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France: Selected Issues

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FRANCE

Selected Issues

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Approved by European I Department

October 1, 1998

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A. Introduction and Summary

1. In the recent period France's economic strategy was governed by a logic of transition. The essential goal of fiscal policy was to satisfy the deficit criterion of the Maastricht treaty so as to ensure France's participation in the monetary union. Now that this goal is completed, the time is ripe for thinking about a new "fiscal philosophy" stating what France expects from its fiscal policy in the new, permanent, EMU regime.

2. The European Economic and Monetary Union will change the framework in which national fiscal policies are determined in two essential respects. First, monetary policy will be determined with reference to the economic conditions in the euro zone as a whole, rather than targeted toward national objectives (including in this connection the use of the French franc exchange rate with the deutsche mark as an intermediate target). Second, the extent to which governments can resort to fiscal deficits will be limited by the 3 percent deficit ceiling of the Stability and Growth Pact (SGP). As a number of economists have noted, this deficit ceiling could limit the scope for fiscal stabilizers to operate precisely at a time when fiscal policy might become more important to stabilize the economy.[2]

3. This paper addresses the question what policy changes in France—if any—are needed under EMU, as regards the role of fiscal policy in stabilizing the economy. In the sections that follow, fiscal strategy over the past two and a half decades is reviewed; and, against this background, an assessment is offered concerning the role and scope of fiscal stabilizers in France under EMU. The main conclusions of the paper are as follows:

- Over the past two and a half decades, fiscal policy operated in a clear counter-cyclical way in France, but this reflected essentially the functioning of automatic stabilizers. There was no systematic and deliberate attempt by the fiscal authorities to stabilize the economy over the cycle by discretionary interventions—indeed, such initiatives were at times procyclical, as, for example, in the economic upswing of 1989–90.

- There is no strong argument, in the case of France, for making fiscal policy more countercyclical because of EMU. The argument based on the loss of monetary autonomy seems weak in the case of France, where monetary policy was already geared towards an external objective before EMU, and the other arguments that can be invoked are speculative and difficult to quantify. Hence, the main challenge ahead is to leave enough room for the automatic stabilizers to operate under the constraints of the SGP.

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[1]Prepared by Olivier Jeanne (RES).

[2]See, e.g., Eichengreen and Wyplosz (1998) and P. Artus (1998).

- Given the constraints of the SGP, the full and effective operation of automatic stabilizers requires the public finances to be close to equilibrium on average. In particular, the general government structural deficit would need to be reduced to a level very close to balance to avoid a significant risk of a breach in the deficit limit that would not appear to fall under the "exceptional circumstances" clause of the Pact. Thus the operation of fiscal stabilizers provides some ground for balancing the public finances over the medium term—in addition to other considerations outside the scope of this paper, such as the need to reduce the burden of the public debt ahead of impending demographic pressures on the public finances.

4. The remainder of this paper is structured as follows. Section B provides some stylized facts on the broad trends and cyclical fluctuations in fiscal policy during 1970–97. Section C scrutinizes the operation of fiscal stabilizers over the past two decades, focusing in particular on the question of whether automatic stabilizers were supplemented or mitigated by discretionary interventions. Section D investigates the implications of EMU for the stabilizing role of fiscal policy. Section E assesses the level of the structural deficit that would allow fiscal stabilizers to operate under the SGP constraint.

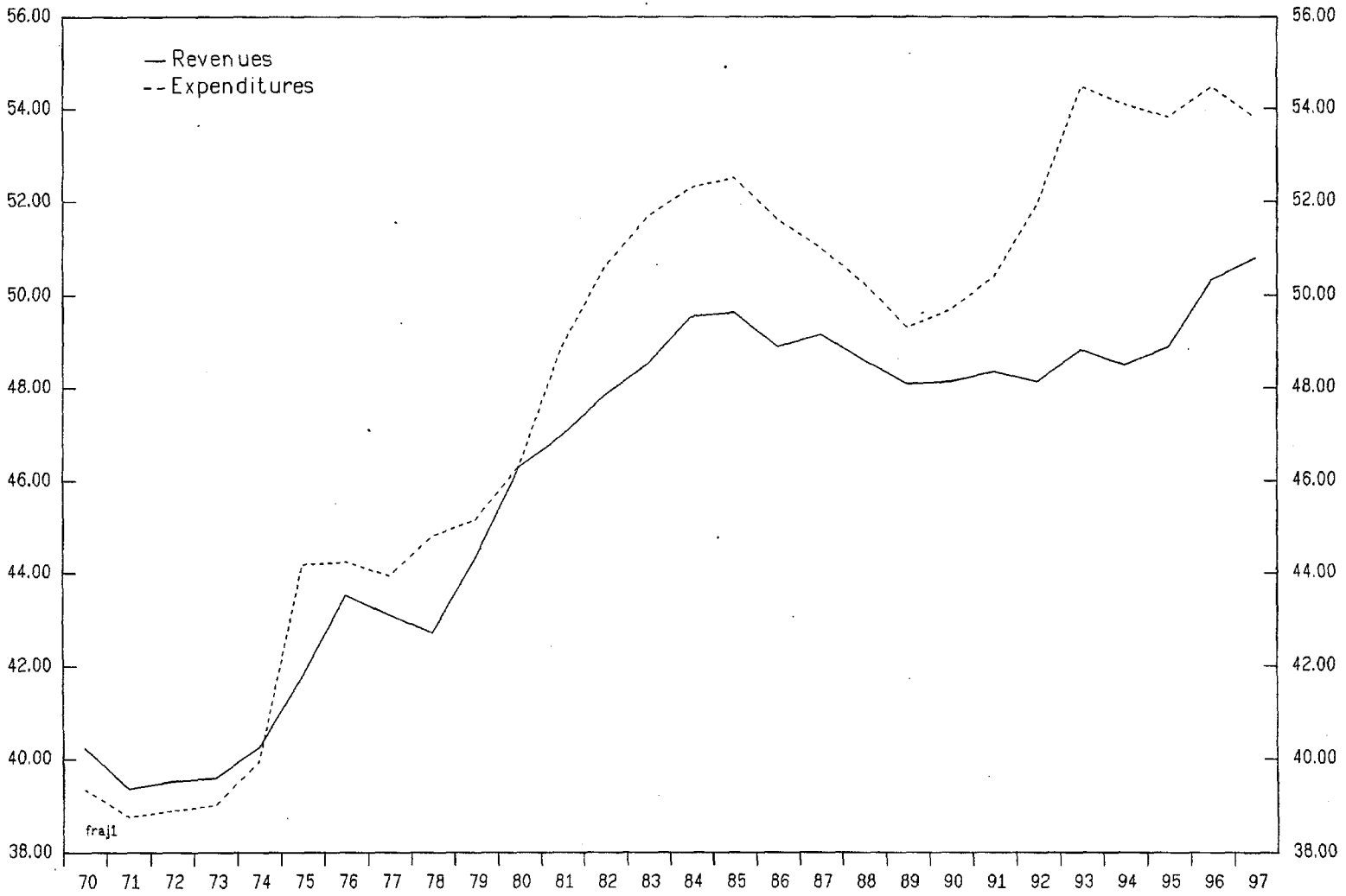
B. Fiscal Policy During 1970–97: Some Stylized Facts

5. The last quarter of a century was marked by a steep increase in the share of general government expenditures in GDP, which approached 55 percent in the 1990s (Figure I.1). Most of this growth can be ascribed to an increase in social expenditures in the 1970s and early 1980s (Figure I.2), following important extensions of the social insurance system in the 1970s, as well as mounting unemployment. The growth of expenditures tended to slow down after 1983, a phenomenon which—though often associated with the shift to more austere policies *(tournant de la rigueur)* in France—was evident more generally in the EU. The revenue side exhibits the same broad trends, with the share of general government revenues in GDP increasing at a rapid pace until the early 1980s—mainly under the pressure of social contributions—and then stabilizing on a plateau around 50 percent (Figure I.3).

6. The increase in revenues and expenditures was accompanied by a steady deterioration of the fiscal balance, which fell from a state of surplus in the early 1970s to a deficit in excess of 3 percent of GDP during most of the 1990s (Figure I.4). Under the cumulative effect of widening deficits, the level of the public debt surged—from about 20 percent to almost 60 percent of GDP between 1980 and 1997 (Figure I.5), and interest payments became an important component of public expenditures—accounting for about one-fifth of the rise in the share of public expenditures in GDP over the period.

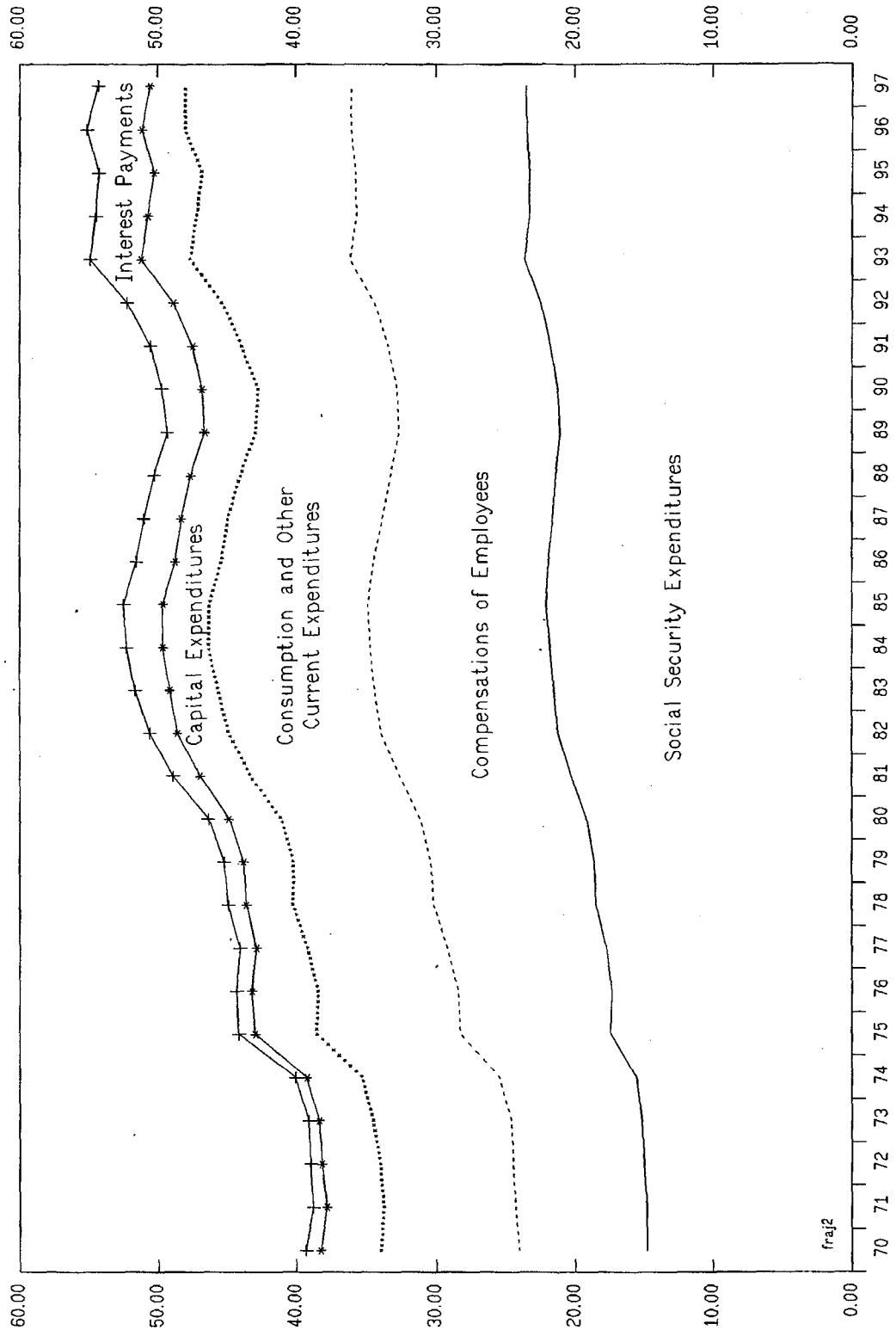
7. The share of general government expenditures—and to a lesser extent revenues—in GDP was also significantly influenced by cyclical fluctuations in economic activity. The troughs of the business cycle—in 1975, 1985 and 1993—were systematically associated with increases in the ratio of expenditures to GDP, which were not completely offset in the

FIGURE I.1
FRANCE
General Government Revenues and Expenditures
(In Percent of GDP)



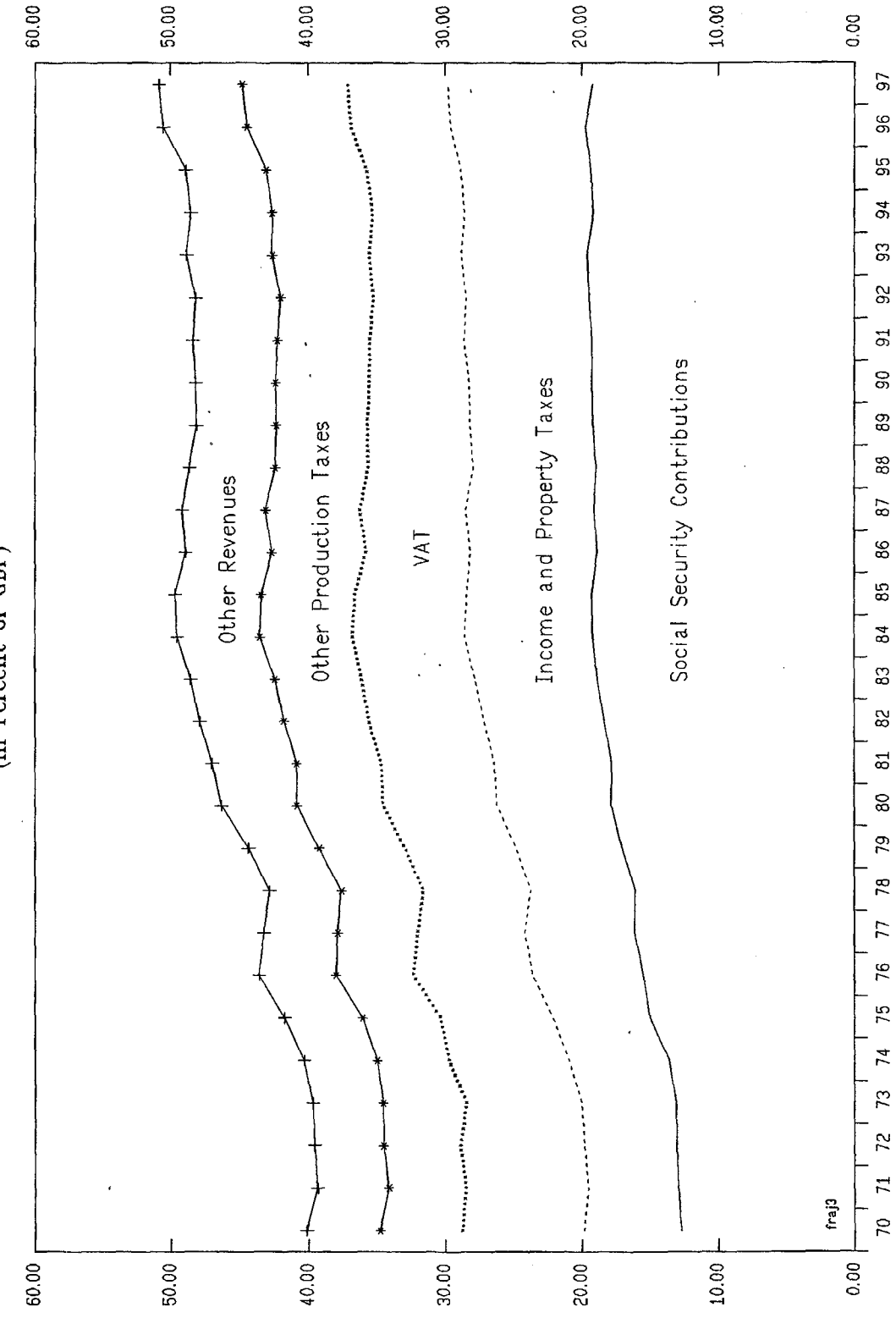
Source: IMF, Datafund.

