FINANCING SOCIAL BENEFITS THROUGH CONSUMPTION (2004)

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ADAPTING FRANCE AND THE EUROPEAN UNION TO THE CHALLENGE OF INDUSTRIAL MIGRATION (Part Four, page 196)

Having set out what we consider to be the essential principles, your Commission concluded that our recommendations should address three main preoccupations : **to place our businesses in a better position in the new international labour market structure ; to support areas affected by industrial migration and changes more generally ; and to promote an industrial policy which, to be sustainably effective, must be included in the field of competence of the European Union.**

On the economic level several courses of action should be followed **in order to avoid the migration abroad – unjustifiable in economic logic - of productive activities providing value-added.** With this aim in view it is necessary to carry out concurrently : **the abolition of constraints, particularly fiscal ones, that hinder economic development and motivate migration of activities** ; the strengthening **of France's** comparative advantages to make the country more attractive for investment and improve its industrial competitivity ; **and organising and supporting, within a logic of innovation, the chains of production, none of which should necessarily be entirely done away with.**

If our compatriots are to accept changes in the economy they must have the means to adapt to them. **The notion of involuntary "sacrifice" of those most exposed to the effects of modernisation cannot be admitted.** First, the rôle of local authorities in the matter of economic development must be **consolidated so as to bring the means of action closer to the areas and communities concerned.** Then the "employability" of the work force must be improved through more determined initial and continuous training aiming at real usefulness. Finally, it appears vital to address the structure of jobs so as not to overlook those close **to others which** have the advantages of not being exportable, **of creating wealth, of being potentially numerous and of enabling increasing needs to be satisfied.**

In addition, this double framework of action must be complemented **by support for a new industrial will at the European level.** A balanced development of the European Union (EU) should be guaranteed which will help an accelerated harmonisation of public policies in all fields affecting the distribution of the means of production within the boundaries of the EU. And it is also necessary to enhance the industrial strength of the Union in the world by making this ambition a political priority backed by the means and the tools that will ensure its success.

I. SUPPORTING PRODUCTIVE ACTIVITIES

Supporting productive activity is certainly of the highest priority in increasing national economic potential and enhancing employment opportunities. It was not part of the mandate of the Working Group to describe all the aspects of this truism, but it did seem necessary to indicate **the three directions in which our economic policy should move in order to act against unjustified migration of economic activity**. The first is **to put an end to those mechanisms, particularly fiscal ones, which objectively encourage such migration.** The second aims to **strengthen our national comparative advantages**, in certain sectors and overall, so as to encourage keeping activities within the country, to make foreign investment in the country more attractive and to take advantage of our national know-how. The last, and not the least, is to organise **and support the chains of production, within a logic of innovation**, while deliberately giving priority to those activities and sectors which provide the highest value-added.

A. ABOLISH THE INCENTIVES FOR MIGRATION OF ACTIVITY

Of the many factors which seem to be hindering economic expansion and mentioned by those the Working Group talked with, (...) the latter found it most worthwhile to concentrate attention on three types of proposal directly related to the issue and, despite the probable difficulties of implementing them, seemingly most immediately applicable.

These proposals relate to : **taxation of the factors of production ; supporting national entrepreneurship; and valorisation of products that conform to social and environmental norms.**

1. Stop taxing the means of production

Every industrialist your Working Group met with thought that the most important of the reasons for the migration of activities – or, more precisely, **of the obstacles to localising investments on French territory – was the cost of labour** (...) .

a) Replace social charges with a Competitivity VAT

Although French salaries are only around the average of those practised in OECD member countries, the cost of labour is higher in France than in many other industrialised countries because **of the high social charges on these salaries**. Over the past ten years various measures exonerating employers from having to make contributions in respect of the lowest paid have been introduced ; and all economists agree that the effects on the employment of unskilled workers have been excellent. Your Commission is of the opinion that it is time to go further and **to generalise the reduction in labour costs – not by penalising those who work but by radically transforming the way family and sickness benefits are financed.**

Already in 1993 our colleague Jean Arthuis proposed that these benefits should be financed by a consumption tax, which could be called a **Competitivity VAT.** And these ideas have been taken up and developed since then by some very varied personalities.[1] The principle is simple; the advantages numerous.

