the last *Survey* recommended making pensions actuarially neutral, particularly in the retirement age bracket. Beyond age 60, the quarterly pension premium (*surcote*) has been raised to 1.25%, or 5% per year, the same as the target rate for the early retirement penalty (*décote*). The government has also relaxed the rules on combining employment and pension income for persons 60 and over (if they have contributed long enough to qualify for a full pension under the general regime), and for those over 65 in all cases. The two previous constraints have thus been lifted: the ceiling on combined work/pension income, and the six-month waiting period before returning to the last employer. Finally, the mandatory retirement age for most private-sector employees has been raised from 65 to 70 years, and this provision will apply fully as of 2010. Other categories of employees (police officers, fire fighters, airline pilots, hostesses and stewards) have been allowed to continue working until they are 65 instead of 55 or 60 as was the case previously. Generally speaking, a more ambitious reform might have left it completely up to the employee to decide how much longer he or she would work beyond the legal retirement age, but selection biases would make it difficult to apply.

To improve the low employment rate for seniors, several other measures were recommended. One of these was to eliminate incentives to early retirement by ending the active job-search dispensation (DRE) for unemployed beneficiaries over the age of 57 and by abolishing the tax exemptions for indemnities from either imposed or voluntary early retirement. The August 2008 law on the rights and duties of job seekers provides for the gradual elimination of the DRE beginning in 2009, progressively raising the age for this dispensation and eliminating it completely as of January 2012. The initial draft law on the financing of Social Security in 2009 called for harmonising the tax treatment of layoff and retirement benefits, but, with the economy and the labour market reeling, this reform was not introduced. On the other hand, in the case of early retirement the employer contribution rate has been raised from 24.15% to 50% for all indemnities and benefits paid from 2009 on. At the same time, the employer contribution rate on indemnities in the case of forced retirement at the employer's initiative has also been increased from 25 to 50%. Finally, the very generous separation allowances (commonly known as "golden parachutes") are now subject to social charges from the first euro if they exceed a threshold of 30 times the annual Social Security ceiling (*i.e.* about EUR 1 million). The discrepancies in the tax treatment of layoff and retirement benefits tend to produce distortions: that treatment should instead respect the principle of taxation from the first euro, with no special exemptions.

Lifelong learning is one of the possible levers for improving the employment situation for seniors. In January 2009 the social partners reached a new agreement on vocational training, professional development and career security. Among its provisions are:

- Establishment of a career security fund, to which labour and management would contribute equally, to support training for job seekers and less skilled workers.
- Possibility for the unemployed to retain individual training rights acquired in a previous job.
- Individual education leave, allowing workers to take training for up to one year, leading to a qualification or a diploma.

- Introduction of training to develop a "*socle de compétences*", a basic set of knowledge and skills (teamwork, mastery of computer tools, competence in English, etc.) to facilitate adaptation and transition between jobs throughout a person's working life.

To encourage the employment of older persons, sectors and uncovered firms with more than 50 employees were asked to work out agreements or action plans based on a set of minimum specifications by the end of 2009. Those specifications were expected to be set by regulation and to reflect the outcome of management-labour negotiations in 2008 dealing with forward planning for employment and skills requirements, occupational training, and unemployment insurance. Firms that did not have an agreement or action plan in place by 1 January 2010 would be liable to a penalty of 1% of their payroll, payable to the old-age insurance fund. However, in the context of a fast rise in unemployment due to the crisis, the government chose to give up, at least temporarily, the idea to penalize financially the companies which would not produce an action plan. Finally, ANPE services for unemployed persons over 50 have been strengthened thanks to an action plan for the employment of seniors announced in mid-2008.

The last *Survey*, citing grounds of fairness and to a lesser extent budgetary considerations, urged the gradual elimination of the special retirement privileges granted to the employees of current or former public enterprises. The reform of the "special regimes" that came into effect in July 2008 harmonised them with the civil service regime. It calls for progressive increases in the contribution period to 40 years by 2012, and to 41 years (as in the general regime) by 2016; the introduction of a *surcote* (premium) and a *décote* (penalty) as in the ordinary regimes, and inflation indexing of pensions starting in 2009. As well, persons hired as of 2009 will no longer enjoy generous treatment of past contributions. In return, however, persons already employed are to receive several advantages (raising within-grade salary ceilings, inclusion of bonuses in pension calculation, etc.), and this at first cast some doubt on the financial impact of the reform. A report from the Senate showed nevertheless that the overall effect would in fact help to reduce the deficit in the special regimes, although the savings in the initial years would be modest (Marini, 2007). Those savings would amount to EUR 500 million cumulatively by 2012 and EUR 1.34 billion by 2020.

Table 2.3. **Progress in structural reform: Seniors employment policy**

Recommendations from previous *Surveys*	Measures adopted since the June 2007 *Survey*
OLDER WORKERS EMPLOYMENT POLICY	
Continue to index the contribution period to life expectancy. Consider extending further the relative length of the contribution period.	Extension of the contribution period from 40 to 41 years by 2012 has been confirmed.
Make pensions actuarially neutral, especially in the retirement age bracket.	The quarterly *surcote* rate was raised to 1.25% past age 60, the rules on combining employment and pension income were relaxed, and the mandatory retirement age was raised from 65 to 70 years.
Abolish tax exemptions for indemnities related to either compulsory or voluntary early retirement and harmonise the overall taxation of redundancy and retirement allowances.	As of 2009, the employer contribution rate was raised to 50% for all benefits paid to early retirees.
End the active job search dispensation for the older unemployed.	Beginning in 2009, the eligibility age for the active job search dispensation will be raised progressively until 2012, when the dispensation will be eliminated.
Extend the principles of the 1993 and 2003 reforms to all the special pension regimes, and align the civil servant schemes fully with the general system.	The reform of the special regimes announced in July 2008 will harmonise them with the civil service regime and will gradually bring them into line with the general regime; however, various advantages have been granted in return to those hired before the reform, which accentuates the dualism between workers of different status.

Strengthening incentives for better performance in the education system

The previous *Survey* addressed the question of eliminating the *carte scolaire,* the catchment-area rule that assigns pupils to a school on the basis of geographic location. It recommended that the *carte scolaire* should be retained unless public school funding could be adjusted to reflect school choices by families. Experimental easing of the *carte scolaire* for secondary schools has been underway since 2007. The underlying principle is that families are free to choose their children's schools, subject to space availability, but also on the basis of priority criteria, including social criteria (students on scholarship, the merit principle, handicapped students, distance, etc.).

A reform of primary education has begun, with the main objective of reducing failure and grade repetition. Each pupil will be given a basic set of knowledge and skills and, by rearranging the school week, time will be reserved for personalised attention to students with problems. An initial stage of the upper-secondary education reform plan for the 2009 fall term was intended to cut the repetition rate and to prepare the students for exercising greater autonomy in their pursuit of further studies.[7] This reform has been postponed to the 2010 fall term in light of the tense social climate.

Several significant reforms have been made to the organisation of higher education and academic research (see also Chapter 3). Notable among them are an increase in the universities' operating budget, increases in the number and value of scholarships granted on social criteria, renovation and expansion of university facilities, generalisation of language learning to first-year non-specialist students and career guidance and placement mechanisms. The "*réussite en licence*" plan should help many students avoid failure. The

Table 2.4. **Progress in structural reform: Education policy**

Recommendations from previous *Surveys*	Measures adopted since the June 2007 *Survey*
EDUCATION POLICY	
Introduce measures of secondary school performance based on genuine "value added", for both lower and upper secondary schools.	With regard to information mechanisms for families: enhancement of the method for calculating value-added indicators for upper secondary schools via incorporation into value added of student outcomes on lower secondary school exit exams; availability, as from 2009, of aggregated results of CE1 and CM2 student evaluations.
Unless public school funding can be adjusted to reflect parental choices, the *carte scolaire* should be retained.	Since 2007 the authorities have been undertaking an experimental easing of the scope of application of the *carte scolaire*.
Higher education institutions should be given autonomy in both financial and personnel management.	The "Universities freedom and responsibility act" of August 2007 laid the groundwork for autonomy in French universities; it was implemented for the first 20 institutions in 2009 and will be for other institutions within five years (see also Chapter 3).
Candidates for university entry should be explicitly selected, and students should be offered more effective guidance at the beginning of the last year of the *lycée.*	The move to university autonomy has not been accompanied by the freedom to select candidates for admission. On the other hand, guidance for *bac*-holders is to be enhanced through the publication of statistics on success rates in examinations, in obtaining a degree, in further studies and in finding a job. To this end, an "active guidance" scheme was generalised in 2009. Universities now send prospective students a non-binding advisory about their wishes, steering them towards the programme in which they would have the greatest chance of success.
Raise university tuition fees to reflect the cost of the various courses.	The move to university autonomy has not been accompanied by the freedom to set tuition fees. These are regulated by the State.
Introduce a nationwide system of student loans with provisions for income-contingent repayment through the income tax system.	A new student loan has been launched, offered at market interest rates with deferred repayment.
Harmonise the diploma-granting and recruitment rules of the *grandes écoles* and the universities.	An initial step to harmonise the *grandes écoles* and universities has been taken with the Boulogne process (LMD) and the establishment of the *Pôles de recherche et d'enseignement supérieur* (PRES, "research and higher education clusters") (see also Chapter 3).

goal is to ensure that, by 2012, 50% of each age cohort will earn a university degree, notably through the offer of supplementary hours of instruction or individualised monitoring for each student. The "Universities freedom and responsibility act" of August 2007 was a very important step towards autonomy in French universities, and the first 20 institutions have adopted new rules as of 1 January 2009. However, contrary to the OECD's recommendations from the previous *Survey*, this reform has not been accompanied by any explicit selection of students at entry (as is already in place at university technology institutes – IUTs) or any significant increase in tuition fees. Yet, a stride forward has been taken in an area related to the previous recommendation, *i.e.* to institute a system of student loans contingent on future income. In September 2008 a new student loan system was introduced, with market interest rates and repayment deferred. The number of loans will depend on how much the government contributes each year to a guarantee fund (70% of the principal is guaranteed by the State), and this, together with the fact that the maximum loan size of EUR 15 000 is low, may limit the impact and scope of this provision (60 000 loans are planned for 2009).

Protecting the environment and promoting sustainable development

Over the last two years, the government has sought to promote sustainable development and to combat climate change, in particular through the Grenelle Environment Round Table – a series of policy meetings held at the end of 2007 to draw up a long-term programme for the environment and for sustainable development. Parliament is now debating implementing laws emerging from those negotiations: they affect all sectors and are intended to change behaviour (a stiffer urban planning code, energy efficiency projects, audits of direct CO_2 emissions of municipalities and large enterprises, consumer information on the carbon equivalent of products and their packaging, etc.). In line with the Grenelle Environment Round Table and the "energy and climate" package adopted by the European Parliament in December 2008, France has selected two major areas for reform: increasing the energy efficiency of buildings, and reducing fuel consumption and transport. On the first point, as of January 2009 French households can take out an interest-free "green loan" to pay for insulating their homes and, more generally, for energy-saving improvements. Until January 2011, this measure can be combined with a tax credit earmarked for sustainable development and energy savings. The 2009 budget also provides for an additional benefit, beyond home ownership assistance and the interest-free loan, if the buildings concerned exceed the energy performance required under current regulations. On the second point, besides the premium for taking old vehicles to the wreckers that was part of the stimulus package for low-polluting vehicles (see Chapter 1), a system of "eco-stickers" was introduced in January 2008: it involves taxing purchases of new polluting vehicles to finance a tax credit for drivers who choose "clean" cars, and is designed to reduce carbon dioxide emissions from private vehicles to 130 g/km in 2020.

The *Economic Survey* of June 2007 also recommended changing some features of the petroleum products tax (TIPP). It is not now being used as a "green tax" but rather as a major source of revenue. There has been no meaningful progress in this field, and action is still needed to address the following problems: the tax per litre is less for diesel than for gasoline, although diesel is more polluting; there are exemptions on fuels used in selected industries and activities (agriculture, the building industry, commercial road transport); the tax on fuel oil is much lower for industrial use or power generation than for home heating, and bio-fuels and the polluting fuels used to produce it are not covered by the tax.

Table 2.5. **Progress in structural reform: Environmental policy**

Recommendations from previous *Surveys*	Measures adopted since the June 2007 *Surveys*
ENVIRONMENTAL POLICY	
Make greater use of "green taxes" (geared to the estimated costs of externalities) and other economic instruments.	Several tax incentives have been adopted to promote "clean vehicles" with low CO_2 emissions and to encourage households to invest in home insulation and energy savings (Grenelle Environment Round Table). No meaningful progress achieved in turning the Petroleum Products Tax (TIPP) into a real "green tax". Agriculture continues to enjoy various exemptions from the polluter pays principle, in particular when it comes to fuel taxes and water charges, exemptions that have no environmental justification.
Take action internationally to tax emissions from air and sea transport.	The French government is pressing for such a move within the European Union.

Notes

1. The various determinants of the employment rate in general, and of youth and older workers in particular, are discussed hereafter. However, that of women more specifically is also affected by the role of joint taxation of income and the existence, as in the French case, of a high marginal tax rate on the second wage earner (Causa, 2008).
2. The *Conseil des prud'hommes* settles individual disputes that arise between employees and employers in the course of fulfilling or terminating a labour contract. The tribunal is composed of lay judges (*conseillers prud'homaux*) elected in equal numbers by employers and employees.
3. SMIC adjustments are based on the evolution of the consumer price index (excluding tobacco), and half the growth in purchasing power of the basic hourly wage for labourers.
4. This new tax can be included in calculating the *bouclier fiscal* ("tax shield"), which caps total direct taxes at 50% of the taxpayer's income.
5. Indexation will now be based on the CPI excluding tobacco and rent, replacing the old benchmark index which combined the CPI (60% weighting), the construction cost index (20%) and the maintenance and improvements cost index (20%). As an illustration, at the end of the first quarter of 2008, rents advanced by 1.8% year–on-year compared with 2.5% with the old index.
6. Blanchet (2006) casts doubt on these findings, however.
7. Among the provisions of the reform are the experimental introduction, in 200 lycées, of measures to bolster individualised support for priority education students.

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Chapter 3

The challenge of restoring French competitiveness

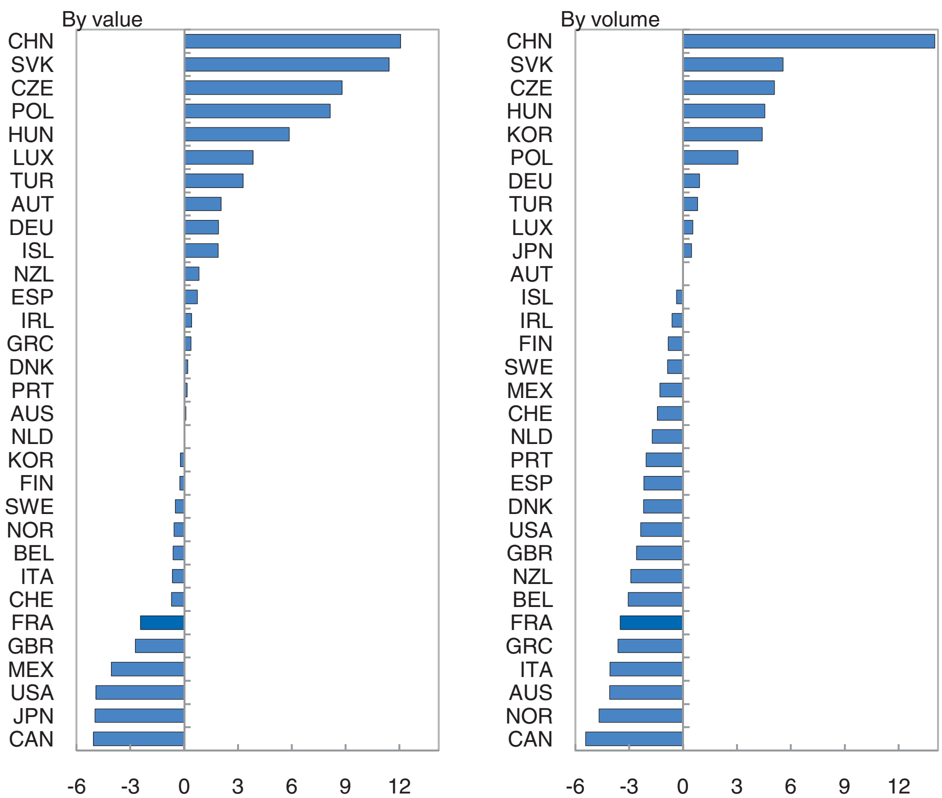
Since the beginning of the decade, France has seen a marked decline in its export performance, leading to growing concerns on the part of the authorities and of civil society about the economy's capacity to adapt to the intensified globalisation of trade and investment in goods and services. The poor foreign trade performance of recent years is related to a series of factors, rather than to any single cause. It cannot be explained by external determinants alone, such as the exchange rate, the trade inroads of emerging countries with strong export potential or the sharp rise in oil prices in 2007-08. Indeed, it is not so much the loss of market share itself that is of concern (many countries have experienced this), but rather the extent of that loss, which reflects problems in responding to the acceleration in global demand earlier this decade, before the apparition of the current crisis. An analysis of the deterioration in competitiveness points to supply-side factors such as the relative inability of French firms to service foreign markets, and the pursuit of industrial strategies of offshoring the entire production process. Restoring competitiveness will require steps to strengthen the country's growth potential and to address the main long-term determinants of that potential, such as fostering research and development, promoting innovation, reducing the tax burden, boosting competition and creating favourable conditions for businesses to grow rapidly. The lack of competitiveness is more often a symptom than the cause of one or more underlying economic weaknesses. What is called for, then, is a comprehensive policy response that addresses the sources of the competitiveness problem, rather than targeted interventions designed directly to remedy the growing trade deficit.

France's export performance has deteriorated significantly during this decade. The balance of trade in goods and services weakened rapidly, though the growing role of export-oriented emerging countries in world trade, the appreciation of the euro, and the worsening of the energy balance cannot by themselves explain this pattern (see below). The latter has been accompanied by pronounced losses of export market share. At the same time, and in an identical economic and monetary setting, other euro-area countries have also incurred losses in market shares, though to a smaller extent, while Germany has been an exception with its shares rising in value and volume terms (Figure 3.1). Yet, existing empirical evidence shows that the performance gap between France and Germany does not seem to be related to differences in geographic and sectoral specialisation.

From the macroeconomic viewpoint, the French productive apparatus seems to be having trouble serving the export markets it already has, rather than suffering from any lack of

Figure 3.1. **Market shares by value and volume in world exports of goods and services**

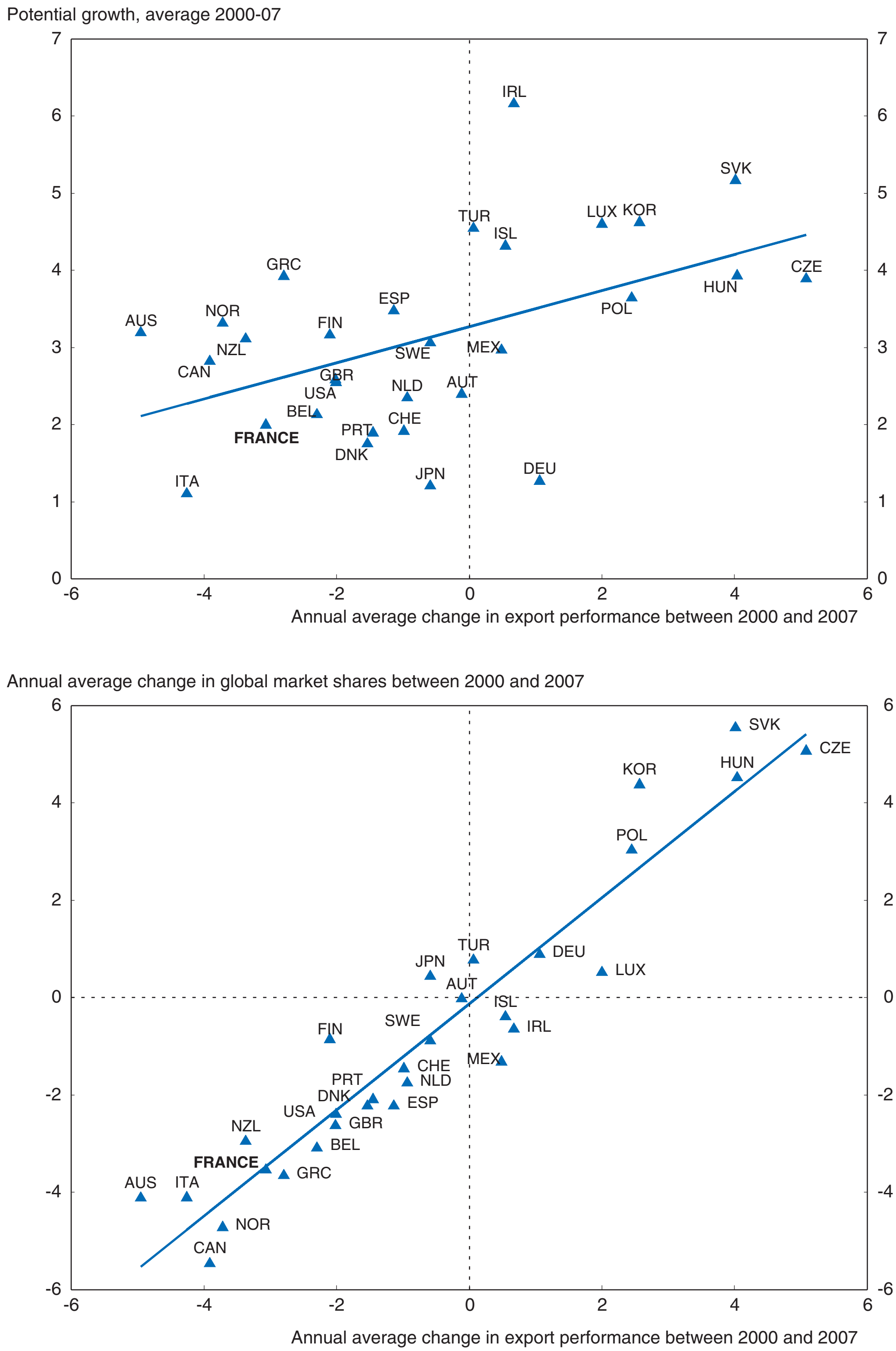
Average annual growth rate, 2000-07



Source: OECD, *Economic Outlook No. 84 database.*

StatLink http://dx.doi.org/10.1787/603613785108

Figure 3.2. **The relationship between potential growth, export performance, and market share**[1]



1. Export performance is defined here as the ratio between a country's exports of goods and services and its export market. The export market measures the worldwide demand addressed to a country and is defined as domestic exports that would be expected if its market shares by volume remained at their value for the reference year, here 2005. A country's global market share is the ratio of its exports relative to total worldwide exports.

Source: OECD, *Economic Outlook No. 84 database.*

StatLink http://dx.doi.org/10.1787/603626027557

opportunities. More generally, in the context of a relatively sustained domestic demand, French industry experienced difficulties in taking advantage of the pick-up in growth of external demand during the decade (before the emergence of the current crisis), and this would seem primarily to bespeak problems on the supply side. The origin of these supply bottlenecks can be traced back to a lack of innovation and research, to the difficulties that SMEs have in growing and achieving critical size for export, and to the deliberate decision of some French groups to offshore production plants. At the same time, in close price competition with French firms, wage moderation and the strategy pursued by German firms, which have been subcontracting a growing portion of the value chain to Eastern Europe, have brought a clear improvement in their cost competitiveness, making up in this way for the losses of competitiveness occasioned by reunification in the early 1990s, and the appreciation of the euro since 2002. On the other hand, French manufacturing firms have lost part of the cost competitiveness gains won through the competitive disinflation strategy of the 1990s, even though they retained a much better control over unit labour costs than did their Italian and Spanish counterparts. Finally, strong profitability in the construction industry, fed by rising house prices, might have diverted a portion of capital and labour resources away from export activity.

The authorities have recently introduced a variety of structural policies to encourage innovation efforts. To the extent that these policies succeed in reinforcing non-price competitiveness, enhancing profitability in the export sector and, more generally, raising the economy's potential growth rate, they will also serve to improve export performance (Figure 3.2, upper panel). Also, by creating conditions for a well oriented international specialisation, they will help to stabilise or recover the country's world market share (Figure 3.2, lower panel). A reduction in the corporate tax burden, financed notably through a rationalisation of targeted support schemes to firms, could also help in this respect. Likewise, faced with the foreign-trade problems France has encountered, the authorities have introduced a large number of tools to encourage firms to seek out international opportunities, and to support them in export markets. These policies may have had positive microeconomic effects in some cases. They are currently undergoing reform to enhance their effectiveness. Finally, microeconomic reforms such as strengthening knowledge of foreign languages or alleviating certain regulatory constraints on businesses would also contribute to the effort of restoring French competitiveness.

The scope and characterisation of the competitiveness problem

A deteriorating trade balance in goods and services

France plays a leading role in international trade. It ranks fifth in world exports of goods and fourth in global service exports, while it is sixth in world imports of goods and services. In addition, it holds third place for foreign direct investment (FDI), both inward and outward. Despite this position, and the country's strong integration into world trade flows, the trade balance in goods and services has swung from an average surplus of 2% of GDP in the second half of the 1990s to a deficit of nearly 2% of GDP in 2007. This evolution is in contrast with that of the best-performing industrialised countries. Over the same period, Germany's trade surplus rose sharply, from 1% to 7% of GDP, while other euro area countries moved from a surplus of 2% to virtual equilibrium. In 2007, among OECD countries, half recorded a surplus, though eight others had bigger deficits than France (Figure 3.3).