FIGURE I.2
FRANCE
General Government Expenditures
(In Percent of GDP)



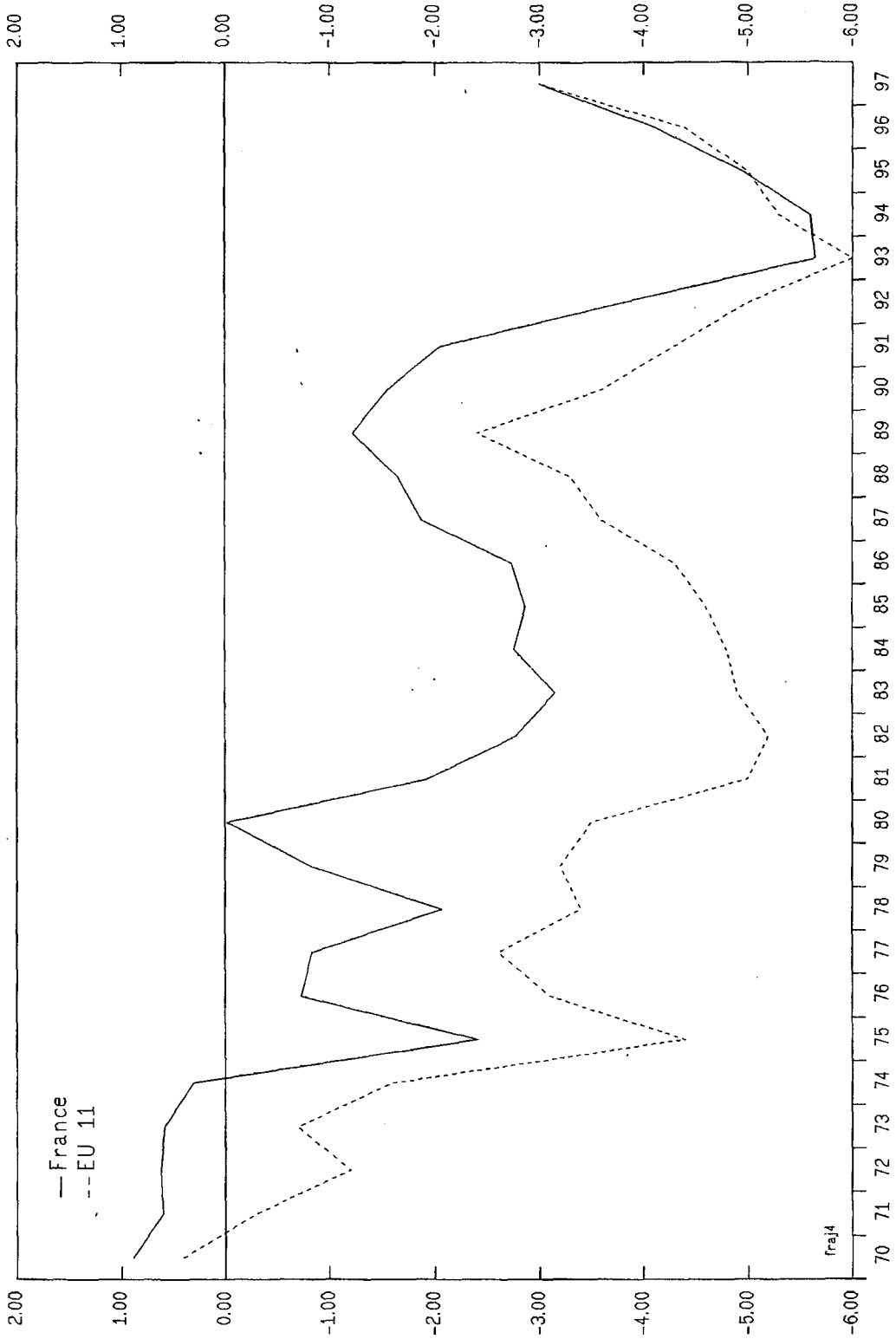
Source: IMF, Datafund.

FIGURE 1.3
FRANCE
General Government Revenues
(In Percent of GDP)



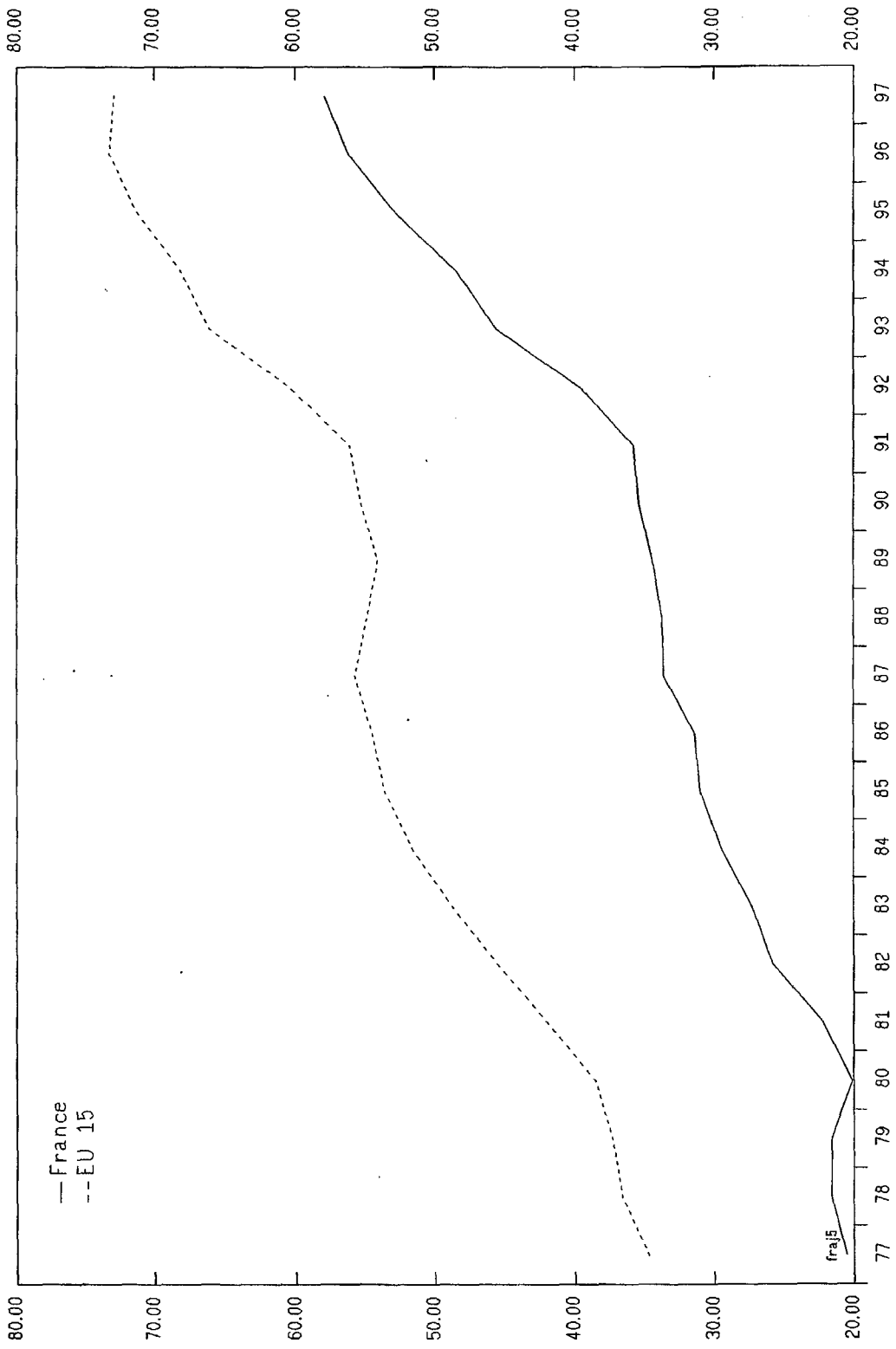
Source: IMF, Datafund.

FIGURE I.4
FRANCE
General Government Balance
(In Percent of GDP)



Sources: IMF, Datafund; and EC, European Economy.

FIGURE I.5
FRANCE
General Government Consolidated Gross Debt
(In Percentage Points of GDP)



Source: EC, European Economy.

following peaks. By contrast, the share of revenues in GDP seems to have been less responsive to the cycle. Overall, fiscal policy has behaved in a consistently countercyclical manner, associating periods of lower output with higher fiscal deficits (Figure I.6).

8. The cyclical properties of fiscal policy can be investigated at a more disaggregated level by looking at the correlation of the components of general government revenues and expenditures with cyclical fluctuations in output. For this purpose, the methodology presented by Blanchard and Fischer (1989/1) was used to establish the correlation between innovations obtained from estimation of univariate ARIMA processes for the growth rate in real GDP and the real level of fiscal variables.[3] Tables I.1 and I.2 report the results for general government revenues and expenditures, respectively. Each table gives the share of the fiscal component in GDP as of 1997, the correlation between the innovations in the fiscal component and the innovations in real GDP, and the coefficient from a regression of the innovation in the component on the contemporaneous innovation in real GDP. While the latter regression should not be interpreted as causal, the regression coefficient provides some indication how far particular fiscal components move with GDP.

9. The results indicate, as might be expected, a significant positive correlation between output and the components of general government revenues. Taxes are very responsive to cyclical fluctuations in output, an effect that is more marked for direct taxes than indirect ones, presumably because of the progressivity in direct tax rates. The elasticity of VAT receipts is not significantly different from 1, as would be anticipated in the case of a tax that is roughly proportional to value added. Social security contributions are less significantly correlated with the cycle, which may be explained by their regressivity—resulting from ceilings on individual social contributions—and the fact that they are based mostly on labor income, which, like employment and wages, is less closely correlated with output than total income.

10. There is a significant negative correlation between output and general government primary expenditures, which reflects in large part the countercyclicality of social transfers. A number of components of social transfers are more or less directly responsive to the level of economic activity: unemployment benefits, but also other transfers linked to employment status or income levels, such as the minimum benefit *(revenu minimum d'insertion)* or family allowances (*allocations familiales)* (Bismut, 1997). Even pension benefits may be indirectly affected by cyclical conditions because of early retirement mechanisms which, in France, act in a sizeable measure as substitute to layoffs during economic downswings (Blanchet and Pelé, 1997). There is some evidence—although not statistically significant—that capital expenditures are procyclical, a result that may be due to a tendency of the government to respond to cyclical increases in its deficit by cutting or postponing public investment. The

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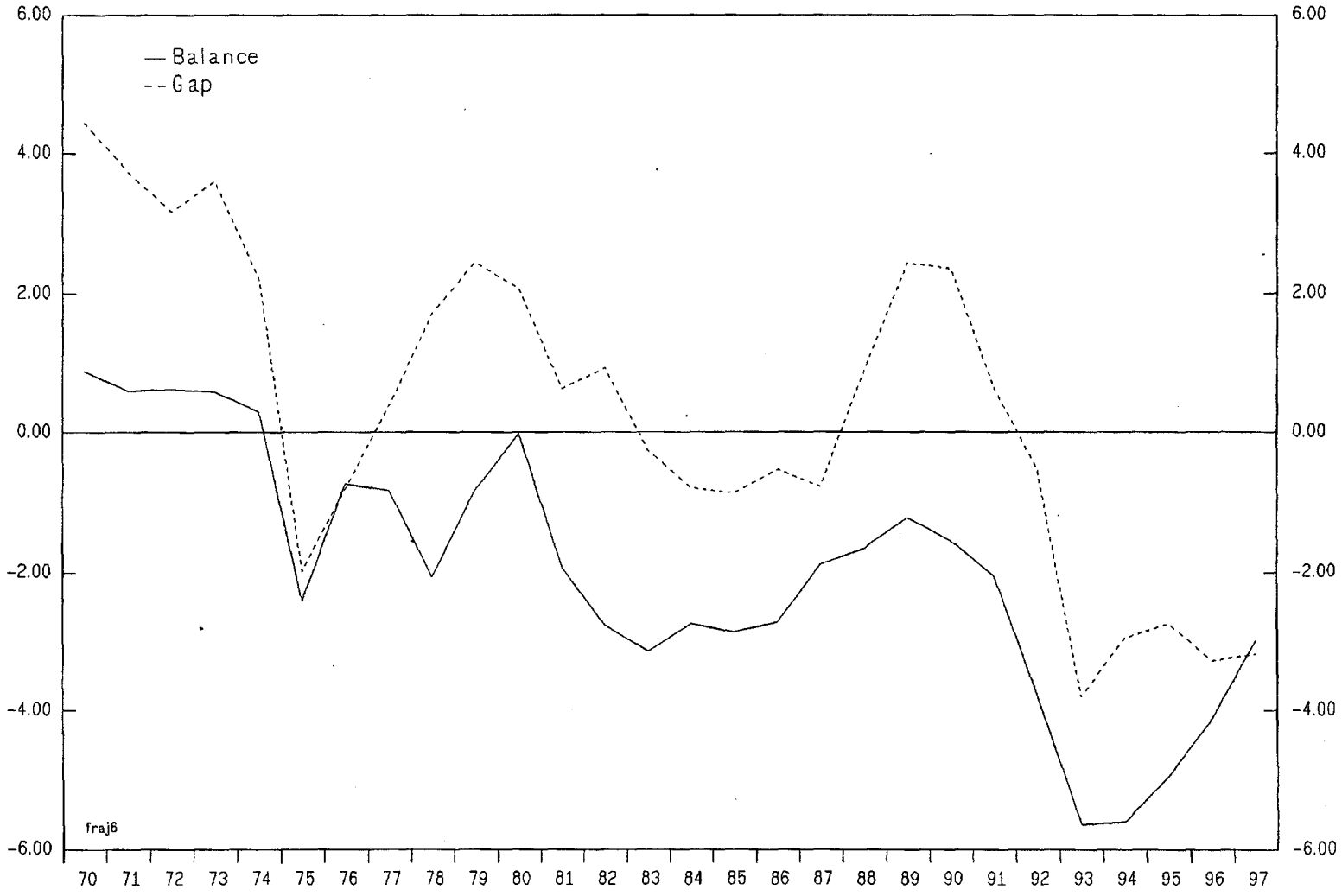
[3]This approach thus offers a broader insight into cyclical fluctuations in the fiscal position by comparison with the conventional analysis of automatic stabilizers used by the staff, which is presented in Section C below.

FIGURE I.6
FRANCE

General Government Balance and Output Gap

(In Percent of GDP and Potential GDP)



Source: IMF, World Economic Outlook.

Table I.1. France: Co-movements in GDP and General Government Revenues

	Share in GDP 1/	Correlation 2/ 3/	Elasticity 3/ 4/
	(In percent)		
Total revenues	50.8	0.48**	0.53***
Taxes	25.6	0.61***	1.15***
VAT	7.4	0.34*	0.95*
Income and property taxes	10.6	0.41*	1.17**
Social security contributions	19.2	0.34*	0.49*

Source: INSEE, *Quarterly National Accounts*.

* Significant at the 10 percent level.
** Significant at the 5 percent level.
*** Significant at 1 percent level.

1/ In 1997.

2/ Correlation between the residuals from ARIMA processes for GDP and the components of general government revenues (deflated by the GDP deflator). Annual data, from 1970 to 1997. A dummy variable for the period 1970–82, denoted by δ, was included when significant:

$\Delta gdp = 1.59 \times 10^{-2} + 0.306\ \Delta gdp(-1) + e$ where gdp is the logarithm of real GDP.
$\Delta ggr = 2.34 \times 10^{-2} + 2.13 \times 10^{-2}\ \delta + e$ where ggr is the logarithm of the real level of general government revenues.
$\Delta ggt = 2.96 \times 10^{-2} + e$ where ggt is the logarithm of the real level of taxes.
$\Delta tva = 0.74\ \Delta tva(-1) + e - 1.30\ e(-1)$ where tva is the logarithm of the real level of VAT receipts.
$\Delta ipt = 5.08 \times 10^{-2} - 0.25\ \Delta ipt(-1) + e$ where ipt is the logarithm of the real level of income and property taxes.
$\Delta ssc = 2.25 \times 10^{-2} + 3.80 \times 10^{-2}\ \delta + e$ where ssc is the logarithm of the real level of social security contributions.

3/ For social security contributions, with one lag in the innovation in real GDP.

4/ Coefficient from a regression of the innovation in the component of general government revenues on the innovation in real GDP.