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[1] See, for example : Letter from the Commmittee on Poverty and Policy n° 21 of March 2004 ("To reduce the migration of jobs and to create new ones") ; Editorial by Jean-Luc Cazette, Chairman of the CFE-CGC, in the Letter of the Confederation n°1107 of 16 April 2004 ("Towards social contributions based on consumption") ; the article by Henri Guiano, former Commissioner-General at the Plan, in *Echos* of 27 April 2004 ("Social VAT : the forbidden debate") ; or the opinion of Christian Saint-Etienne, university professor and President of the Institute for French Strategy *(Institut France Stratégie)* in *Echos* of 1st June 2004 ("Health reform and job migration : a revolutionary linkage") .

(1) A simple principle

No question of principle is raised by collectiong money from economic activity to pay for social expenditure that is linked to it (unemployment, retirement, working accidents, professional training) ; but this is not the case for sickness insurance, **family allowances or housing allowances**. There is no reason other than historical accident why these social benefits, which are based on the principle of national solidarity, **should be linked to employment. Yet these costs directly penalise national economic production by adding to the cost of goods produced in this country** as compared with the cost of those produced in countries where labour is cheaper – very often because of lower levels of **social protection.**
This change in the competitivity of our domestic products affects them both in the home market, where they are confronted with obviously attractive imports, and in export markets.

These social costs are far from negligible. Under the general social security system they amount to a quarter of gross salary. (...)

Your Commission proposes a reform which would replace these levies with a tax raised on consumption – or a tax on value-added (VAT). The switch should not change the revenue position and the level of this tax should be calculated so that it would generate revenue at least equal to that obtained by means of present contributions. But in view of the ongoing debate about the financial sustainability of the sickness insurance system one could take the opportunity **to liquidate the accumulated deficit [2] and establish a balance between receipts and expenditure so as to avoid the need to further increase the tax.** Furthermore, your Commission would point out that it would be useful at **the same time to re-examine the whole structure of the present VAT rates [3] applied to goods and services**, which results from successive historical compromises and reflects little economic logic.

While the principle of this reform is simple, your Commission is aware **<u>that its implementation will be very complicated and must of necessity be preceded by a careful analysis of the conditions for its success.</u>** However, **the advantages** that can be expected from the switch are such that **it would be prejudicial to throw it out just because of the undeniable complexity of the implementation of the switch.**

(2) Numerous advantages

What are the benefits to society of such a mechanism?

First, to restore a certain equity to price structures. The present system penalises all goods and services for which the labour content is high, and particularly the output of labour-

[2] Given the present state of the sickness insurance branch, it is difficult to avoid this objective. However, in pursuing it, it is clearly needful to fix the rate of the Competitivity VAT at a level higher than its “natural” level of balance. And this will proportionally reduce the advantage that may be drawn from the measure concerning competitive pricing of French products.

[3] In accordance with the European Directive concerning VAT, three rates are at present applicable in France : the normal rate of 19.6%, the reduced rate of 5.5% and the super-reduced rate of 2.1%.

intensive industry, which has been the prime concern of your Working Group. This leads to replacing labour by capital goods, which, while it yields appreciable gains in productivity, **brings down employment, particularly of unskilled workers**.

Second, **to improve the competitivity of goods produced in France and which face competition in the domestic market from imported goods.** This is obtained through a double positive mechanism. On the one hand imported goods would also be subject to the Competitivity VAT and their sales price would go up accordingly : there would therefore result a direct competitive advantage for domestic goods. And on the other hand attributing the tax revenue from imported goods to the funding of our national social security would mean that the social contributions levied on the whole national production would not need to be so high. In this way, the increase in price, owing to the tax, of a domestic product may be lower than the reduction in its cost resulting from the abolition of part of the social charges and its sales price would therefore go down. [4] The prices of French products would thereby become more attractive in two distinct but complementary ways.

Third, **to increase the competitivity of French goods on export markets.** No VAT is levied on exported goods and their production cost would therefore go down by the full amount of the reduction in social contributions. And such competitive gains would be proportionally higher in the case of goods produced with a high labour input.

All these advantages would have an immediate effect on the siting of labour-intensive industries because, taken together, **they would make the consumption of French products more attractive**. In addition, they may be reinforced by two considerations of another sort.