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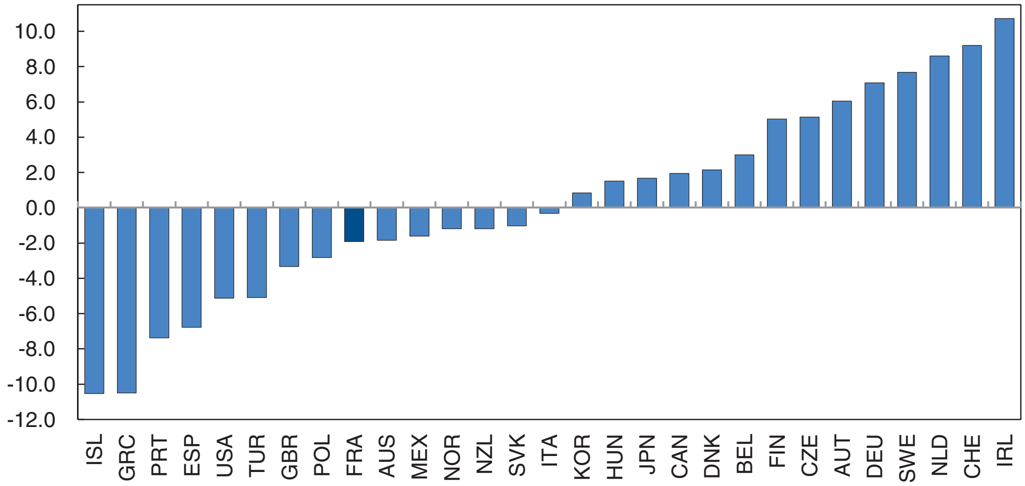
Figure 3.3. **Trade balance in international comparison in 2007**

Goods and services, FOB-FOB, in percentage of GDP



Source: OECD, *Economic Outlook No. 84 database.*

StatLink http://dx.doi.org/10.1787/603658870461

A breakdown of the structure of trade sheds additional light on the performance of French exports. Despite the traditional underpinning supplied by the tourist sector, the surplus in services has fallen by nearly half since 2002. The CIF-FOB merchandise trade balance went from a surplus of around EUR 2 billion in 2002 to a deficit of EUR 52 billion in 2007, thus reaching 2.7% of GDP. The contribution of energy products played a large part in the deterioration. While buffered by the appreciation of the single currency, the energy bill soared (as the price per barrel of Brent crude rose from EUR 27 to EUR 53 between 2002 and 2007), reaching EUR 46 billion (Figure 3.4, upper panel), and this trend has since continued with the price per barrel reaching more than EUR 60 on average in 2008, with an energy trade deficit of nearly EUR 60 billion. The merchandise trade balance excluding energy has also pursued a downward trend since 2002 and became negative in 2007. More specifically, while trade in agro-food products has remained stable over all, the balance on manufactured goods has behaved unfavourably, almost without interruption. It declined from a structural surplus in the second half of the 1990s and the early years of this decade to a deficit in 2007. That slippage was accompanied by a declining surplus in capital goods, the virtual disappearance of the automotive surplus, and a downturn in the balance of intermediate products and consumer goods (Figure 3.4, lower panel), even if the latter rebounded somewhat in 2008.

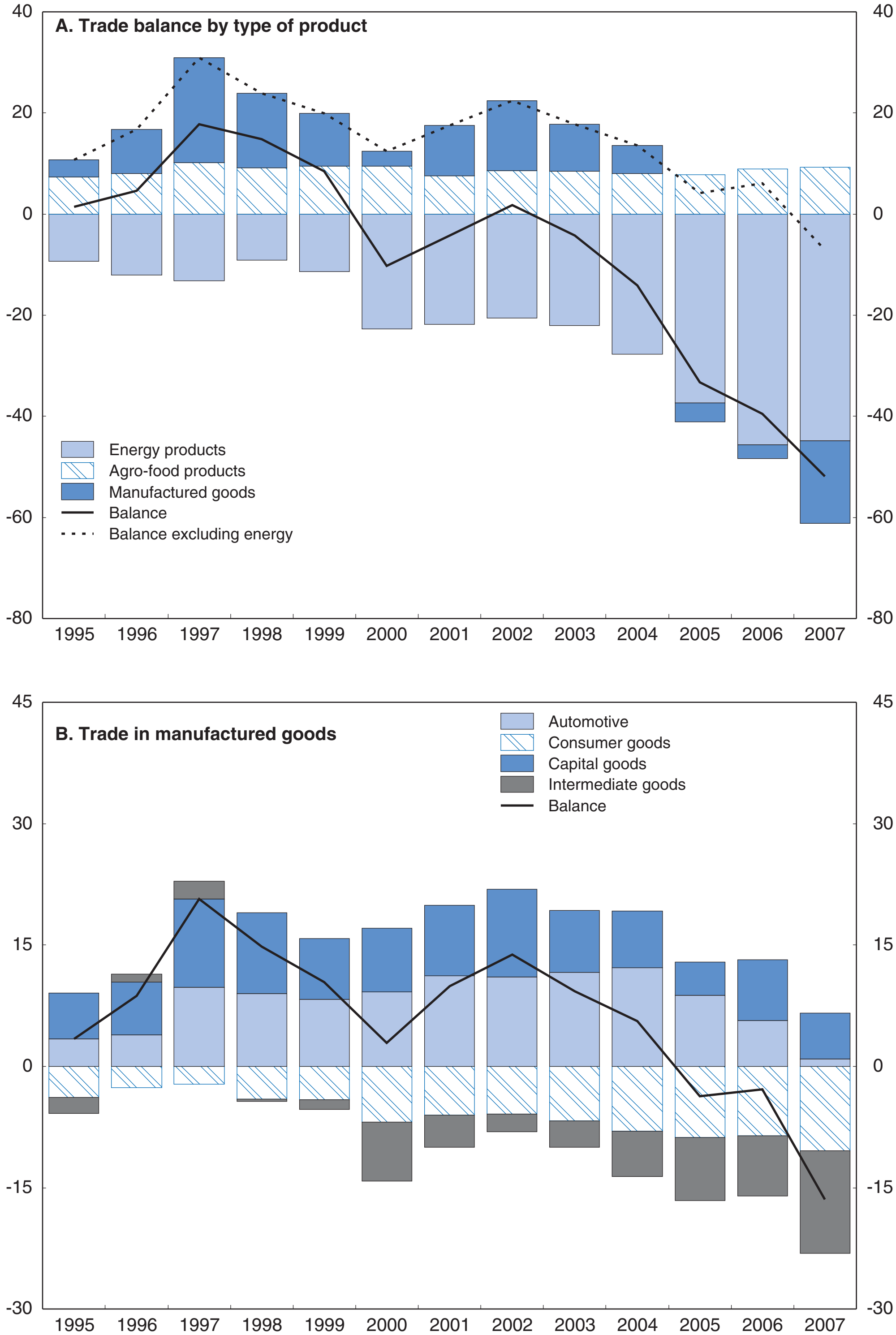
An analysis of the trade balance excluding energy shows that since 2002 its deterioration has been mainly driven by a few product categories (Usciati, 2008). These include automotive products, under the combined effect of falling exports and rising imports; consumer electronic goods, for which Asian imports rose sharply; and non-ferrous metals and organic chemicals and mining products, where rising raw material prices pushed up the price of imports.

Falling export market shares and the nature of specialisation

The pattern of export performance raises a question about French specialisation in world trade. An initial approach is to calculate revealed comparative advantages

Figure 3.4. **French merchandise trade balance**

In billions of euros, CIF-FOB



Source: Ministry of Economy, Industry and Employment.

StatLink http://dx.doi.org/10.1787/603672641848

(Coe-Rexecode, 2007).[1] Covering a long period of time, this analysis reveals a degree of inertia in French specialisation. France may be classified as a "generalist" country, more oriented towards "mid-tech" products. Five industries – the aeronautics industry, pharmaceuticals, private cars, toiletries and beverages – have demonstrated steady comparative advantage in terms of international trade performance, while energy, textiles, wood, paper, computers and consumer electronics have shown fairly consistent weakness. This relative stability of specialisation can be explained in part by the functioning of the labour market. Indeed, Cuñat and Melitz (2007) find that the emergence of comparative advantage is influenced not only by factor endowments but also by labour market regulations. Thus, the exports of countries with more flexible labour markets are biased towards more volatile sectors, where the capacity to adjust to idiosyncratic productivity and demand shocks is more important. These shocks are likely to occur more frequently in newer industries.

Despite a "generalist" export profile that offers diversification for dealing with the risk of demand fluctuations, a merchandise market share analysis shows that French export growth is lagging behind global export expansion. It is true that the appearance on the world trade scene of export-oriented emerging countries such as China has mechanically contributed to this situation, not only in France but also in the other major OECD countries. Yet the market share losses identified have not been systematic or equally distributed among countries. The French share in global exports of goods and services by value has retreated on average by around 2.5% each year (Figure 3.1). In addition, the comparison of changes in market share by volume shows that the 3.5% average annual loss of French market share since 2000 was one of the steepest of all OECD countries, with the exception of major raw-material exporters such as Canada, Australia and Norway (Figure 3.1). At the same time, the Euro-12 area (excluding France and Germany) also recorded an average annual loss, but that was more than 1 percentage point less than France's.

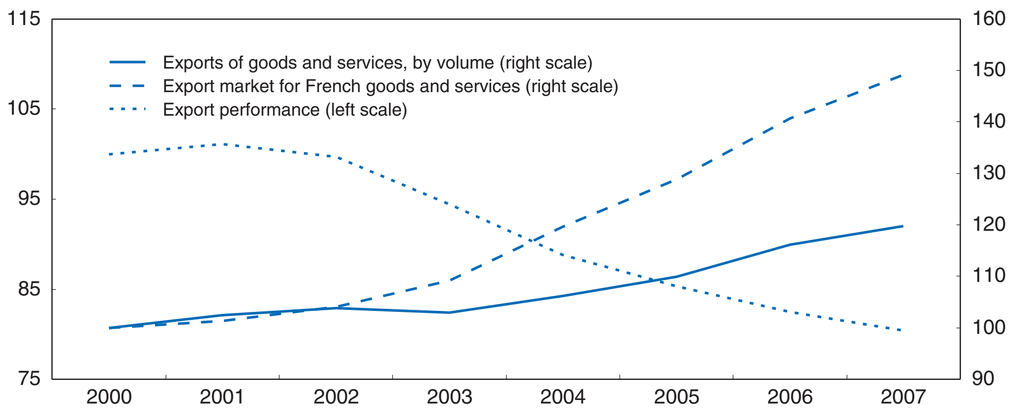
An analysis of disaggregated data for France shows virtually across-the-board losses of market share, in several dimensions. On the most important external markets, the retreat between 1995 and 2005 was most noticeable within the European Union (which represents around 65% of France's exports), followed by Africa (17% of exports), but also in China and Russia, and to a lesser extent Japan and the United States. Nevertheless, France managed to preserve its position in India and to strengthen its presence in Brazil. In sectoral terms, French manufacturers were able to maintain or increase their market shares for only 17 out of 72 products (Coe-Rexecode, 2007). A classification of exports according to their technological content (following the OECD-Eurostat classification) shows that, between 1995 and 2005, the French market share in high-tech products fell by around a third in absolute terms, *versus* 15% for the EU-15 and slightly more than 10% for the EU-25 (Cheptea *et al.*, 2008). Compared to the largest OECD countries, the French loss was less pronounced than Japan's (more than half), comparable to that of Italy and the United Kingdom, but higher than those of the United States (more than a quarter) and Germany (virtually stable). In terms of positioning by market segment, the French losses seem to have been more modest in low-end goods, but more significant in high-end goods, in particular on the European market (Fontagné and Gaulier, 2008). Between 1995 and 2004, among the leading industrialised countries, only Germany saw its market shares progress in high – end goods (Cheptea *et al.*, 2008).

The gap in export performance between leading OECD countries and Germany is significant. However, the sectoral structure and geographic orientation of trade, at various levels of disaggregation, do not reveal any major differences between France and Germany in terms of specialisation (Boulhol and Maillard, 2006; Fontagné and Gaulier, 2008). More precisely, using the methodology of Cheptea *et al.* (2005), the change in market shares can be broken down econometrically into three contributions: a geographic structure effect, a sectoral structure effect and a pure performance effect. The results show that, while Germany may have been more oriented toward more dynamic geographic zones, France has also positioned itself in good markets. Moreover, the French sectoral structure actually appears to be very slightly better than that of Germany, being more in phase with the products for which there is growing world demand. Yet these structural differences are of secondary importance in comparison to the pure performance effect, which indicates a country's capacity to gain (or lose) export market share. That effect may be attributable in part to an economy's ability to adapt its sectoral and geographic specialisation and, in a residual manner, to the effects of price and non-price competitiveness. Thus, the pure performance effect would explain most of the discrepancy in the two countries' export outcomes.

Overall, the generalised losses of export market share would result not from an inopportune international specialisation but from a relative inability to satisfy foreign demand. French industry has not been able to respond fully to the accelerating worldwide demand for its products (*i.e.* its export market) since 2003 (Figure 3.5).[2] In fact, that export market was growing at around 7.5% annually until 2007, *versus* only 3% for actual exports. The existence of a supply constraint in the context of a relatively sustained domestic demand can explain the difficulty of serving overseas markets in the French case (Cochard, 2008). This has not been the case with all other OECD countries (Figure 3.2, lower panel). Some have lost global market share, even if they were able to satisfy demand in their own export markets (Mexico, Iceland), suggesting that those countries are specialised in relatively unpromising niches. Others have also had troubles with their export performance since 2000, but have been able to increase their global market share (Japan) or at least to slow down its decline (Finland). In still other cases (Canada, Norway), global market shares have fallen more sharply than expected, perhaps because of a "Dutch disease" problem.[3]

Figure 3.5. **France's export performance**

2000 = 100



Source: OECD, *Economic Outlook No. 84 database.*

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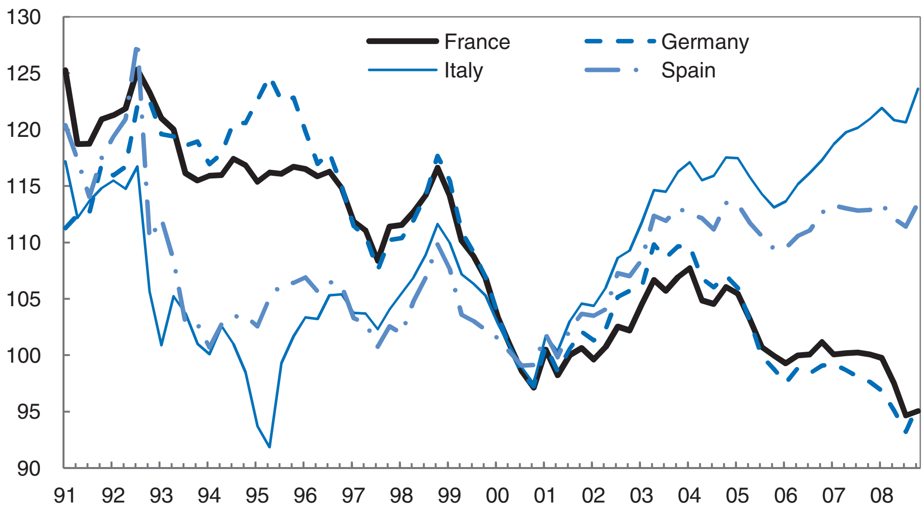
Analysis of price and cost competitiveness indicators

The analysis of price and cost competitiveness indicators usually makes it possible to better work out a diagnosis of export performance. France has very good price competitiveness, similar to that of Germany and significantly better than the positions held by Italy and Spain (Figure 3.6). However, when introduced into an export equation, this variable cannot explain the decline in export market shares in the current decade (Villetelle and Nivat, 2006; Cochard, 2008). Several explanations have been suggested for interpreting the loss of explanatory power of the price competitiveness indicator (Fontagné and Gaullier, 2008). *First*, it gives a very imperfect reflection of *ex ante* performance, to the extent that there is a selection effect prior to export. In fact, this variable captures only the prices of "surviving" exporters, *i.e.* those who are more efficient or who face less competition in their markets. *Second*, French exporters, who are obliged to "price to market", are constrained in their ability to reflect changes in costs or exchange rates in their prices, making the adjustment rather through lower margins.

Figure 3.6. **Price competitiveness: export prices relative to all competitors**

2000 = 100



Source: OECD, *Economic Outlook No. 84 database.*

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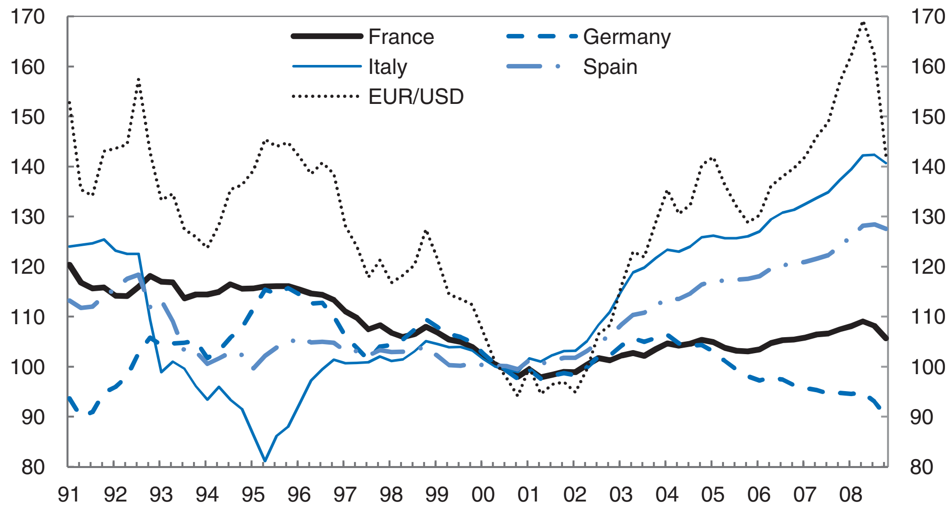
Because their sectoral specialisation and the geographic orientation of trade are so similar, France and Germany would be in direct competition not only in their own domestic markets but also on export markets. In 2005, Germany was France's prime competitor on the market for goods, followed by the United States, Italy, the United Kingdom and Spain, with China appearing only in ninth position (IMF, 2008a). In 2004, competitive pressure was less severe in the case of services, with Germany ranking fourth among the main competitors. Overall, these elements help to explain why the two countries pursue noticeably comparable export pricing policies, as evidenced by the great similarity of their respective price competitiveness indicators.

Given the limitations of the price competitiveness indicator, it is useful to examine cost competitiveness factors as potentially better determinants of export performance. On this score, Germany has improved its position significantly since 2004, while some erosion has happened in France, but to a much smaller extent than in the case of Italy and Spain (Figure 3.7).[4] This boost to German competitiveness was made possible by very significant cuts in unit labour costs, under the combined effect of wage moderation and the development of a "bazaar economy", aimed at breaking up the value chain so that activities that make more use of unskilled labour could be subcontracted to Eastern European countries (see Box 3.1). Such an offshore outsourcing strategy has also improved firms' margins through a lower cost of intermediate inputs. Indeed, in the context of an appreciation of the exchange rate, although export margins have remained stable in the German case, French exporters have had to trim their margins significantly in order to offset the upward pressure from their relative unit labour costs and simultaneously maintain their price competitiveness. This may have dampened investment spending in general, and on R&D in particular, in the export sector, thus leading to tighter supply-side constraints and an insufficient non-price competitiveness. In particular, the investment rate of the manufacturing industry declined in the first half of the decade and this for various sizes of firms (Conseil économique et social, 2008a).

Figure 3.7. **Cost competitiveness: unit labour costs relative to all competitors**

Manufacturing, 2000 = 100



Source: OECD, *Economic OutlookNo. 84 database.*

StatLink http://dx.doi.org/10.1787/603826083530

From an economic viewpoint, the effects of offshore outsourcing are equivalent to a positive supply shock. Consequently, they do not necessarily lead to a reduced growth and employment over the long term (see Box 3.1). Moreover, manufacturing employment in France could, ultimately, be penalised by inadequate outsourcing of industrial inputs, insofar as the factories that remain in France do not benefit from this positive shock (Fontagné and Gaulier, 2008). The percentage of intermediate inputs imported from emerging or transition countries was only around 8% for France in 2006 (Erkel-Rousse and Sylvander, 2008). The figure was twice as high for Germany, although the two countries were in a comparable situation in the early 1990s. In the 1980s, French offshore outsourcing was largely to Spain (and primarily in the automotive industry), but the relative cost advantage of Spanish labour has since been much reduced. Consequently, French firms could potentially improve their competitive position by making greater use of

Box 3.1. **The "bazaar economy"**

It was partly by internationalising its productive system that Germany was able to improve its cost competitiveness and to boost its exports so strongly. More precisely, according to the "bazaar economy" theory developed by Sinn (2006), it is the growing reliance on offshore outsourcing that underlies this improvement. In pursuit of that strategy, German industry has specialised increasingly in downstream activities that make intensive use of physical and human capital, and that stand at the end of the value-added chain (assembly, finishing, packaging, marketing and consulting services). On the other hand, the initial, upstream activities of the production cycle, which make greater use of unskilled labour, are outsourced to low-wage countries (Central and Eastern Europe in the automobile industry, Asia for computer components). They are then re-imported as intermediate goods. The result is less value added in production and a higher import content in exports, but also an improvement of margins of German firms. The Porsche Cayenne car illustrates this phenomenon: while it bears the "Made in Germany" label, many of its parts are manufactured in Eastern Europe, to the point where only one-third of the car's value is actually produced in Germany.

According to Sinn (2006), German entrepreneurs adopted this strategy in response to growing competition from low-wage countries, in a setting where domestic wages were too high and inflexible. Offshore outsourcing led to the loss of unskilled jobs in domestic manufacturing and, because labour was not reallocated to other sectors, unemployment rose steadily. In the end, domestic demand was depressed by the stripping of domestically produced intermediate content from exports, and hence a loss of jobs, compounded by a domestic "investment strike". Domestic demand has in fact grown much more slowly in Germany than in the rest of the euro area since 2000. More generally, the German economy's growth potential over that time has lagged behind its export performance (Figure 3.2).

This theory has sparked intense debate over its validity, although a number of elements tend to corroborate it.* Yet the issue calls for several remarks. *First*, the domestic employment impact of offshore outsourcing needs to be viewed in perspective. While capital intensity has certainly increased significantly since 1991, most of the job-shedding in manufacturing took place in the first half of the 1990s, followed by smaller cuts since 2003 (Coe-Rexecode, 2007). Moreover, offshore outsourcing does not necessarily mean job losses (European economic advisory group, 2008). In fact, the outsourcing of certain tasks allows firms to deepen the division of labour. A stronger specialisation increases labour productivity in manufacturing industry for the less labour-intensive activities maintained in Germany. The resulting cost savings imply, in turn, favourable economies of scale effects, boosting demand for local labour to perform operations that are less readily outsourceable. Consequently, offshore outsourcing should affect the demand for labour in the same way as labour-augmenting technological progress. Finally, the number of domestic jobs directly dependent on exports was estimated at slightly more than 8 million in 2007, or one job in five (Schneider, 2007). In addition, even if the "bazaar economy" generates a fall in the share of value-added in production, the total value-added (in absolute terms) should rise with the increase in the number of units produced, if part of the falling manufacturing costs is reflected in prices. *Second*, the linkage between offshore outsourcing, exports and domestic demand would depend on the time horizon used. Erkel Rousse and Sylvander (2007) and Blot and Cochard (2008) argue that it is the sluggishness of domestic markets that would have driven German entrepreneurs to seek new external outlets. In a more in-depth study, however, Erkel Rousse and Sylvander (2008) show that this is only a short-term effect, as in the medium term the effect would be indirect, so that offshore outsourcing would explain the relative sluggishness of German domestic demand. Finally, in the long term, growth in the economy would be unchanged or even slightly higher than in the absence of offshore outsourcing.

* See Boulhol (2006), Gaulier (2008) and Erkel Rousse and Sylvander (2008) for a review of the literature.

this strategy. However, the distance from foreign markets has an impact on the competitive position of firms (Boulhol and de Serres, 2008) and, in comparison with Germany, France has a less advantageous geographical location *vis-à-vis* Eastern European countries. More generally, offshore outsourcing is subject to certain constraints. It is difficult to extend it beyond a certain limit, at which point the unity and continuity of the production system would be jeopardised (through problems of quality control, sensitivity to late delivery of supplies, etc.). Other constraining factors include exposure to exchange-rate risk and rising transport costs in the wake of higher fuel prices (Gaulier, 2008).

In contrast to Germany, France has opted for a strategy of offshoring the entire production process. In 2006, the two French carmakers for the first time produced more vehicles abroad than in France (Fresson-Martinez, 2007). This policy was intended not only to serve growing foreign markets more readily, but also to supply the domestic market, while benefiting from reduced production costs. Between 2004 and 2007, automobile imports from countries where the main French carmakers have set up shop (Central and Eastern Europe, Turkey and Spain) accounted for around 60% of the average growth of total vehicle imports to France (Usciati, 2008). Hence, it is likely that when the trade balance is "corrected" using the methodology proposed by Schaff *et al.* (2008), where the criterion is the ownership rather than the location of firms, the trade deficit would have been lower. Viewed from that angle, market share losses may have been smaller than the geographic definition of trade would suggest.[5] If this is the case, it would indicate that firms are suffering not so much from poor performance *per se* as from the poor competitiveness of the French territory where they have to operate. However, carmakers have also lost domestic and foreign market shares due to the competition of major industrialised countries (Italy, the United Kingdom, and especially Germany). These difficulties suggest supply-side problems relating to the production of models that are at the end of their life cycle or that are not in tune with demand (Bauer, 2008). If this is the case, it raises the question of non-price competitiveness and, more generally, the role of innovation policies in strengthening French industry's product range.

Streamlining export support policies

In the face of a deteriorating French trade balance, the authorities have introduced various export support policies. The number of available products and services has in fact expanded as firms' perceived needs have grown, and efforts have been made to improve co-ordination among the various export promotion institutions. Yet, despite the progress made, the tools and mechanisms now in place for supporting foreign trade could usefully be streamlined further. The result could be significant gains in terms of efficiency, transparency and budgetary savings.

The support available to firms seeking to "go international" presents a very complicated picture, with a profusion of agencies and "one-stop shops", and inadequate co-ordination among different networks (Comité national des conseillers du commerce extérieur de la France, 2007; Cousin, 2007). Prior to the 2008 reforms, this was also the case with the official government assistance system, which comprised several entities. *First*, there were 145 economic missions in 113 countries, covering a total of 155 countries, making it one of the densest networks in the world. Those missions, run by the Ministry of economy, finance and industry, were tasked with gathering intelligence on the whole range of international economic, trade and financial questions and sending it back to the Ministry, local government bodies and businesses. Yet the central government was in fact the primary recipient of this information, and much less went directly to businesses. *Second*, the regional foreign trade offices (*Directions régionales du commerce extérieur*, DRCE) served as the relay points throughout the country for the delivery of official export assistance. Their job was to prospect for new exporters, to manage export assistance and to co-ordinate local initiatives in the area of foreign trade. Yet they were chronically under-endowed with resources. For example, in 2005 the DRCE for Ile-de-France employed only 16 people (including five receptionists) for a region that accounts for nearly 20% of French exports and is home to 680 000 firms. *Third*, the year 2004 saw the creation of Ubifrance, the French agency for international business development, which was supposed to provide information and coaching to French firms in foreign markets. That agency, however, lacked a permanent presence in the regions of France and also abroad, making it difficult to establish linkages between France-based firms and export markets.