Table I.2. France: Co-movements in GDP and General Government Expenditures

	Share in GDP 1/	Correlation 2/ 3/	Elasticity 3/ 4/
	(In percent)		
Primary expenditures	50.6	-0.33*	-0.29*
Social transfers	23.6	-0.42**	-0.43**
Compensation of employees	12.5	-0.14	-0.11
Number of employees		-0.34	-0.16*
Wage		0.36	0.37*
Consumption and other current expenditures	11.9	-0.14	-0.31
Capital expenditures	2.6	0.17	1.06

Source: INSEE, *Quarterly National Accounts*.

* Significant at the 10 percent level.
** Significant at the 5 percent level.

1/ In 1997.

2/ Correlation between the residuals from ARIMA processes for GDP and the components of general government expenditures (deflated by the GDP deflator). Annual data, from 1970 to 1997.

$\Delta st = 2.66 \times 10^{-2} + 3.36 \times 10^{-2}\ \delta + e - 0.38\ e(-1)$	where st is the logarithm of the real level of social transfers.
$\Delta ec = 1.76 \times 10^{-2} + 4.16 \times 10^{-2}\ \delta + e + 0.64\ e(-1)$	where ec is the logarithm of the real level of general government compensation of employees.
$\Delta coe = 3.10 \times 10^{-2} + e$	where coe is the logarithm of the real level of general government consumption and other current expenditures.
$\Delta ce = 0.56 \times 10^{-2} + e$	where ce is the logarithm of the real level of general government capital expenditures.

3/ For wage, with one lag in the innovation in real GDP.

4/ Coefficient from a regression of the innovation in the component of general government expenditures on the innovation in real GDP.

compensation of public employees is negatively correlated with output—a correlation that is not significant and subsumes opposite cyclical behaviors of the hiring and wage policies of the public sector. The number of employees in the public sector is significantly countercyclical (even though the low value of the elasticity coefficient shows this effect to be small) suggesting an attempt by the general government to offset cyclical variations in the level of private employment. On the other hand, the average real wage in the public sector is procyclical, which may reflect the general tendency of wages to grow more during economic upswings than during downswings.

11. Overall, the cyclical properties of fiscal policy seem to conflate a number of different mechanisms by which fiscal variables adjust—or are adjusted—to cyclical fluctuations in output. Some of these mechanisms, such as those involving the passive response of taxes and social contributions to cyclical fluctuations in income, clearly fall in the category of automatic stabilizers. Others—those related to the hiring and investment policies of the public sector, in particular—reflect the discretionary behavior of the fiscal authorities. Between the two lies a grey zone of "semi-automatic" stabilizers, which may not reflect a deliberate attempt by the authorities to stabilize the economy, but at the same time do not function mechanically as automatic stabilizers *stricto sensu*. Social benefits that are indirectly linked to unemployment, such as early retirement schemes, would be an example of this intermediate category. Another example is the sensitivity of public expenditures to macroeconomic variables, such as the real wage or interest rates, which are systematically correlated with the cycle through mechanisms that do not involve the active use of fiscal policy. While the estimates presented here point to the existence of such a "semi-automatic" component of fiscal stabilizers, they do not allow a conclusion on their statistical and economic significance.

12. In order to assess the options that will be open to the authorities in the operation of fiscal stabilizers under EMU, it is important to draw an operational borderline between the discretionary and automatic components of fiscal policy. This is a delicate exercise, but also a necessary one, and it is considered in the following section of this paper. The correlations and elasticities reported in Tables I.1 and I.2, while producing useful information on the cyclical properties of fiscal policy, cannot be used for that purpose because they mix the automatic and discretionary components and suffer from a simultaneity bias—output being partly endogenous to fiscal policy. However, they do indicate the need—when formulating medium-term fiscal objectives—to assess and factor in any desired latitude for "semi-automatic" responses to fluctuations in the economy.

C. The Operation of Fiscal Stabilizers

13. The traditional approach to the assessment of automatic stabilizers is to perform a decomposition of fiscal developments into structural and cyclical components, along the lines of staff analyses used in the World Economic Outlook, and similar analyses made by the IMF,

the OECD, and the European Commission.[4] While some of the assumptions underlying these estimates are questionable (Blanchard, 1990), they offer the advantage of being structural, in the sense that they are based on the cyclical elasticities of the different component of revenues and expenditures as they can be computed from the prevailing fiscal structure, and not from statistical correlations observed in the past. A next step in the analysis, therefore, is to review the operation of fiscal stabilizers in France over the past two decades in the terms of this conventionalized staff measure of automatic stabilizers.

14. Following the conventional approach, the observed fiscal balance is decomposed into two components, the structural balance and the cyclical balance:

$$b_t = b_t^s + b_t^c$$

where the variables are expressed as ratios to GDP. The cyclical or automatic stabilizer component captures the built-in response of the government balance to cyclical output fluctuations. It is assumed to be proportional to the output gap (expressed in percentage points of GDP):

$$b_t^c = \alpha \, gap_t$$

where coefficient α measures the *cyclical responsiveness* of the fiscal balance, that is, the percentage point change in the balance-to-GDP ratio caused by a 1 percentage point change in the output gap.[5]

15. The staff estimate of the cyclical responsiveness is 0.6 for France, broadly in line with the estimates used by the OECD and the EC.[6] The assumptions underlying this estimate are broadly consistent with the cyclical behavior of fiscal variables documented in the previous section. The tax and social contribution components of public revenues are assumed to be automatically responsive to cyclical variations in output, with elasticities that depend on the progressivity or degressivity of tax rates and the cyclical responsiveness of the tax base. The aggregate responsiveness of government revenues is then computed as the average of the different tax elasticities, weighted by the share of each tax in total revenues. On the

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[4]The methods used by the IMF, the OECD and the EC to construct these estimates are presented in IMF (1993), Giorno *et al* (1995) and Commission of the European Community (1995), respectively.

[5]For expositional simplicity, lags in the response of the balance to the cycle are ignored, as are the (small) changes in coefficient α resulting from the evolution of the fiscal structure over time.

[6]The OECD estimate is the same as that of the IMF staff. The Commission estimate is slightly lower (0.5), because of small differences in the computation of the tax elasticities.

expenditure side, the only component that is assumed to be automatically responsive to the cycle is unemployment benefit payments. This assumption does not take into account other social transfers that may be sensitive to the cycle as well as other mechanisms involved in the "semi-automatic" stabilizers, but it is not clear, on the basis of the estimates presented above, that ignoring these effects biases the estimate of the cyclical component of fiscal policy to an important extent.

16. The structural—or cyclically adjusted—balance is the hypothetical value that the balance would take if the output gap was zero. It is estimated as a residual, by subtracting the automatic stabilizer component from the observed balance:

$$b_t^s = b_t - \alpha\ gap_t$$

The structural balance reflects changes in interest payments on the public debt as well as new fiscal measures. The evolution of the structural balance net of interest payments, the *primary* structural balance, gives a rough indication of structural changes in fiscal policy.

17. Figure I.7 shows the evolution of the primary structural balance and the output gap over the past two decades. If the fiscal authorities were systematically attempting to reinforce the automatic stabilizers by discretionary fiscal interventions, the primary structural balance and the output gap would tend to move in the same direction. Conversely, if the government was trying to insulate the deficit from cyclical influences a negative correlation would appear between the two variables. There is no visible stable pattern of correlation in Figure I.7, a finding that is confirmed by regressing the change in the primary structural balance on the change in the output gap:

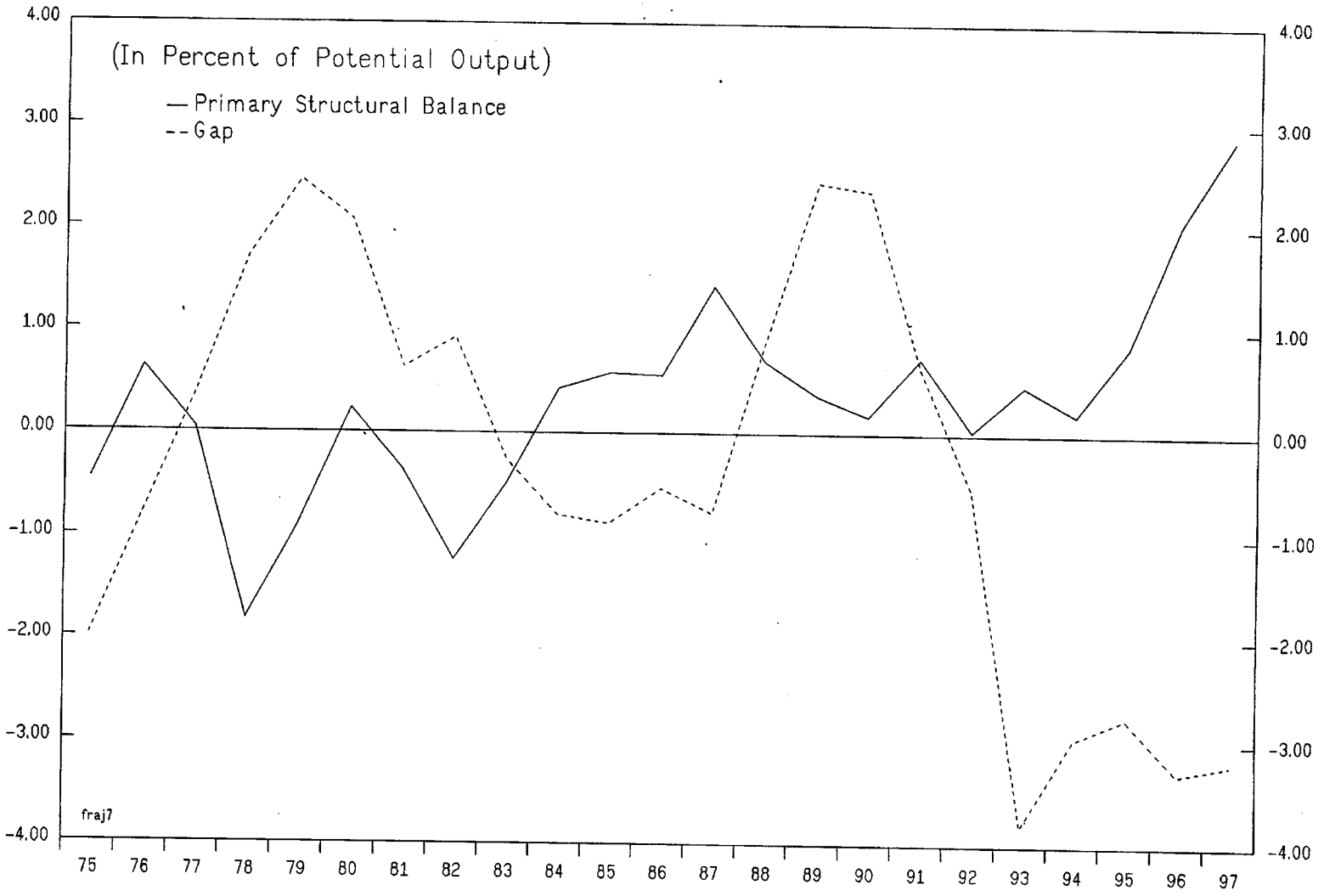
$$\Delta b_t^{ps} = -0.215\ \Delta gap_t$$
$$(0.144)$$

The regression coefficient is not statistically different from zero at standard levels of confidence. Thus, a crude analysis of the data attributes the cyclical properties of fiscal policy to the operation of automatic stabilizers, which do not seem to have been significantly augmented—or mitigated—by discretionary interventions over the past two decades.

18. The results of these regressions should be interpreted with care, as fiscal policy has undergone several changes in regime since the 1970s. The beginning of the period was characterized by two Keynesian reflationary experiments that were quickly reversed under the pressure of their consequences: first, the reflationary measures adopted by the Chirac government in 1975, followed by the austerity plan formulated by the Barre government in 1978; and second, the expansionary fiscal policy of the first socialist government in 1981,

FIGURE I.7
FRANCE

General Government Primary Structural Balance and Output Gap



Source: IMF, World Economic Outlook.

followed by a shift to fiscal rigor with the Fabius government in 1983. Another regime break occurred in the last few years of the sample period, when a sizeable fiscal retrenchment—involving mostly the revenue side—was implemented by the Juppé government to satisfy the convergence criteria of the Maastricht treaty.

19. The period from the mid-1980s to the mid-1990s may be more revealing of the true preferences of fiscal authorities than the rest of the sample period since, on the one hand, it was free of the reflationary Keynesian experiments of the late 1970s and early 1980s, and on the other hand, it was not yet constrained by the Maastricht treaty. Regressing the change in the primary structural balance on the change in the output gap over 1983–95 gives:

$$\Delta b_t^{ps} = -0.218\ \Delta gap_t \quad (0.109)$$

As before the coefficient is negative, but it is now different from zero at the 10 percent level of confidence, suggesting a significant procyclical behavior of the fiscal authorities during this period.[7] Thus, it may be interesting to look in more details at the forces and constraints that were important in shaping fiscal policy outcomes and its adjustment to the cycle from 1983 to 1995.

20. The period from 1983 to 1987 was dominated by fiscal consolidation, in a context of stable but slightly lower than potential output. The central government budget for 1985 was the first one to endorse explicitly the political commitment in 1983, under the Mitterrand presidency, to lower the share of taxes and social contributions in GDP; and the budget of 1986 had similar orientations, with the declared objective of containing central government budget deficit under 3 percent of GDP. On the expenditure side, reductions dominated, particularly as a result of substantial cuts in transfers to social insurance funds, as well as in subsidies and capital transfers to nationalized enterprises. The new conservative government that came into office after spring 1986 general elections was keen to reduce even further the share of the government deficit and public debt in GDP. One major move consisted of privatizing a number of state-owned companies and using the proceeds of the sale to reduce central government debt.[8]

21. Fiscal policy took a new turn in 1988, when the structural deficit embarked in a path of relative deterioration. This change in fiscal orientations finds its origin in a string of expenditure-increasing measures initiated by the government of Prime Minister Rocard—and pursued by its socialist successors—including notably the renegotiation of public employees' wages, the institution of a new minimum income scheme *(revenu minimum d'insertion)*, and

---

[7]IMF (1998a) finds that in Germany procyclical discretionary interventions appear to have largely offset the operation of automatic stabilizers since the end of the 1970's.

[8]A more detailed account of fiscal policy during this period may be found in Le Cacheux (1994).

the adoption of a major program in favor of higher education. At the same time, the strong recovery of 1988-1990 allowed the authorities to reduce a number of taxes—the personal and profit tax rates, in particular, were lowered—without visible consequences for the public deficit. The extent of the underlying deterioration of the public finances, however, became blatant in the economic slowdown of 1992–93, when the general government deficit came close to 6 percent of GDP. The fiscal policy of the conservative government of Prime Minister Balladur that took office in the spring of 1993 was affected by its changing perceptions of the extent of the recession. The government first took a number of measures to stop the degradation of public financial conditions—excise taxes, the *Contribution Sociale Généralisée* and employees' social contributions were raised—but then shifted to a more expansionary stance, as the recession appeared even deeper than anticipated, with a one-off measure to the benefit of private firms. As a result of these different measures in 1995 the structural primary balance was about at the same level as in 1991.

22. Overall, the historical record does not suggest that the French fiscal authorities resorted to discretionary interventions in order to stabilize the economy, even when they were free to do so. Between 1983 and 1994 the determination of fiscal policy was subject to a complex set of influences, in which the desire to stabilize output, without being absent from policymakers' preoccupations, were often outweighed by other considerations. In the years leading up to the cyclical peak of 1989-90 the structural stance of fiscal policy was in fact procyclical—the cyclical improvement in the public finances being used to develop the supply of public goods and reduce taxes. The recession certainly became an important concern of the French fiscal authorities in 1993, but their ability to stimulate the economy using fiscal policy was constrained at that time by the size of the deficit—and it is difficult to conjecture how fiscal policy would have been used in the absence of this constraint.

23. While the record of this subperiod does not demonstrate a clear counter-cyclical pattern in discretionary policy actions (a conclusion consistent with the findings of Section B above), one important lesson of these years is the danger of failing to aim for sufficiently ambitious fiscal goals during a period of economic recovery, when the **actual** fiscal balance performs deceptively favorably, and thus of constraining the scope for policy to operate freely in a subsequent downturn.