The first is that to base the funding of that part of our social security system which is concerned more with the principle of solidarity, rather than with insurance, on consumption instead of on employment would be a way of guaranteeing the future of the French social model. Household consumption tends to move upwards and its fluctuations are less marked than those of the labour market, so the change would provide steadier funding of social security. The recurrent difficulties of the latter, particularly concerning sickness insurance, would thus be sustainably reduced – at least as far as receipts are concerned.

The second consideration is that Competitivity VAT need not be applied at a uniform rate : on the contrary, it could be organised so as to favour certain sectors or activities in accordance with clearly established political and economic objectives. It is in this perspective, furthermore, that the reform could be extended to cover existing rates of VAT , in order to render the structure more coherent, particularly with regard to its economic rationality.

(3) Objections that do not stand up to examination

Apart from the sheer difficulty of undertaking the reform, which is undeniable but that your Commission could not consider prohibitive, [5] three categories of objections can be raised against it.

[4] This potential indirect gain depends on two variables : (a) From revenue drawn from subjecting imported products to Competitivity VAT must be deducted the revenue lost by not subjecting French exports to this tax ; the overall margin of manoeuvre with regard to the sums available for financing social security will thus be a function of import-export ratios. (b) The size of price reductions rendered possible will vary from one product to another depending on the importance of social contributions in their cost structures.

[5] In as far as this difficulty is a political one : it is relatively simple to calculate the average rate of the Competitivity VAT such that it will compensate for the loss of social revenue owing to the abolition of the contributions in question ; and it is hardly impossible for the experts to work out two or three different rates to secure the economic objectives

- **The first is an objection to the creation of another indirect tax, considered unfair because it is supposed to hit the lower incomes hardest.** Numerous economic studies show that in reality VAT is more onerous for middle incomes than for lower incomes, and that it only appears to be a regressive type of tax. [6] But apart from that observation, there are three arguments against this criticism :

- First, as our colleague Mr Jean Arthuis pointed out to the Working Group, all taxes and charges paid by companies are financed out of their revenues – and hence finally by the consumer. For this reason to replace one mode of funding sickness insurance and family allowances by another will be globally neutral for the consumer, whose choice relates only to the contents of his "shopping basket" ; and one of the objectives of the reform is precisely **to motivate** him to buy more French products in place of imported ones made dearer by being subjected to Competitivity VAT.

- Second, as indicated above, the rate of this tax need not be **a uniform one.** This allows one to envisage that the rates could be determined **taking into consideration the average structures of consumption of different income groups,** so as not to deform this structure and to guarantee them that their purchasing power remains unchanged.

- Last, the aim of your Working Group's proposal is **to support employment** in France and thus contribute to the lowering of unemployment. People who return to work become better off and enjoy increased purchasing power. Any disadvantage that could be introduced with the reform is likely to be more than compensated by the global advantages it brings.

- **The second objection is an institutional one** : funding sickness and family benefits by a VAT **would jeopardise the nature of the social security organisation, called "*paritaire*", in which the two parties (employees and employers) are equally represented** – a form which is the fruit of some sixty years of history. Your Working Group is **of the view that, given the way the system has had to develop since it ran into financial difficulties, this objection is not valid.** Social security funding is **no longer just the business of the social partners**, as is **proved by numerous factors** : the creation of the Generalised Social Contribution (*CSG – Contribution Sociale Généralisée)* or the Contribution for the Reimbursement of the Social Debt *(CRDS – Contribution au Remboursement de la Dette Sociale)*; various policies reducing or abolishing social contributions ; the annual vote by Parliament on the funding of the Social Security. **But these proofs, on the contrary, demonstrate that partnership can survive even when it has to adapt to a method of funding which resembles taxation.** Seen in this light, replacing certain social contributions by a Competitivity VAT does not seem to represent a dire threat to the joint management mode of our social security organisation. Nor is this contested by the Chairman of the Employers' and Senior Managers' organisations *(CFE – Confédération française des Employeurs; CGC – Confédération générale des Cadres)*, Mr Jean-Luc Cazette, who himself has called for this type of funding, and for just the same reasons as those put forward by your Working Group.

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desired ; the present system of collecting VAT could be used, without significantly increasing the cost ; it is only the actual switch from one system to the other which might be delicate : but in France it is has been possible, in the distant past (creation of the VAT) and in the recent past (introduction of the Euro), to meet such technical and logistical challenges. On the political level, however, the reform will give rise to reactions since it will affect the various sectors differently : in this zero sum game, those which are labour-intensive will gain, at the expense of capital-intensive ones.