Apart from the government networks listed above, there are a great number of other players in export assistance, comprising the regions and certain local governments, business organisations (such as MEDEF International), the Chambers of commerce and industry (*Chambres de commerce et d'industrie*, CCI), the French chambers of commerce abroad (*Chambres de commerce françaises à l'étranger*, CCI FE), of which there are 114 in 75 countries, the foreign trade counsellors (*Conseillers du commerce extérieur de la France*, CCEF) – they number some 3 800 volunteers, but their dedication is secondary to their professional occupation – as well as specialised agencies such as SOPEXA in agro-food and COFACE, a private company that manages official export insurance backed up by a government guarantee (see Box 3.2). This great variety of services leads occasionally to competition among the players in ways that are potentially counterproductive and suboptimal for attaining in terms of the objectives. The multiplicity of networks is such that in major Chinese cities such as Beijing or Shanghai there may be almost a dozen French agencies jostling each other (Cousin, 2007). Indeed, a recent survey of CCEF counsellors showed that one of their primary concerns was to ensure better co-ordination and co-operation among the various agencies that support exporters (Comité national des conseillers du commerce extérieur de la France, 2008).

In light of this finding, reforms have been launched to make the current arrangements more transparent and useful. Launched in February 2008, one reform made Ubifrance the centrepiece of a government mechanism to support international business development. *First*, a framework convention for partnership between Ubifrance and consular networks (chambers of commerce and industry) in France and abroad established a new organisation and a redistribution of tasks.[6] This framework document will be supplemented gradually as Ubifrance signs agreements with its other partners. *Second*, it was decided to strengthen the role of Ubifrance by having it gradually take over the running of economic missions providing services to companies in the 44 leading countries for business development assistance. In addition, agencies are now being encouraged to negotiate co-operation agreements and local country-specific conventions and to work together abroad as part of a "Programme France", as well as to establish a catalogue of common products and services. Yet the authorities should consider reinforcing these streamlining efforts, with special attention to consolidating the "one-stop shop" approach centred on Ubifrance. Such a move would make it even easier for exporters to access information and would help reduce their compliance costs. This would seem especially useful, given the official objective of turning 10 000 new firms into steady exporters over the next five years. At the same time, such a reform would make it easier to track the assistance provided and to make public spending more effective.

There are various types of assistance available for entering new markets, and most of them have been bundled together under the "*Cap Export*" programme that was introduced in 2005 and reformulated in 2008 (see Box 3.2). In principle, COFACE provides guarantees against commercial and political risks that cannot be insured by the market. It charges premiums for these guarantees and should operate on a long-term break-even basis by pooling risks. This is the case, for example, with export credit insurance. Exchange-rate risk insurance also respects the rule of long-term break-even financial management. Even if 80% of the underlying risk in outstanding contracts relates to the euro/dollar exchange rate, and nearly 95% to parities *vi-à-vis* the world's major currencies, it is justified that the authorities propose the same type of guarantee as the market. However, it is necessary to make sure that the terms and conditions are not more favourable than those potentially available in the market. One principle that should be maintained, for example, is that while an exporter can in some cases keep from 50 to 70% of any rise in a currency during the period of commercial negotiation, that benefit should be offset by an increase in the premium reflecting the total cost of the particular financial instruments to be put in place.

After surveying the literature, Wagner (2007) and Greenaway and Kneller (2007) conclude that selling abroad would be limited primarily to the most productive firms, which self-select according to profit expectations after paying the fixed costs inherent in exports. "*Assurance prospection*" (canvassing or scouting insurance) is not really a guarantee as such, but rather financial support in the form of an advance aimed at compensating such costs for SMEs, which are relatively steeper than for large groups (which may explain why exporting increases with firm size). Indeed, it gives businesses cash facilities. In order for this measure not to appear weak in light of international competition laws, it ought to be managed on a long-term break-even basis and thus not entail any net subsidisation. Indeed, while such assistance is repayable, depending on sales revenue, the indemnities a firm receives may be kept if sales are insufficient. For this reason, it could theoretically generate sporadic exports in order to benefit from such support, or lead to "last-chance exports" designed to stave off bankruptcy rather than to durably conquer new markets. Nevertheless, and in contrast to an approach based on particular, one-off assistance, this mechanism is part of a comprehensive export-support policy.

Other measures are designed to bolster export-oriented employment, especially for young people. This is the main feature of the International Business Volunteers (VIE) programme, which helps overcome cultural and linguistic barriers (key considerations when it comes to exporting) and which should therefore be pursued and enhanced (see below). On the other hand, the export tax credit does not seem to be used very much for market prospecting expenses: according to a recent survey, slightly less than 70% of CCEF counsellors make no use of it, and around 15% of others are dissatisfied with it (Comité national des conseillers du commerce extérieur de la France, 2008). The authorities could consider eliminating this tax credit. In addition, the fact that the tax credit for market prospecting expenses was extended to the European Economic Area in 2006[7] raises the more general question of whether assistance for exports to nearby markets is appropriate. Crozet *et al.* (2008) show that, in contrast to long-distance exporting, exports to EU-15 markets generate almost no productivity gains in comparison with serving only the French market. On the other hand, exporting to nearby markets can be important because of a learning effect, especially for first-time exporters

Box 3.2. **Main forms of support for business internationalisation**

The main forms of support for business internationalisation have several components. Some are delivered directly by the government or the French agency for international business development (Ubifrance), while export insurance products are managed by COFACE, a private company, on the government's behalf. In the former category are the following tools:

- The labelling procedure for group initiatives (French pavilions at fairs and trade shows, presentations of products and know-how, encounters with buyers and partners and commercial promotions) organised by a third party with government financial backing was launched in 2003. The procedure was bolstered in 2005 and 2008 as part of the *Cap Export* plan. Labelling consolidates the adherence of export partners (professional organisations, private operators, chambers of commerce and industry etc.) to government priorities, focusing their efforts on countries with high export potential.
- International Business Volunteers (*Volontariat international en entreprise*, VIE): this programme recruits young professionals between the ages of 18 and 28 for a stint of 6 to 24 months abroad, in return for a basic allowance free of all social contributions. Since January 2006, this allowance has been an eligible expense for the tax credit for market prospecting expenses. The number of international volunteers has risen sharply, from 2 600 at year-end 2004 to 6 300 at the end of 2008. The goal is to reach 10 000 VIEs in 2011.
- The tax credit for market prospecting expenses (*crédit d'impôt pour dépenses de prospection commerciale*) equals 50% of eligible expenses and is available to SMEs (up to EUR 40 000) or consortia of SMEs (EUR 80 000) that hire a person assigned to export development or that make use of a VIE (triggering event). The tax credit may be used during the 24 months following recruitment. Six categories of market prospecting expenses to promote exports of services, goods and merchandise are now eligible. The tax credit is non-recurrent, *i.e.* a firm may claim it only once. Since January 2006, it has been expanded to include market prospecting within the European Economic Area.
- The Individualised Support to Exporting (*Soutien Individualisé à la Démarche Export*, SIDEX) provides tailored support for export efforts and is targeted at French SMEs and very small enterprises. It covers travel and accommodation expenses, foreign market prospecting costs, etc., up to a ceiling of EUR 7 500.

At the government's request, COFACE offers a range of guarantees designed in principle to cover exporters against various types of risk:

- The primary guarantee, in terms of amounts covered, is credit insurance. Here, exporters are insured against the risks of contractual default or non-payment as a result of political or catastrophic events, government acts or decisions, transfer problems, debtor insolvency or arbitrary cancellation of contract. The guarantee applies irrespective of the nature of the buyer (public or private). The premium is set as a function of the risks covered. In 2007, the volume of cover was EUR 15 billion, but, in accordance with the OECD Arrangement rules, the procedure is managed on a long-term break-even basis.
- Canvassing or scouting insurance (*assurance prospection*): the purpose is to support market prospecting efforts, in one or more countries, by SMEs with annual sales of below EUR 150 million. It offers firms significant cash facilities, amounting to 65% (80% for firms meeting the criteria for innovative firms or firms with proven export success with this vehicle) of the difference between scouting costs incurred and a percentage of the resulting revenues (7% for goods, 14% for services, 30% for licenses, royalties and other rights). In return, the firm pays an annual premium of 3% of the prospecting budget under guaranty. The premium is raised to 5% in the case of advance payouts for innovative firms or those whose annual sales total EUR 1.5 million or less. Moreover, the export risk is limited to the amount of the premiums actually paid since, when the contract expires (after the guarantee period and the amortisation period, *i.e.* generally seven years), if revenues do not fully cover the compensation received, the firm may keep all or a portion of it. The budgetary cost of this measure was EUR 31 million in 2008. Banks are authorised to distribute the subsidy under certain conditions.

Box 3.2. **Main forms of support for business internationalisation** *(cont.)*

- Exchange rate insurance: in return for a premium, this insurance covers the exchange rate risk that exporters face when responding to international calls for tender, spanning the time between submission of a bid and signature of the potential contract, as well as the payment period. In addition, firms can keep 50% to 70% of a currency's increase during the commercial negotiation stage in the case of a "profit-sharing" guarantee (*avec intéressement*). At the end of 2007, total cover stood at EUR 2.1 billion, with the US dollar accounting for the predominant portion (80%), followed by the Swiss franc (6.5%), the yen (3.5%), the pound sterling (2.5%), and the Canadian dollar (2%). This procedure follows a long-term financial break-even rule through risk pooling and coverage arranged in the market. In 2006 and 2007, the outcome was positive in the amount of EUR 1.5 million.
- Surety and preliminary financing insurance: this covers all forms of conventional surety required by the foreign buyer (return of down payments, for example) as well as preliminary financing needed to fulfil export contracts (purchase of machinery and parts, hiring, etc.). It also offers cover for the bank, up to 85%, against the risk of non-recovery of all or a portion of its claim on an exporter that finds itself in a situation of financial default.
- Foreign investment insurance: this guarantees investments against political risks involving expropriation and non-recovery of property. The programme produced a surplus in 2006 and 2007, but the volume of guarantees outstanding has declined over the last four years. Reforms over the course of 2008 have expanded the guarantee base by eliminating the EUR 15 million floor for projects, extending the maximum term of the guarantee and allowing for restatement of the investment's value.
- The FASEP guarantee fund supports firms with annual sales not exceeding EUR 460 million in their efforts to establish themselves and grow internationally. This procedure, which is very limited in terms of the number of contracts and amounts outstanding, covers the risk of failure of foreign subsidiaries in all countries outside the European Economic Area and Switzerland. In 2005, the guarantee fund's geographic zone was extended, and the procedure was made more accessible to SMEs.

(Bouyoux, 2008). The combination of these two arguments suggests that, while exporting to neighbouring markets may be useful, official assistance for such exports should be time-bound. Otherwise, there is a risk of undermining the incentives needed to tackle dynamic markets that are geographically distant. Overall, while export support tools have been in constant flux for several years, the authorities would do well to reconsider them further: first, with a view to simplifying and clarifying them, as recommended by nearly 60% of CCEF counsellors (Comité national des conseillers du commerce extérieur de la France, 2008), and secondly with a view to rationalising them in economic terms while avoiding net subsidisation.

Increase incentives to promote innovation

According to an "image" survey conducted by Coe-Rexecode, French goods provide good value for money (Coe-Rexecode, 2006, 2007 and 2008). On the other hand, the non-price aspect such as the technological innovation content of both consumer and capital goods lags behind that of German, Italian and Japanese products. Moreover, the evolution of this criterion over time suggests that competitiveness has declined. This weakness may reflect a framework and conditions that are not propitious for promoting the rapid development of innovation, even though the erosion of export margins may have dampened R&D efforts over the last years. In this context, the strong productivity gains achieved by French industry were more defensive (obtained by closing the least profitable activities and laying off the least

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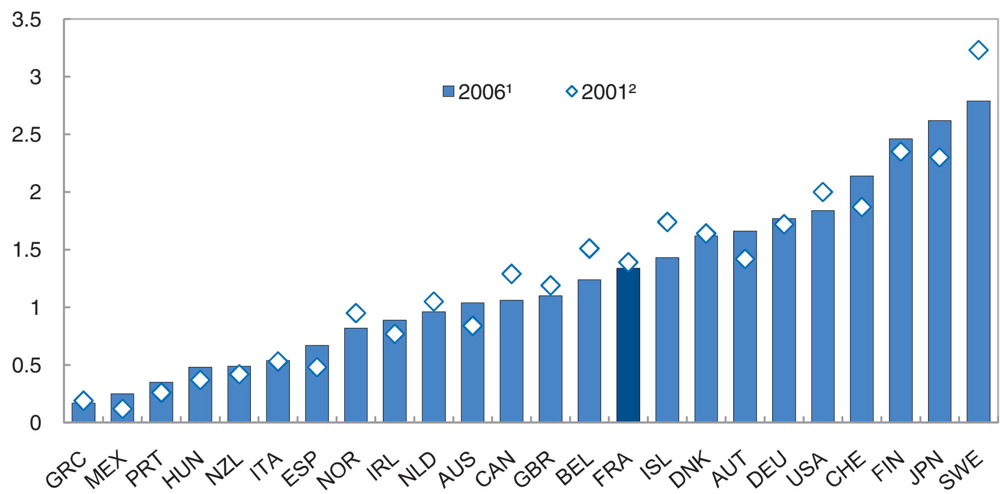
productive employees) than offensive, *i.e.* generated by a wave of technological innovation (Saint-Etienne, 2008). Yet, recent empirical studies show that the innovation deficit, as measured by a relatively low level of R&D expenditure as a percentage of GDP, has been a drag on the country's foreign trade performance (Cochard, 2008). In 2006, with a ratio of 2.1% of GDP, France's R&D intensity was higher than that of the 27-country European Union (1.8%), but lower than in the best-performing OECD countries.

Industrial innovation in France is marked by structural weaknesses, as revealed by several indicators (Conseil économique et social, 2008b). Not only are there too few innovative SMEs, there is little private R&D performed in comparison with leading countries in Scandinavia, Japan, the United States and Germany (Figure 3.8), even if the number of patents taken out by SMEs has risen by 9.3% over the past six years. Another characteristic feature is weak private-sector involvement in public research. Government R&D contracts are concentrated in a small number of sectors, and there is little mobility or interaction between researchers in the public and private sectors. As a result, research is not very productive (for instance when measured by the number of scientific articles published in relation to the amounts invested) in comparison with the other major OECD countries (Observatoire des sciences et des techniques, 2008), and the overall framework for promoting research is too fragmented. Even if the ranking produced by Shanghai's Jiao Tong University is imperfect, it reveals nevertheless a deficient position held by French universities. To a large extent, this reflects a dispersion of higher education and research institutions, but also the low productivity of research. A number of policies have been introduced or further developed in recent years to deal with these insufficiencies. In line with the Lisbon strategy, these include the promotion of "competitiveness clusters", changes to the research tax credit, and a general reform of universities, and of university research in particular.

Figure 3.8. **Private investment in R&D**

Percentage of GDP



1. 2005 for Australia, Iceland, Mexico and New Zealand; 2004 for Switzerland.
2. 2002 for Austria and 2000 for Switzerland.

Source: OECD, *Science, Technology and Industry Outlook 2008.*

StatLink http://dx.doi.org/10.1787/603844634334

Reinforcing the effectiveness of the "competitiveness clusters" policy

In 2004, the authorities launched an ambitious programme of "competitiveness clusters" (*pôles de compétitivité*), which aims at promoting clusters. The general objective is to enhance the competitiveness of the French productive apparatus by encouraging greater innovation, spurring regional development within the country, and constituting a critical mass to face international competition and to win new export markets. On this last point, empirical studies confirm that geographical proximity among different exporters tends to increase the likelihood that a firm will be able to sell abroad (Koenig *et al.*, 2008). More specifically, a competitiveness cluster brings together in a single place firms, research centres and training and education facilities belonging to the same sector of activity. The goal of this "triple-thrust" approach is to foster collaboration among these different players through the joint pursuit of innovative projects. The designated clusters involve a variety of fields and include emerging high-tech sectors (nanotechnology, biotechnology), more mature sectors (automobiles, aeronautics, rail, textiles) as well as low-tech ones (meat processing, construction). They are divided into three categories: there are seven "global competitiveness" clusters (among world leaders in their industries); ten clusters with global ambitions (having the potential to become leaders but lacking sufficient size); and fifty-four domestically oriented clusters (that have no immediate prospects of an international profile, but are striving to develop exports and produce positive fallout for the economy of their regions).

Significant funding is being allocated to develop these competitiveness clusters: EUR 1.5 billion for the period 2006-08, and a similar envelope for the period 2009-11. The primary focus is on financing applied and innovative research projects to develop products or services that can be brought to market in the short or medium term. Subsidies are provided both by the central authorities (through a single inter-ministerial fund) and also by specialised government agencies (*Agence nationale de la recherche* – National research agency; *l'Agence de l'innovation industrielle* – Industrial innovation agency; and OSEO, which supports innovation and growth for SMEs), as well as the *Caisse des dépôts et consignations* (the national savings administrator). Participating firms are also eligible for tax exemptions on research positions, and they can obtain additional financing from local governments.

The success of this competitiveness clusters policy is conditional on several factors (OECD, 2008a). The efforts must be more concentrated. When the programme was launched, the plan was to designate 15 clusters only, but the desire to spread the benefits won out over the intention to focus on a few large clusters, with the result that 67 were selected in 2005, and their number now stands at 71. In other words, instead of targeting the system exclusively on technological innovation in leading-edge industries, the clusters policy also contains a territorial development component. The risk of spreading funds too thinly is limited, however, in view of the evaluation carried out in May 2008, insofar as global or potentially global clusters are using roughly four-fifths of the funding, and some 55% of projects undertaken since the mechanism was launched are concentrated in 10 of the 71 clusters (Boston consulting group, 2008). This portends a certain tension, however, between the search for efficiency through concentration of resources on the one hand and the desire to promote regional development by expanding the number of clusters on the other.

It is also advisable to get SMEs closely involved and to take account of their R&D requirements, notably in high-tech clusters. The presence of large firms can discourage

SMEs from submitting their own, more modest proposals. At first glance, the proportion of SMEs in the clusters, at 85%, is high. However, the clusters are still organised primarily around large firms. In fact, nearly half of all establishments are subsidiaries of conglomerates, and it is the large firms that do most of the R&D. On this basis, it might be that the competitiveness clusters have assembled essentially those firms that have the least need for R&D support (Conseil économique et social, 2008b). This fear needs to be qualified, however, since 60% of projects already involve independent SMEs. Above all, the primary objective of the clusters policy is in fact to develop partnerships and synergy between all parties to innovation. The authorities need to conduct in-depth evaluation and monitoring to prevent the system from being turned into direct support for corporate R&D (for which the research tax credit is already in place). Moreover, while the subsidies benefit firms of all sizes when they collaborate with one or more research laboratories, international experience shows that it is important that independent SMEs benefit from a broader dissemination of information regarding possible opportunities, and that they be well represented in governance structures (OECD, 2007f). Nevertheless, more than one out of ten SMEs that have taken out patents at the national level have been integrated into a competitiveness cluster (Abitbol *et al.,* 2009).

Public research institutions should do more to publicise the results of their work and the techniques they have developed, through effective communication and dissemination policies. Creation of the "Institut Carnot" label, which has been awarded to 33 public institutes working with the private sector, is a step in the right direction.[8] In addition, 13 Advanced thematic research networks (*Réseaux Thématiques de Recherche Avancée*, RTRA) have been created with State financial assistance, embracing research centres in a given geographic area, so as to produce a critical mass of high-level researchers with a common scientific objective, and this has led in some cases to work on themes that intersect with those of the competitiveness clusters. Finally, the establishment of ten clusters for research and higher education (*Pôles de Recherche et d'Enseignement Supérieur*, PRES), combining universities and research establishments and, in seven cases, a *grande école*, should enhance the outlook for closer ties between the academic world and the private sector and, more generally, should encourage greater empirical spin-offs from research. Yet, it has been underlined that there could be problems of positioning and task sharing between the RTRA and the PRES, particularly when it comes to co-operating with the competitiveness clusters (Lefebvre and Pallez, 2008). Without a clear definition of their respective roles (which could be difficult to achieve), it would be advisable to merge the RTRA and the PRES operating in a given territory.

The clusters' institutional framework needs to be simplified and the process for accessing funds streamlined. The administrative structures should be better co-ordinated and made lighter as well as more flexible in order to preserve an innovation-friendly environment. In addition, the time that elapses between the submission of projects and the receipt of funds should be reduced to the minimum, as delays in bringing products to market can undermine the firms' competitive advantage. Finally, giving the clusters a greater international dimension, for instance by allowing a wider participation of foreign partners in projects, would favour new opportunities for co-operation as well as greater responsiveness to market trends.

Quite apart from measures that could improve the way the competitiveness clusters function, the clusters policy itself involves several risks that need to be taken into account (OECD, 2007a). Public-sector officials are less well equipped than the private sector to select and nurture "winning" industries at a time when markets are highly competitive and rapidly evolving. This is particularly true for sectors undergoing constant technological change in the context of increased globalisation, which requires a flexible approach, allowing the specialisations of clusters to evolve beyond the fields initially defined. Thus, the existing device, based on business initiatives but on elements of more-fundamental research as well, seeks to alleviate this risk. There is also a risk of capture of administrative authorities by key firms when they become the central focus of government action. Finally, if regions become too specialised, they could be vulnerable to sector-specific shocks, which are more likely in a globalised context. This would be all the more problematic if inter-sectoral labour mobility is low.

The geographic concentration of activities in the form of clusters can produce localised economies of scale, reduce transaction costs and boost the productivity of firms.[9] Yet these effects are non-linear: they follow an inverted U-curve because of the congestion effects that materialize beyond a certain threshold. Duranton *et al.* (2008) and Martin *et al.* (2008) emphasise that firms may, on their own for the most part, internalise the benefits induced by clustering effects in their choice of location, doing so prior to any public intervention. Their estimations would suggest that the establishment in the late 1990s of "local productive systems" (*Systèmes productifs locaux*, SPLs) had little impact on the productivity of the firms concerned, insofar as to raise it by 5% they would have needed to double their degree of specialisation in an activity and in a given zone. These studies show clearly that government policies must also seek to eliminate the obstacles to the "natural" emergence of clusters of optimal size. Those obstacles have to do, among other things, with constraints on the mobility of labour (such as high transaction costs on the housing market, local regulations that reduce the housing supply, rising real estate costs) and congestion in local transportation networks. For instance, negative externalities in terms of congestion and house price increases were observed in the case of the Grenoble business cluster (OECD, 2007f), which underscores the need for companion measures aimed at tackling such challenges.

However, the findings of this research as for the effectiveness of government initiatives to enhance the productivity gains of clusters cannot be generalised insofar as there are differences to be noted between the former SPL policy and the more recent policy of promoting competitiveness clusters. While the budgets allocated to the SPLs were modest, the clusters are much more amply funded. Thus, even if the risk of potential windfall effects could be more important, a more pronounced leverage effect of governmental intervention could also occur. Indeed, in contrast to the clusters policy, there is no requirement for the SPLs to co-operate with research and training centres as a condition for financing. Consequently, the stress that the clusters policy places on linkages among firms, R&D centres and universities could produce greater spin-offs and economic benefits, for example, by creating a better match between students' fields of expertise and the needs of businesses, or a more effective transmission of technological innovations resulting from research activities.

Overall, if it is to be effective in promoting innovation and minimising related risks, the policy for supporting clusters must be active and adaptable. *First of all*, by involving the private sector to the greatest extent possible in the different stages of establishing of a cluster programme (design, selection of targeted activities, implementation). *Next*, the eligibility for future financing should be dependent on the results of regular evaluations and, more specifically, the achievement of predetermined objectives and performance indicators. If those are not met, then further government funding should be denied. It should be noted that, according to an evaluation submitted to the government in June 2008, 13 out of the 71 clusters had not fully achieved their objectives (Boston Consulting Group, 2008). No immediate penalties were imposed, and the clusters concerned were given another year to prove themselves. The French authorities, however, are also planning to introduce performance contracts for three years for all the clusters, and this is a move in the right direction. *Finally,* international experience shows that support programs for clusters are not only often conditioned by the achievement of a certain number of objectives, but also that they can be amended in time, or even possibly stopped (OECD, 2007a). Once launched, the collaboration between different actors leading to a process of self-sustaining technological dynamics and a rise in firms' own R&D spending, government subsidies should not last indefinitely. A situation where firms regard State intervention as a given is likely to be both ineffective and costly, notably due to risks of a possible capture of the authorities by the beneficiaries of such financial support. To derive maximum efficiency from their current action, the authorities should make the subsidies temporary by setting and indicating in advance a sunset date for their payment. A greater role of private financing (banks, venture capital) that in due course could replace public funding thus appears desirable.

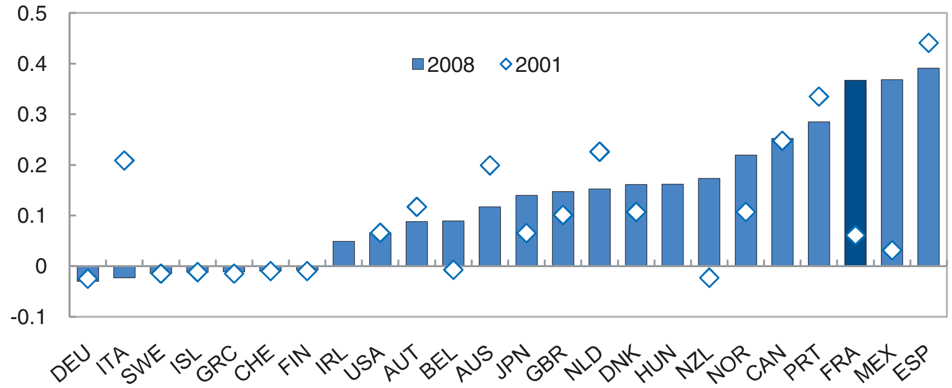
Establishing appropriate tax incentives for R&D

Another aspect of the reorganisation of innovation and research policies involves a reform of the research tax credit (*crédit d'impôt recherche*, CIR). This is a horizontal tax benefit in support of R&D (with no restriction as to size or sector) that allows firms to claim research and development expenses as a deduction under the corporate tax (*impôt sur les sociétés*, IS) or a fiscal refund. It has been modified through several amendments over time. From 1983 to 2003, the basis for calculating the tax credit was limited to the increment in R&D spending, 50% of the increase in a given year over the average of the two previous years, and there was a ceiling on the annual tax credit for each firm. However, the scope of the measure was broadened in 2004. A growing portion of this tax relief was based on the volume of committed expenditure (and not only on the change), and both the annual ceiling per firm and the rate of tax credit applied on volumes were raised. A further major amendment was made in January 2008, in light of the Lisbon strategy, with the declared aim of encouraging R&D spending by local firms and enhancing the international attractiveness of French territory in this area. Indeed, the subsidy for one dollar of R&D expenditure nearly doubled between 2006 and 2008, from 19% to 37%, making France one of the most attractive countries in terms of R&D assistance (Figure 3.9). The amendment completely eliminated the portion calculated on the basis of incremental spending, it raised the tax credit rate applicable to the volume of expenditure significantly, and it eliminated the ceiling. The rate was raised to 30% of R&D spending up to EUR 100 million and stands at 5% for all investments beyond that. In addition, the rate for new participants in the programme was increased to 50% for the first year and to 40% for the second year.