D. Should Fiscal Policy Become More Countercyclical Under EMU?

24. EMU involves a major change in regime, and taking the statistical regularities observed in the past as a benchmark to analyze the future raises a Lucas-type critique. In order to address this critique one needs to consider the different ways in which the economic environment of fiscal policy might be changed by EMU. A widespread argument is that the loss of their national monetary autonomy will induce countries adopting the common currency to shift the burden of stabilization to fiscal policy. EMU may also affect more broadly the nature of the shocks hitting the economy, and the response of economic agents to them.

25. It is often argued that because monetary policy is no longer available as a national policy tool, fiscal policies should become more countercyclical under EMU. This argument,

however, assumes that countries exploit their monetary independence in the period leading up to the monetary union—for example, in order to support economic activity at times of a significant output gap. This was not the case in France, which—under the auspices of the "franc fort" policy—has kept its EMS central parity unchanged since 1987, and has maintained the objective of holding the French franc/deutsche mark rate within a narrow band. French monetary policy was geared toward an external objective for more than a decade before the transition to EMU, and the completion of the monetary union should not significantly shift the allocation of the stabilization burden from monetary to fiscal policy.

26. In fact, monetary policy may, if anything, become more tuned to the French economic conditions under EMU, not less. In the past decade, French monetary policy was determined by German interest rates plus shocks to the credibility of the franc/mark parity.[9] Under EMU, credibility shocks will disappear, and monetary policy will be determined with reference to the economic conditions in the whole euro zone. As Figure I.8 shows,[10] the French cycle has in the past been more closely correlated with the euro zone cycle than with the German one—and to that extent, monetary policy may become more in phase with the French cycle under EMU than before.

27. Second, EMU may affect the nature of the shocks hitting the economy—a question that has been addressed extensively, if not conclusively, by the literature on EMU as an Optimum Currency Area (Eichengreen, 1993). A common currency will obviously remove the shocks to relative prices that were previously made possible by devaluations of the currencies of the trading partners concerned. Closer international trade with other members of the union may also significantly affect the nature of national business cycles in a way that could result, from a theoretical point of view, in either tighter or looser correlations of national business cycles. On the one hand, trade integration may favor the specialization of countries in the goods in which they have a comparative advantage, making them more sensitive to asymmetric sector specific shocks (Krugman, 1993). On the other hand, most of the European trade is intra-industry, rather than being based on specialization, so that closer integration might lead to more diversified portfolio of industries in each country, and less asymmetry in national shocks. Which effects will dominate is an empirical matter. The study of Frankel and Rose (1997) lends support to the view that closer trade integration will make shocks more symmetric, not less, in the euro zone.

28. The Lucas critique also suggests considering carefully the way the behavior of economic agents may be affected by the change in policy regime associated with the monetary union. Some authors, like Cotis *et al* (1998), have argued that households might become less responsive to fiscal impulses, as the SGP will make them more conscious of the future tax

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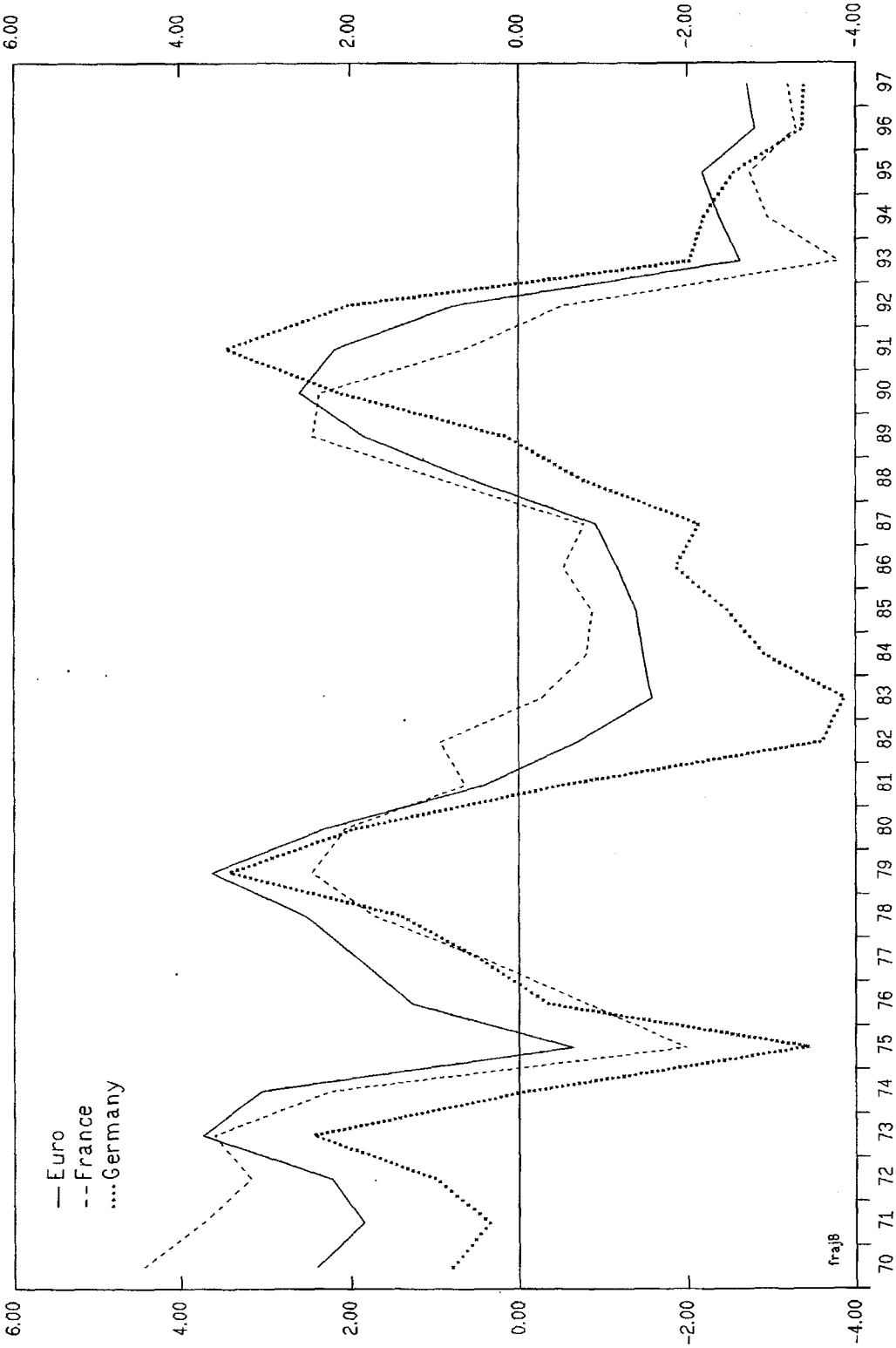
[9]For a discussion, see Levy and Halikias, IMF Working Paper No. 97/44.

[10]Figure I.8 depicts the output gap in France, Germany and the Euro zone. The index for the latter was computed as a GDP-weighted average, in which Finland was excluded because of the lack of data.

FIGURE 1.8
FRANCE

Output Gaps in France, Germany, and The Euro Zone

(In Percent of Potential GDP)



Source: IMF, World Economic Outlook.

consequences of current fiscal policy. In this less Keynesian environment, fiscal policy would have to become more active to obtain the same degree of output stabilization. On the other hand, it has been argued that under EMU the working of European labor markets may improve in ways that make stabilizing fiscal policy less necessary. The common currency may make labor more mobile internationally, and the impossibility to address national unemployment problems using monetary policy will increase the pressure on policymakers to make labor markets more flexible. Whether or not the monetary union will produce these effects is difficult to predict, and quantifying them seems even more difficult.

29. To summarize, the classical argument for making fiscal policy more countercyclical under EMU—the loss of monetary autonomy—seems rather weak in the case of France, and the other arguments that can be invoked are highly speculative and difficult to quantify. Overall, it would appear that the objective of leaving enough room for the automatic stabilizers to operate may provide a reasonable initial basis for assessing the structural goal for fiscal policy under EMU.

E. What is the Size of the Structural Deficit That Would Allow the Fiscal Stabilizers to Operate Effectively Under the Stability and Growth Pact (SGP)?

30. The SGP clarifies the provisions of the Maastricht Treaty regarding the 3 percent reference value for budget deficits and the Excessive Deficit Procedure.[11] Countries that breach the deficit limit may be subject to an excessive deficit finding leading to financial sanctions if the breach is not corrected in time, but the Pact also allows significant scope for discretion in the application of the Excessive Deficit Procedure. In particular, a country would not be subject to an excessive deficit finding if the breach of the 3 percent deficit limit is small, temporary, and can be attributed to "exceptional circumstances." These exceptional circumstances are defined to encompass unusual events outside the control of the member state in question, or a severe economic downturn. While the Pact defines a severe economic downturn as an output decline of 2 percent or more, it also allows member states to argue that smaller output declines can be considered exceptional, notably on the basis of evidence concerning the abruptness of the slowdown or cumulative loss in output relative to past trends. Countries have agreed not to take advantage of this provision for annual output declines of less than ¾ percent. Further room for discretion is provided by the clause that

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[11]The SGP was agreed at the June 1997 meeting of the Council in Amsterdam. It consists of Council Regulation (EC) No. 1466/97 on "the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies," Council Regulation No. 1467/97 on "speeding up and clarifying the implementation of the excessive deficit procedure," which were adopted on July 7, 1997, and the Resolution of the European Council of 17 June 1997 on the SGP. Some analysis of the Pact implications is provided in Eichengreen and Wyplosz (1998), Buti, Franco and Ongena (1997) and IMF (1998b).

countries subject to an excessive deficit finding can be given an extended period of adjustment if there are "special" circumstances, which the Pact leaves undefined.[12]

31. What is the size of the structural deficit that would allow fiscal stabilizers to operate effectively under the SGP? This question can be approached first from a retrospective point of view, and reformulated in terms of the level of the structural deficit that would have prevented excessive deficits in the past (Buti, Franco and Ongena, 1997). This, of course, involves assessing past policy ex post in terms of a framework and incentive structure that did not then exist—inevitably a somewhat artificial procedure. This said, the only period in which the deficit limit would have been a serious concern for France appears to be 1992–96, when, for five years in a row, the deficit was markedly larger than 3 percent of GDP (Table I.3).

Table I.3. France: Fiscal Developments, 1992–96
(In percent)

	1992	1993	1994	1995	1996
GDP growth rate	1.2	-1.3	2.8	2.1	1.5
General government balance/GDP	-3.8	-5.6	-5.6	-5.0	-4.1
Output gap (percent of potential GDP)	-0.5	-3.8	-3.0	-2.8	-3.3
Counterfactual balance/GDP $b^s = 1$ percent	-1.1	-3.3	-2.8	-2.7	-3.0

Sources: *World Economic Outlook*, and Fund staff calculations.

32. Hypothetically, had the SGP then applied, France would likely have been subject to an excessive deficit finding in 1993 on the basis of the breach in the deficit limit in 1992, if indeed this was judged to be large, unlikely to be temporary, and not justified by a recession or other exceptional circumstances. If corrective action based on the Council's recommendations had not then been taken, a financial penalty, in the form of a non-interest bearing deposit of 0.28 percent of GDP, would have been applied to France by the end of the year. While the French government might have invoked special circumstances in 1994, on the basis of the 1993 recession, the Council, hypothetically, would have been entitled to increase the deposit

[12]The normal timing is for a finding to be made in the spring of the year following that in which the excessive deficit arose, and then for measures to be adopted in that year (consistent with the Council's advice) to correct the deficit in the next year.

by 0.26 percent of GDP, and convert it into a fine in 1995.[13] This scenario assumes that France would have made no fiscal effort to meet the 3 percent deficit limit.

33. The usefulness of this example is that it provides a practical illustration with which to assess the level of the structural deficit that would have preserved France from an Excessive Deficit Procedure in the economic downswing of 1992–95—in other words, the maximum structural deficit that would have kept the actual deficit below 3 percent from 1992 to 1995, except in 1993, where the recession might justify—temporarily—a slightly higher deficit limit. As the last row of Table I.3 shows, a structural deficit of 1 percent of GDP would have been just sufficient for France to escape an excessive deficit finding. This figure is slightly higher than the 0.8 percent estimate derived in IMF (1998b) under the assumption that the deficit ceiling should have been strictly satisfied also in 1993.

34. Retrospectively, it is always possible to specify a level of the structural deficit that would just have prevented a breach in the deficit limit—but the result will hinge on the historical accidents of the period under consideration, here the 1993 recession. Prospectively, however, uncertainties surrounding future output developments make it more difficult to determine a given level of the structural deficit to ensure that the deficit limit will not be breached. The choice of a lower structural deficit, from this point of view, may be interpreted as an insurance against the risk of excessive deficit—an insurance, however, that does not cover the most extreme output fluctuations and entails some cost in terms of fiscal adjustment. How can one characterize, in the case of France, the tradeoff between the level of the structural balance and the risk of excessive deficit?

35. The frequency with which the deficit limit will be violated depends on the long-run statistical distribution of the output gap. Given a constant structural deficit b^s, the deficit limit is violated when the output gap falls below a threshold level, $gap*$, defined by:

$$b^s + \alpha\ gap* = -3$$

and the frequency of breaches is given by:

$$p = F(gap*) = F(-(3+b^s)/\alpha)$$

where $F(.)$ denotes the long-run (unconditional) cumulative distribution function of the output gap.

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[13]The first year of the breach the amount of the deposit comprises a fixed component equal to 0.2 percent of GDP and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 percent of GDP. Each following year, the additional deposit, if it is decided, is computed according to the same formula as the variable component in the first year.

36. Over 1970–97 the output gap had a mean not significantly different from zero and a volatility of 2.32 percent; a Kurtosis test does not reject that it was normally distributed. While these statistics may give an imperfect measure of the long-run distribution of the output gap—in particular in view of the short duration of the sample period over which they are estimated—they nevertheless allow some empirical content to be given to the relationship between the level of the structural deficit and the frequency of breaches in the deficit limit. Table I.4 gives the frequency of breaches, p, for different levels of the structural balance, b^s, assuming that the past behavior of the output gap reflects its long-run distribution. As expected, the frequency of breaches in the deficit limit increases with the level of the structural deficit. It is noteworthy that a structural deficit of 1 percent of GDP, which was found to be sufficient to prevent an excessive deficit finding in the retrospective application of the SGP, now implies that the deficit limit is breached with a frequency of 7.5 percent, or every thirteen years in average. It is not clear that these breaches could be justified, as a rule, by the exceptional circumstances clause of the SGP.

Table I.4. France: Frequency of Breaches in the Three Percent Deficit Limit: Univariate Estimates

General Government Structural Balance (In percent of GDP)	Frequency of Breaches in SGP Deficit Limit 1/
0.0	1.6
-0.5	3.6
-1.0	7.5
-1.5	14.0
-2.0	23.6

Sources: *World Economic Outlook*, and Fund staff calculations.

1/ Unconditional probability of a general government deficit higher than 3 percent of GDP based on the univariate statistical distribution of the output gap.

37. The exceptional circumstances clause of the SGP applies *automatically* in case of an exceptionally severe recession involving a negative growth rate of 2 percent or more, but governments breaching the deficit limit are entitled to invoke it for milder recessions with growth rates between -2 and -¾ percent. This might seem to imply that the admissible threshold for the frequency of breaches in the deficit ceiling can be made equal to the frequency of recessions. This conjecture is not completely correct, however, because there is no guarantee that the largest deficits systematically coincide with recessions. If actual growth is lower than potential growth several periods in a row the cyclical deficit may become large

even though no recession is observed, and conversely a recession may not lead to a large cyclical deficit if the economy was initially above potential.

38. Thus, the determination of the optimal structural deficit must be based on a model of the co-movements of the growth rate and the cyclical deficit. In the absence of obvious theoretical restrictions on these co-movements, we estimated a bivariate VAR for the output gap and the real GDP growth rate including one lag of the endogenous variables and a constant, and then used Monte Carlo simulations to assess the extent to which breaches of the 3 percent deficit limit could be justified by exceptional circumstances.[14] Table I.5 reports the frequency—in terms of the average number of years per century—with which the 3 percent deficit limit is breached, as well as the frequency with which these breaches are associated with recessions that might allow the authorities to invoke exceptional circumstances.[15] The difference between these two variables is the frequency of "unjustifiable" deficits, which are presumed to trigger excessive deficit findings.

