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Reforms in France: focused and fast

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In the first year of its term, the French government has embarked on a remarkable path of reform. Even before the election year ended, it fast-tracked a labour market reform that met with only few protests – even though it was farther-reaching than under the previous government. Policymakers also undertook visible efforts to bring the deficit back below the Maastricht three-percent target for the first time in ten years and they were successful here as well.

But there are limits to what can be achieved in a year. The government is pursuing ambitious goals, including for the French budget. First achievements are primarily the result of a favourable business cycle and should not hide the fact that much remains to be done for improvements to be sustainable. But the government's resolve thus far is good reason to be optimistic.

Broad public support for reforms

The French government has been in office for roughly a year since the 2017 elections. France's president has vowed to press ahead with changes not just to the domestic economy but also at EU level and in the euro area. In order to be perceived internationally as a credible and reliable partner, he wants national reforms to demonstrate the will to make painful cuts that also affect France's citizens.

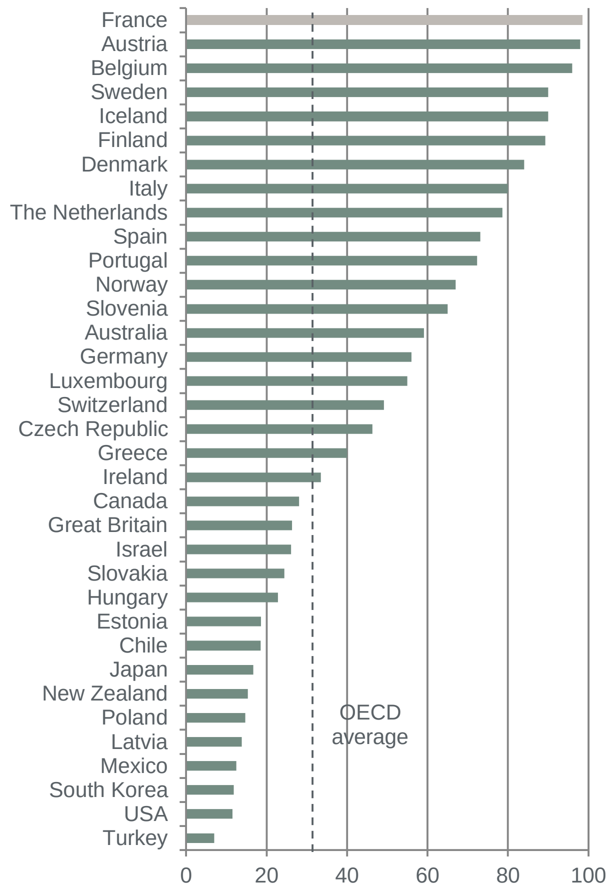
Reforms were therefore decided at a fast pace during the first year in office. Since the reform plans were also openly communicated during the election campaign, the government regards its election win as a mandate for comprehensive change within French society. So far, public acceptance corroborates this perception. Headwind against the labour market reform over the past year has remained far behind the sharp protests against the restructuring of the labour market in 2016. So far there are no signs of the reform momentum abating. The opposite is true: the reform of the national railway company was not announced in the campaign and is now also on the well-filled agenda. Widespread protests and strikes have now been called for the first time. Nevertheless, so far there are no signs suggesting that the government might be forced to back down from or significantly water down its reform plans. In other words, the renewal process is on track – and addressing the right issues.

Labour market reform: systematical continuation of previous reform approaches

With the labour market reform initiated last autumn, the government remains on the path of previous reforms. First, it has given more flexibility to small enterprises with fewer than 50 employees, which employ roughly half of all French workers. These businesses are allowed to deviate from collective agreements and make their own arrangements with their employees, for example regarding wages and working times. As collective bargaining coverage is higher in France than in any other OECD country, this makes the labour market significantly more flexible (Figure 1). And it can be expected to lead to more moderate wage growth, which is to help prevent job losses in periods of economic weakness by temporarily lowering wages while securing jobs in return. At the same time, of course, flexibility grows in both directions: Businesses expanding successfully can also negotiate higher wages, for example in order to retain urgently needed skills.

Figure 1: High collective bargaining coverage in France

Share of workers covered by collective agreements, in per cent



Note: Latest available data (mostly 2016)

Source: OECD

Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.