The changes to the research tax credit, notably due to the gradual shift from an incremental to an absolute base, have been accompanied by a sharp jump in total annual claims under this scheme. While they ranged between EUR 0.4 billion and EUR 0.5 billion until 2003, they jumped to nearly EUR 1 billion in 2005, EUR 1.6 billion in 2006, and EUR 3.9 billion in 2008.[10] The new scheme can be expected to mean larger research tax credits for large firms and SMEs alike. Nevertheless, it is likely to go proportionately more to

Figure 3.9. **Tax treatment of R&D in OECD countries**[1]

Tax subsidy for one dollar of R&D spending



1. Tax subsidy to R&D calculated as 1 minus the B-index, defined as the present value of before-tax income necessary to cover the initial cost of R&D investment and to pay corporate income tax. Positive values indicate a subsidy; negative values indicate a tax burden, when the expenditure cannot be deducted the same year.

Source: OECD, *Science, Technology and Industry Outlook* (2004 and 2008).

StatLink http://dx.doi.org/10.1787/604077508358

large, R&D-intensive companies (Chertok *et al.*, 2008). Generally speaking, as might be expected, firms that already spend a great deal on R&D tend to prefer a volume-based, rather than an incremental approach (OECD, 2003). More importantly, taking into account the total level of R&D expenditure rather than only incremental spending has the disadvantage of subsidising investments that companies would have made anyway, without any tax relief. This implies that a portion of the expense incurred by the government has no impact as an incentive for businesses to do more R&D, and consequently it entails a significant windfall.

Tax credits based on incremental spending are generally more complicated to develop, and some of the methods used for defining the base periods (such as a rolling average base over two years that was previously employed in France) can distort incentives in R&D activities (Bloom *et al.*, 2001). To the extent that the period of reference can be properly defined, however, incremental systems can be more efficient in promoting research at the margin while minimising perverse incentives and guaranteeing the efficient use of public funds (OECD, 2003). In particular, this is the case with fixed-base systems, or when a firm's all-time maximum R&D expenditure is taken as the base for calculating eligible incremental investments (Bloom *et al.*, 2001). Overall, in light of the high budgetary cost of the scheme now in effect, the authorities would be well advised to carry out regular assessments of its effectiveness so as to adjust for the best its configuration and scope of application.

As can be seen from a comparison of Figures 3.8 and 3.9, while Spain and Portugal have introduced mechanisms that are also very advantageous for promoting R&D, the corresponding private investment has been very modest. Conversely, the R&D effort is very strong in Finland and Sweden, whereas these countries have not established any specific tax incentives to promote it. It is therefore important to ensure that rising CIR expenses are actually giving a tangible boost to firms' innovation and competitiveness. The risk of a windfall is increased insofar as a significant increase in R&D intensity will probably be difficult without a modification of the industrial structure. Consequently, opportunistic behaviour can develop such as wrongly classifying ordinary expenditures as R&D spending or diverting the benefit of this measure into higher salaries for scientific staff without any necessary increment in the volume and productivity of their research. The findings of empirical studies evaluating the impact of horizontal tax measures such as the research tax credit are contrasting and difficult to compare because of differences in the data and methodologies used (Mohnen, 1999; Hall and Van Reenen, 2000). The OECD's empirical studies show that horizontal tax measures such as the research tax credit have only a weak impact on R&D spending levels and on total factor productivity in the private sector, even if the impact is larger than in the case of direct subsidies and is more pronounced in R&D-intensive industries (Jaumotte and Pain, 2005a and 2005b; Johansson *et al.*, 2008). Other studies find more substantial effects, with a EUR 1 tax credit feeding through to a rise in private outlays of between EUR 2 and EUR 3.60 (Klassen *et al.*, 2004; Hall, 1993; and, on French data, Mairesse and Mulkay, 2004). Estimates by the Directorate-General for the Treasury and Economic Policy of the long-term impact of CIR reform are based on an intermediate assumption of a multiplier of 2 on private research outlays, which should generate an increase in GDP of nearly 0.05% per year on average over fifteen years – equivalent to a multiplier of 4.5 on GDP for each euro spent by the government (Cahu *et al.*, 2009).

Besides the CIR, other measures have also been sought to reduce the cost of R&D and to spark positive externalities for the economy as a whole. The "Aid for Projects of Innovative Young Businesses" subsidy (*Aide aux projets des jeunes entreprises innovantes*, APJEI), introduced in 2004 for a ten-year run, is designed to foster the growth and development of high-tech SMEs through different tax exemptions. It applies to innovative young enterprises (*Jeunes entreprises innovantes*, JEI) that have been in existence for less than eight years, are independent, and highly R&D intensive (*i.e.* R&D spending must account for at least 15% of eligible costs).

To encourage the dissemination of scientific knowledge and promote research work in higher education, the 2008 budget law extended the benefit of JEI status to "Young University Enterprises" (*Jeunes entreprises universitaires*, JEU), owned or run by students or by academic researchers. Other measures could also be considered. Technology transfer and licensing offices, for example, could be created in universities to promote spill-over effects from research. This would be consistent with recent recommendations from the OECD and other international organisations that regard the transfer of knowledge from public research agencies as a strategic consideration (OECD, 2007b; European Commission, 2008). This would also represent an extension of the "business incubators" policy linked to public research that has been in place since 1999. Indeed, although France is the leader among G7 countries for the share of higher education institutions in the total number of patents filed by inventors living in the country, few of these patents are actually commercialised (OECD, 2008a). At the same time, France leads the G7 in the proportion of inventions that are held by domestic enterprises but were created in another country. Generally speaking, having universities commercialise inventions or become shareholders in private firms in exchange for licenses to exploit patents would help foster an entrepreneurial culture and strengthen resources in higher education, as the UK example illustrates (Cercle d'outre-Manche, 2008). It would also serve to overcome the scant involvement of the private sector in public research. The proportion of university R&D that is financed by businesses in France is among the lowest in the OECD. It was less than 2% in 2006, *versus* an OECD average of 6%, and 14% for Germany (OECD, 2008b).

Further reforms to universities and public research

A number of significant reforms have been recently launched to boost fundamental and empirical public research in France. The authorities have used the financing lever to this end and have also initiated a broad programme to reform the governance of research.

The year 2006 saw the creation of agencies to provide strategic guidance (the High Council for Science and Technology – *Haut conseil pour la science et la technologie*, HCST) and to perform evaluations (Research and Higher Education Evaluation Agency – *Agence d'évaluation de la recherche et de l'enseignement supérieur*, AERES). In the latter case, the first round of evaluations of research units was conducted in 2007-08. The publication of delivered scores (A+, A, B or C) and the evaluation reports marked a significant step forward in terms of transparency and information. As from 2009, 20% of the funding for research units is from now on a function of the evaluation operated by the AERES. It is important that this link between financing and performance be gradually tightened. It would be desirable that the same approach be adopted and extended to universities and tertiary courses. Moreover, the creation in January 2007 of the National Research Agency (*Agence nationale de la recherche*, ANR) opened another channel of public financing for research projects. Its role in financing public R&D is still minor, but it deserves to be developed further. Indeed, the purpose of the agency is to increase the number of research projects emanating from the scientific community or in response to calls for tender, financed on the basis of competition and peer evaluation. It is also important that the selection of projects be as transparent as possible and that involves more foreign experts (OECD, 2008a). A greater attribution of credits using such criteria would help strengthen the governance of public research institutions and create conditions for a better allocation of resources.

The Universities Freedom and Responsibility Act (*Liberté et responsabilité des Universités*, LRU), promulgated in August 2007, lays the groundwork for greater autonomy for French universities, which should boost the quality and efficiency of higher education. Twenty universities have now signed up for the new operating mode, and the others are to follow suit within five years. With this new law, the internal governance of universities has been revised, increasing the powers of the university president and reinforcing the position of the Board of Directors within the administrative structure. The number of board members has been reduced to facilitate decision-making. At the same time, the proportion of outside members has been increased slightly, and at least one member must be a corporate CEO.[11]

The LRU law has also enabled the transfer of movable and immovable property to the universities and has given them responsibility for their budgets, which comprise an overall government subsidy and their own internal resources. There has also been an emphasis on generating new resources through the creation of foundations, and encouraging philanthropic donations to universities by extending various tax mechanisms or making them more flexible. However, this financial autonomy is not complete, as can be seen in the fact that tuition fees are still regulated by the State. Moreover, universities are still not allowed to select their incoming students, although there are plans to provide students with better information on the quality of universities through the publication of statistics on the numbers of candidates passing examinations, receiving degrees, pursuing further studies, finding professional employment, and the implementation of an active guidance mechanism. This mechanism, which was generalised in 2009, imposes a mandatory pre-registration procedure during which the university provides applicants with a considered opinion on their intended course of study, inviting them, as the case may be, to shift the focus of their applications to a field in which their prospects for success would be greater. Lastly, an initial draft of the law called for the selection of Masters' degree candidates, but this was unfortunately abandoned under pressure from student organisations.

In the wake of the officially commissioned Schwartz (2008) and Hoffman (2008) reports, an ambitious plan was proposed in October 2008 to make scientific careers more attractive.[12] This is an important step, given the growing brain drain that France is experiencing, particularly to the United States (Tritah, 2008). Even if its implementation encounters difficulties, this plan goes in the right direction by stipulating, in return, a strengthening of performance requirements of the research staff. As well, the National Scientific Research Centre (*Centre national de recherche scientifique*, CNRS) is being reformed following the adoption of the "Horizon 2020" plan in July 2008. Under that plan, the Centre will be divided into six institutes (mathematics, physics, chemistry, engineering, human and social sciences, and ecology and biodiversity), which could be tasked by government with national co-ordination duties in their field of specialisation. The idea is to bring greater openness to the CNRS by strengthening co-operation in research fields shared with universities and other national research agencies. Finally, in February 2008 the government launched "Operation Campus" to renovate and modernise the physical facilities of ten existing campuses, financed through the transfer of 3% of EDF's capital, in the amount of EUR 5 billion. This renovation policy should also help make the universities more attractive to French and foreign students, teachers and researchers. In the end, it is important that the effort to reinforce university autonomy be pursued, particularly in the areas of budgeting and the hiring and remuneration of personnel. In this respect, giving universities the freedom to select students on entry and to set tuition fees would contribute to it and should be paired with an expansion of the system of students loans recently introduced (see Chapter 2).

Promoting the growth of enterprises

The probability that a firm will become an exporter rises with its size, as measured by the number of employees (Ceci and Valersteinas, 2006). Nearly 70% of French firms with more than 250 employees make sales abroad, *versus* slightly more than 20% of SMEs with between 10 and 249 employees, and only 2% of very small enterprises. In the absence of sufficient numbers of manufacturing-sector SMEs, as compared with Germany in particular, the French export sector is highly concentrated: large firms with more than 250 employees are responsible for the majority of trade (55%), but they represent barely 3% of exporters. At the other extreme, very small enterprises with fewer than 20 employees account for more than 70% of exporters, but only 20% of total export sales. A major challenge for strengthening competitiveness, then, is to create conditions that will help small and medium-sized businesses to grow and develop and expand their size. A number of recent reforms have moved in the right direction, particularly by alleviating the tax burden somewhat, improving the financing of firms, and reducing the regulatory burden. However, further progress is needed in several of these areas.

Reducing the tax burden and restructuring targeted business support schemes

The competitiveness of export firms and their growth prospects depend, among other things, on the tax system. Steps have recently been taken to reduce the tax burden to some extent. The annual minimum tax (IFA), aimed at guaranteeing a minimum tax payment of the corporate income tax, is to be eliminated by 2011, with a budgetary cost of EUR 1.2 billion.

In February 2009, the authorities also announced the elimination in 2010 of the *taxe professionnelle*, the local business tax, at least the part based on productive investments.[13] This is an important decision in order to strengthen the competitiveness of firms. The *taxe professionnelle* has no equivalent in Europe or other Western countries: it works to the detriment of attractiveness and growth of the French economy, while posing risks of driving productive activities abroad. According to a recent INSEE survey, it is regarded as a real handicap by more than 85% of business people (Bardaji and Scherrer, 2008). It is a very complex tax, with a host of exemptions, and the effective tax base is far removed from the theoretical base (OECD, 2007c). In reality, the tax is effectively calculated on a base comprising value added, the value of fixed assets, and the gross value of equipment and movable capital (industrial materials and tools, vehicles, office equipment and furnishings). Consequently, the *taxe professionnelle* applies to all factors of production but imposes a greater burden on firms in the most capital-intensive sectors, *i.e.* industry, energy and transportation, which account for a third of national value added but pay two-thirds of its burden. Even if the total burden of this tax has been reduced somewhat in recent years, in particular with the introduction of rebates for new capital investment, it remains very high, EUR 25 billion in 2008, equivalent to about 15% of government revenues at the sub-national level (regions, departments and communes). Consequently, the issue of restructuring the *taxe professionnelle* raises the broader question of local taxation reform and the financing of local governments (OECD, 2007c), at a time when the authorities are preparing a more thorough overhaul of local government structures. When that happens, a greater use of the real property tax (*taxe foncière*) and a complete overhaul of local government aid to businesses could represent a significant source of financing (see below).

Corporate profits in France are subject to a progressive tax system. The standard tax rate on businesses is 33.33%, but, since 2001, some firms have been eligible for a reduced rate of 15% on a portion of their taxable profits (capped at EUR 38 120). To qualify for this lower rate, a company must meet a certain size limit (before-tax sales below EUR 7.63 million), and it must be independent (not part of a larger group) in order to avoid artificial splitting of businesses in order to benefit from the preferential rate.[14] Generally speaking, lessening the tax burden through the reduced corporate tax rate cuts the cost of equity financing and in this way facilitates access to bank credit for firms of modest size. Nevertheless, its scope of application seems too limited to spark the emergence of companies capable of achieving a critical size for exporting. While one out of every two companies subject to corporate tax actually benefits from this measure, the main beneficiaries are “very small enterprises” (TPEs), rather than “small and medium-sized enterprises” (SMEs): 80% have fewer than 10 employees and only 1% more than 50 (Raspiller, 2007).[15] Moreover, it is primarily the sectors that do little or no exporting and are characterised by weak productivity – construction, retail trade, real estate, personal services – that reap the main advantage, as opposed to industrial sectors. More generally, while many tax distortions can hamper the creation and development of SMEs in OECD countries (OECD, 2009), reduced rates of corporate tax for small firms do not seem to enhance growth (Johansson *et al.*, 2008).

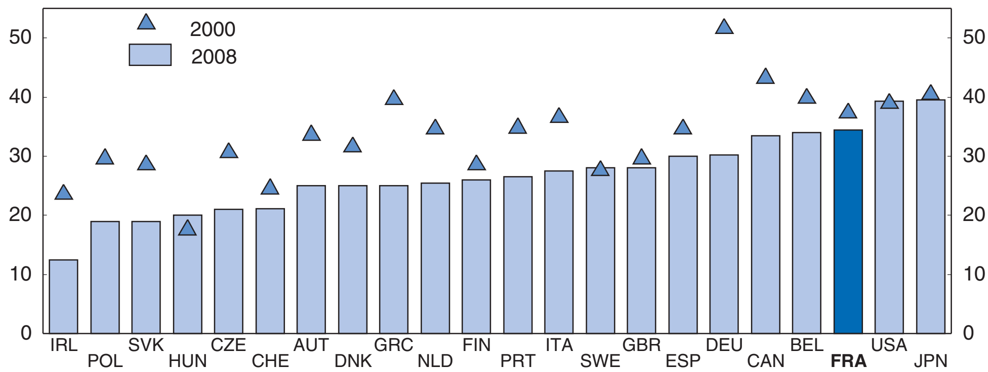
With the creation in 2007 of the status of “growth SME” (*PME de croissance*), the authorities were seeking to use tax relief to “gazelles” – firms of intermediate size with strong growth potential. This status applies to firms that employ between 20 and 250 workers, that have seen their payrolls increase by at least 15% in each of the last two fiscal years, and that meet the European definitions of SMEs.[16] However, while this programme represents progress in terms of overcoming the shortage of mid-sized companies in France, it tends to help those firms (some 4 000) that have already been growing rapidly for two years, rather than creating the initial conditions for such growth. In this respect, a generalised reduction of the various social contributions and taxes (with the priority to the *taxe professionnelle*, but also social security contributions and the turnover tax) would give a boost to the entire industrial fabric, in particular for mid-sized firms where growth has lagged. Social security contributions are perceived as being the principal handicap of "France incorporated" by the professionals involved in export activities (Comité national des conseillers du commerce extérieur de la France, 2008).

Knowing that large companies in France are subject to a tax surcharge of 3.3%, the adjusted legal maximum rate of corporate tax was 34.43% in 2008.[17] This is the highest rate of any country in the European Union, other than Malta, and it is one of the highest among OECD countries (Figure 3.10). While it has remained relatively unchanged, some significant gaps have recently appeared or have grown to the statutory tax rates prevailing in France's main trading partners.

Yet the fact is that the high rate of corporate tax in France does not reflect the effective tax burden (OECD, 2008a). France has some advantageous provisions relating to capital depreciation allowances, which makes the effective average (Figure 3.11) and marginal

Figure 3.10. **Statutory corporate tax rates in international comparison**

Combined rate, per cent



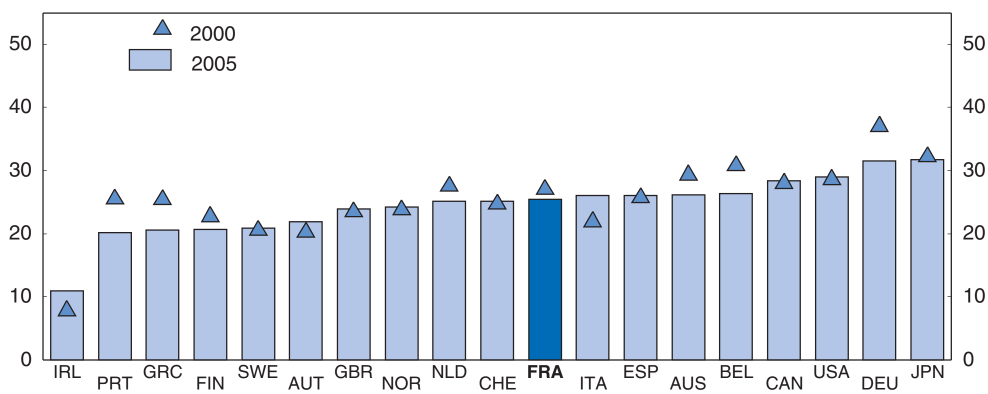
1. Basic combined central and sub-central (statutory) corporate income tax rate.

Source: OECD, *Tax database*.

StatLink http://dx.doi.org/10.1787/604085008577

Figure 3.11. **Effective average corporate tax rates in international comparison**

Base case, per cent



Source: Institute of Fiscal Studies.

StatLink http://dx.doi.org/10.1787/604217304770

(at 25% and 20%, respectively, in 2005), comparable to the unweighted average of the industrialised countries of the OECD (OECD, 2007d). However, when considering all the measures that affect the tax base (and not only depreciation allowances), it would seem that the implicit tax base in 2006 was one of the narrowest among the major developed countries (IMF, 2008b).[18] The recent move to make the research tax credit more generous has undoubtedly accentuated this feature (see above).

The authorities should simplify the system of corporate taxation by carrying out a reduction of the statutory rate in return for base broadening. The generous depreciation allowances could be reviewed to bring them more into line with an economic concept, and the deductibility rules could be tightened with respect to provisions (*e.g.* for risks and expenses) and losses (OECD, 2008a). In addition, the principle of territoriality (regarding, for example, the deduction of interest payments or doubtful claims on foreign investments) could also be applied more strictly. Such an *ex ante* revenue-neutral reform would have the advantage not only of reducing the distortions that different exemptions generate inevitably (for example related to the fact that certain firms can be better informed than others as to the various existing tax reliefs), but also to reduce administrative burdens as well as to improve France's attractiveness. As to the latter element, recent studies show that tax competition among countries to preserve or attract capital tends to focus more on the statutory rates of corporate taxes than on the breadth of the corporate tax base (Devereux *et al.*, 2008). Finally, there could even be an *ex post* increase in tax revenues. While recent work by Clausing (2007) has shown that there was a Laffer curve for 36 countries of the OECD and the European Union over a long period of time, Brill and Hassett (2007) find that the revenue-maximising tax rate in the wealthiest OECD countries has declined from around 34% in the second half of the 1980s to 26% in the first half of this decade. Higher corporate tax revenues could, however, partly result from bigger incentives to incorporate, leading to lower aggregate personal income tax receipts (de Mooij and Nicodème, 2008).

A powerful lever for reducing the tax burden weighing on the productive apparatus could come from reforming the broad array of targeted business support schemes for which, in some cases, the number of principal recipients can be limited. Two recent governmental reports have offered a particularly critical assessment of current instruments (Cour des Comptes, 2007; Audit de Modernisation, 2007): the amounts involved are very substantial, including schemes targeting SMEs and particular industries (EUR 26 billion). There are at least 6 000 different schemes, and, according to those reports, many of them are virtually identical in their mechanisms or objectives (for example, there are no fewer than 120 different programmes for creating enterprises), while contradictions among the various measures are not necessarily avoided.[19] Moreover, some practices can, in fact, be considered at variance with national rules and/or with European competition law. For instance, France was recently condemned by the authorities of the European Union for failure to abide by its obligations to refund aids granted for the rescue of the companies in difficulty, which were delivered between 1989 and 2004 (Junghans, 2008). In addition, while impact assessments have been performed in some cases, quantifiable and measurable performance indicators are rare or improperly used, and there is no follow-up action for bringing greater co-ordination and efficiency to the system. Indeed, it is to some extent regulated by the firms themselves: by picking and choosing among the various instruments available, they can obtain a pure windfall. Apart from mechanisms that operate at the national level (such as reduced social contributions for low-wage workers),

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it is likely that the aids are of benefit only to a relatively small number of firms. In the case of support from local governments, they were used in 2005 by only 2% of newly created firms and by 1% of those already established. Yet the Cour des Comptes report shows that, between 2000 and 2005, up to 40% of beneficiary businesses in some regions drew upon at least two different types of support. The search for windfalls would seem, then, to be a persistent phenomenon, and one that benefits only a limited number of firms. Finally, the administrative cost of managing the schemes administered by local governments is very high, on the order of one-quarter of the amounts disbursed. In sum, the bulk of targeted business support schemes should be reallocated to finance the cut in different tax burdens weighing on firms, so as to eliminate windfalls and enhance the competitiveness of the productive economy as a whole.

Reducing threshold effects and improving financing

A number of measures have recently been adopted to reduce obstacles to business development. Under the Economic Modernisation Act (*Loi de modernisation de l'économie*, LME), promulgated in August 2008, progress has been made in reducing the financial impact of exceeding certain size thresholds, in trying to improve firms' cash flows, and in allowing them to strengthen their equity positions.

To facilitate the growth of enterprises, the costs of exceeding one of the 10- or 20-employee thresholds have been alleviated temporarily, but this measure could eventually be extended at the end of 2010. More specifically, the law provides for a three-year freeze and a four-year adjustment period of the financial consequences linked to such a crossing: higher contribution rates for vocational training, a contribution to the national housing fund, and the loss of eligibility for reduced contributions on low-wage workers or on overtime. Generally speaking, the thresholds were designed to favour SMEs over larger firms, while avoiding the concentration of new provisions around a single threshold, which explains why there are so many of them (Camdessus, 2004). In fact, there are numerous thresholds (for 10, 11, 20, 50, 150, 200, 250, 300, 500 and 1 000 employees), and the associated obligations become heavier and more constraining as each one is crossed. Nor are those obligations solely financial: they also have implications for the firm's corporate governance. For example, a firm must arrange for election of a staff delegate if it has more than 11 employees; beyond 50 employees, it must establish a "works council" (*comité d'entreprise*, CE) and a hygiene, safety and working conditions committee (*comité d'hygiène, de sécurité et de conditions de travail*, CHSCT); if it has 150 employees, there are supplementary obligations relating to meetings of the CE, etc..

Thus, rather than favouring SMEs over large groups (the static vision), it is far more likely that the legal thresholds hamper their growth, when viewed in light of economic dynamics. Consequently, some employers prefer not to hire rather than to cross a new threshold, or they create new business structures as they approach the threshold, rather than grow the existing firm (Amiot, 2008). This effect is perceptible in the data. For example, when looking at the universe of firms with up to 80 employees, a threshold effect can be detected already for 10 employees, but it is more pronounced for 50 employees (Camdessus, 2004; Cahuc *et al.*, 2005). The move from 49 to 50 employees leads to a reduction of 500 firms. This is hardly surprising: crossing the 50-employee's threshold now invokes 34 additional laws and regulations, the cost of which amounts to about 4% of payroll (Attali Commission, 2008). More generally, an in-depth reform is needed to simplify and lighten substantially the number of statutory thresholds. This would help to overcome the shortage of mid-sized firms in France. To begin with, it would be very useful to carry out a harmonisation of the various social functions and trade union representation in the companies of less than 250 employees. For instance, as recommended by the Attali Commission, this could be done by establishing a single representative council in all SMEs with fewer than 250 employees, as a negotiating body that would fulfil the functions of the CE, staff delegates, union delegates and the CHSCT.

The LME reduced payment times in the private sector to 60 days (as from the date of emission of the invoice) starting in January 2009. The average waiting times for payment in France are significantly above the European average (68 days *versus* 57 days). With large retailers, they can be as long as 120 days. However, this law also authorised temporary dispensations with this rule that can be applied by January 2012, established on the basis of inter-professional branch agreements. Several branches have already signed such agreements, and this generates the risk that a heterogeneity in the reduction of payment times negatively affects cash-flows of other inter-connected sectors not benefiting themselves from any particular exemptions. From this point of view, it would have been preferable to smooth the shift to payment times of 60 days in a progressive way until 2012 for all firms. In addition, it is not certain that the reduction of payment times is beneficial for export businesses insofar as foreign customers are not subject to this rule, whereas simultaneously the French producers are in the obligation to respect it with respect to their domestic suppliers. Overall, even if their reduction is desirable as such, it would be preferable that the payment times be determined on the basis of contractual agreements between purchasers and suppliers in a context of more vigorous competition (see Chapter 4).