39. As Table I.5 shows, the frequency of unjustifiable excessive deficits increases with the size of the structural deficit. If the public finances are structurally in equilibrium, an unjustifiable excessive deficit would occur less than once per century in average. On the other hand, if the structural deficit amounts to 1 percent of GDP, the breaches in the deficit limit—which occur about every thirteen years in average—can be justified by a recession less than one-fourth of the time, implying, hypothetically, that France would be subject to an excessive deficit finding about every twenty years in average. As a linear interpolation of the values given in Table I.5 shows, the structural deficit needs to be lower than 0.1 percent of GDP for the frequency of unjustifiable excessive deficits to remain below 1 percent. More generally, keeping the risk of unjustifiable excessive deficits at a low level requires the finances of the general government to be structurally close to balance.

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[14]The estimated VAR was simulated over periods of one hundred years one thousand times, and each time the series for the fiscal balance was computed for different levels of the structural balance.

[15]To simplify the illustration, the cut-off period of an output decline of ¾ percent of GDP has been applied mechanically, although this is not the intent of the SGP. The frequency of breaches reported in the first column of Table I.5 is slightly different from that reported in Table I.4 because it is based on a bivariate—as opposed to univariate— estimate of the long-run distribution of the output gap.

Table I.5. France: Frequency of Breaches in the Three Percent Deficit Limit

General Government Structural Balance (In percent of GDP)	Frequency of Breaches in Deficit Limit 1/	Frequency of Breaches Concomitant with Recessions 2/	Frequency of Breaches not Concomitant with Recessions
0.0	2.0	1.3	0.7
-0.5	3.6	1.4	2.2
-1.0	7.6	1.8	5.8
-1.5	14.9	2.1	12.8
-2.0	25.9	2.3	23.6

Sources: *World Economic Outlook*, and Fund staff calculations.

1/ Average number of years per century in which the general government deficit is higher than 3 percent of GDP.

2/ Average number of years per century in which the general government deficit is higher than 3 percent of GDP and the growth rate in real GDP is below -¾ percent.

40. As noted above, these calculations are based on past fiscal performance, under a policy regime different from that which will prevail under EMU. Nonetheless, they appear to provide some interesting and useful insights concerning appropriate goals for fiscal policy in light of the constraints set out in the SGP. At the same time, in framing such objectives, two considerations underscored in earlier sections of this paper should doubtless be borne in mind when setting and implementing medium-term fiscal goals: (1) the need to factor in any desired use, in the future, of the "semi-automatic" stabilizers that operated at times in the past; and (2) the importance of forming a prudent assessment of the cyclically adjusted fiscal position at times when the actual balance is favorably affected by strong economic activity. More broadly, of course, an important lesson of recent years is the scope for structural reforms in labor and product market policies to enhance the flexibility of the economy in complementary ways, so that the burden on fiscal policy in this regard is more limited.

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II. THE 35-HOUR WORKWEEK INITIATIVE[16]

41. This chapter gives an overview of the French government's initiative to reduce the legal workweek from 39 to 35 hours. It is organized around three questions:

- How significant a departure from current practices in France and elsewhere is such a reduction in legal work time?
- How do the authorities intend to implement the shift to the new regime?
- What is the likely micro- and macro-economic impact of the adoption of a shortened workweek?

These questions are taken up in the next three sections, one at a time. Section A gives the historical perspective and some international comparisons. The main conclusion is that the scheduled reduction in the legal workweek is a significant development that makes France an outlier within the group of industrial countries. Section B outlines the current legislation on this matter and the official strategy to promote an early adoption of the 35-hour week. This section is descriptive rather than normative, and provides a comprehensive presentation of the legal framework. The economics of a shortened workweek is finally discussed in Section C. The topic is complex and a formal treatment is beyond the scope of this paper; nonetheless, the discussion goes some way in highlighting from first principles the main sources of concern. The critical issue of wage compensation at the level of the hourly minimum wage receives, however, less attention than it deserves, since an in-depth analysis can be found in the appendix to the staff report on the 1998 Article IV Consultation with France (SM/98/229). Section D concludes.

A. The 35-Hour Workweek in Perspective

42. Over the last 150 years, reduction in work time has been the rule rather than the exception in all industrial countries.[17] In this respect, the French experience is typical: since 1831 the average annual hours of work per person have fallen by about 50 percent (Figure II.1). Several factors have driven the secular process, including: the growing importance of the

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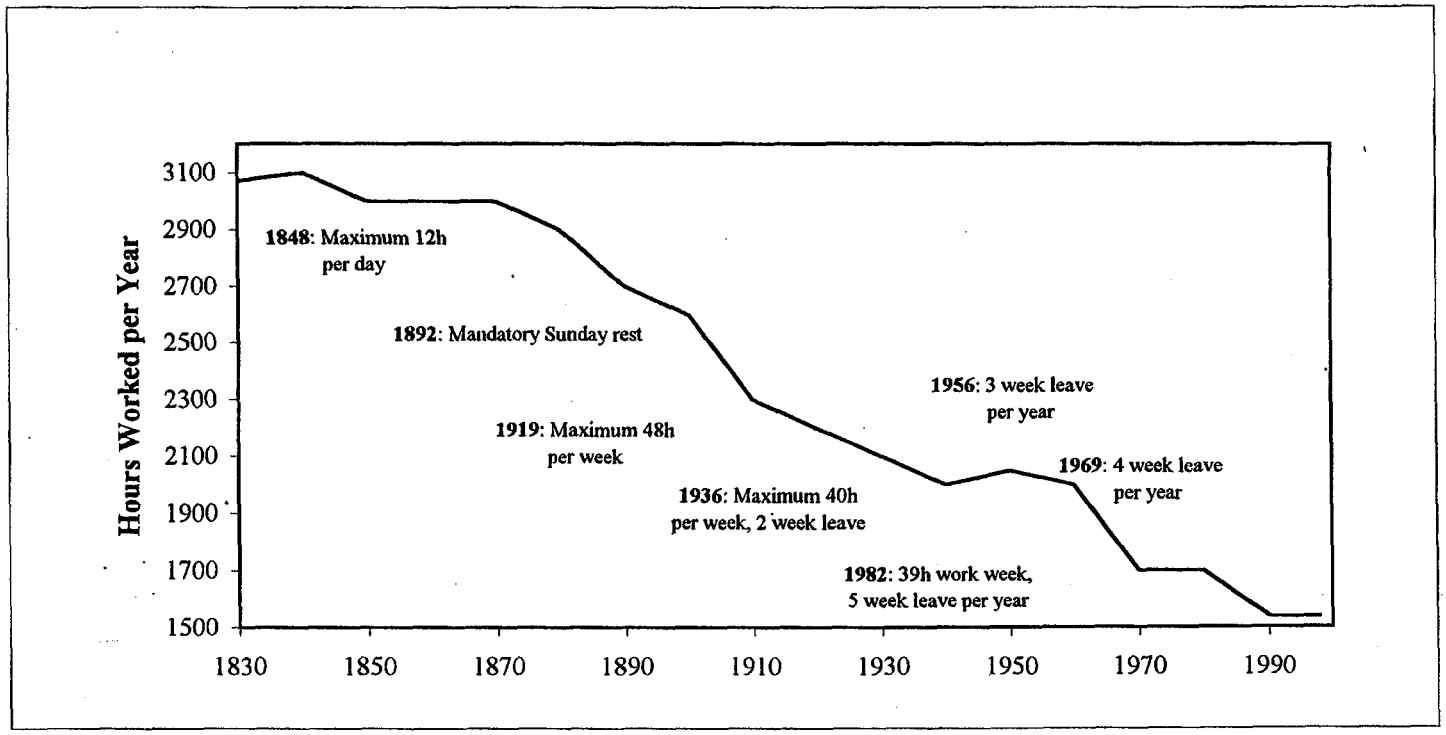
[16]Prepared by Alessandro Zanello.

[17]In 1870, annual hours worked per person employed averaged 2,900 for a group of countries comprising Austria, Belgium, Denmark Finland, France, Germany, Italy, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, Australia, Canada, the United States and Japan. That average was down to about 1540 by 1993. See Maddison, A.: *Monitoring the World Economy*, OECD, 1995, Table J-4, p. 248.

FIGURE II.1
FRANCE

WORK TIME NORMS 1830–1998



Source: Ministère de l'Emploi et de la Solidarité, 1998.

service sector—with shorter work times than in industry and agriculture[18]; the evolution of union density and collective bargaining[19]; the increasing popularity of part-time work—linked to both trends in female participation to the labor force and the employers's search for increased flexibility in production[20]; the lengthening of paid vacations; the progressive diffusion of work times below the norms of collective agreements; and the overall reduction in these norms, of which the 35-hour week initiative is but the latest example.

43. The global nature of the process since the 1970's is illustrated by Table II.1. The broad pattern is one of a steady decline in hours worked over the last three cycles with a significant slow down since the 1980's. The exceptions are Japan—where the government has been

Table II.1. France: Trends in Average Annual Hours Worked per Employed Person

(Changes in hours)

	Cycle	Average Change Per Year	Cycle	Average Change Per Year	Cycle	Average Change Per Year
Canada	1970–75	-9.6	1975–82	-12.5	1982–92	-1.3
France	1971–75	**-21.7**	1975–85	**-19.6**	1985–93	**-4.7**
Germany	1971–75	-31.8	1975–82	-13.4	1982–94	-14.0
Japan	1972–75	-41.2	1975–83	-3.1	1983–94	-19.7
Netherlands	1972–75	-22.3	1975–83	-21.1	1983–92	-7.3
Sweden	1972–78	-16.4	1978–83	-2.1	1983–93	4.3
United Kingdom	1971–75	-2.6	1975–82	-24.1	1982–93	5.3
United States	1970–75	-5.2	1975–82	-4.2	1982–91	8.4

Source: OECD, Employment Outlook, Table 5.1
1/ Cyclical periods taken from trough-to-trough according to OECD dating.

actively promoting a reduction in work time—and, to a certain extent, Germany. In the United States, the United Kingdom, and Sweden the trend appears to have reversed due to

[18]Over the period 1982–95 three-fourth of the economy-wide reduction in work time can be linked to reductions in the service sector, and one-fourth to reductions in other non-agricultural sectors. (*Conseil Supérieur de l'Emploi*, op. cit. p.49.)

[19]See OECD, Employment Outlook, 1998, p.166.

[20]Without the increase in part-time, the average annual work time would have been in 1995 the same as in 1982. (Ibid.)

country-specific factors—increased reliance on overtime in the US, growing share of the self-employed in total employment in the UK, and in Sweden a rising proportion of women part-timers working longer hours.[21] It is noteworthy that in this sample the slow-down has been most pronounced in France.

44. A cross-country comparison of the number of hours worked—rather than their changes through time—is complicated by differences in the coverage of labor surveys, and the lack of an harmonized definition of workweek. Table II.2 shows the length of the **legal** workweek as determined by the law or industry-level agreement, the duration of the **normal** workweek (which differ from the legal norm by the extent that overtime is used or industry agreements take precedence), and the number of paid vacation days and official holidays per year (which further influence how long people actually work).

Table II.2. France: Duration of Workweek and Paid Vacation: Selected Countries

	Legal Workweek (hours)	Normal Workweek (hours)	Paid Vacation (days per year)	Official Holidays (days per year)
Australia	35–40	39.9	20	10
United States	40	43.2	12	10
Canada	40–48	41.0	10	10
Japan	44	47.5	10	12
Europe				
Austria	40	40.0	25–30	12
Belgium	40	38.3	20	11
Denmark	not defined	38.7	25	10
Finland	40	38.7	25	9
France	**39**	**39.1**	**25**	**11**
Germany	48	40.0	24	12.5
Greece	48	40.4	22–25	11
Ireland	48	40.4	15	9
Italy	48	38.6	25	11
Netherlands	48	39.4	20	9
Norway	40	39.9	21	10
Portugal	40	41.2	22	13
Spain	40	40.6	25	13
Sweden	40	40.0	27	11
Switzerland	46–50	41.9	20	13
United Kingdom	not defined	43.9	20–30	9
Average		**40.6**	**21.8**	**10.8**

Source: *Revue de l'OFCE*, July 1998, p.73.

[21]OECD (1998), Ibid. p. 155.

45. Only Denmark, the U.K., and—since 1991—New Zealand, do not have a legal limit on work time. The duration of the workweek in these countries is determined through collective agreements or individual contracts: as the table shows, the resulting practices are nonetheless in line with those of other industrial countries. The table also shows that Japan is a clear outlier as regards the duration of the normal workweek. By contrast, France already has the lowest legal workweek among industrial countries, although the normal workweek (which is perhaps a better indicator of the organization of work) broadly conforms to the European average.

46. This observation is confirmed by additional factors that are likely to affect the duration of the normal workweek besides the legislative limits and the structure of holidays. These appear in Table II.3 (below). The normal average workweek will tend to be shorter, the

Table II.3. France: Selected Countries: Labor Market Indicators

	Normal Workweek For Full-Time Wage-Earners (hours)	Self-Employment (percent in total employment)	Share of Women in Employment (in percent)	Share of Part-Time Workers in Employment (in percent)
Australia	40.9	14.2	43.1	25.0
United States	44.5	8.3	46.2	18.3
Canada 1/	37.3	10.9	45.3	18.9
Japan	49.0	11.8	40.5	21.4
Europe				
Austria	40.2	10.4	42.7	14.9
Denmark	39.4	8.3	45.6	14.0
Finland	39.4	13.8	47.7	11.6
France	**40.5**	**11.3**	**44.5**	**16.0**
Germany	40.4	9.2	42.1	16.0
Greece	41.4	33.7	39.9	5.3
Ireland	42.0	19.8	38.8	11.6
Italy	39.8	24.8	35.8	6.6
Netherlands	39.5	11.2	41.1	38.1
Norway	41.0	7.8	46.4	26.5
Portugal	42.7	26.8	45.2	8.7
Spain	41.0	21.5	35.2	8.0
Sweden	40.1	10.6	48.1	23.7
Switzerland 1/	36.3	11.7	41.0	27.4
United Kingdom	45.7	43.9	45.1	24.6
Average	**41.0**	**14.9**	**42.7**	**18.1**

Source: Eurostat (1997), and Revue de l'OFCE, July 1998, p.74.
1/ For Canada and Switzerland, includes part-time workers.

shorter the average hours worked by dependent full-time wage-earners, the larger the shares in total employment of part-time workers and women, and the smaller the share of self-employed workers. On all these accounts, France ranks in the middle of the reference group of major industrial countries.

47. The impression that France does **not** stand out as an exceptional case must be modified, however, when the focus shifts to a measure of the **effective** average duration of work on an annual basis. This measures corrects the reported normal workweek for the time lost due to absence from work, pauses while on the job, "down-times," holidays, interruption of production, strikes, etc. Three facts then emerge: (i) in France the average annual effective duration of work per dependent worker is already below the average for other OECD countries; (ii) because of the low participation ratio and the reliance on early retirement, the average effective duration of work per person in the active population is one of the lowest in the industrial world; and (iii) the spell in employment over the life-cycle is also remarkably short, especially for men. Table II.4 presents the data supporting these claims.

Table II.4. France: Effective Duration of Work for Selected Countries

	Average Effective Duration of Work per Employee in 1997 1/ (hours per year)	Average Effective Duration of Work per Person Aged 15–64 (hours per year)	Duration of Work in Life-Cycle of Men Aged 14–70 in 1992 (hours)
United States 2/	1,967	1,458	61,343
Japan 2/	1,990	1,408	71,123
New Zealand	1 838	1,307	--
Spain	1,745	856	62,257
United Kingdom	1,731	1,223	73,904
Canada	1,721	1,182	--
Italy	1,682	861	61,825
Switzerland	1,643	--	--
France	**1,539**	**973**	**60,635**
Germany	1,519	1,014	64,578
Netherlands	1,397	896	61,622

Source: OECD, Employment Outlook, 1998, p. 207, and Commission d' Enquête du Senat sur les 35 Heures, 1998.