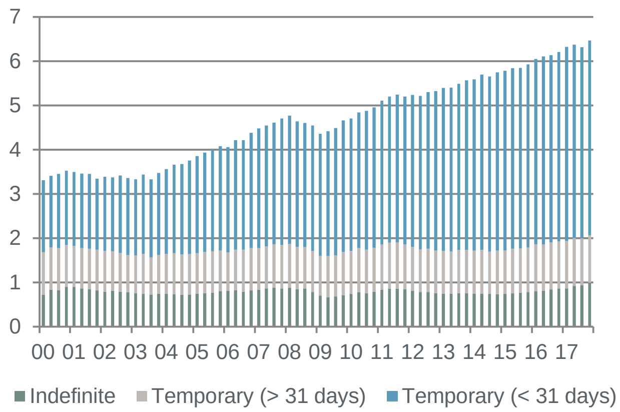
Second, the government is relaxing employment protection. Dismissals for operational reasons can now be based merely on a company's poor business performance within French borders, whereas previously a poor global performance was a necessary condition. In the 'strictness of employment protection index', the most recent data put France in eighth place among the OECD countries, which indicates relatively strict labour market regulation. Redundancy pay for unjustified dismissal will be capped from now on as well. These sums are determined by employment tribunals and have previously varied greatly, reducing planning certainty for enterprises. The El Khomri reform already envisaged capping these payments in 2016. After massive protests, however, the previous government withdrew this proposal.[1] This example clearly illustrates that the population is now more willing to accept reforms: Although the changes under the current reform go further, they have not triggered any protests worth mentioning.

In addition, raising social security contributions on temporary employment compared with indefinite-term contracts is intended to encourage permanent employment and reduce the insider-outsider problem. Fixed-term contracts – particularly for very short employment – have dominated in France for years. In the age group 15 to 24 years, nearly 60 % of workers had temporary employment contracts in 2016. Only in four other OECD countries was the rate even higher. The share of indefinite-term hirings has risen again at least slightly of late (Figure 2).

It will take a while for the successes of the labour market reform to become visible. At 9.2 %, the unemployment rate is currently trending clearly downward on the back of the solid business cycle and has returned to the level of mid-2009. President Macron aims to reduce unemployment to 7 % by the end of his term in 2022. This is an extremely ambitious goal that is probably unachievable unless the additional flexibility prevents significant increases in unemployment, also in coming periods of weakness. In any case, the timing of this reform increases the chances of this government to reap the fruits of its own efforts while it is still in office – which is not always the case with often unpopular and, therefore, deferred labour market reforms.

Figure 2: Short contract terms are on the rise

New hirings in France, seasonally adjusted, in millions.



Source: Acoss

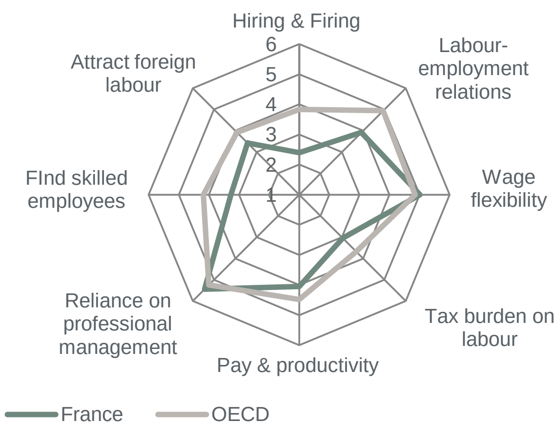
Reform of unemployment insurance and vocational training: more support for workers

Last year's reform to liberalise the labour market also contains worker-friendly elements, of course. These include the introduction of minimum redundancy pay for unjustified dismissals as a counterpart to the newly introduced capping and the increase in redundancy pay for justified dismissals as well. The main focus, however, is on deregulation, which is designed to encourage companies to hire permanent workers, as they can lay them off again at lower costs as soon as the business cycle turns.

The changes in the labour market have to be seen in connection with the ongoing reform of unemployment insurance and vocational training. The aim of these reforms is to allow workers to benefit from expanded protection and more government support. The level as well as the period of entitlement to wage-replacement benefits – both of which are relatively high by international standards – are not up for discussion.[2] Instead, the circle of eligible recipients will presumably expand to include self-employed persons and insured persons will have a limited entitlement to benefits, even if they quit their job themselves. This is intended to encourage worker mobility and contribute to higher productivity growth in the economy. In addition, unemployed persons will receive more support in seeking employment but will have to accept cuts to benefits if they refuse acceptable jobs.

Figure 3: Need for improvement in the labour market

Assessment of labour market efficiency in 2017, qualitative categories, scores



Note: Scores range from 1 (poorest) to 7 (best)

Source: World Economic Forum

The government aims to promote youths, long-term unemployed and unskilled workers in particular by expanding the range and creating an entitlement to more annual professional training measures.[3] Besides, occupations requiring an apprenticeship are to become more attractive in order to grow the relatively low number of apprentices. The government is planning to introduce higher pay for apprentices and reduce social security contributions payable by enterprises. At the same time, the training provided is to be better aligned with the needs of the labour market, thereby reducing the discrepancy between skills required and skills offered. For this purpose businesses are to receive more power to influence the training system, including the right to have a say on the subject matters taught by professional schools.