The growth prospects of SMEs depend on the extent of their capitalisation and, more generally, on their capacity to access external funding sources (OECD, 2002). Previous provisions that offered exemption from the wealth tax (*impôt de solidarité sur la fortune*, ISF) in return for an equity investment in an SME proved to be weak incentives. The Law to Promote Work, Employment and Purchasing power (*Loi en faveur du travail, de l'emploi et du pouvoir d'achat*, TEPA) of August 2007 instituted a new tax advantage. It allows ISF taxpayers to reduce their tax liability by subscribing directly to the capital of SMEs (exemption of 75% to a limit of EUR 50 000), or indirectly by subscribing to shares of certain investment funds (exemption of 50% to a limit of EUR 10 000). Over the first year these tax measures raised nearly EUR 1 billion for investment in SMEs. Finally, with the LME, the authorities took steps to modernise venture-capital instruments, by creating specialised funds that invest in unlisted "early-stage" start-ups or growing SMEs, as well as by simplifying the venture-capital measures established at the EU level.

In order to give SMEs preferential access to procurement, the French authorities have adopted a mechanism similar to the US small business act (SBA) so as to spur SME growth and innovation by awarding such companies a first government contract and making their turnover expand. More specifically, the LME instituted the principle whereby governments at all levels are authorised to reserve 15% of their so-called "technology" purchases (high-tech, R&D, and technological studies) for innovative SMEs. The 15% limit is slightly higher than actual practice for the year 2006 (12%). However, although the measure was intended to be applied for an experimental period of five years, the idea of establishing quotas for SMEs in the award of procurement contracts has run into opposition from the European Commission, which argues that some 40% of government procurement is already awarded to SMEs in the European Union, and that this percentage rises to 60% when subcontracting is included (Maillet, 2008). These figures from the European Commission should be

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compared with those of the French Economic Observatory of Public Procurement (*Observatoire économique français de l'achat public*, OEAP), according to which, in 2007, French SMEs, as defined by the Community, obtained 35% of government contracts in terms of nominal value whereas they accounted for 42% of market value added. Most countries deem this strategy discriminatory, and the approach preferred in the proposed European SBA is to institute a "code of good conduct" that would focus on providing SMEs with better information about procurement opportunities, reducing the capital base and qualifications requirements, and strengthening legislation governing payment times.

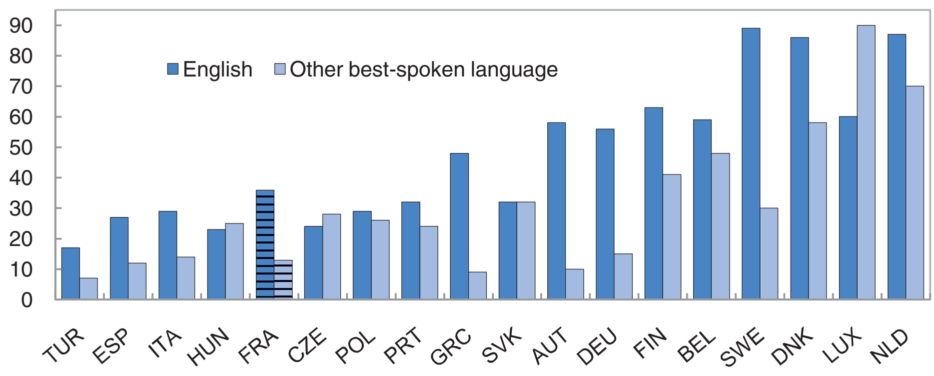
Other structural determinants of business competitiveness

Enhancing knowledge of foreign languages and entrepreneurship

The access of SMEs to overseas markets is conditioned by a set of factors, among which a sufficient financial standing, coupled with a capacity to identify and analyse business opportunities (OECD, 2007e). Yet an important factor for competitiveness is also the knowledge of foreign languages. A report commissioned by the European Commission reveals that, in a sample of 2 000 SMEs in the European Union, 11% had lost a contract because of inadequate language skills (Centre for Innovative Learning Technologies, 2006). Over three years, losses would have amounted to some EUR 325 000 per firm. That study also found that English is the most widely used language in exporting and that the English language can be a determinant in making an initial breakthrough in new markets. Finally, sensitivity to the issues involved in learning foreign languages, and in the use of English in particular, is more prevalent in large firms than in SMEs. For the sake of efficiency, many large French groups actually encourage the use of English and even stipulate it as the language of business. This may help to explain why large groups are more successful than SMEs at exporting.

However, knowledge of foreign languages in general, and of English in particular, is fairly weak in France. Another survey by the European Commission (Eurobarometer, 2006) found that just over a third of the French population was able to conduct a conversation in English, compared to 56% of Germans and more than 85% of Swedes, Danes and Dutch (Figure 3.12). Moreover, French universities offer only a limited number of courses in English (OECD, 2008c). Finally, an international assessment of English skills in 2002 among 15 year-old students in seven European countries placed France in last position. In the face

Figure 3.12. **Percentage of the population able to converse in foreign languages**



Source: European Commission, Eurobarometer (2006).

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of this finding, the Ministry of National Education recently issued proposals and took a first set of measures to strengthen students' linguistic knowledge. Those proposals call for generalising the teaching of languages in early primary education; promoting video conferencing with speakers of English; teaching English after-hours in lower secondary school (in the form of coaching sessions) and during vacation times for upper secondary school students (in the form of internships); and giving high school students the chance to take the Test Of English as a Foreign Language in their final year. While these ideas go in the right direction, they will take time to have any impact on export performance. On the other hand, the authorities could move immediately to introduce a broader measure that would boost the knowledge of foreign languages in the general population. Following the example of countries in Northern Europe, they could encourage the public television networks to carry reports and films in their original version, with subtitle – this could be a powerful learning tool. The reorganisation of the public audiovisual service, which the authorities recently launched, offers a fine opportunity to introduce such an approach on one or more channels. In time, this could have a favourable impact not only on the geographic orientation of trade (toward the more dynamic zones, which are generally not French-speaking), as well as on tourism, where the traditionally positive balance has dropped in recent years.

In 2007, France saw a record number of enterprises created, raising the total to more than 320 000, up by 50% from the year 2000. However, this dynamism does not necessarily reflect a strong entrepreneurial spirit. According to an INSEE survey, more than 60% of entrepreneurs who created a business in 2006 were essentially trying to ensure their own employment (Kerjosse, 2007). In fact, 40% of these new entrepreneurs were unemployed when they created their business. Moreover, the percentage of new entrepreneurs who received public support in establishing the business rose sharply, from just under 30% in 2002 to around 45% in 2006. The spirit of entrepreneurship and innovation is, however, a determining factor in the survival rate and the growth prospects of enterprises. On this point, having higher education and, more generally, the development of managerial skills are certainly major determining factors. The problem in France is that the engineering and management schools do not sensitise students sufficiently to the potentialities of entrepreneurship, nor do they create enough "bridges" among themselves to offer supplementary training for developing a strong entrepreneurial culture. Consequently, graduates of the *grandes écoles* tend to gravitate towards large corporations or the public service, rather than take up the challenge of a career in the SME world. Yet this risk aversion and lack of entrepreneurial drive could also be explained by the extremely strict company law, which until recently prevented an entrepreneur to take up a new business activity following a bankruptcy. The LME has changed this state of affairs by offering a "second chance" to such people by leaving it to the bankruptcy court to determine in each case whether a person can avoid *incapacité commerciale* (disqualification from doing business).

Avoiding support for non-exporting sectors related to real estate activities

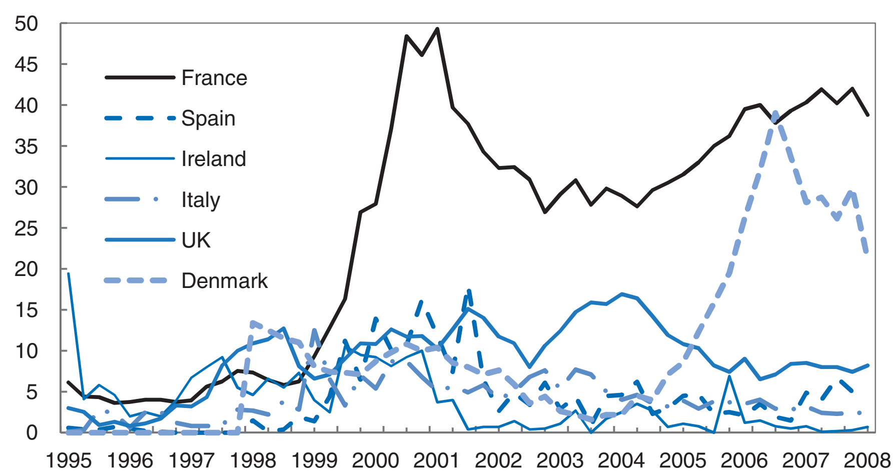
Between 2000 and 2007, the number of exporting firms declined by 10 000 (or 10%), and this has coincided with pronounced market share losses. In addition to a "selection effect" resulting from international competition, it would seem that exporting has become less attractive overall. Among the various factors affecting France's export performance in the first decade of the new century, it is possible that existing resources have been reallocated between tradable and non-tradable sectors of the economy, to the detriment of the manufacturing sector and to the benefit of construction, among others. Following the steep rise of real estate prices until 2007 the latter sector enjoyed very high margins and could offer more advantageous compensation terms, thus attracting fresh capital and labour respectively. Empirical studies on OECD countries confirm that higher real estate prices can trigger an intersectoral reallocation of labour (Bover and Jimeno, 2007).

Since 2000, the French construction sector has faced a very tight labour market, and this situation has very likely been reinforced by the introduction of the 35-hour week. France has in fact had one of the most severe labour shortages in this sector among the major EU countries (Figure 3.13), in particular because of the temporary restrictions on labour mobility imposed on the new member countries of the European Union. This caused wages to rise more quickly in the construction industry than elsewhere in the economy (Figure 3.14), but it did not reflect any corresponding productivity gains. Between 2000 and 2007, the construction industry's share of aggregate employment rose by nearly one percentage point, with the sector accounting for a quarter of the French economy's new job creation over that period. Nevertheless, the high productivity of the manufacturing sector helped free up some labour with no detrimental effect on output. Likewise, the construction industry might have been also able to draw labour from the primary and tertiary sectors and not solely from manufacturing.

The labour factor would not be able to shift significantly towards a given sector if the capital factor had not already done so. INSEE data on the creation of enterprises seem to confirm the key role that housing and construction activities play in channelling capital: between 2000 and 2007, on average, slightly more than one-fourth of new enterprises were created in these two sectors, whereas manufacturing (excluding agribusiness) accounted for only 5%. It would seem that the profit outlook had a decisive role. Picart (2004) has shown that construction offered very high net operating profit margins (28%) – the highest of any French sector, while at the same time, other sectors had an average net operating profit margin of 10.5%. Although these figures relate only to the year 2001, it is very likely that, until recently at least, construction has remained in the lead among the most profitable sectors of the French economy. Indeed, like the pattern observed in a number of

Figure 3.13. **Labour availability as a constraint on activity**

Construction industry survey

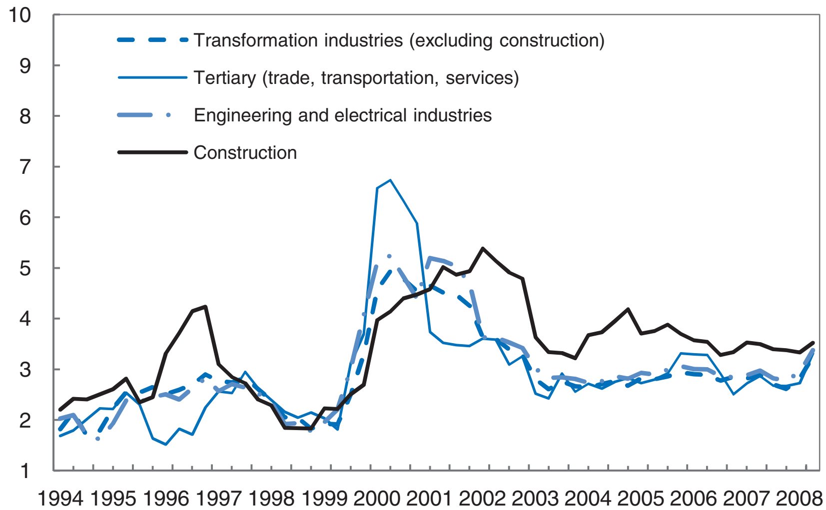


Source: European Commission.

StatLink http://dx.doi.org/10.1787/604248013143

Figure 3.14. **Basic hourly wages of manual workers in France**

Year-on-year growth rate



Source: ACEMO Quarterly Survey.

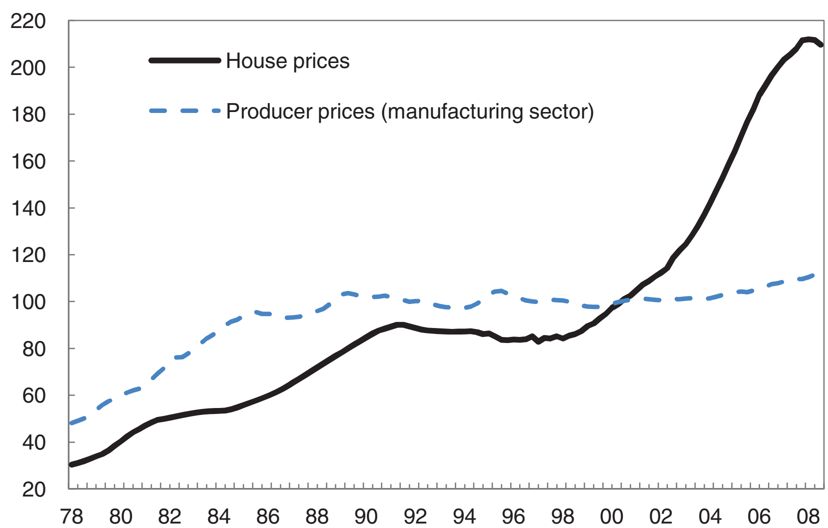
StatLink http://dx.doi.org/10.1787/604271053664

other countries, real estate prices trended sharply upwards relative to manufacturing-sector production prices in the 2000s (Figure 3.15). Moreover, according to OECD estimates, real estate prices have diverged significantly from their long-term trend relative to household income and rent growth rates (OECD, 2008d).

Variations in real estate prices can affect the allocation of production factors, especially if capital and labour are scarce and growth potential low. The main economic policy implication that follows from this is to avoid creating distortions that could have counterproductive effects on price movements (amplifying rises or impeding declines),

Figure 3.15. **House prices and producer prices in the manufacturing sector**

2000 = 100



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thereby negatively impacting the export sector. The risk of such effects is induced by schemes to promote home ownership (such as the tax deductions for mortgage interest adopted in mid-2007 as part of the TEPA law) or more-direct support for the construction sector. This includes the creation of specific new tax incentives, and in particular those that would prove difficult to remove afterwards.

Box 3.3. **Main recommendations for strengthening French competitiveness**

Policies to promote the development of research and innovation

- To make the "competitiveness clusters" policy more effective, the maintenance of state aids should be contingent on results, notably by creating mechanisms that stop funding in the event of failure to achieve predetermined performance objectives; in due course, establish a sunset date for subsidies while gradually replacing them with private financing.
- Promote project-based public research financing by giving a greater role to the National Research Agency (ANR). For the financing of research units, universities and tertiary courses, establish a progressively tighter relationship between performance and financing by consolidating the role of the Agency for the Evaluation of Research and Higher Education (AERES).
- Pursue efforts to make the universities more autonomous, particularly in terms of budgets, hiring and staff compensation. Greater freedom to select incoming students and to set higher tuition fees would contribute to this objective and should be paired with an expansion of the recently introduced system of students loans.
- Carry out regular assessments of the effectiveness of the research tax credit so as to adjust for the best its configuration and scope of application.
- In order to enhance the spill-over effects of public research, create technology transfer and licensing offices in the universities.

Policies to make France more attractive and expand the size of firms

- Lower the statutory rate of corporate tax while simultaneously broadening the base of the tax. Reduce fiscal, social and administrative burdens weighing on the productive apparatus, notably via a thorough overhaul of targeted support schemes to businesses. Implement the decision to eliminate the *taxe professionnelle* in 2010.
- Ease the regulatory burden on firms that cross the 50-employee threshold, in particular by creating a single works council to perform the various social and union representation functions.

Other policies

- Prevent distortions in the allocation of labour and capital between tradable and non-tradable sectors, especially towards the construction sector, but towards export activities as well.
- Consolidate the "one-stop shop" approach centred on Ubifrance to make it even easier for exporters to access information.
- Increase knowledge of foreign languages, in particular by arranging for public television to carry reports and films in their original version, with subtitles.

Notes

1. The revealed comparative advantage is an indicator which provides, for a given product and country, the contribution of this product to the trade balance, adjusted for changes which are not specific to the country, but which come from the evolution of the weight of the product in the worldwide economy.
2. The export market for goods and services is defined as a country's exports that would be expected if its market shares by volume remained at their value for the reference year, here 2005.
3. However, for a raw-material exporting country such as Norway, the contraction of market shares in volume could result from a fall in volumes in reaction to the rise in world prices, thus making it possible to stabilise market shares in value terms (see Figure 3.1).
4. Germany's enhanced cost competitiveness and the tendency to erosion incurred by France must be viewed in perspective (Figure 3.7). Indeed, the 1990s saw the competitiveness of the two countries diverge, under the impact of the competitive disinflation strategy in France and the wage inflation that took place in Germany in the wake of reunification. Over the long term, however, cost competitiveness patterns would tend to even out. By the end of 2008, Germany had restored its cost competitiveness to pre-unification levels, while France still benefited from a net advantage compared to the situation in 1991.
5. Schaff *et al.* (2008) define a "corrected" trade balance for the United States, taking into account the strategies of American firms. To do so, they treat as exports the local sales of American subsidiaries abroad and consider as imports the purchases they make locally. Conversely, sales made by subsidiaries of foreign groups to Americans are recorded as imports for the United States, while the purchases they make locally are treated as exports. According to authors' calculations, such a methodological change reduces the US current account deficit by one-third.
6. See the framework partnership agreement (*Convention cadre de partenariat*) of 23 April 2008 signed by the DGTPE, ACFCI, Ubifrance and the UCCIFE.
7. The European Economic Area is an agreement of association between the countries of the European Union, Iceland, Norway and Liechtenstein.
8. The Carnot label is a label of excellence allotted by the National Research Agency to support researching partnerships. The designated institutions (called "Carnot Institutes") receive funding from the Agency, calculated according to the volume of receipts resulting from research contracts led with their partners, businesses in particular.
9. There are a number of phenomena behind the economies of scale generated by clusters. They may result from a more efficient sharing of equipment and facilities, lower provisioning costs, a better matching of employers and employees or of buyers and suppliers, greater ease in learning new technologies, wider dissemination of knowledge, and better tracking of market trends.
10. The fiscal liability in year *n* corresponds to the amount of the firm's tax credit for year *n*. It does not reflect the immediate budgetary cost, as it is imputed to corporate tax due over the next three years, and the residual portion becomes refundable in the fourth year. One of the measures of the stimulus plan adopted at the end of 2008 consisted of an acceleration of the refunding of this tax credit (see Chapter 1).
11. University governing boards currently include representatives from more than 100 firms of different sizes and sectors.
12. With EUR 250 million over three years (2009-11), in addition to the EUR 750 million allocated to pay increases at the national level, this plan contains many provisions that go in the right direction. In particular, it offers newly appointed assistant professors a pay increase of 12 to 25%. It also creates common chairs between universities and research agencies, thereby promoting mobility for their holders, giving them supplementary resources and reducing their teaching load; increased and targeted bonuses for teaching responsibility and for scientific excellence in return for more systematic evaluation; enhanced bonuses for the most outstanding researchers; and accelerated career paths with greater possibilities for promotion.
13. This announcement followed measures taken in October 2008 in order to support business investment in view of the recession. Accordingly, all new investments made before 1 January 2010 are exempt from this tax over their entire amortisation. The cost of the amendment is estimated at around EUR 1 billion for a full year.
14. The independence rule stipulates that at least 75% of the corporate capital of the enterprise must be entirely paid up and held continuously by individuals or legal persons that themselves meet these conditions.

15. In France, there is no single official definition, but the term "very small enterprise" (TPE) is most often applied to firms with fewer than 10 or 20 employees, while those with up to 250 or 500 employees are regarded as "small and medium-sized enterprises" (SMEs).
16. The European definition of "micro, small and medium-sized enterprise" (SME) is as follows: a firm which employs fewer than 250 persons, with an annual turnover not exceeding EUR 50 million, or total assets not exceeding EUR 43 million, and which is not more than 25%-owned by one or more enterprises not meeting the definition of an SME.
17. The surcharge applies to firms with turnover exceeding EUR 7.63 million and taxable income over EUR 2.289 million. It is levied on the fraction of the aggregate tax exceeding EUR 763 000.
18. The implicit tax base is calculated by dividing corporate tax revenues by the maximum statutory rate.
19. Indeed, the report of the Modernisation Audit (2007) had concluded that a gain of EUR 4 billion was achievable within one year, with the same or enhanced effectiveness.

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Chapter 4

Strengthening competition to boost efficiency and employment

*Despite the great progress France has made in opening its markets for goods and services, and in strengthening the overall framework for competition, there are still regulatory barriers to entry in many sectors, particularly in retail trade and various professional services. This chapter traces the most significant changes that have been made in competition policy in recent years, and looks at the main challenges. In terms of the competition framework, an important step was taken with the creation of a new Competition Authority, which now exercises substantial powers that were previously in the hands of the Ministry of the Economy. In the retail trade sector, the amendments to the Economic Modernisation Act have moved further along the path of reform that began some years ago, without lifting the prohibition on resale below cost (RBC), but easing the conditions of negotiation between suppliers and retailers. While these changes should help lessen upward pressure on prices, particularly for "*brand name*" products, it would be necessary to repeal the Royer-Raffarin laws on commercial zoning to encourage the development of large retail outlets while ensuring greater competition in the many areas where large-scale retailers are concentrated. Moreover, there are relatively high regulatory barriers to entry in many professional services, including legal services and healthcare. OECD indicators show that the restrictive nature of regulation in certain professions varies greatly from country to country and suggest that French entry barriers and restrictions on practice in many cases exceed what is necessary for adequate consumer protection. In the case of telecommunications, one of the main challenges for government is to promote broader access to high-speed Internet service through prompt deployment of a fibre optics network, while at the same time trying to repeat the successful development of ADSL in terms of competition and investment. Finally, the emergence of real competition in the retail market for gas and electricity is constrained by several obstacles, the most important of which is the presence of regulated prices along with market prices.*

Introduction

France has made considerable progress over the last 10 years in encouraging greater competition in various service sectors that were previously sheltered. For example, most of the State public utility monopolies have been wholly or partially privatised and are now facing stiffer competition in their traditional markets, even if they have in many cases lost relatively little market share. Even in sectors long exposed to competition, such as the goods sector, competition has to some extent been boosted through closer surveillance by the French and European competition authorities, and the stiffer fines imposed on violators. Yet despite the overall trend towards greater competition, there remain numerous entry barriers in many service sectors, particularly in retail trade and regulated professions performing a variety of personal and business services, due in part to the reliance on self-regulation mechanisms.

A number of studies point to a positive link between economic growth and the intensity of competition in the markets for goods and services. Moreover, theoretical and empirical analyses both suggest that this linkage has a positive effect on productivity and employment. In theory, the benefits of competition come mainly from the greater incentives that firms will have to deploy and use their physical capital and manpower as efficiently as possible, to acquire cutting-edge technologies, and to innovate so as to preserve a technological, and consequently a competitive, advantage (Arnold, Nicoletti and Scarpetta, 2008). In empirical terms, it is more difficult to establish a causal link between productivity or employment and the level of competition on goods markets, in part because the competition variable cannot be directly observed. Yet numerous studies using data at the industry or firm level have shown that competition-restricting regulation weakens productivity growth, because firms take longer to catch up with the technological leader in any sector (Hoj *et al.*, 2007; Conway *et al.*, 2005). On this point, the update of OECD indicators on regulatory barriers to competition in goods and services markets shows that there were still significant discrepancies between countries in 2008 (Wölfl *et al.*, 2009). Based on the methodology used in a previous study (Conway *et al.*, 2005), it can be estimated that the level of productivity in France could rise by nearly 10% over a period of 10 years if current regulations in several producing sectors were brought into line with countries where regulatory barriers to competition are lowest. This would put France in roughly the middle of the potential gainers among European countries.[1]

This chapter looks at the major issues facing competition policy and reviews the reforms undertaken in recent years, particularly since publication of the 2005 *Economic Survey of France*, which included a chapter on competition. The first section examines the main changes to the overall competitive framework, and more particularly in the institutions responsible for its implementation. The second section examines the obstacles to competition in retail trade (in particular supermarket chains) as well as in various professional services and assesses the reform proposals issued in recent years for

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enhancing market competition in these sectors. The third section offers a brief overview of changes in specific network industries.

Changes in the competition framework

The overall framework for competition has changed significantly in France over the last 25 years, to the point where the main provisions concerning horizontal and vertical collusion, abuse of dominant position, and control over mergers and acquisitions are now to a large extent comparable to those elsewhere in Europe and, more generally, in OECD countries. The most significant changes in this area occurred in 1986, with the abandonment of price regulations and controls and the creation of the Competition Council (*Conseil de la Concurrence*), and in 2001, when the "new economic regulations" were introduced, sparking an improvement in investigative and decision-making procedures and introducing a leniency provision, together with stiffened penalties. Despite these changes, the competition framework has retained a French specificity that is a particular concern with respect to unfair competition, resulting in additional rules based on the concept of abuse of economic dependence, the importance of which is reflected in sector-specific legislation as well as in case law (OECD, 2004).

The most important recent changes affecting competition were introduced in the Economic Modernisation Act (LME), the main competition provisions of which came into force in late 2008. One of the major reforms introduced by the LME was to create a new Competition Authority, with an expanded mandate and significantly greater powers *vis-à-vis* the Competition Council it replaced. Its role as "competition watchdog" was previously shared with a directorate of the Ministry of Economy, Finance and Industry, known as the Directorate of Competition, Consumption and the Suppression of Fraud (DGCCRF). One important step was to give the new authority its own investigation powers so that it could intervene more effectively through a better-integrated procedure (with investigation and referral to prosecution handled by the same authority) when anticompetitive behaviour is suspected. About 30 investigators have now been transferred from the DGCCRF to the Authority to allow it to perform its new functions.[2]

The new authority also has been given the responsibility to examine concentration operations, to assess their impact on competition, to authorise them, subject to conditions if need be, or to refuse them. Formerly, control over mergers lay with the Ministry of Economy, Industry and Employment (jointly with the sector ministry concerned), with the Competition Council getting involved in an advisory capacity at the Minister's behest. Henceforth, the decisions of the new Authority will carry much more weight, for whenever the government overrules those decisions it will have to do so on the basis of factors not related to competition, and these will have to be publicly justified. Lastly, the Authority now has the power to address competition questions and to issue opinions on measures to be taken to strengthen market competition.