1/ Column 1 reproduces Table F in OECD, 1998. It gives total hours worked in the year divided by the average number of employed people in 1997, including part-time workers. There are dissimilarities in coverage across countries: data for Italy refers to 1994, for Switzerland to 1995, and for Canada and New Zealand to 1996. Also, in the cases of New Zealand, Switzerland and the United Kingdom, self-employment is included.

2/ For the United States and Japan, under column 3, the average refers to total employed.

48. As said, considerable measurement and methodological problems complicate the international comparisons: the empirical evidence needs to be interpreted with caution. However, even if the current organization of work time in France may not be atypical by international standards, the 35-hour week initiative will make France's legal workweek more than 2 standard deviations shorter than the European norm. Will this be a substantive change or merely a formal one? While the duration of the legal workweek does not limit an enterprise in its choice of the work organization nor determines the maximum work time permissible under the law, it does establishes the threshold after which overtime is calculated.[22] As such, legislative provisions on the workweek can potentially affect unit labor costs directly. Whether this will be the case depends on the response of firms and employee to the new constraint. Tables II.5 and II.6 provide some evidence that the shift to a shorter legal workweek will have pervasive effects: 75 percent of employees currently work more than 35-hours per week (Table II.5), and the sectoral break-down (Table II.6) points to the fact that the mode of the distribution is at about the duration of the legal workweek in both industry and service sector.

Table II.5. France: Frequency Distribution of Work Time by Year[23]

	<15 Hours	15-30 Hours	31-35 Hours	36-38 Hours	39 Hours	40 Hours	41-45 Hours	46-50 Hours	>50 Hours
1976	2.2	5.5	2.1	1.5	0.2	36.0	31.3	14.3	7.1
1981	2.1	6.3	2.8	1.6	0.3	51.7	22.6	8.1	4.6
1983	2.5	7.8	3.3	7.1	43.7	14.1	11.6	5.6	4.3
1992	2.3	9.6	3.6	5.3	45.3	10.0	12.1	6.7	5.1
1997	3.1	12.8	5.2	4.8	43.7	5.4	10.6	7.2	5.4

Source: Conseil Supérieur de l'Emploi, des Revenues, et des Coûts, 1998, p. 54.

[22]Maximum legal work time is 10 hours a day, although this limit can be by-passed by agreement among the social partners. The maximum permissible workweek is 48 hours except if special derogations are accorded.

[23]The frequency of people working more than 46 hours is 11.2 percent for the European Union as a whole. (See, *Conseil Supérieur de l'Emploi*, 1998, p. 44.)

Table II.6. France: Frequency Distribution of Work Time by Sector (1995)

	<32 Hours	32-37 Hours	38-40 Hours	41-43 Hours	>43 Hours
Industry	4.9	5.0	76.7	3.6	9.8
Construction	3.8	0.8	81.1	5.5	8.9
Commerce	15.4	4.4	62.7	4.6	12.9
Transport	6.3	5.4	68.6	4.7	15.0
Banking	7.1	9.1	63.7	3.5	16.6
Services to Enterprises	14.2	4.9	61.1	3.2	16.6
Services to Individuals	23.8	4.8	46.1	4.8	20.5
Public Administration 1/	28.8	8.7	53.7	1.9	6.9
Agriculture 1/	15.0	3.0	68.1	2.0	11.9
Total	**12.1**	**5.1**	**66.9**	**3.8**	**12.1**

Source: DARES, *Travail et Emploi*, No. 74, 1998, p. 97
1/ Not covered by the 35-hour law.

49. The expectation of significant changes in the organization of work at the firm-level has motivated the authorities to draft the law to implement the 35-hour initiative in a way that encourages a flexible approach to implementation.

B. The Legal Framework

50. The *Loi d' orientation et incitation à la reduction du temps de travail* of June 13, 1998, and the *Decret d'application* of June 22, 1998, lay out the broad blueprint for the adoption of a legal workweek of 35-hours. This blueprint reflects the government's commitment to "*create jobs and reduce unemployment by all available means*" and—implicitly—the official perception that a positive (social) externality justifies government's intervention in these matters.[24]

51. The law mandates that enterprises with more than 20 employees adopt the shorter legal workweek by January 1, 2000. Firms with a smaller workforce must do the same by

[24]The quote in Italic is from the Instruction of June 24, 1998, signed by Minister Aubry.

January 1, 2002. These deadlines apply to firms in the non-agricultural market sector which employed in 1996 about 13.5 million workers or 60 percent of total employment.[25]

52. Employers and trade unions are called upon to start negotiations in advance of those deadlines to find the modalities most suited to local conditions (i.e., at the level of the plant, firm or the sector) for reducing the workweek. These negotiations will address outstanding issues related to an early adoption of the 35-hour week; the possible re-organization of production processes and work time; the treatment of part-timers and senior workers (*cadres*); the number of new hires (or preserved jobs); and the internal procedures to monitor and enforce any agreement reached by the social partners.[26] The outcomes of these negotiations are expected to influence a law due in the Fall of 1999 concerning as yet unspecified implementation issues (see paragraph 12 below).

53. The law also establishes fiscal incentives for firms that negotiate a reduction in work time before the shift to the mandatory 35-hour workweek **and** create jobs (or preserve jobs at risk). These incentives are in the form of a rebate of the employer's social charges (*abattement de cotisations sociales*). Eligibility for the aid requires three pre-conditions: (i) a reduction of hours worked of at least 10 percent to attain a workweek of 35-hour or less; (ii) new hires or preserved jobs of at least 6 percent of the workforce in the enterprise; and (iii) the signature of a formal agreement among the social partners on the modalities of reducing the work time.[27]

54. The amount of the rebate and its duration are conditional on the firms's employment plan, the implementation schedule and other firm-specific factors. It will last five years for firms committed to net job creation and three years (with a possible extension of other two) in the cases where jobs at risk are preserved, provided that the workforce is not reduced for at

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[25] The field of application of the law is more restricted than this since about one employee in five works part-time. Pending legal decisions on the treatment of part time workers, the law is expected to affect about 9 million employees, or 40 percent of total.

[26]Special authority to engage in these negotiation may be vested on individual workers if there is no trade union representative in the firm. Temporarily, these workers will enjoy the same legal protection vis-à-vis the employer as union representatives. Firms with more than 50 must negotiate in order to be eligible for employment subsidies. Firms with less than 50 employees qualify if simply adopt the agreement negotiated at the sectoral level once validated by the *Ministère de l'Emploi et de la Solidarité* (*accord de branche étendu*). See *Ministère de l'Emploi et de la Solidarité*, 1998, p.15.

[27]This agreement will form the basis of a contract (*convention*) between the employer and the state for the disbursement of the subsidy. It will have to vetted by the departmental office of Labor, Employment and Professional Training (*Diréction Departementale du Travail, l'Emploi, et de la Formation Professionelle*).

least two-year.[28] The rebate is greatest with an early implementation schedule. In any event, the employer will receive the rebate for each worker whose work time is reduced to 35 hours or less, and for each new hire (or each preserved job, as the case may be.) As Table II.7 shows, the rebate is expected to become permanent after 5 years, although no official decision has been taken on this matter yet.[29] These rebates can be increased under special circumstances (for example, if the enterprise concerned has a sufficiently large number of low-wage

Table II.7. France: Structure of Fiscal Incentives
(per employee, per year)

Date of Agreement	Reduction in Work Time (in percent)	1st Year (in FF)	2nd Year (in FF)	3rd Year (in FF)	4th Year (in FF)	5th Year (in FF)	Permanent Rebate (projected)
For firms with more than 20 employees:							
Through June 1999	10	9,000	8,000	7,000	6,000	5,000	5,000
	15	13,000	12,000	11 000	10,000	9,000	5,000
From July to December 1999	10	7,000	6,000	5,000	5,000	5,000	5,000
	15	11,000	10,000	9,000	9,000	9,000	5,000
For firms with less than 20 employees:							
year 2000	10	7,000	6,000	5,000	5,000	5,000	5,000
	15	11,000	10,000	9,000	9,000	9,000	5,000
year 2001	10	6,000	5,000	5,000	5,000	5,000	5,000
	15	10,000	9,000	9,000	9,000	9,000	5,000

Source: *Journal Officiel de la République Française*, June 23, 1998; and *Ministère de l'Emploi et de la Solidarité*, 1998, p.17.

workers) and are to be pro-rated in the case of part-time workers.[30] To put the figures in context, 5,000 francs correspond to about 3 percentage points of social charges at the level of

[28]See *Conseil Supérieur de l'Emploi, des Revenus, et des Coûts*, 1998, p.110.

[29]See *Conseil Supérieur de l'Emploi, des Revenus, et des Coûts*, 1998, p.29, and *Ministère de l'Emploi et de la Solidarité*, 1998, p.16.

[30]Under the law, a worker is employed part-time if he works on average no more than 80 percent of the legal workweek.

the average wage. The 1998 budget allocates three billion francs for the initial implementation of this scheme.[31]

55. The law does not address operational details beyond the transitional arrangements outlined in the previous paragraphs. It simply defers to another law due in late 1999 the resolution of outstanding issues such as: (i) the regulation of overtime and compensatory leave; (ii) a new statute for of part-time work; (iii) the legal workweek of senior workers and managers; (iv) the scope for defining the legal duration of work with reference to a period other than a week; and (v) how to ensure that the purchasing power of earners of the hourly minimum wage (SMIC) will not be negatively affected by the shift to a shorter workweek.

56. The incompleteness of the current legal framework is, however, by design. In the authorities' view, lack of specificity is necessary to assure a broad margin for maneuver at the implementation stage, without the inflexibility that would ensue from a centralized, "top-down" approach.

C. The Economic Effects of a Reduction in Work Time

57. While generality in the legal framework may facilitate the transition to the new regime, it complicates an *ex ante* assessment of the effectiveness of the 35-hour workweek in promoting employment and work-sharing. For example, the likely employment effect depends critically on the evolution of unit labor costs in the new regime, but these cannot be estimated without knowing the impact on factor productivity of a shorter work time, and the induced changes in the wage structure especially in the neighborhood of the minimum wage. These factors are clearly influenced by the legislative provisions defining the dimensions of choice of the decision makers.

58. A noteworthy research effort has attempted to clarify these issues, leading to a broad consensus along the following lines:(i) employment creation will be favored by gains in the productivity of labor and capital; (ii) these are more likely to materialize if a flexible approach to implementation allows firms to re-organize production processes and work schedules; (iii) moderate wage compensation for a reduction in hours worked is nonetheless necessary if adverse developments in labor costs are not to undermine the benefits from greater productivity; (iv) and—in transition—fiscal resources may be used to re-align at the margin the private and social costs (and benefits) of the reduced workweek.[32]

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[31]See Maarek, G.: *Le fétichisme des 35 heures,* in *Problèmes économiques*, July 1998, No. 2.575, p.6.

[32]See for example the paper by G. Cette and A.Gubain in *La Réduction du Temps de Travail: une Solution pour l'Emploi?*, Cahuc P., and P. Granier (Eds.), 1997.

59. If the 35-hour week leads to an increase in unit labor costs, the outlook for employment will suffer for at least three reasons. First, competitive firms faced with an increase in the cost of labor will reduce production and factor demands, other things equal. Second, an increase in the relative price of labor will induces substitution towards more capital- intensive techniques of production.[33] Thirdly, in an open economy external competitiveness may be lost as firms increase prices to preserve profitability, further reducing labor demand. So, it is critical that unit labor costs be safeguarded. This will be so if labor productivity is enhanced, capital utilization does not fall, a wage moderation prevails. We consider these conditions in turn.

60. The argument that workers perform better if work time is reduced rests on the presumption that the relationship between effort and the duration of work in non-monotonic: beyond a certain threshold, a reduction in work time lessens workers' "fatigue" and thus increases productivity. In addition, a shorter work time may make possible a reduction in the number of incompressible down-times and pauses that punctuate the normal work schedule, adding to the productivity gains. More importantly, there is the expectation that, in the context of negotiating the switch to the 35-hour week, firms will be able to over-haul the organization of production processes and work schedules, thus boosting efficiency. For example, the negotiations may lead to the adoption of flexible schedules and a better synchronization between production and sales, or workers may agree to shorter breaks and "bell-to-bell" work. A popular (but unproved) claim is that the gains in labor productivity due to a reduced workweek may be of the order of 50 percent of that reduction, i.e., about 5 percent with the passage from 39 to 35 hours.[34]

61. If hours worked are reduced in line with the legal workweek, the utilization of capital—and its productivity—will fall *pari passu,* since the user cost of capital goes up once depreciation is to be amortized over a shorter working life of the equipment. To avoid this, the production process must be re-organized, for example through greater reliance on

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[33]It follows from the convexity of the profit function in wages and prices, and Hotelling's Lemma, that demand curves for inputs are always negatively sloped. See for example, H. Varian, *Microeconomic Analysis,* 1984, p.51.

[34]See Cornilleau G., E. Heyer and X. Timbeau: *Les 35 heures en douceur?* in *Lettres de l'OFCE,* January 21, 1998. The gain from re-organization would presumably be a one-off affair. To put the claim in perspective, recall that the rate of productivity growth over the last 20 years in France has averaged 2.5 percent per year (see Accardo, J. and M. Jlassi: *La productivité globale des facteurs entre 1976 et 1996,* INSEE, May 1998.) Note that "excessive" productivity growth may damage employment creation to the extent that less hours worked are then needed to produce the same output.

shift-working and multiple crews, or by scheduling working hours with greater flexibility.[35] The expectation of such work re-organization is a recurrent argument offered by the proponents of the 35-hour initiative. It is based on the perception that pervasive rigidities, including in the bargaining process, have prevented firms from exploiting in the past these open profit opportunities. According to this view, the introduction of the shortened workweek will provide the catalyst for revamping industrial relations, inducing bargaining over dimensions of work not before discussed by the social partners, and thus re-optimizing the production process.

62. The question of how the reduced workweek will affect labor costs is more complex. Two aspects are considered here: (i) the effect of greater reliance on overtime; and (ii) the role of income maintenance at all level of wages, including the minimum wage, and the contribution of the fiscal incentives in the law to a containment of labor costs.

63. The shift to the shortened legal workweek has the immediate effect of increasing the average hourly wage in a firm that will keep the effective workweek unchanged at or above 39 hours. On the basis of current legislation, an extra 188 hours per year (or (39-35)*47) will have to be counted as overtime. This will, first, require special dispensation from existing provisions (since there is a legal limit on annual overtime per employee of 130 hours,) and, secondly, special remunerations to the worker affected. Existing regulations set the overtime premium over the straight-time rate at 25 percent for the first 8 hours in a week, and 50 percent thereafter. In addition, a "compensatory rest" (*repos compensateur*) of half an hour for each hour of overtime has to be awarded beyond a threshold of 42 hours of overtime, bringing the cost of overtime to 50 percent of the straight-time rate.[36] The award of compensatory rest is further increased when the total of overtime hours passes the 130 hour limit, with a marginal cost of overtime then equal to 100 percent of straight-time rate. As an illustration, if a firm keeps the effective workweek at 42 hours, its cost per employees will increase by the equivalent of 2 hour of straight-time (6 hours of overtime at a 25 percent premium and one hour at a 50 percent premium) or about 5 percent. Although legislative dispositions on these matters are deferred to the second law on the 35-hour initiative, it seems clear that a significant burden will be placed on firms that will not—or cannot—reduce the effective workweek.

64. Greater reliance on overtime in the new regime seems likely since the costs of adjusting employment are higher at the straight-time margin due to the presence of fixed costs *inter alia* related to search, training, and job protection legislation. This observation is relevant even for firms that are considering adopting the shortened workweek and expand

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[35]For some evidence of the scope for such reorganization see Blanchard O.J., and J-P. Fitoussi, *Croissance et Chômage, La Documéntation Française*, Paris, 1998, p. 27.

[36]The 35-hour law mandates that this threshold will be reduced to 41 hours on January 1, 1999.

employment, if the straight-time hourly wage increases as workers seek compensation for a reduction in purchasing power. In this case, in fact, a profit maximizing firm will reduce overall employment in the short run **and** change the mix of straight-time to overtime hours since adjustment at the latter margin is cheaper.