[6] See in particular « Value-Added Tax » - The Tax Council – Nineteenth Report to the President of the Republic – Editions des Journaux Officiels – 2001.

One should add that the arrangements suggested would also be economical with public funds. By enlarging the basis of funding of part of the regime it becomes possible to do away with a complex system of exemptions from making social contributions that, although often justified on economic grounds, still represent a considerable burden on the public purse - while their efficacity is not always evident.

- **The third and last objection** is concerned with the feasibility of the reform with regard to **France's obligations within the European Union and internationally**.

On the European level, the regulation of indirect taxes being a matter within the competence of the EU raises questions about the latitude France has for introducing such a mechanism. The difficulties the Government encountered in order to extend to traditional restaurants the lower VAT rate applicable to labour-intensive activities indicate the need for a certain degree of prudence in the matter. However, three considerations seem to counter such reserves :

- **First, Denmark has already adopted this system and finances part of its social security by means of VAT;** this was not opposed by the EU institutions and the mechanism cannot therefore be considered in essence contrary to European prescriptions.
- **Second,** while the underlying principles of these prescription date from 1977 [7] , a decision of the European Court of Justice [8] , ten years later, distinguished between taxes of a fiscal nature **that were covered by the Directive and those that were not, depending on the use made of the funds so collected** : "*The notion of taxes, duties and levies which do not possess the character of taxes on turnover, as it appears in Article 33 of the Sixth Directive (...), should be interpreted in the sense that it includes a tax, of a non-fiscal character, (...) for the benefit of social security regimes (...).*" It thus seems possible, independently of the prescriptions of the 1977 Directive, **to institute a VAT with a social objective, distinct from the fiscal VAT, and in addition to the latter.**
- Finally, even if this last path could not be followed, **nothing prevents changes in VAT rates within the framework of EU provisions.** These provisions define certain categories of rates and specify which sectors may be exempted from the normal rate. And this normal rate, like the other rates (reduced, super-reduced, "parking"), is not strictly defined : each Member country is free to fix its own rates subject to **the minimum limits set for the normal rate** (15%) and **the reduced rate** (5%). For example, the normal VAT rate applied within the 15 Member countries varies at present between 15% (Luxembourg) and 25% (Denmark and Sweden). France, with 19.6%, comes almost exactly on the EU average of 19.4%. So nothing prevents France from increasing its normal rate, as well as its reduced rate, by the number of points necessary to compensate for the abolition of certain social contributions.

There remain certain questions about **the compatibility of the system with the rules adopted in the World Trade Organisation (WTO)** : would a Competitivity VAT represent **a protectionist measure susceptible to sanctions?** Your Working Group says No. This position has not been legally validated by competent authorities, but it is one of common sense. **Since French products and imported products would be subjected to the same tax** and in the same way, **France could not be accused of introducing a**

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[7] Directive 77/388/EEC of the Council of 17 May 1977, called the Sixth Directive, modified and complemented by Directives of 1992, 1999, 2001 and 2002.
[8] SA Rousseau Wilmot v ORGANIC – 27 November 1985 – Case concerning the legality of a levy on turnover for financing the pensions of self-employed workers and shopkeepers.

discriminatory measure contrary to international undertakings. Furthermore, the Danish example, again, supports this position.

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Your Commission considers this reform essential. A Competitivity VAT will not, of course, reduce the cost of labour to such an extent as to place it on a competitive footing with that of emerging countries. But this way of financing social security seems **truly modern in the sense of being adapted to the new conditions of economic activity** : globalisation and increase in world trade have rendered **obsolete our existing arrangements for social contributions,** which can **be effective only in a system that is closed and constrained** (fixed prices, high customs duty, controlled foreign exchange), in which competition was exercised **within a defined geographical territory and the possibility of migrating was limited.** When some 20% of products consumed in France are imported **it would be paradoxical to continue to penalise our own labour by maintaining a system whereby the part of our social expenditure relating to social solidarity is funded exclusively out of that labour**. It would be not only paradoxical, but also culpable, because the *status quo* would only aggravate the difficulties our producers are experiencing in the face of ever-increasing competition from emerging countries.

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