These two significant changes – which in fact were recommended by the Attali Commission (2007) and by the OECD (2005) – have made regulation of competition in the markets more effective and helped foster a culture of competition in which stakeholders are less reluctant to blow the whistle on unfair practices by their competitors. Moreover, by giving an independent agency full power to enforce competition law, the government is bringing France closer to the practice that prevails in most OECD countries. The model adopted by the government still differs from that in neighbouring countries in two respects. One has to do with the treatment of "minor cases" and the other involves the scope of the governmental veto in the case of mergers and acquisitions.

The treatment of practices of local dimension

Competition law in most countries provides a mechanism to save the authority from dissipating its resources among a large number of minor cases and thus undermining its ability to address the larger and more important ones. The most common approach is to give the independent authorities a degree of discretion that allows them to pass over cases deemed *de minimis* and leave these to a subsidiary body (or a "second window"). Without investing the Competition Authority with such power, the French Government nevertheless wished to spare the independent authority from having to deal with a barrage of cases with strictly local ramifications, to the detriment of other cases of greater significance to the economy or to consumers. Consequently, the Minister of the Economy has retained the power to propose an injunction and/or a settlement to firms whose turnover does not exceed a certain threshold (EUR 50 million each and combined turnover of EUR 100 million), affecting exclusively a market of local dimension and not governed by Community law. And, this power is to be exercised only after the Authority, previously informed, has declined to pursue the case. The turnover threshold set by the legislation seems high, especially in relation to the ceiling on the firm's contribution to the settlement (EUR 75 000). This could be reconsidered so as to ensure that the power of "injunction and settlement" in fact applies only in markets that are of local dimensions. Moreover, consideration should be given to letting the Competition Authority validate agreements that are worked out within the Ministry with regard to such practices.[3]

The power of pre-emption (évocation)

When it comes to reviewing concentrations, the reform represents a major step forward. As noted earlier, while transferring to the Authority the power to make decisions regarding concentrations, on the basis of competition considerations, the government retains the power to override the decision from the Authority's on national interest grounds that are other than competition-related. This power of pre-emption is legitimate and thoroughly consistent with practice in the major EU countries. Here, it is formulated so that it can be wielded whether the Authority accepts or rejects the proposed concentration, which is also the practice in Spain. In comparison, German anti-trust law empowers the federal government to authorise a merger that has been prohibited by the competition authority, but not to ban an authorised concentration. In principle, one may well question whether the government should have this pre-emptive power in cases where the Authority has held that the proposed merger does not restrict competition. In practice, it emerges fairly clearly that this right may be exercised only in exceptional cases, insofar as that to override a decision by the Competition Authority the government will have to issue a public justification. For instance, since the power of pre-emption was instituted in 1973, and out of some 170 cases of concentrations being banned by the competition authority, the German government authorised the transactions only 11 times.

Class actions

In addition to government regulation of competition, private enforcement mechanisms should be introduced for regulation by consumers. To this end, the introduction of class actions into French law would give consumers effective recourse in "minor everyday disputes" for which individual proceedings would be dissuasively costly and time-consuming. The threat of a class action suit can also play an important role in regulating markets by depriving the perpetrators of anticompetitive practices of unlawful profits and discouraging improper business behaviour. Such a procedure can result in a good fit between public and private actions in the realm of competition and consumer protection. France is considering the introduction of class actions in conjunction with the legislation to adjust criminal penalties for economic and financial offences.

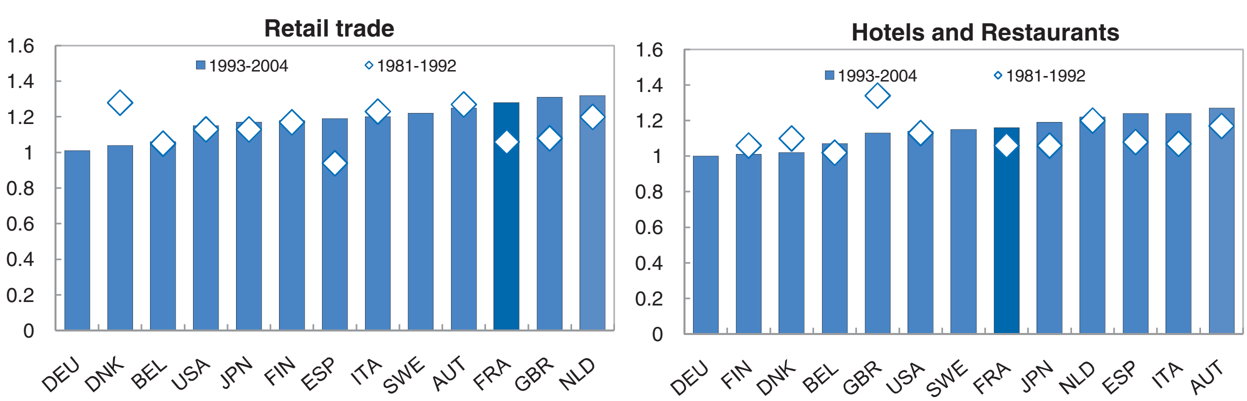
Competition policies in selected service sectors

Despite the gradual strengthening of overall competition policy during the last two decades, there remain a number of regulatory barriers in several sectors providing personal and business services. While the LME represents welcome progress in the retail trade sector, its beneficial effects are to some extent hostage to what will happen to the commercial zoning laws, which the government is still debating. Moreover, it should be a government priority in the competition area to lower barriers to entry for new players in several professional services as this would reduce user costs, help improve the diversity of services and, above all, increase employment. While the restrictions in these sectors are often justified by national interest and consumer protection considerations, many of them appear to be useless or at least disproportionate to their objectives.

Retail trade

A number of studies have pointed to a lack of competition in the French retail sector and in the hotel and catering industry (which includes restaurants), on the basis of various cross-country and/or cross-sector indicators. These sectors, taken together, account for slightly over 7% (0.8% for hotels and restaurants) of the business sector value added, and food retailing itself is the largest industry in terms of employment (with some 600 000 jobs). A recent study (Bouis, 2007) measuring mark-ups in various sectors of the economy shows that those in the retail and hotel/restaurants sectors in France are among the highest (Figure 4.1), and that there is a sharp discrepancy *vis-à-vis* countries where mark-ups are lowest (Germany, Denmark). The study also shows that mark-ups in these sectors have jumped considerably in France since the mid-1990s, to a degree matched by only a few countries (Spain in both sectors, and the United Kingdom in retail trade).

Figure 4.1. **Mark-ups in retail trade and the hotel industries in selected OECD countries**



Source: OECD based on Bouis (2007).

StatLink http://dx.doi.org/10.1787/604328043381

The findings from the mark-up study relating to the intensity of competition in retail trade are partially corroborated by measures of market concentration, in particular when it comes to food products (or daily consumer goods).[4] Thus, in the case of France, the market share of the five largest retail groups rose steadily from 1993 to 2004, before retreating slightly. While a similar trend has been observed in many other European countries (especially in small countries where the arrival of foreign groups has spurred local consolidation), concentration at the end of the 1990s was significantly higher in France than in Germany, Italy or Spain (Dobson *et al.*, 2002). By contrast, it was comparable to or below that in the United Kingdom, and in some of the smaller countries.

The weakness of competition on the French retail market stands out more sharply when one looks specifically at the relationship between distributors and suppliers, on one hand, and between distributors and consumers at the local level. First of all, the five largest retail chains[5] account for nearly 90% of the market for consumer products and fresh produce, and thus have what amounts to monopsonistic power, at least over small suppliers.[6] Next, two recent studies suggest that concentration at the local level is even higher than at the national level. According to one of those studies, a single large distributor has a market share exceeding 25% (and it is more than 15 points ahead of the runner-up) in 60% of consumer catchment basins (Astérop, 2008). The second study, which focuses on "hypermarkets" or "superstores", shows that barely a quarter of France's 634 shopping basins are really competitive (UFC-Que Choisir, 2008). In a third of cases, there is virtually no competition, while in the remaining areas there may be competition to varying degrees.

The main factors shaping market structure

The French market has been shaped by several tendencies that are common to all developed countries and that have brought profound changes over the last three or four decades, particularly in food retailing. These trends include the development of big shopping centres on the outskirts of major cities where hypermarkets flourish. This has been accompanied by investment in sophisticated logistics and distribution systems made possible by technological progress, and these have produced increasing economies of scale. At the same time, the steady opening of borders, especially in Europe, has encouraged concentration at the national level and the emergence of big retail chains with enormous buying power.

While these concentrations have in many cases meant gains in efficiency and a wider range of services to consumers, the competition authorities are nevertheless concerned over the great market power that retailers might wield *vis-à-vis* suppliers and consumers. The authorities have reacted to these fears in different ways, in part because the effect on economic efficiency that strong retailer buying power may have depends on several factors, the influence of which varies from country to country. Those factors include the concentration of hypermarkets in local markets and the presence of "hard discounters", which can fuel competition even in a relatively concentrated market.[7] In addition, countries have placed varying degrees of importance on competition *vis-à-vis* other considerations such as urban planning, protection of small businesses, and the development of national champions able to gain foreign market shares.

In France, the market structure, the effective degree of competition and their impact on prices have been greatly influenced by two types of regulation introduced some decades ago and which, with changes over time, have considerably weakened competition, especially in the 1990s. The first regulation concerns commercial zoning and the second refers to the negotiability of sales fees and conditions between retailers and suppliers.

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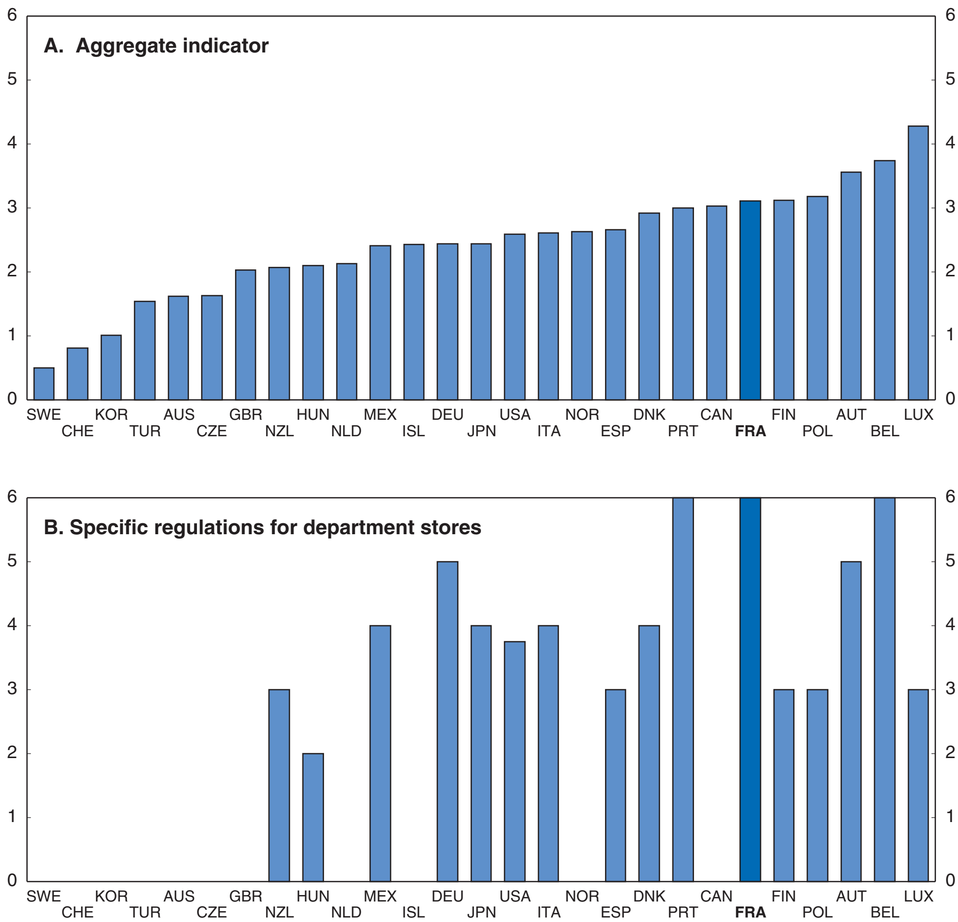
Commercial zoning regulations: the Royer and Raffarin laws

The Royer Law, introduced in 1973, was intended to protect small shopkeepers in the face of rapidly expanding large-scale retail outlets by requiring that any new store of more than 1 500 m^2 (in cities with more than 40 000 inhabitants) must be approved by regional zoning boards (*commissions départementales d'urbanisme commercial*, CDUC) made up, in most cases, of elected officials, merchants and independent trades people. In this way, established businesses had a direct say in the entry of new competitors into their territory, and their power was enhanced by the fact that one of the many rules imposed by the law dealt specifically with economic need or the local market's capacity to absorb a new competitor. The idea was not to halt the spread of hypermarkets entirely but to prevent fierce competition among big retailers from innovating and cutting prices to the point that small businesses could not survive.

These provisions were considerably strengthened by the Raffarin law of 1996, which reduced to 300 m^2 the threshold beyond which zoning board approval was required. This

Figure 4.2. **Regulatory barriers in the retail business**[1]

Indicator scale of 0-6 from least to most restrictive, 2008



1. No data are available for Greece, Ireland and Slovak Republic. The charts do not reflect the changes introduced in France in late 2008 through the LME.

Source: OECD, *PMR database.*

StatLink http://dx.doi.org/10.1787/604355132064

tightening of the regulations was aimed primarily at the "hard discounters", which were already widespread in Germany and whose arrival in France was seen as an even greater threat to small retailers than were the hypermarkets.[8] At the same time, the membership of the zoning boards was reduced from 20 to 6, a move that reinforced control by elected officials but did not entirely strip established merchants of their right to have a say in the arrival of competitors.[9] In another important change, the Raffarin law extended the commercial zoning rules, including the 300 m^2 threshold, to cover hotels and restaurants. The main provisions of these laws made France of the OECD countries with the highest regulatory barriers to retail competition (Figure 4.2, which does not factor in the changes introduced in France in late 2008 through the LME). This outcome reflects, more specifically, the approval procedures for large stores, which were until recently the most restrictive of any OECD country (Panel B).

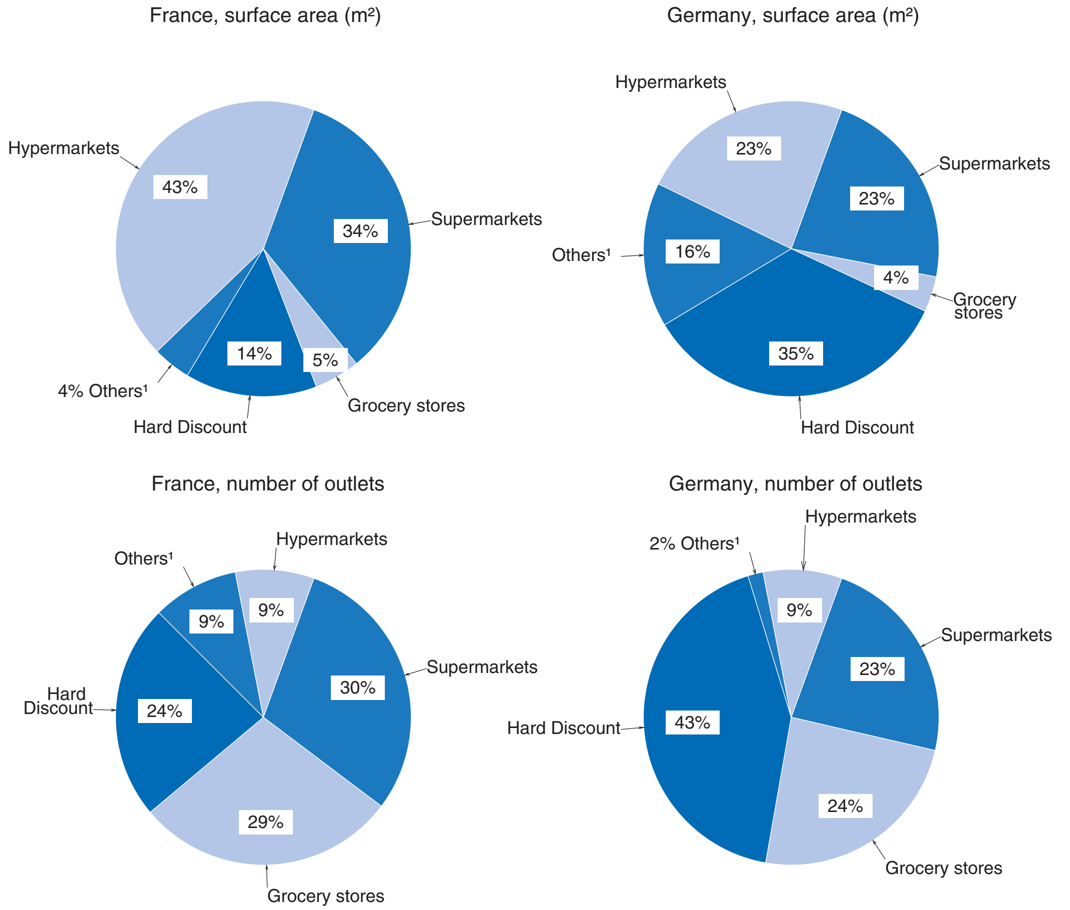
While these measures have not really succeeded in halting the steady decline in the ranks of small shopkeepers, they have helped stabilise the market share of small-scale food retailers (although this stabilisation was apparent even before the Raffarin law came into effect).[10] Above all, these measures have affected market structure by limiting the growth of the hard discounters in favour of the traditional supermarkets and smaller-scale retailers. Thus, the proportion of hard discounters is still far below that in Germany, to the detriment of competition (Figure 4.3).[11] Overall, the Royer-Raffarin laws seem to have resulted in a general dearth of large retail outlets in France, and they have allowed the large, long-established groups to strengthen their market position, undermining competition in many regional markets. For example, the floor area of hypermarkets, in absolute as well as per capita terms, is around 20% less than in the United Kingdom where, in contrast to France and Germany, no special authorisation is required to open a big store (Messerlin, 2008). Moreover, by limiting the space available for displaying goods, the negotiating power of retailers *vis-à-vis* suppliers has also been increased, and the authorities have felt compelled to intervene to "rebalance" this relationship (see below). While the impact of these laws has been more visible in food retailing, they have certainly played a role in the hotel and catering industry, where they have held up the development of large-scale hotels to the benefit of small inns and B&B's (Attali Commission, 2007).

The Galland law and the prohibition on price discrimination and resale below cost

The second type of regulation prohibits resale below cost (RBC) and bans discrimination in the prices offered to distributors. Its primary goal is to protect manufacturing suppliers *vis-à-vis* large-scale retailers, whose market power has allowed them to impose prices and purchase conditions unilaterally, to the detriment of small and medium-sized firms. By preventing distributors from using their purchasing power to drive down prices, the regulations have attempted at the same time to shelter small merchants from intense price competition, in line with the main objective of the Royer and Raffarin laws. While the RBC ban dates back to the 1960s, it actually became effective only with the changes introduced by the Galland law of 1996.

In effect, this eliminated two sources of ambiguity that until then had allowed the rule to be circumvented: first, there was no clear and precise definition of the RBC threshold, and second, the calculation of this threshold could include various promised discounts that the suppliers would have to pay later in exchange for commercial services (Allain,

Figure 4.3. **Structure of the food retail market in France and Germany, 2008**



1. In the case of France, this category includes popular stores, frozen food stores and bio-food stores. For Germany, the category essentially includes warehouses.

Source: OECD and Trade dimension.

StatLink http://dx.doi.org/10.1787/604388374312

Chambolle and Vergé, 2008). Such discounts can be used to distinguish two components of the retailer's commercial mark-up, which have played an important role in the law's impact on retail prices: the "front margin" and the "back margin" (Box 4.1).

Global impact of regulations on prices, employment and productivity

The performance of relative food prices between mid-1996 and mid-2001 offers a fair reflection of the impact that these laws have had on the main market players' behaviour. Not only has the relative price index of food increased faster in France than in the principal neighbouring countries (Figure 4.4), but the marked acceleration at the end of the 1990s came close on the heels of the Galland law, even if it also coincided with the move to the euro.[12] Moreover, on the basis of an empirical relationship for the price of food products (excluding fresh fruits, vegetables and fish), the additional inflation attributable to the Galland law over the period 1997-2001 can be set at slightly over 3% (Boutin and Guerrero, 2008). Although this was more pronounced in the food sector, an inflation

Box 4.1. **Distinction between the list price and the real price paid by the retailer**

The unit price of a product represents only a portion of the overall or effective price paid by the retailer, which is affected by numerous clauses in supply contracts relating to the commercial services to which suppliers may be entitled, and for which they give discounts or rebates in return. Some of these services, such as product promotion (*e.g.* preferential shelf space), are covered by rebates paid to the retailer at the time of sale to the consumer ("front margins"). However, contracts can also include numerous rebates that are conditional on sales results for the year, or that correspond to various commercial services which may go beyond conventional transactions (advertising, logistics etc.). These rebates are paid not at time of sale but later, as part of the "back margins" (see chart below).

It should be noted that back margins generally apply to specific categories of product, namely processed foods (as opposed to fresh produce, meat or fish sold in bulk) and brand-name products (as opposed to retailers' own-label goods). This goes part way to explaining why price hikes following the Galland law were more pronounced in brand-name products.

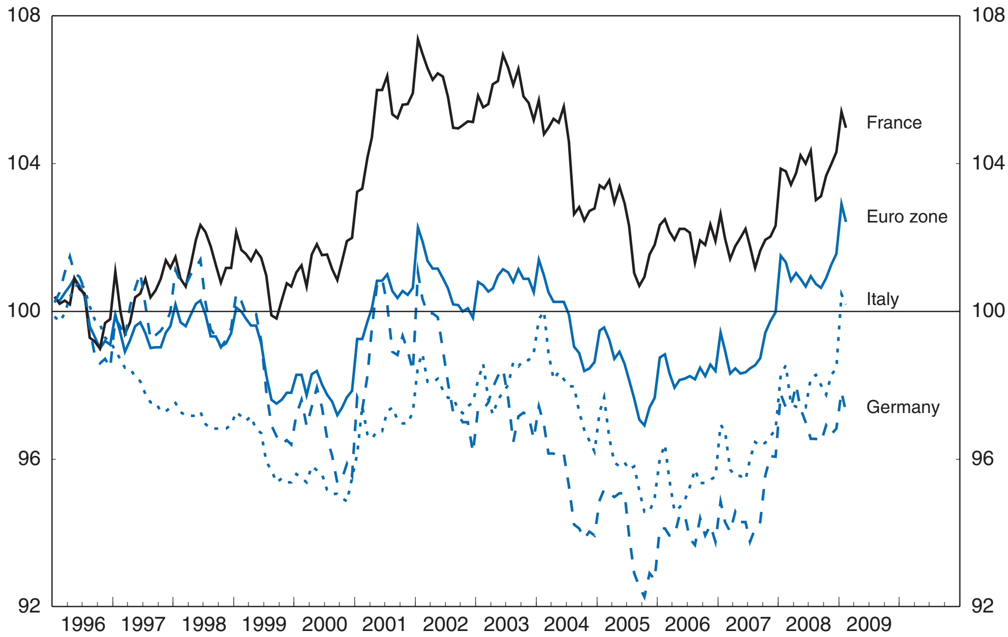
Since 1997, the RBC threshold has been very clearly defined as the price appearing on the purchase invoice adjusted for taxes and transport costs. Moreover, for the sake of transparency, only the "front margins" could henceforth be included in calculating this threshold. The main impact of these changes, when combined with the principle of non-discrimination, has been to allow suppliers to set a common floor price applicable to the entire industry, for each product, and to make the "back margins" the central focus of negotiation over the general conditions of sale. In fact, suppliers and retailers alike had an interest in reducing the front margins (included in the calculation of the RBC threshold) in favour of the back margins (not included): suppliers, because they could guarantee themselves a minimum price for their products, and retailers (especially the less competitive ones), because a high and uniform RBC threshold would neutralise the effects of competition if it no longer left room for a variety of prices in the final sale to the consumer. Back margins thus rose from slightly more than 20% of the net invoiced price in 1998 to 33% in 2005, and cases of abuse were verified where the RBC threshold was artificially inflated in return for conditional rebates for fictitious services (Boutin and Guerrero, 2008). This shift towards back margins in the negotiation of sales conditions suggests that these measures have been only partially successful in achieving their objective, which was to strengthen the position of small suppliers in their dealings with big retailers.

General conditions of sale (GCS)	**Supplier's invoice**
• Price list ❖ Volume discount ❖ Sales-related rebate ❖ Other discount (as stipulated in the contract)	• Price • Simple net price invoiced (determines the "front margin")
• Conditional rebates (not directly tied to sales) • Services spécifiques (prévus aux CGV ou conventions spéciales)	• Defered invoice or credit = double net price (back margin)
Commercial co-operation services	**Retailer's invoice**
Services not related to the purchase of goods	Separate = triple net price (other «back margins»)

Source: Canivet Commission (2005).

Figure 4.4. **Relative prices of food products**[1]

January 1996 = 100



1. Corrected for general inflation.

Source: Eurostat.

StatLink http://dx.doi.org/10.1787/604445287142

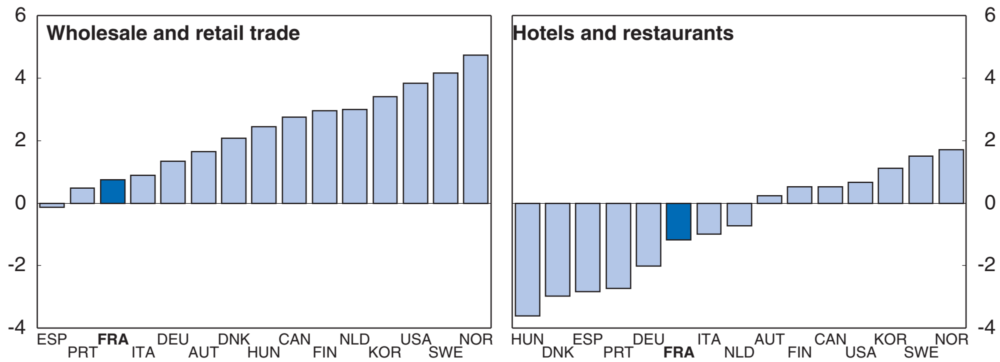
increment of slightly over 1% in manufactured products sold in large retail outlets can also be blamed on the Galland law.