65. The degree of wage compensation or income maintenance is a second channel through which labor costs will be directly affected by the 35-hour initiative, since a reduced workweek implies a higher hourly wage if the weekly wage is not reduced proportionally. The more reluctant workers are to "buy" greater leisure, i.e. to accept a reduction in their income in exchange for less work, the greater the increase in labor cost and the less favorable the employment outlook: wage moderation is a *sine qua non* for job creation. For workers earning more than the minimum wage, the degree of income maintenance is to be decided in the context of the negotiations envisaged by the law between the social partners. Regardless of the (re-)distribution of rents in the short run, over time the market-determined wage will (tend to) return to the level compatible with the equilibrium distribution of value added between labor ad capital. To the extent that a greater proportion of labor income will be linked to overtime work, the straight-time hourly wage will eventually be reduced below its level with a 39-hour workweek.

66. The situation is different for earners of the hourly minimum wage (SMIC) since their compensation is set administratively and is not influenced by market forces. The authorities are committed on social grounds to safeguard fully the purchasing power of SMIC-earners (and workers earning close to the SMIC), which implies a 11.4 percent (or 39/35-1) increase in the cost of employing them, *ceteris paribus*, under the 35-hour legal workweek. Possible problems arising from this approach are discussed in the appendix to the staff report on the 1998 Article IV Consultation with France (SM/98/229). Here, it suffice to say that the system of fiscal incentives described in Section II is intended to cushion the impact of this wage shock. However, the prospective (permanent) rebate of F 5,000 would compensate only about 40 percent of the increase in labor costs. Moreover, the system of subsidies is not targeted to support the employment of low-wage earners, and it would be ineffectual in preventing a shift in labor demand away from the low-skilled. Thus, an extremely significant productivity gains would have to occur to contain unit labor costs to their earlier level, and/or wage moderation must prevail for some time, lest employment prospects of the low skilled be negatively affected in the long run.[37]

67. Some information on the likely wage and productivity developments can be gathered from the experience under the 1993 *Loi Robien.* This law was introduced to encourage on a voluntary basis the adoption of a shorter workweek in exchange for a reduction in social

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[37]Two-third of the 2.3 million SMIC-earners are employed in the service sector; of these, one third in hotels and restaurants, recreational activities, and "personal services," where the scope for productivity gains may be limited by the use of fixed coefficient technologies.

charges of the employers.[38] The historical record shows that income maintenance has in general being full in the instances of net job creation (the so-called "offensive" cases covered by the *Loi Robien*), and partial in the "defensive" cases where job preservation was at stake—a situation more common in the industrial sector. Even when full income maintenance has been the rule, the social partners have agreed to a follow-up period of wage moderation. As regards productivity gains associated with a reduction in work time under the *Loi Robien*, the evidence is largely circumstantial: about 50 percent of the firms involved reached agreements to define legal work time on an annual basis—suggesting that the opportunity to reorganize the work schedule was often seized.[39]

68. To summarize, the switch to a 35-hour week is less likely to have an adverse effect on employment in the short and long run if it leads to gains in total factor productivity, and wage compensation is moderate, other things being equal. Existing regulations on overtime also would need to be modified to contain unit labor costs, and fiscal resources may have to be mobilized initially to cushion the wage shock from the reduction in the legal workweek.

69. This prescription focuses on first-round responses, and as such it is not a full characterization of the conditions for a favorable impact of the 35-hour week. A general equilibrium assessment is, however, a complex task, in part because the relevant channel of transmissions are not usually spelled out in conventional macro-economic models. In the textbook paradigm of an open economy with a fixed exchange rate and perfect capital mobility, the dynamic response to the reduced workweek is determined by the initial change in unit labor costs. The most unfavorable scenario looks at a reduction in work time as a negative productivity shock. Starting for ease of reference from an equilibrium at the natural rate of unemployment, a shortened workweek raises costs to firms which increase prices in the short run to preserve their profit margins (i.e., the aggregate supply curve shifts up). The price level increase leads to a real appreciation and net exports fall accordingly, reducing equilibrium output. The initial short run equilibrium is then characterized by a higher price level, lower output, a worsening current account, a deteriorating fiscal balance, and unemployment in excess of the natural rate. The unemployment gap will in time depress wages and reduce unit costs. As this dynamics unfolds, output and employment recover towards their natural rates and the real appreciation unwinds.[40]

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[38]The impact of the law has been limited to about 200,000 workers. Self-selection bias suggests caution in deriving lessons from this experiment.

[39]See *DARES, Premières Informations et Premières Synthèses,* No. 03.1, 1998.

[40]The presumption that the natural rate is independent of the length of the legal workweek is of course consistent with the historical record. It can be given a theoretical underpinning by thinking of a reduction in work time as a negative productivity shock that shifts by the same amount the wage-setting and the price-setting relationships in real wage-unemployment space.

(continued...)

70. This description of the dynamics glosses over two important points. First, in a medium-run perspective, the transition period will be longer—and costlier—the more pervasive are nominal wage rigidities. This observation underscores the importance of promoting from the onset wage moderation, including at the level of the minimum wage, to speed up convergence. Second, the original long-run equilibrium may not be restored if the transitional increase in unemployment has permanent consequences. This would be the case, for example, if real wage rigidity at the level of the minimum wage prevent an undoing of the initial shock in a segmented labor market, or if insider-outsider effects come into play. In addition, it could be argued that in the new equilibrium, the total supply of hours may in any case be somewhat lower if workers opt for leisure and find it easier to reduce their supply of labor by resisting overtime work. Moreover, some employers, faced with an increase in the hourly wage after 35 hours of work rather than 39, may similarly decide to reduce total hours demanded and use more capital instead. On both accounts, total labor input is adversely affected even if long-run employment is unchanged, and equilibrium output may suffer.[41]

71. Under more favorable circumstances, unit labor costs are preserved through wage moderation and productivity gains. Then, output and employment will expand only if work-sharing involves a redistribution of disposable income in favor of a segment of the population (the formerly unemployed) with a higher propensity to consume than the workers currently forced to work shorter hours, or if confidence effects play out in the household and in the business sectors. This hardly seems a foregone conclusion.

72. The case for the 35-hour week rests on even more benign assumptions. These have been incorporated in three macro-models to estimate probable employment gains: the models of the Banque de France (BDF) and of the *Observatoire français des conjunctures économiques* (OFCE) and the model of the *Diréction de la Prevision* (DP). In the BDF simulations it is assumed that the reduction in work time affects 9 million workers and amounts to about 7 percent of the effective workweek; productivity increases by about 3 percent; the rate of capital utilization is kept constant; and reductions in social charges and productivity gains leave unit labor costs unaffected. Under these conditions, it is projected that in three years employment would increase by about 700,000 jobs.[42] If, on the other hand, there is no re-organization of work processes and monthly income is maintained fully, employment increase only by 115,000 as a result of favorable aggregate demand effects. By

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[40](...continued)
See Blanchard O.J., *Macroeconomics*, 1997, p.518.

[41]This, in turn, may have negative fiscal consequences if total revenues become insufficient to finance an unchanged supply of public goods. Prospective tax increases will in turn discourage work.

[42]Using the Blanchard-Fitoussi estimate of a -0.8 elasticity of unemployment with respect to employment, unemployment under this scenario would fall by about 2 percentage points.

contrast, the OFCE model assumes only 70 percent of wage earners see their legal workweek reduced;[43] productivity increase by half the reduction in work time; 35 hours are paid on average like 38 hours (i.e,. a 70 percent income maintenance); and the rebate in social charges is as described in the law. The projected increase in employment is then 150,000 each year for two year, on average, but the figure is sensitive to modifications in the assumptions. For example, the employment effect is a gain of only 130,000 jobs if workers demand full income maintenance, and could be a loss of 100,000 jobs if firms offset the higher cost of overtime by reducing proportionally the number of hours worked. The model of the DP assumes productivity gains on the order of 3.5 percent for 8 million worker and wage income maintained at about two-third of its level with a 39-hour week. Under this scenario, employment could increase by about 300,000 jobs by the year 2000. However, if firms effectively boycott the reduction in work time, there could be an employment loss of about 20,000 jobs.

73. These studies show that the 35-hour week initiative is likely to increase employment only under fairly optimistic assumptions, and to damage employment creation only under fairly pessimistic ones. However, the simulations are mechanic exercises and tend to down play the uncertainty associated with each outcome, *inter alia* by ignoring the endogenous changes in preference and technology that might accompany the regime switch. An additional limitation is that capital-labor substitutability is ruled out, and labor itself is considered an homogeneous commodity—a potentially misleading simplification when the wage structure is likely to be compressed with the adoption of the 35-hour week as low wages increase relative to the average wage. The models are also linear, which precludes the analysis of non-convexities arising from work-reorganization. On balance, these simulations are suggestive at best, and do not produce a compelling case for a reduction in the legal workweek as a strategy for job creation.

74. This perception is corroborated by the experience to date. Since the passage of the 35-hour law, 258 agreements to reduce the work time of about 30,000 workers have been signed, 170 of which have led to requests for government subsidies. Net job creation (or preservation) has amounted to about 2,500; and typically the agreements have involved full maintenance of weekly wages.[44] In the metal-processing sector , the industrial agreement recently reached between the employer association, UIMM, and the trade unions avoids any attempt at job creation and instead centers on how to accommodate overtime: the limit on overtime has been increased from 94 hours per employee to 180 with the option for an extra 25 hours. Companies will also be allowed to annualize the time worked over the full year with

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[43]This corresponds to all workers in firms with more than 20 employees.

[44]See, *Le Figaro*, August 31, 1998, p. 9, and the Web-site: www.35h.travail.gouv.fr.

a limit before overtime of 1,645 hours.[45] So far, the 35-hour initiative has failed to live up to the expectations of its most enthusiastic supporters. Moreover, Figure II.2 hints at the fact that the observed weak impact on employment may be representative of future developments: in a cross-section of industrial country, there does not seem to be a linear relationship between the length of the workweek and the unemployment rate.

D. Conclusions

75. On balance, the economic consequences of a switch to the 35-hour workweek remain difficult to predict with great confidence. There is little doubt, however, that a necessary condition for positive outcomes is flexibility at the implementation stage, in the two-fold sense of an unfettering legal framework and an innovative approach by the social partners. If the economic agents are left with ample latitude to respond to the changed environment, the potential for productivity gains—and, hence, for offsetting possible negative developments in labor costs—will be maximal. There will also be a need for wage moderation, including at the level of the SMIC. If wage increases are not curbed and best responses are constrained by institutional or procedural rigidities, there is a risk that the 35-hour initiative would amount to a negative supply shock, and could well harm the employment situation and the long-run output and fiscal prospects.

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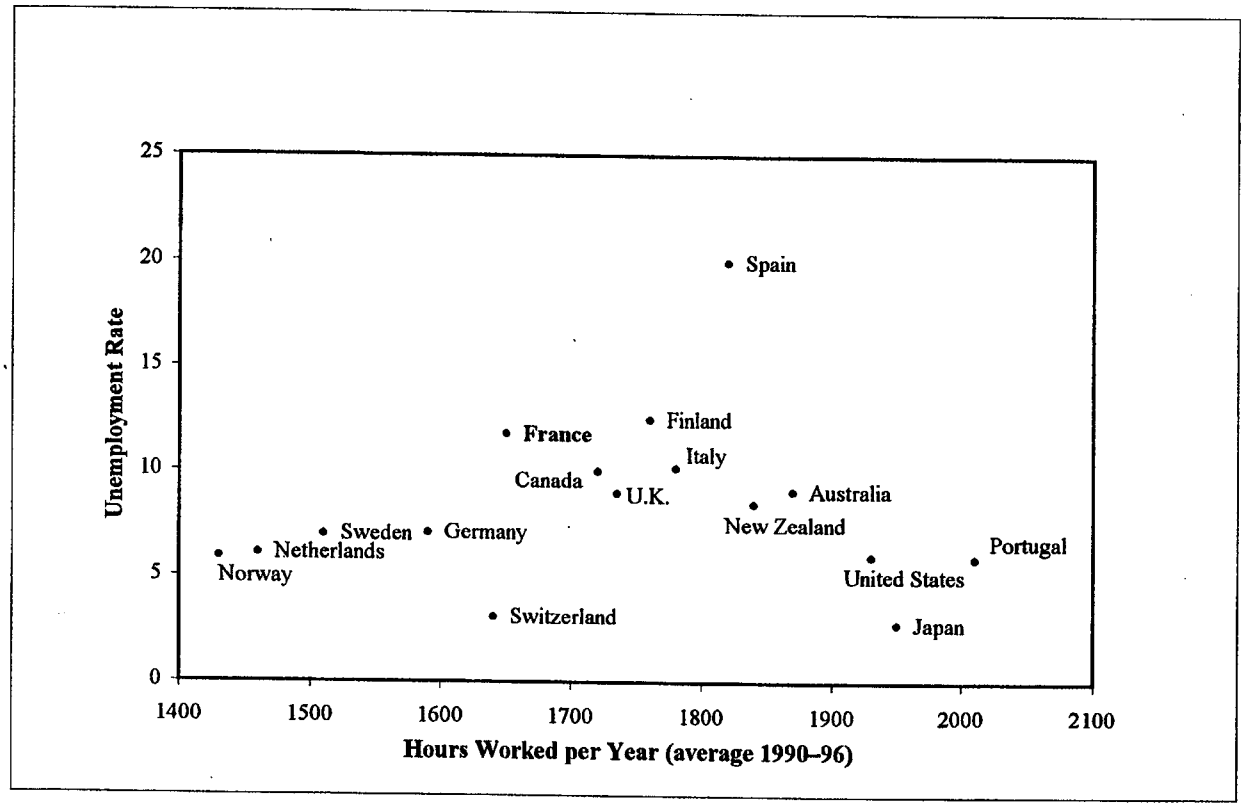
[45]Two trade unions—the CGT and the CFDT—refused to sign the agreement because it failed to generate jobs. Minister Aubry has declined to endorse the agreement and has even suggested that it may be invalid. See *The Financial Times*, July 30, 1998.

FIGURE II. 2
FRANCE

HOURS WORKED AND UNEMPLOYMENT FOR SELECTED COUNTRIES



Source: Revenue de l'OFCE, 1998.

III. Unemployment and the French Labor Market Institutions[46]

A. Introduction

76. Despite recent cyclical improvements, unemployment continues to be France's most pressing issue in economic management (Figure III.1; Table III.1). Long-term unemployment is particularly high and makes up a large proportion (40 percent in 1997) of total unemployment, with half of the long-term unemployed having been out of work for more than two years. Although youth unemployment has fallen in recent months, it is still high by international comparison (about 25 percent); in fact the proportion of young people employed fell from 20 percent in 1990 to 14 percent in 1997 (Figure III.2; Table III.2). The situation is especially difficult for the low-skilled; the unemployment rate among blue-collar workers was about 16 percent compared with 5 percent for white-collar workers in 1997. Moreover, the labor market situation is perceived as "precarious" even in the face of strong employment growth; nearly two-thirds of the jobs created in 1997 were in market services and commerce, and in these sectors part-time and fixed-term contracts are now predominant. Survey data indicate that this was not in line with employee preferences. The proportion of temporary jobs has increased from 5 percent in the 1980s to over 10 percent, and part-time work as a share of total employment rose steeply to 16 percent.

77. This paper assesses the extent to which French unemployment must be viewed as structural, considers the factors responsible for it, and suggests possible policy solutions.

B. The Magnitude of Structural Unemployment in France[47]

78. Econometric estimates of the French NAIRU by the staff were last presented in SM/95/141. At the time the NAIRU was put at about 9.5 percent with a confidence interval of about 1.2 percentage points around this point estimate. This section revisits the topic and investigates the possibility of a significant change in structural rate of unemployment since then. The conclusion is that the data do not allow for any strong inference to be drawn at this point. The section motivates the econometric exercise by reviewing the notion of a time-varying NAIRU; a formal statistical model is then briefly described and estimated.