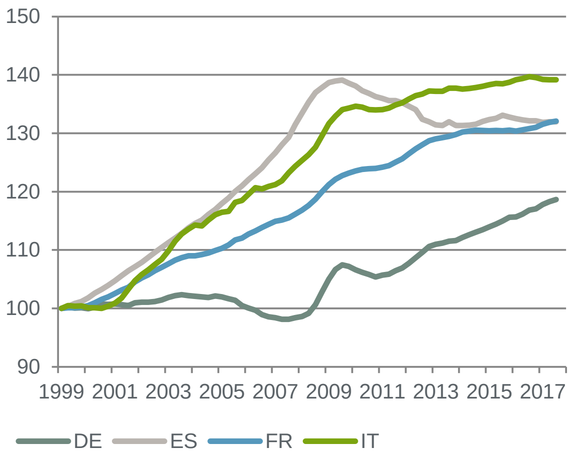
The government is also adding some fiscal policy measures to support its labour market reforms. From 2019, businesses will benefit from a permanent reduction in social security contributions, which is now granted only temporarily and renewed over and over. The lower an employee's wage, the higher the reduction will be, with the aim of creating incentives for employing workers with low qualification levels.[4] In future the social security system will be funded to a higher degree by taxes, and contributions for employees will be reduced. This will shift the burden from employees to the society at large. Overall, these changes to taxes, social charges and professional training will provide impetus for employment primarily in the low-wage sector.

Impetus for competitiveness and foreign trade

The labour market reform also has effects on the development of labour costs and thus on the competitiveness of the French economy. First, shifting a portion of wage negotiations to the company level will tend to result in more moderate wage settlements. Second, the burden on enterprises from social security contributions will decrease permanently from 2019. Coupling this reduction with the wage level will additionally act as a brake on wage growth. After all, proportionally higher reductions for workers earning lower wages create further incentives for employment in the low-wage sector. These measures, of course, also produce negative distribution effects. In order to compensate them, a reducing effect on the unemployment rate is urgently needed.

Figure 4: Wage restraint in Germany

Unit labour costs per hour worked, index 1999=100



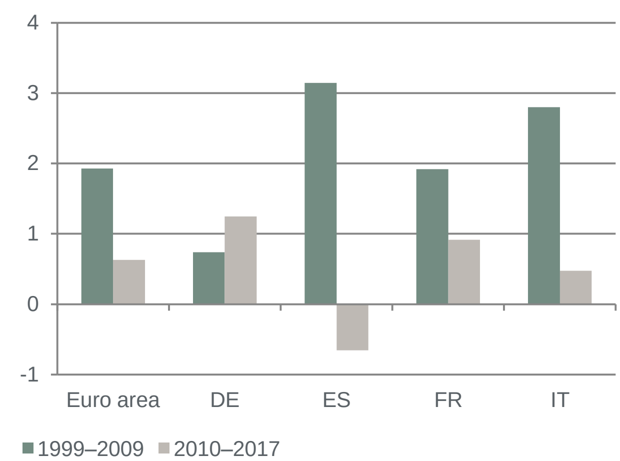
Source: Eurostat

Such an effect occurs when, for example, excessively high costs for businesses create obstacles to France's foreign trade and growth. In fact, France is often suspected of producing at high cost and being too uncompetitive. Measured by its unit labour costs, however, this observation is only partly accurate. Compared with Germany and its moderate wage policy before the financial crisis, France's (price) competitiveness indeed decreased for a long time.[5] But its wage growth in relation to the euro area was generally in midfield and much lower than that of Italy or Spain, for example (Figure 4). Besides, after the financial crisis, unit labour costs in France rose only at half the rate (Figure 5).[6]

France has had a persistent current account deficit since 2007. On average, however, it has been just under 1 % of GDP, requiring no immediate intervention. What is more problematic is the development of its world market share in goods exports. Since the creation of the euro area alone, France's world market share has almost halved – a much sharper drop than the share of other euro countries (Germany lost one seventh, the euro area as a whole one fifth). Besides, France's exports to GDP ratio is remarkably low. In spite of its slightly positive trend it was a mere 30 % in 2017 – the lowest level in the entire euro area. Subdued labour cost growth may thus indeed provide much needed impetus for France's foreign trade, and the labour market reform may have a positive effect in this regard as well.