A recent study shows that one of the effects of the Galland law has been to reduce price sensitivity to competition (Biscourp, Boutin and Vergé, 2008). While in 1994 the degree of local concentration had an impact on prices of between 10 and 15% (which is consistent with findings in other countries), that relationship had practically disappeared by the late 1990s, and the degree of competition no longer had any significant impact on prices. It is not surprising, then, that the price discrepancies noted for identical products vary by only 1 to 2% between areas of weak and strong competition (UFC-Que Choisir, 2008). In this context it is also difficult to identify accurately the effect of commercial zoning rules on prices, especially since numerous factors can influence price discrepancies between regions, in particular differences of living standards which are reflected by variations in commercial real estate prices, among other things (Griffith and Harmgart, 2008).[13]

On the other hand, various estimates suggest that commercial zoning rules have had substantial and adverse effects on employment and productivity. First, an econometric study produced a direct estimate of the impact that entry barriers to new businesses had on employment in the retail sector between 1975 and 1998 (Bertrand and Kramarz, 2002). After noting that the provisions of the Royer law were applied to varying degrees in different regions, depending in particular on the political party in power locally, the authors used these differences in approval rates to conclude that between 7% and 15% of additional jobs (*i.e.* between 112 000 and 240 000 jobs) could have been created in the sector in the absence of regulatory barriers to entry. Moreover, a more recent study estimates that between 50 000 and 100 000 jobs were lost during the 10 years that followed application of the Raffarin law (Askenazy and Weidenfeld, 2007). The range corresponds to assumptions as to the sharing of the surplus rent to the sector between lower prices and higher employment.[14] As to the impact on productivity, even if direct estimates are more difficult to establish, it has been observed that growth in value-added per employee in the retail and hotel sectors has been weak both in terms of absolute value and in international comparison over the period 1995-2006 (Figure 4.5).

Figure 4.5. **Average productivity growth rate 1995-2006 in selected OECD countries**

Value added per employee



1. SWE: 1995-2005, PRT: 1995-2005.
2. FRA: 1995-2005, SWE: 1995-2005, PRT: 1995-2005.

Source: OECD, *STAN Database,* 2008 edition.

StatLink http://dx.doi.org/10.1787/604454230433

Changes introduced by the LME

The LME was voted in the summer of 2008. It made various changes to the rules governing the negotiation of sales conditions between suppliers and retailers (Galland law) and those concerning commercial zoning (Royer-Raffarin laws). With respect to the Galland law, the LME continues along the path of reforms followed in recent years (see Box 4.2), without affecting the ban on below-cost pricing. First, the prohibition on discriminatory business practices was lifted, allowing greater freedom in trade negotiations and giving suppliers the right to modulate their prices for different retailers without having to justify their actions. Thus the GCS, including prices, can now be negotiated directly between producers and retailers with no need to justify differential conditions between retailers. The process is however still controlled by the signature of a convention or a package consisting of a framework contract and implementing contracts formalising the outcome of the negotiation. At the same time, the LME encourages the reduction of *back margins* by moving trade obligations directly relating to the act of sale to front margins. Compensation for these obligations will now appear on the invoice as rebates. On the other hand, it will be easier for the courts to identify retailers who are abusing their purchasing power over suppliers, and the penalties for such behaviour have been stiffened considerably. In addition, the payment terms that suppliers can grant retailers have been shortened (see Chapter 3).

With respect to zoning regulations (the Royer-Raffarin laws), the LME makes two important changes: the threshold beyond which approval is required for businesses is raised from 300 m^2 to 1 000 m^2, and the makeup of the regional boards is changed so as to

Box 4.2. **Reforms prior to the LME**

With food prices spiralling upwards, the authorities have taken successive steps in recent years to reduce the perverse effects of the Galland law. As early as 2004, an official report on the issue proposed that the RBC threshold be redefined to include back margins and thereby to reflect the price that retailers actually pay suppliers (Canivet Commission, 2005). It also suggested allowing suppliers to discriminate among retailers. Either one of these measures could have served to restore competition both among producers (same product type but different brand) and among retailers (products of the same brand), thereby eliminating the effect of the uniform floor price (Allain and Chambolle, 2007). While the government promptly committed itself to this path in 2005, the approach followed was gradual. First, with respect to the RBC threshold, an initial reform introduced in 2005 (Dutreil Law II) allowed initially 15% and later 20% of back margins to be included in the threshold. To preserve the balance in the bargaining power between retailers and suppliers, however, the freedom in commercial negotiations was reduced so that the form and content of contracts specifying services rendered by retailers became more strictly specified.

Complete inclusion of back margins in the threshold was finally established in January 2008 (Chatel Law). The RBC threshold was thereby set at the "triple net" price, *i.e.* net of front margins (simple net), conditional rebates not acquired upon sale (double net) and additional rebates for commercial cooperation or specific services (triple net). As to the principle of non-discrimination, an initial breach was made in 2003 with a directive (Dutreil) authorising "moderate" differentiation in the general conditions of sale, for the purpose of moving negotiation towards the back margins. This change did not however have the intended effect, and the impact of back margins in the net invoice price continued to climb between 2004 and 2006. Among other things, the directive allowed differentiation in GCS between categories of clients (for example between wholesalers and retailers), as well as price differentiation linked to payment terms and the early payment discount.

As to the Royer-Raffarin laws, they were not seriously challenged prior to introduction of the LME. On the contrary, a law adopted in 2000 added three new criteria to the long list that members of the regional boards had to consider when examining applications. As a result of this change, members were required to consider up to nine criteria, some of which could lead to contradictory conclusions.

exclude representatives of the chambers of commerce and independent merchants and to strengthen the power of elected politicians. They will now once again hold a majority of seats on the boards, as they did prior to 1993. In addition to elected officials, the number of which is increased from 3 to 5, the boards will now have three members qualified to consider consumer interests, sustainable development, and land-use planning. Furthermore, the economic criteria such as commercial density, supply and demand have been abandoned in favour of criteria relating to land-use and sustainable development. The moves to delete the economic criteria (designed to determine whether the market is sufficiently large to support an additional competitor) and to exclude competing interests (chamber of commerce and small shopkeepers) from the board were necessary in any case, because these provisions ran counter to the European Union's Service Directive. Finally, the scope of application of the special approval procedure has been narrowed with the exclusion of hotels and restaurants as well as service stations and automobile and motorcycle dealers.

Considering the distortions induced by the key laws in the structure of markets, with adverse consequences in terms of efficiency, employment and inflation, one may ask whether these amendments are sufficient to restore true competition in the retail sector. As to the zoning regulations, abolition of the requirement for special approval beyond a threshold (the main motivation for Royer-Raffarin laws) would do away with a case-by-case decision-making procedure that is by definition discriminatory and can be blamed for most of the distortions noted above. A special approval procedure based on floor area seems particularly unnecessary now that the approval criteria have been amended to promote the objectives of land-use planning, the environment, and transport facilitation. Because these objectives can for the most part be served by existing zoning plans (the "territorial coherence scheme"), the procedure for issuing construction permits should be sufficient for dealing with applications to open large stores, as is the case in many European countries. At the same time, the fact that elected officials now have a majority on the regional boards may give rise to some concerns, especially since their power has been enhanced by the possibility of pre-empting land slated for a new store and substituting an alternative project, at the risk, once again, of blocking entry for foreign competitors. In this regard, the government has put a mission in place to explore the options.

With respect to the Galland law, the removal of the rule that prohibited suppliers from discriminating among retailers when negotiating general conditions of sale and the reinsertion of the back margins into the calculation of the RBC threshold should remove the fixing of an industry floor price and the consequent neutralisation of price competition. The question now is whether the RBC ban should be retained at all, recognising that only a minority of OECD countries have such a mechanism. While a great deal of literature exists on RBC, economic theory does not offer a decisive conclusion as to its positive or adverse effects on efficiency.

Because predatory pricing by firms in a dominant market position is in most cases already punishable under competition law, an outright ban on RBC appears unnecessary, and it moreover deprives consumers of potential benefits (OECD, 2006). Retailers may in effect engage in RBC for various reasons that have nothing to do with driving out a competitor, and in many cases this will benefit consumers (Chambolle, 2005). On the contrary, numerous empirical studies comparing outcomes in US states that have adopted different practices in this area show that, while an RBC ban tends to produce higher retail mark-ups, it also tends to push down wholesale prices, and the net impact on the final selling price is uncertain (Anderson and Johnson, 1999). One reason suggested is that a general prohibition on RBC may in time serve to keep more competitors in play, and its advantages may in this case outweigh its drawbacks. Against this background, possible reform of the rules banning RBC would not seem to take priority over repealing the Royer-Raffarin laws.

Other obstacles to retail competition

Apart from the food sector, the desire to protect small shopkeepers, combined with strong concern over unfair competition, has in the past led to the introduction of regulations the benefits of which are not readily apparent and which, in any case, are unsuited to the emerging new forms of sale, in particular online sales.[15] For example, the Lang Law of 1981, which severely constrained the ability of booksellers to discount their wares (to attract customers or simply to clear stocks) has recently been invoked to prohibit

Amazon from offering free delivery, on the grounds that this would constitute "*vente à prime*" ("bonus sales"). One might question the need to maintain a rule that seeks explicitly to impose a single selling price, given its perverse effects on competition.

Regulations governing the opening hours of stores are still fairly restrictive, particularly when it comes to Sunday shopping. Despite some recent easing of these restrictions, Sunday store openings are still tightly controlled. Sunday as a "day of rest" is enshrined in the labour code, but there are some exceptions that relate for the most part to essential services (hospitals, transportation, etc.) and certain businesses located in tourist zones. To these exceptions may be added some partial exemptions whereby, for example, municipal mayors or regional prefects may allow businesses to be open on up to five Sundays a year, a right that is generally exercised in the weeks leading up to Christmas and New Year's.[16] The principal advance with the reform currently under discussion, in its present form, is to extend this exemption to five additional Sundays in the larger cities (over a million inhabitants).[17] On the other hand, the law imposes double pay for Sunday work. In addition to offering consumers greater freedom, additional flexibility in Sunday openings would be especially beneficial for youth employment, judging from experience in the many countries where this practice has been generalised. On the other hand, the reform's effects on prices, along with its social spillovers, are more uncertain.

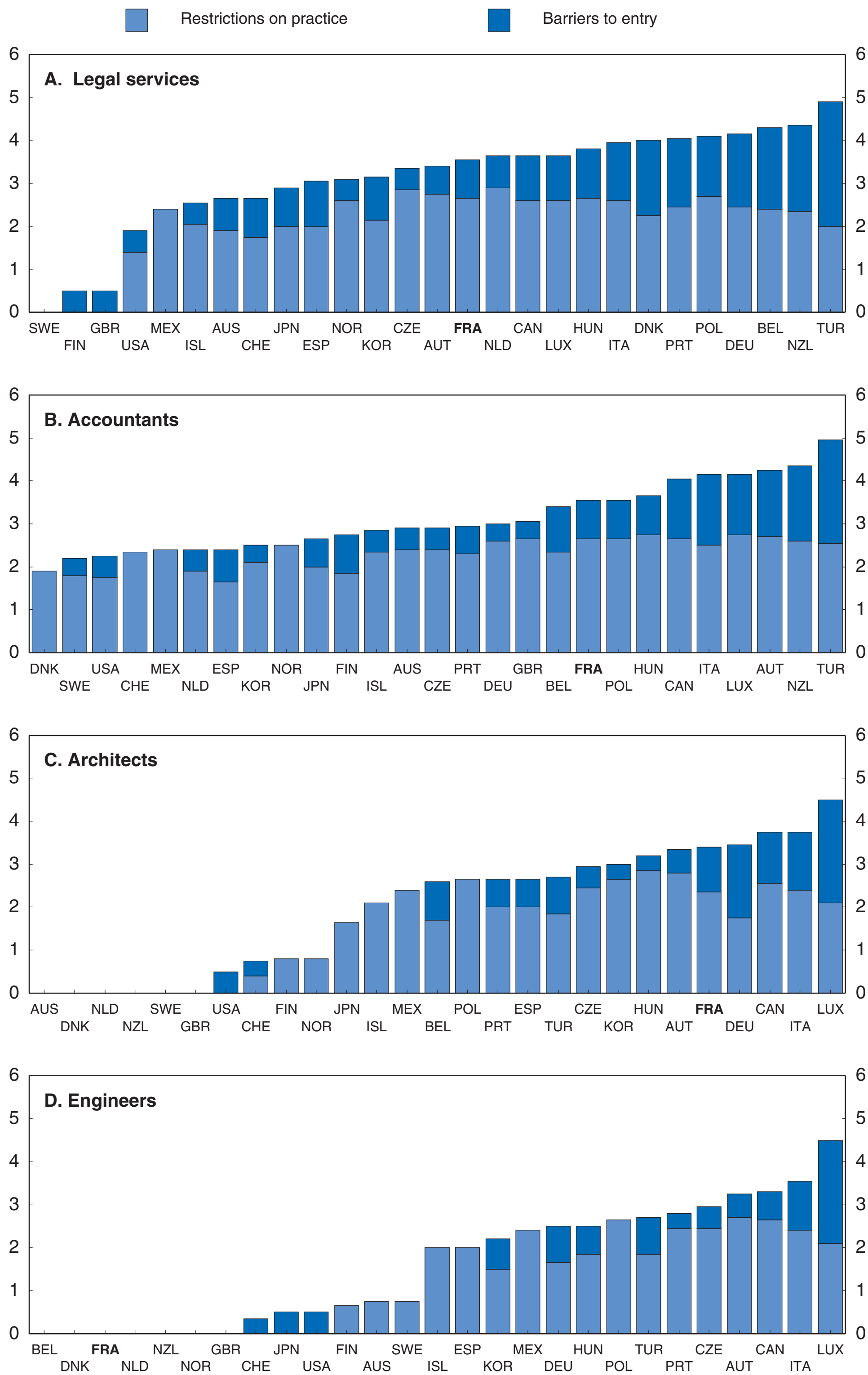
Professional services

In most OECD countries, numerous professional services are subject to a broad array of regulations (in the form of self-regulation or regulation imposed by the State), and some of these have a direct impact on competition. Apart from regulatory barriers to entry, there are various restrictions on the exercise of professions, the main impact of which is to limit competition. The principal barriers to entry include the minimum number of years of study required to exercise the profession, supplementary examinations for recognition as a full member, and the imposition of *numerous clauses* provisions (quotas). The restrictions on practice include control over fees, the prohibition on advertising, and strict rules concerning the tasks that the professional can perform and/or the legal form of the business through which the service is offered. These various regulations are generally motivated by market failures due primarily to the asymmetry of information between the professional and the customer.[18] The objective of the regulations, which may be imposed either by the government or by the professions themselves, is thus primarily to fill the information gap by giving potential clients cost-free assurance as to the professional's integrity and qualifications.

Yet the restrictiveness of regulatory barriers in some professions varies considerably across the OECD, suggesting that barriers to entry and restrictions on practice in some countries go beyond what is necessary to protect the consumer adequately. Thus, the regulatory indicator in certain specific services shows that, as in many of its European neighbours, France maintains relatively high regulatory barriers in three of the four professions examined: accounting, architecture, and legal services (Figure 4.6). In each case, the direct barriers to entry are much more restrictive than the regulations governing practice, although these too are constraining. For example, the number of years of study required to obtain a license as an accountant, architect or lawyer is much higher in France than in many other OECD countries. In the case of architects, licensing conditions and education requirements have both been stiffened since 2003, while the international trend has been in the other direction.

Figure 4.6. **Regulatory barriers to competition in selected professions**[1]

Indicator scale of 0-6 from least to most restrictive, 2008



1. No data are available for Greece, Ireland and Slovak Republic.

Source: OECD, PMR database.

StatLink http://dx.doi.org/10.1787/604458751477

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Moreover, a number of studies in recent years have found excessively high barriers to competition in various other professional services involving health or beauty (physiotherapists, veterinarians, pharmacists, hairdressers), and more generally in personal home services.[19] For example, employment in veterinary services is well below the European average, mainly because of very restrictive quotas. Pharmacists moreover have a much broader range of products for which they have exclusive selling rights, compared to practice in many European countries.[20] Even with hairdressers, training requirements exceed what would be considered necessary in light of the demands of the trade, and thereby constitute a barrier to entry. Highly restrictive regulations in these professions stand in striking contrast to the case of engineers, where there are virtually no obstacles to entry. In fact, the case of engineering shows that it is quite possible to reconcile objectives of quality control and integrity with those of healthy competition (Cahuc and Kramarz, 2004).[21] While it is true that the degree of regulatory restrictiveness can legitimately vary from one profession to another in light of the risks they represent, for example to health or public security, it is by no means certain that the current discrepancies are justified, particularly in the case of accountants, architects and hairdressers.

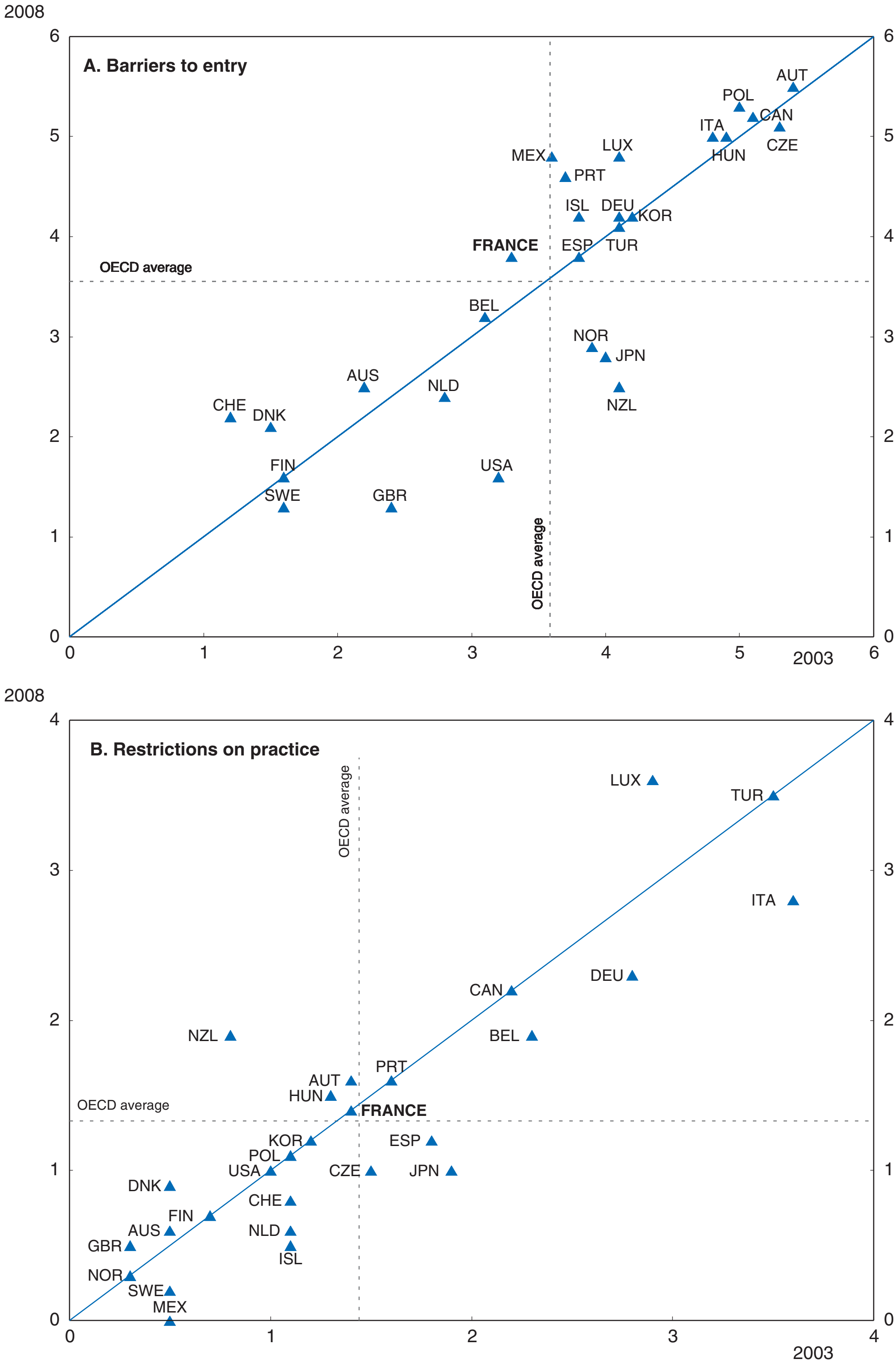
Taken individually, most professional services account for a relatively low portion of total employment in tradable goods and services and in value-added, particularly in comparison with retail trade. Yet taken together they have a considerable impact and they moreover have substantial potential for growth, given their relatively low employment levels compared to other countries. Apart from the adverse impact on employment, restrictions on entry and practice generally lead to higher fees and, in some cases, lower productivity (Paterson, Fink and Ogus, 2003).[22] Experience in several countries indicates that where services are protected by intensive self-regulation, the self-regulation bodies have a tendency to go beyond the objective of assuring quality and integrity and to take advantage of the economic rents inherent in their position to exact higher fees (OECD, 2007a). On the other hand the studies do not show that more restrictive regulation entails a significant increase in the quality of services, or better protection for consumers.

The fact that in most cases the barriers remain very high despite the many recommendations contained in the various expert reports (some dating back several years) demonstrates once again how difficult reform can be in the face of long-entrenched rents.[23] Nor is this finding confined to France, as demonstrated by the slow rate of change over time in regulatory indicators for the majority of OECD countries (Figure 4.7). This situation persists in part because it is not easy for customers/consumers to measure directly the penalty they bear in terms of higher fees or reduced variety and quality of service. Yet some countries have managed to reduce significantly the restrictions on entry and practice in a number of professions. For example, entry into the legal profession has been greatly relaxed in the United States and the United Kingdom since 2003, bringing those countries to the same level as Sweden and Finland in this respect. There is nothing to suggest that the quality of legal services is lower in these countries, and indeed these changes may have contributed to the persistent domination of the big American and English legal firms on the international scene, even if other factors have also played a key role. The regulatory indicator suggests, by contrast, that barriers to entry were somewhat reinforced in France between 2003 and 2007.

Despite the difficulties of undertaking far-reaching reforms in these sectors, the government was induced by the Attali report's analysis and recommendations to open

Figure 4.7. **Regulatory restrictions on entry and practice in professional services**

Indicator scale of 0-6 from least to most restrictive



1. Simple average of indicators for legal services, accountants, architects and engineers. No data are available for Greece, Ireland and Slovak Republic.

Source: OECD, *PMR database.*

StatLink http://dx.doi.org/10.1787/604472851670

discussions with representatives of certain professions and, in a so-far limited number of cases, to take steps to foster competition. In the case of legal services, eliminating the system of *avoués* (advocates) before the Court of Appeals is under consideration, with a view to unifying the legal profession.[24] Moreover, a commission has been directed to make proposals, including the creation of a comprehensive legal profession in order to improve the quality of services rendered to clients of legal services. In addition, a bill arranging for a merger between the professions of attorney and intellectual-property counsel is being adopted. Also, the Ministry has already started to explore ways to adjust the number of attorneys at the Council of State and the Court of Cassation to suit the caseloads of the country's two highest courts. Lastly, a reform to the establishment of bailiff (process serving) offices to facilitate the grouping of professionals and encourage greater competition has been in force since the beginning of 2009, and a decision has been made to increase the number of notaries by 20% over four years.[25] With respect to pharmacists, an amendment to their code of ethics will allow pharmacies to offer free access to a broader range of drugs that were hitherto available only at the counter.

But as is frequently the case in the competition field, the European market integration process could well bring with it some significant progress. The principles of freedom of establishment and free offer of services that underlie the EU "Services" directive will lead to a degree of harmonisation of national systems, and this should make it easier to establish operations in member countries. However, the scope of application of the directive is clearly circumscribed. It is possible, then, that the Services Directive will be of limited applicability in several of the professions mentioned above, particularly those relating to law and health.[26] Moreover, the LME has introduced the status of "independent entrepreneur" (*auto-entrepreneur*) with greatly simplified administrative procedures and tax rules, and this could also increase competitive pressures, at least in professions where regulatory barriers to entry are not too high.

While recent measures represent progress, the persistent barriers to entry in many professions will have to be challenged more directly if there is to be real competition. Thus, the quota system will have to be gradually eliminated for various legal services (advocates before the Council of State and the Court of Cassation) and could be replaced or supplemented by more-flexible mechanisms for pharmacists and veterinarians (*e.g.* creation of an intermediate category of veterinary nurses). Challenging these quotas is particularly important because they encourage students who have been rejected to seek the required diploma in neighbouring countries, where such restrictions do not exist.[27] In addition to removing the quotas, the conditions of entry could be further eased by reducing the field of activities over which certain professions have exclusive rights (architects, notaries, bailiffs) and by reassessing professional requirements (architects, veterinarians, hairdressers) to determine whether there is any justification for keeping them significantly more restrictive than in other countries where these professions function just as well. Finally, there are severe constraints on the ability of practitioners of "soft medicine" (complementary and alternative medicine) to compete with conventional physicians.

In addition to direct barriers to entry, the supply of many professional services is also constrained by regulatory restrictions on the financing and diversification of firms, which limit their growth and dynamism. Many professions in fact are subject to constraints on capital ownership. Accountants, for example, must control two-thirds of their capital, and lawyers must own all the shares in their firm (Attali Commission, 2008). The code of ethics of the college of veterinarians prohibits non-veterinarian investors from financing their activities, even though this is authorised by law (Cahuc and Kramarz, 2004). These constraints impede the emergence of multidisciplinary groups in the form of large professional firms in the case of legal services (which could then do business internationally) or large clinics in the case of veterinarians, thereby limiting the ability of these professions to achieve economies of scale. Along with the easing of constraints on the supply of professional services, the rules governing fees should also be reviewed, especially in the case of notaries and bailiffs, to set ceilings on fees rather than fixing their level.

Competition policies in selected network industries

The major network industries have been opening-up to competition at varying speeds. The greatest progress has been made in response to European directives, which have been transposed into domestic legislation to a greater or lesser degree, depending on the country. In telecommunications, where the liberalisation process is most advanced, the benefits are clear in terms of lower prices and a greater variety of services to consumers. This progress shows that, with appropriate and readily adaptable regulation, it is possible to reconcile competition, efficiency gains, and general public objectives. The pursuit of these favourable dynamics, however, demands ongoing vigilance on the part of the regulator to ensure that the benefits of greater competition are not compromised by new concentrations.[28] In the energy sector (gas and electricity), the last two years have seen significant progress, with the complete opening of retail markets and legal and managerial separation of activities that cannot be subjected to competition (network infrastructure) from competitive activities (production, customer sales). Yet competition is still constrained by a number of significant barriers, not least the presence of administered tariffs on retail markets.

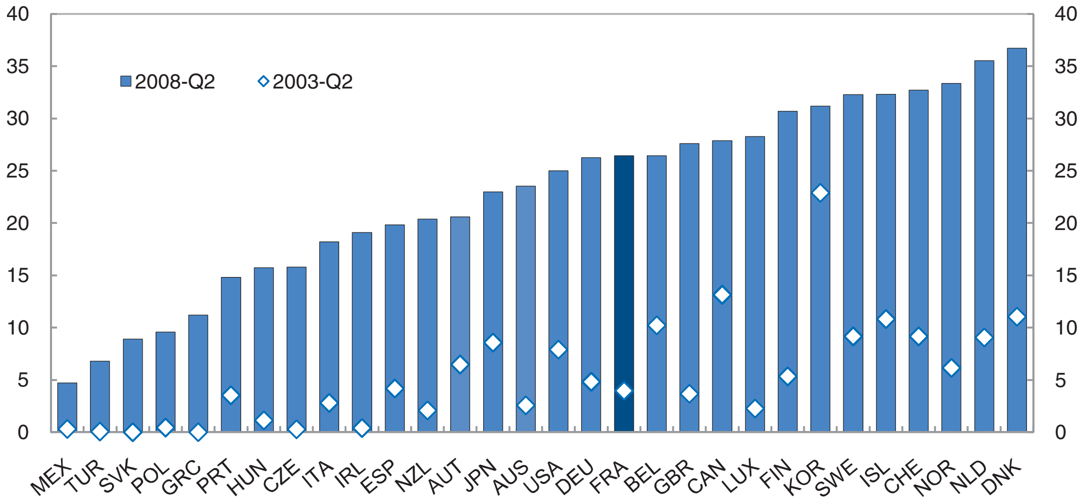
Telecommunications

Among the main network industries, telecommunications is the one that was the first to open its retail markets to competition (nearly 10 years ago). The market structure has since evolved greatly, and after a period marked by the entry of new operators, the market seems to be going through a consolidation phase, with new concentrations emerging. With completion of the initial phase, which saw privatisation of the State monopoly and unbundling of the local loop, the regulatory framework has had to adapt to new challenges. The current framework, based on five European directives from 2002 which are being revised, relies on a few general principles, one of which is to focus regulation on the wholesale market and to leave the retail end as open as possible to market forces. In examining the impact of these developments on competition, it is useful to distinguish between fixed services (telephony and high-speed Internet), mobile telephony, and very high-speed Internet.

Fixed-line services

Fixed-line telephony (including high-speed Internet connection) is the service that poses the fewest challenges in terms of competition. The success with unbundling (allowing third-party access to the network) after 2000 and the deployment of ADSL has allowed entry for several operators offering innovative and competitive services. The resulting decline in user charges and the improvement in service have in recent years sparked sharp growth in "triple play" subscriptions, combining fixed telephony, high-speed Internet and TV, and allowing France to close part of the gap in Internet penetration rates (Figure 4.8). The historic operator, France Telecom (through its Orange subsidiary), still has the biggest share of the high-speed Internet market, but it was less than 50% at the end of 2007. Nevertheless, the tendency since 2005 has been toward consolidation, and the three leading access providers now hold more than 85% of the market.

Figure 4.8. **Number of high-speed Internet subscribers per hundred inhabitants**



Source: OECD broadband portal, 2008.

StatLink http://dx.doi.org/10.1787/604475186037

Mobile telephony

The situation is slightly more worrying in the case of mobile telephone service, primarily because of the mixed success of virtual mobile network operators (VMNOs), which use other operators' networks to offer services. In fact, the three operators possessing these networks together hold more than 95% of the market, representing in effect an oligopoly, a situation that is not unusual among OECD countries.[29] Not only is competition less intense than on the Internet access market, it is in fact focused on quantities offered at a fixed price rather than on subscriber charges, which means that charges for low-use customers are well above the OECD average, while they are near the average for high-use clients (OECD, 2007b). The low market presence of VMNOs and the fact that what they offer are complementary rather than substitute services[30] can be explained in part by the restrictive hosting conditions imposed on them by network operators, which reduce their incentive to undertake head-on competition. Challenges have focussed on four types of constraints:[31]

- Until quite recently network access conditions did not leave the VMNOs with much manoeuvring room in their pricing, as they were not allowed to price subscriptions for high or unlimited use. This severely constrained their ability to compete directly with the network operators.
- The VMNOs do not have sufficient technical independence to make up for the lack of pricing flexibility by attracting customers through the offer of innovative services.
- The contracts are long-term (from 6 to 10 years), early termination is severely restricted, and penalties are steep, and the contracts include exclusivity clauses that constrain still further the ability of the VMNOs to compete with the networks.

- The contracts give the host network operators a veto on transferring a VMNO's hosting rights, limiting its ability to capitalise its assets and thereby attract investors.

These constraints inherent in the hosting conditions are compounded by the low level of competition between network operators. The Competition Council in fact imposed sanctions on the operators for unlawful collusion in 2005.[32] In the United Kingdom, stiffer competition among the four network operators has led the two smaller ones to offer favourable access to VMNOs as a way of making their network more profitable, recognising that any new VMNOs customers were likely to be won at the expense of the two dominant operators. By contrast, it was only very recently that the third-ranking French operator (Bouygues Telecom) opted for a strategy of attracting VMNOs to its network by offering more favourable hosting conditions.

Recent government decisions should nonetheless be conducive to heightened competition in mobile telephony, with the attribution of a fourth UMTS licence and an improvement in the conditions imposed on VMNOs. Some of the frequencies still available will in fact be set aside for a new entrant and should be attributed in July 2009. Moreover, one of the attribution criteria will be the conditions proposed to VMNOs. In addition to these measures, it might be advisable to intervene directly in the conditions of access to the three (soon four) networks so that the VMNOs will have the means to compete head on with the network operators. In this case, the regulator would have to review the length of the contracts as well as the exclusivity clauses and adopt a cost-plus pricing policy that would treat call origination, transit and termination services differently. The regulator has already struck a blow for fairer competition by lowering the roaming charge paid to the network operators, thereby reducing the operators' possibilities for cross-subsidisation.

The other obstacles to competition have more to do with the retail market. They concern, in particular, the switching costs that users incur when they change their provider. The government took steps in early 2008 to reduce these costs and to make the market work more smoothly. Minimum contracts have been capped at 24 months, and operators are now required to offer a 12-month contract as well. In addition, clients can now cancel their contract after the twelfth month, upon payment fixed at 25% of the balance due. Moreover, since mid-2007, customers have been able to switch providers while keeping their personal phone number ("number portability"). At the government's behest, the regulatory authority (ARCEP) has developed a procedure for fixed- and mobile-number portability in a maximum of ten days.

The deployment of very high-speed Internet service

Fibre-optic Internet access is in its infancy, and it is too soon to assess the competition situation. The main challenge facing the authorities is to put in place regulations that can repeat the success achieved with ADSL, *i.e.* to avoid local monopolies while preserving incentives to invest. France has a considerable advantage over other countries in the physical infrastructure inherited from the former public monopoly (France Telecom) which will allow the deployment of a nationwide fibre-optic network at modest cost.[33] To ensure that this advantage is not exploited in ways that will undermine competition, the regulator has required the historic operator (in light of its overwhelming market power) to make its civil engineering accessible. In other words, the issue is not one of access to a fibre optic network that would be shared by several operators, but rather access to the underground infrastructure that will allow each operator to install its own cabling. The other main issue

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concerns the sharing of the last (vertical) segment of the fibre-optic network, *i.e.* the entry to the user's premises (the sharing principle).

More generally, because the principal operators involved in fibre-optic deployment are the three mobile network operators, there may be a risk of horizontal concentration, *i.e.* combining fixed and mobile telecommunications services. Indeed, the few operators covering all markets have already begun to attract customers with package offers covering high-speed Internet, mobile and fixed phone service and television, thus stealing a march on other Internet access providers. One possibility would be to limit or even prohibit "bundling", but as such arrangements are often seen as useful for clients it is not clear that this would enhance consumer welfare.

Gas and electricity

With gas and electricity, a major step was taken in 2007 with the complete opening of markets to competition for residential customers. Energy markets had been opened gradually to business customers between 2000 and 2004. In principle then, all domestic customers have been free since July 2007 to choose their electricity and natural gas supplier. At the same time, the accounting and legal separation of distribution networks became effective at the beginning of 2008, when the historic operators, EDF and GDF, created distribution subsidiaries. With the transport networks, legal separation had already been introduced in 2005. While it is still too soon to assess the impact that opening of the residential market has had, the evidence suggests that there is still little competition, although it has been growing throughout the year.[34] On the non-residential retail market, after rising steadily until 2006, the share of alternative suppliers appears to have stabilised at levels that are still very low, at 7 and 10% respectively in the electricity and natural gas. Moreover, SME participation remains virtually nil, at less than 1% of the electricity market. Despite a similar finding, the situation is more encouraging in the case of gas, as the emerging residential market is more dynamic than in the case of electricity.

The major obstacle to real competition in the retail market is probably the persistent coexistence of regulated and market sales prices. The rationale for maintaining regulated prices for gas and electricity is based on public service considerations, and in particular the need to provide what is deemed an essential service at a reasonable price to the most vulnerable consumers or those for whom service would not be profitable because of their remote geographic location. The retention of regulated prices may also be designed to facilitate the gradual transition to greater competition by giving those customers who so wish a degree of stability in the evolution of charges. Fixed charges are set by the State on the advice of the regulator and are reserved to the historic operators: in effect, only suppliers that were established before market opening can offer them to their customers, although they are also allowed to compete with new entrants on the basis of market prices. Until mid-2005, charges were set fairly close to market levels, and they were even higher for a brief period in certain segments, a fact that encouraged many customers to switch from the administered prices.

Since 2005, soaring oil prices have sparked a jump in market prices for gas and electricity, creating a substantial gap *vis-à-vis* regulated prices.[35] Rather than attempting to close this gap, the government introduced a new provision, in the case of electricity, whereby customers who had previously opted for market prices could revert to administered rates, known as "transitional market adjustment regulated prices (Tartam)", which have been kept well below market prices.[36] This provision was originally to run for two years, but has been renewed until mid-2010 (and longer for residential customers) despite its many adverse impacts on competition. First, the regulated rate for large and medium-sized enterprises is not sufficient for alternative suppliers to cover their costs of production, and they are no longer in a position to compete with EDF. To remedy this distortion, the government introduced a mechanism in early 2007 to compensate suppliers for the costs of serving customers at the Tartam. However, this mechanism raises questions of financing and adds a degree of administrative complexity that discourages potential competitors. Second, by removing many large customers from the open market, the Tartam reduces the number of participants in the wholesale market, thereby hampering its growth. The benefits of competition, after all, include the development of a wholesale market that is sufficiently liquid to spread risk among producers. Third, by contributing to the multiplicity of available prices, the Tartam and other regulated retail market prices do nothing to teach customers about competitive markets.

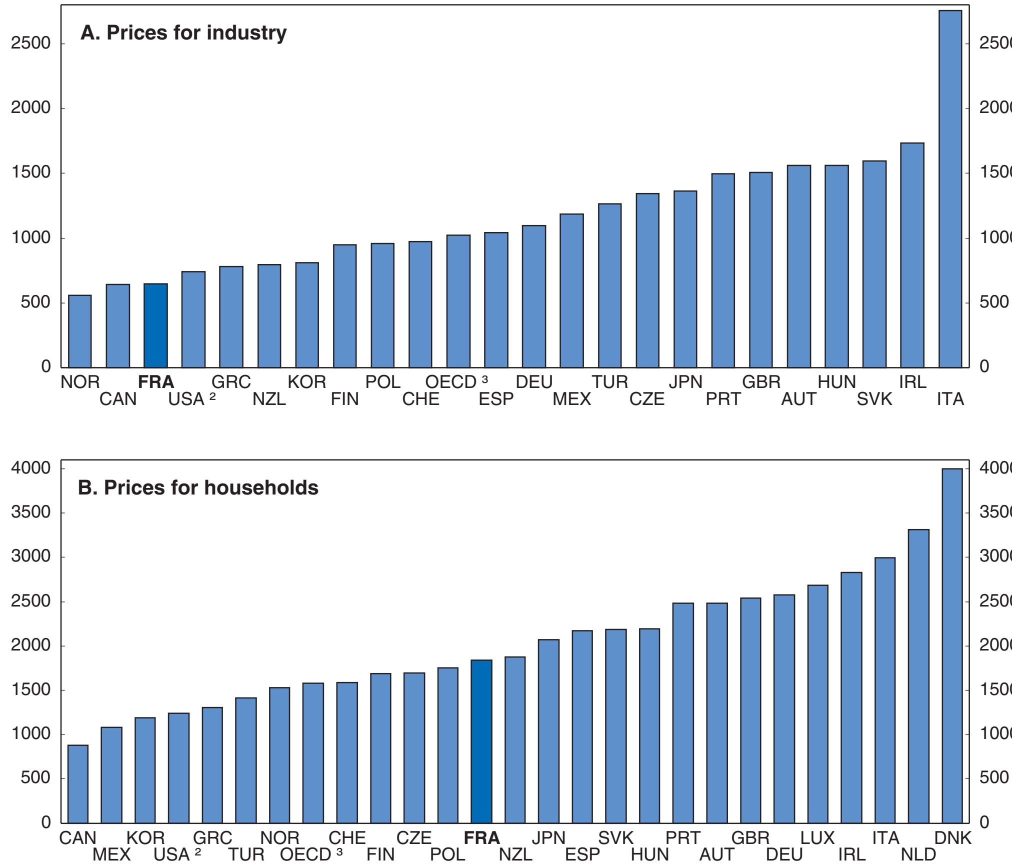
In view of the authorities, the main objective is to allow industrial and residential customers to benefit from the nuclear choice, made in the 1970s and frequently renewed, and which has placed France in a relatively good position with respect to electricity generation costs. It is quite legitimate that, having supported this choice, French society should benefit from its positive fallout, but it is by no means certain that the most economically efficient and equitable way of doing so is to maintain a rate well below the European market price for consumers, particularly electricity-intensive industrial customers. In fact, while the prices charged to French households are slightly above the OECD average, those charged to industrial customers fall well short of the average (Figure 4.9). Beyond the obstacles to competition already mentioned, this could constitute, according to the European Commission, a form of public subsidy to large firms that could distort competition in other markets.[37] Another drawback is that this practice does nothing to facilitate the integration of European energy markets. Finally, keeping prices low in comparison to production costs discourages investment in new production capacity: this applies to new-generation nuclear facilities, where the cost is higher, and also to other forms of energy.[38]

For all these reasons, it would be strongly desirable to raise prices enough to reduce significantly the gap *vis-à-vis* market prices, especially in the case of medium and large-scale firms. In doing so the French State would still be one of the main beneficiaries of the "nuclear rent", through its interest in EDF. The government has already taken a step in this direction: the prices applied since mid-2008 are substantially higher.[39] Yet according to the energy regulator (CRE) analysis, those prices remain below cost recovery levels, and further increases should be envisaged more or less promptly. From this viewpoint, and in order to give competition to real chance, it would be better to allow the Tartam to expire in 2010. Beyond the Tartam, which concerns only electricity, it would be well to reconsider the entire range of regulated prices to ensure that they allow the government to fulfil its public service obligations while reducing to a minimum State interference with price determination on the retail market. A commission was established at the beginning of 2009 to re-examine the entire structure of prices in light of European directive provisions.

Competition in the electricity sector is also constrained by problems in the wholesale market, which is still dominated by EDF. Moreover, the vertical integration of production and retail sales within EDF allows it to offer very long-term contracts that effectively dry up the wholesale market by denying it the liquidity needed for greater price stability (Chevalier and Percebois, 2008).[40] Better integration at the European scale would allow more liquid and efficient markets to develop, but the obstacles to integration and the

Figure 4.9. **Electricity prices for industry and households**

US dollars/toe, 2007[1]



1. Toe = tonne of oil equivalent. 2005 for Canada and Greece. 2006 for Japan and Germany.
2. Price excluding tax for the United States.
3. Weighted average.

Source: International Energy Agency, IEA, Energy Prices and Taxes, 2nd quarter 2008.

StatLink http://dx.doi.org/10.1787/604482654357

problems of interconnection here are well known.[41] Some progress has been made, however, on the basis of regional initiatives among small groups of countries. Meanwhile, wholesale markets would function better under stiffer regulatory supervision, which could detect anticompetitive behaviour by operators with strong market power. Any lack of transparency on those markets could also be remedied through the dissemination of information. Concentration in the wholesale market poses similar problems in the gas market, although there it is of lesser scope, thanks to "gas release" programmes that are fostering competition in certain regions. The CRE's powers, in this regard, should be strengthened so that the decisions to extend these programmes are taken by the regulator rather than by the two dominant operators.

When it comes to access for competitors to the national or regional transportation and distribution networks, vigorous regulatory surveillance will be important, particularly since the choice of legal rather than financial separation does not guarantee the same degree of independence between the producer (parent corporation) and the network manager (subsidiary). In its annual report on observance of codes of good conduct, the CRE criticises the fact that the distribution networks, newly created as affiliates of the former monopolies in gas (GDF) and electricity (EDF), have chosen to operate under names (GrDF and ErDF respectively) that give them the benefit of their parent corporation's favourable image.

Box 4.3. **Competition policy: summary of recommendations**

General competition framework

- Reconsider the scope of application of the Economy Ministry's power of "injunction and settlement" in the case of "micro-practices" to ensure that it actually concerns only those violations of competition law that are of local dimension and no major impact.
- Consider allowing the Competition Authority to vet settlements brokered by the Ministry in relation to "micro-practices".
- Facilitate class-action lawsuits and ensure that they are applicable to damages from anticompetitive practices.

Retail trade

- Repeal the Royer and Raffarin laws on commercial zoning to do away with the requirement for approval formalities other than a building permit.
- Assess the impact of measures under the LME regarding the conditions of negotiation between retailers and suppliers and ascertain whether they should be eased further.
- Further ease the rules governing Sunday shopping hours to give consumers greater freedom and to encourage employment, especially for students.

Professional services

- Eliminate gradually the quotas (*numerus clausus*) in certain legal services (attorneys before the Council of State and the Court of Cassation) as well as in health-related professions (pharmacists, physiotherapists and veterinarians).
- Simplify entry conditions in certain professions, either by reducing the field of activities over which they hold exclusive rights (architects, notaries, bailiffs) or by reconsidering the required years of study (architects, veterinarians, hairdressers).
- Facilitate access to external sources of capital by allowing third parties to invest in the equity of certain professional firms (lawyers, accountants, veterinarians).

Network industries: telecommunications, gas and electricity

- Strengthen competition in mobile telephony by proceeding with the decision to attract a fourth network operator during the next bandwidth allocation and facilitate access for VMNOs to the three (or four) networks.
- In the case of electricity, allow the Tartam (transitional regulated prices) to expire in 2010. More generally, reconsider the scope of application of various regulated prices in the retail market, at least as they apply to non-residential customers.
- Pursue efforts at the European level to improve interconnection of gas and electricity networks so as to facilitate market integration and promote the development of liquid and efficient wholesale markets.
- Strengthen the powers of the CRE (Energy Regulatory Commission) so that it can intervene more directly with the historic operators.

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Notes

1. See OECD (2009) for more details. For comparative purposes, the expected gains from such a reform are slightly lower in France than in Germany (11.3%), in Italy (12.0%) or in Belgium (14.2%), but higher than in Spain (7.2%), the Netherlands (8.2%) or the United Kingdom, where the impact is negligible because of a generally favourable regulatory framework.
2. In total, 60 positions have been transferred to the authority; half of those transferred are management and support staff, while the other half are investigators.
3. Under current procedure, the Competition Authority may opt to take charge of investigations before they are triggered by the Ministry, or to take up an investigation as a matter of course once the Ministerial units have conducted their investigations. Only if the Authority decides not to pursue a case as a matter of course can those units deal with a case directly, *e.g.* by proposing a settlement and/or an injunction to the firms in question.
4. While the usefulness of concentration indices as an indicator of competition intensity may be questioned, they do shed light on the issue when interpreted with caution.
5. The main central buying units are Lucie (regrouping Leclerc and Système U), Carrefour (including Champion), Auchan, Casino (including Géant, Franprix, Leader Price and Monoprix) and Intermarché.
6. For many products, in particular the major brand names, suppliers are themselves large multinationals with strong bargaining powers, and retailers have no choice but to deal with them. On the other hand, the great majority of "no-name" (generic) products are supplied by SMEs (more than two-thirds of which are domestic).
7. For example, strong purchasing power in the hands of distributors is not necessarily bad from a welfare economics viewpoint, and can even be beneficial if competition among retailers is sufficiently sharp that the benefit is passed on to the final consumer.
8. While the average size of the hard discounters is around 600-700 m^2, they are often closer to 400 m^2, a factor that no doubt influenced the arbitrary choice of a 300 m^2 threshold.
9. The boards, now renamed the "regional commercial facilities boards", comprised three elected officials, a representative of the chambers of trades, a representative of the chambers of commerce and industry, and a representative of the consumers' associations.
10. The fact that the market share held by small retailers shrank from 67% in 1970 to 38% in 2004 does not in itself mean that the law is ineffective, given the many factors behind their decline. In fact, the small retailer presence in France is only slightly higher than in Great Britain, which has no specific law protecting small merchants (2008).
11. On the other hand, the hypermarkets retain a greater share of retail floor area than in Germany, where there are also special regulations on the opening of large retail outlets
12. Between 1997 and the end of 2001, the period when prices rose fastest, the increase in prices of mass consumption products was 4.2% greater in the big supermarkets (more than 120 m^2, but excluding the hard discounters) than in the other forms of sale (essentially small specialised shops) (Boutin et Guerrero, 2008).
13. In a study of the impact of commercial zoning rules on retail prices in Great Britain, these authors find an effect that is statistically significant but fairly modest in economic terms.
14. The authors estimated that the profit margin in supermarkets and hypermarkets rose from 20.7% to 32.9% between 1994 and 2002, while the labour share in value-added declined from 79.3% to 67.1%. The figure of 100 000 jobs (representing an increase of 18%) is obtained by supposing that most of the increased margin was devoted to employment.
15. The Lang Law has had no notable impact on the decline of small booksellers (2004).
16. Faced with these restrictions, many businesses located in large cities have opted to open on Sundays even at the cost of a fine.
17. With the exception of the city of Lille, where the restriction on the number of Sundays has been removed to save merchants from losing customers to Belgian stores that are permitted to open on Sundays. The measures adopted do not go as far as those contained in the draft law initially submitted to the assembly, which was challenged by a high proportion of members of the ruling party.
18. The economic analysis also cites negative externalities and under-provision of "public goods" as other market failures applicable in specific cases (Van den Bergh, 2008). For example,

incompetence or fraudulent practices in legal or health services can cause injury to individuals beyond the parties directly involved in a client-professional relationship.

19. See in particular Attali Commission (2008), Cahuc and Kramarz (2004) and Camdessus (2004).
20. The list of products sold exclusively through pharmacies goes well beyond prescription drugs.
21. The authors stress the selective and differentiated nature of engineering education, where a degree can be earned by many routes.
22. A negative correlation has been observed between the degree of regulatory restriction and productivity in the case of legal and accounting services.
23. In 1960 a committee of experts pointed to the great number of obsolete regulations governing various professions, with the effect of closing them to competition (Armand and Rueff, 1960).
24. An *avoué* is a justice auxiliary, a ministerial officer entitled to plead and provide counsel before the Court of Appeals. As such, the advocate has a monopoly in representing parties before the court of appeals in all proceedings where representation is mandatory, as is the case in civil and commercial matters.
25. The number of notaries has already increased by 12% over the past ten years.
26. Among those identified as subject to the directive are real estate services (real estate agents), construction and architecture, tourism, maintenance, and office upkeep.
27. The best-known example is that of students in physiotherapy and veterinary medicine who pursue their studies in Belgium in order to get around the quotas in France.
28. In France, as in many other countries, regulatory enforcement power lies with the sector regulators, while the Competition Authority retains responsibility for enforcing the general competition rules applicable to these industries. Since 2004, there has been a single regulator for posts and telecommunications (*Autorité de régulation des communications électroniques et des postes – ARCEP*). Similarly, a single regulator is responsible for the gas and electricity industries (*Commission de régulation de l'énergie – CRE*).
29. Market shares at the end of 2007, in terms of subscribers, were as follows: Orange (44.3%), SFR (34.1%), Bouygues Telecom (17.4%) and the 13 VMNOs (4.2%).
30. VMNOs have in fact concentrated mainly in niches not served by network operators, and on residential rather than business customers.
31. See the Opinion of the Competition Council on the situation of VMNOs in the French mobile telephony market (Avis no. 08-A-16 of 30 July 2008).
32. The operators were found to have shared confidential sales information unlawfully and to have agreed among themselves to freeze their market shares for the period 2000-02.
33. There is in fact an entire system of underground ducts that is readily accessible, and within which several lines of cable can be installed.
34. In the case of electricity, slightly under 2% of residential sites (515 000 out of 29.6 million) were being served by a supplier other than the historic operator in September 2008. This proportion rises to 3% (416 000 out of 11 000 000) in the case of natural gas.
35. This entails cross-subsidies between prices that have distorted competition. In April 2006, France was charged with two counts of violating the directives on the domestic gas and electricity market, one relating to the system of regulated prices and the other dealing with what was deemed at the time to be insufficient separation of gas and electricity network managers.
36. As with the basic regulated prices, there are three different Tartams, allowing distinct prices to be maintained for large-scale industrial customers, medium-sized enterprises, and small business customers. From the outset, only the first of these prices proved attractive to customers. During most of 2007, there was a gap of between 5 and 10% between the Tartam and the one-year futures price on the market. The gap below the market price increased at the beginning of 2008, peaking at more than 40% in the autumn. The Tartam for medium-sized enterprises became attractive only in 2008, but there too the gap deepened over the course of the year. Little interest has been shown in the Tartam for small business clients.
37. In June 2007, the European Commission opened a formal investigation of State subsidies relating to the regulated price of the Tartam. The government contested that move, claiming that the amounts involved had little quantitative impact on competition and should be deemed *de minimis*.

38. From this viewpoint, while it is true that the regulated prices are sufficient to cover all of EDF's costs on this score (which is not necessarily the case with other distributors), it is less clear that these prices reflect the future costs of building new nuclear plants. In fact, according to EDF evaluations, the projected cost for the first EPR plant in France has been revised upwards by 20%, to [euro] 55 per kilowatt hour. These cost increases, combined with falling prices on the energy market as a whole, raise questions about the true dimension of the "nuclear rent".
39. Prices have been raised by 8% for large industrial customers, 6% for medium-sized enterprises, and 2% for small businesses.
40. Following a decision of the Competition Council in 2007, EDF must now offer alternative suppliers the possibility of acquiring electricity wholesale over 15 years so that they can compete with the historic operator's market offers (CRE, 2008).
41. The obstacles include differences in market architecture and in the powers and jurisdiction of national regulators; a lack of binding regulations and, more generally, a lack of incentives for regulators and network managers alike. Harmonization problems will often be hard to resolve, as long as each country is convinced that its own rules are superior.

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