Figure 5: Sharp corrections to labour costs

Average growth in unit labour costs in per cent p.a. on the previous year



Source: Eurostat

Ambitious fiscal policy targets

Besides the labour market, fiscal policy is the economic policy area in which the government has initiated the most significant changes for the country since it took office. It wants to exit the excessive deficit procedure of the EU Commission against France as quickly as possible and eliminate the deficit of 3.4 % of GDP of the year 2016 completely by the end of the legislative period. But it got off to a rocky start: The previous government had introduced a tax on dividends which was declared unconstitutional in the autumn of 2017. As a result, the new government had to fill a budget hole of around EUR 10 billion. To do this, it introduced a special levy for large corporations – which was in conflict with the planned policy of reducing business tax burdens – and so demonstrated its determination to meet the 3 % deficit criterion already in its election-year for the first time in ten years.

France was even able to exceed this target. The budget deficit was 2.6 % of GDP in 2017. However, the good result was mainly a consequence of the better-than-expected business cycle. Last year the French economy grew 2.3 %, nearly twice the rate of 2016. Public expenditure, however, increased by 2.5 %, more than in the past years. Improving the structural balance as well thus remains another important task, especially since the government intends to reduce the debt level from currently 97 to around 90 % of GDP. And it also plans to scale down the size of public administration and shave a few percentage points off the current spending-to-GDP ratio of 56 %. The IMF has regarded the high government expenditure rate as one of France's core problems for a long time.[7] The overall government expenditure rate in the euro area is only 47 %.

The government is planning to reduce public expenditure through measures that include gradually cutting 120,000 government jobs. Remuneration for public servants is to become more performance-related and more of them are to work as employees instead of as civil servants. France spends a higher share of revenue on remuneration for public servants than any of the other 18 euro area countries.

Besides these austerity measures, the French government is focusing primarily on reducing burdens for business and individuals. The corporate tax rate is to be reduced gradually from 33.3 to 25 %, income from capital is to be taxed at a flat rate, wealth tax is to be levied on real estate only and a EUR 50 billion state investment programme is to be implemented that should provide stimulus, among others, in the areas of innovation, digitalisation and environmental protection. The declared goal of tax policy is to attract additional domestic investment and make France more attractive to foreign investors.[8] This is intended to increase potential growth and achieve higher tax revenue in the medium term.

Policymakers still face major challenges but are on the right path

The reforms are generally well-designed. The labour market has been regarded as a structural weakness of the French economy for a long time, as illustrated by the Global Competitiveness Report, for example.[9] The reform is likely to help reduce structural unemployment in particular but will take time to reach its full effect. The government was therefore right to initiate these reforms at the beginning of its term.

There is no way of telling whether the fiscal policy will be successful in the current legislative period. Recent successes are more the result of cyclical developments. In the past ten years, the debt level has grown by one third of economic output and the public sector is very large by European comparison. France is planning a comprehensive spending review that is to identify inefficiencies and potential for cuts. It is still unclear whether the intended reduction in the spending-to-GDP ratio can really be achieved. But the spirited move to close the gap resulting from the unconstitutional dividend tax and the pace of the reform already underway are encouraging. ■

[1] Cf. Ehmer, P. and Schwegmann, A.-C. 2017, **Labour markets in the euro area: reform successes are good news for employment**, Focus on Economics No. 155, KfW Research.

[2] Cf. Cabau, F. and Gudin, P. 2017, France: (carefully) "En Marche", Barclays Economics Research, Euro Themes, 30 October 2017.

[3] According to the OECD Skills Outlook, France occupies one of the last places among the OECD countries in the participation rate of 25 to 64-year-olds in professional training measures, cf. OECD 2017, OECD Skills Outlook 2017: Skills and Global Value Chains, OECD Publishing, Paris.

[4] Combined with a minimum wage that is above the international average and still rising, this measure is another expression of the current government's social liberal economic policy. While raising the minimum wage benefits employees, at the same time the disproportionally high reduction in social security contributions for workers earning low wages prevents the minimum wage to act as a brake on employment creation. According to OECD data, the minimum wage in France is 61 % of the median wage – the second-highest level of all OECD countries.

[5] Cf. Hornberg, C. 2014, **A fair look at France**, Focus on Economics No. 68, KfW Research.

[6] Other economies, however, particularly Spain, were much more successful still in lowering their labour costs.

[7] Cf. IMF 2017, France: Staff Report for the 2017 Article IV Consultation, IMF Country Report No. 17/288.

[8] Cf. de-Muizon, M. 2017, France: Clarifying fiscal timetable, Deutsche Bank, Focus Europe 14 July 2017.

[9] Cf. World Economic Forum 2017, The Global Competitiveness Report 2017–2018.