79. Figure III.3 shows a plot of the annual rate of change in GDP deflator inflation ($\Delta\pi_t$) against the unemployment rate in the previous year (u_{t-1}) for France over the period 1971 to 1997, as well as a regression line.[48] The horizontal intercept of that line corresponds to the (otherwise unobservable) rate of unemployment at which inflation is constant, the NAIRU or

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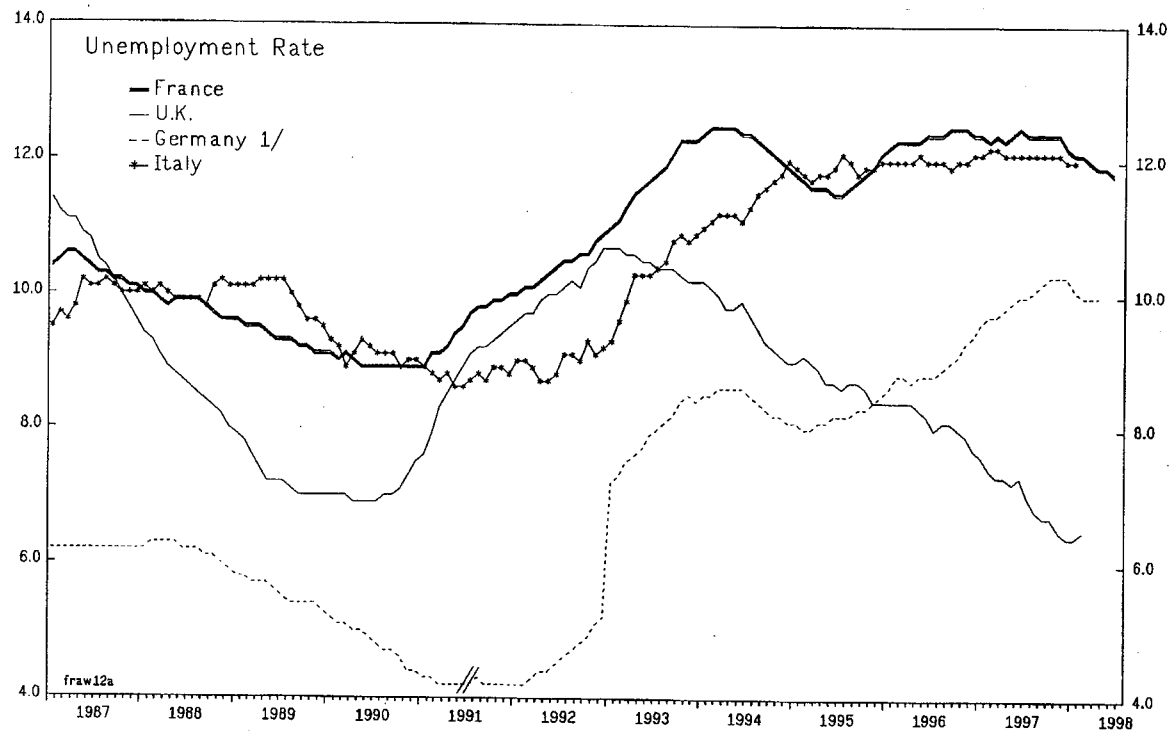
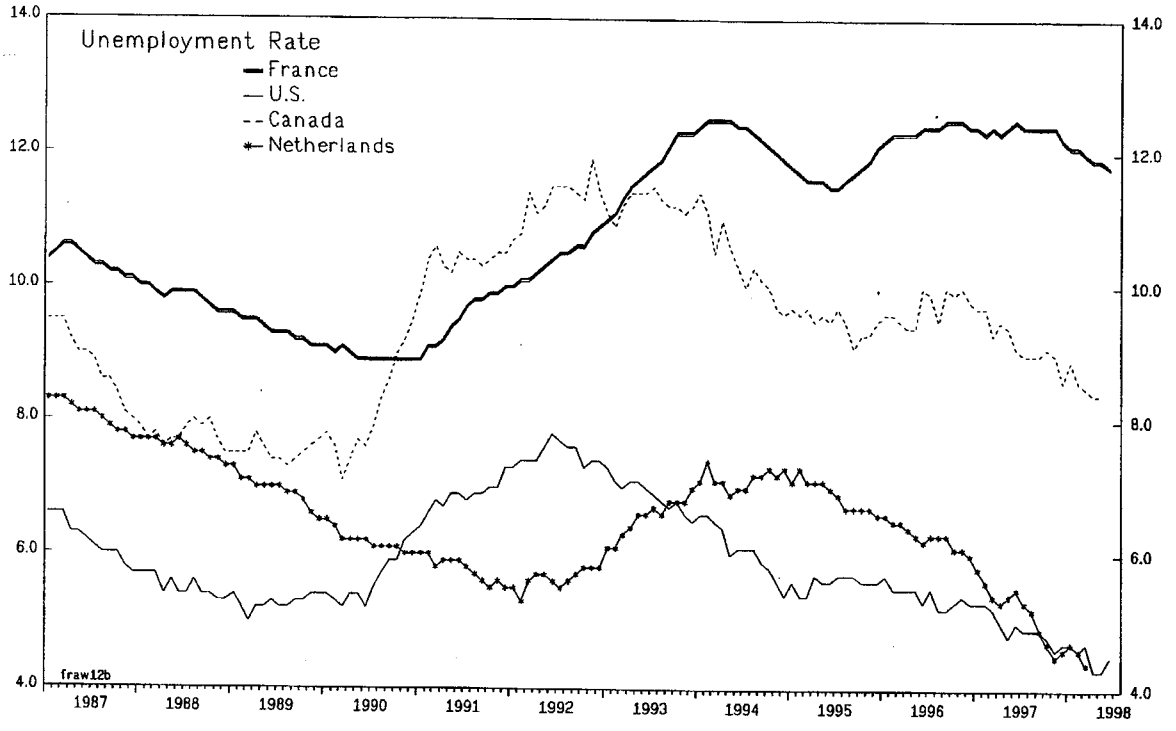
[46]Prepared by Ousmane Doré.

[47]Section B prepared by Alessandro Zanello.

[48]Lagged unemployment is used to avoid a simultaneity bias.

FIGURE III.1
FRANCE
Comparison of Unemployment Rates in Selected Countries





Source: OECD, Main Economic Indicators.
1/ Prior to 1991, data are for West Germany only.

Table III.1. France: Unemployment Profile

(In percent of the labor force)

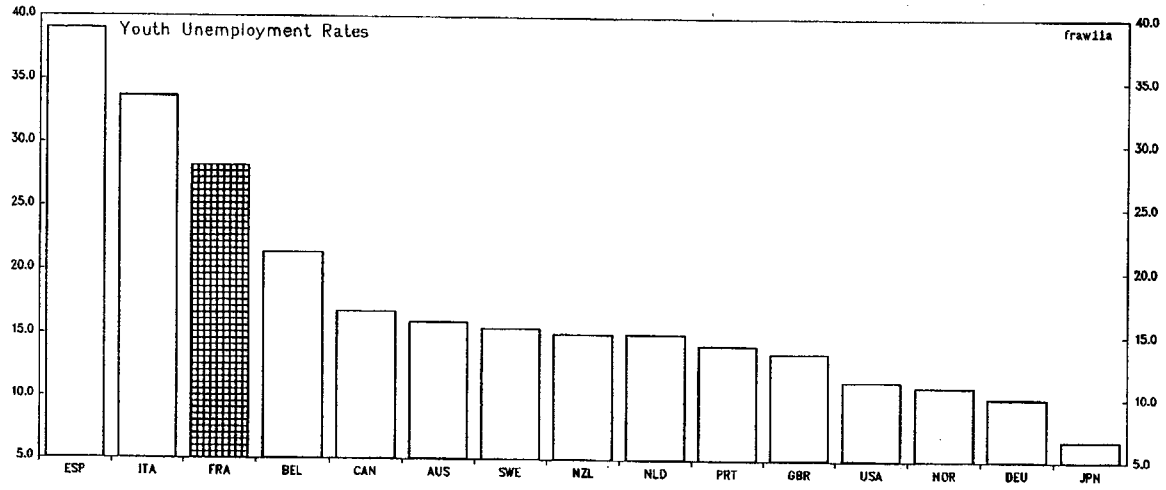
	1997			1998						
	June	Sept.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June	July
Total	12.6	12.5	12.4	12.1	12.1	12	11.9	11.9	11.8	11.8
15-24 years	25.1	24.9	23.8	23.3	23	22.8	22.7	22.6	22.5	22.5
25-49 years	11.5	11.5	11.2	11.1	11.1	11	10.9	11.0	10.9	10.9
Over 49 years	9.7	9.8	9.8	9.8	9.9	9.9	9.9	9.3	9.2	9.3
Males	11.2	11.1	10.8	10.7	10.6	10.5	10.5	10.2	10.1	10.1
15-24 years	22.0	21.9	20.7	20.3	20.0	19.9	19.8	19.2	19.2	19.3
25-49 years	10.1	10.0	9.7	9.6	9.6	9.5	9.4	9.3	9.2	9.2
Over 49 years	9.3	9.4	9.4	9.4	9.5	9.4	9.5	8.7	8.7	8.7
Females	14.3	14.3	14.0	13.9	13.8	13.8	13.7	13.9	13.8	13.8
15-24 years	28.9	28	27.2	27	26.7	26.4	26.2	26.7	26.5	26.5
25-49 years	13.3	13.2	13.0	12.9	12.9	12.8	12.7	13.1	13.0	13.0
Over 49 years	10.2	10.3	10.3	10.3	10.4	10.4	10.5	10.0	10.0	10.0

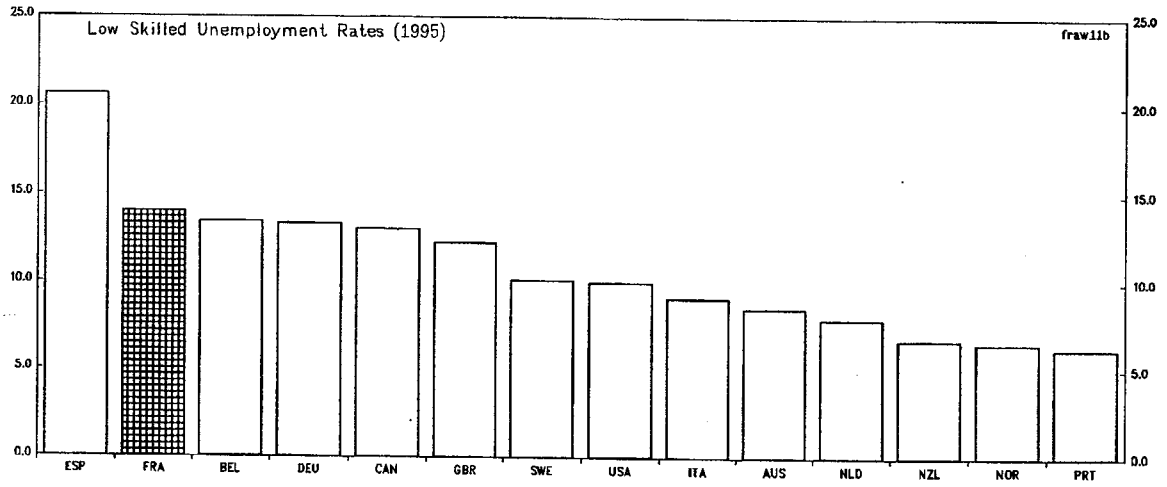
Source: Insee, *Bulletin Mensuel de Statistiques, 1997*.

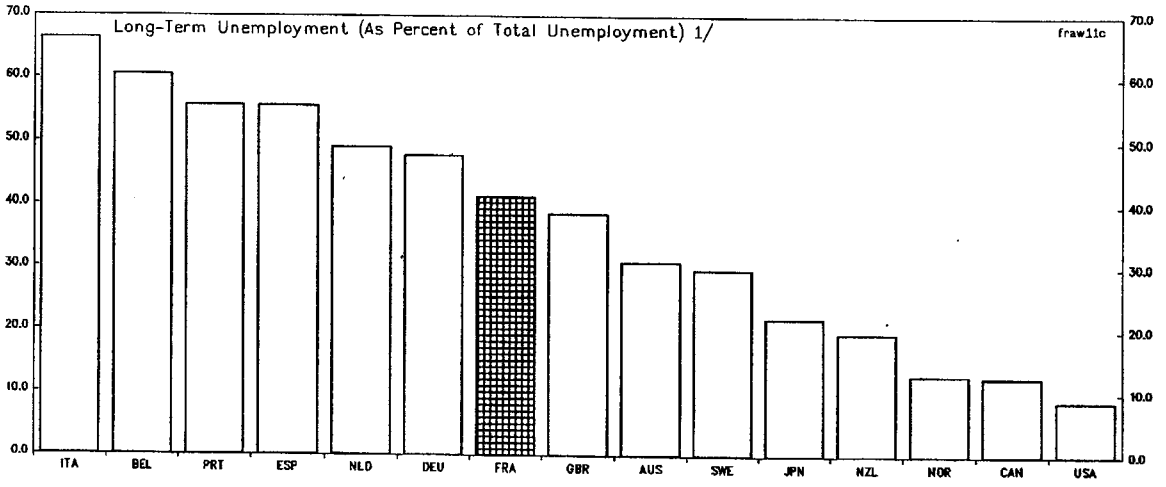
FIGURE III.2

FRANCE.

Labor Market Indicators in Selected Industrial Countries in 1997 1/







Source: OECD, Employment Outlook, June 1998.
1/ 1996 data for Germany.

Countries are: AUS=Australia, BEL=Belgium, CAN=Canada, FRA=France, DEU=Germany, ITA=Italy, JPN=Japan, NLD=Netherlands, NZL=New Zealand, NOR=Norway, PRT=Portugal, ESP=Spain, SWE=Sweden, GBR=United Kingdom, USA=United States.

Table III.2. France: Unemployment Characteristics in Selected EU Countries

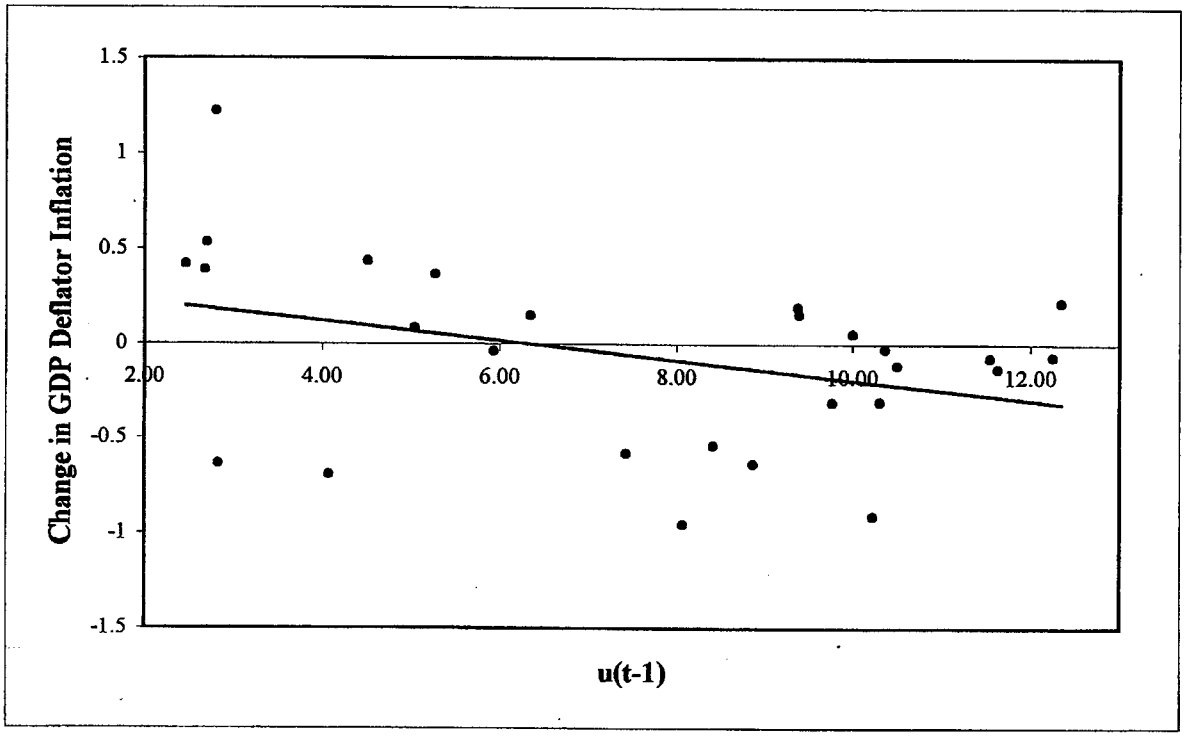
	Total 1/		Structural		Youth		Long-term 2/		Low-skilled 3/	
	1990	1996	1990	1996	1990	1996	1990	1996	1990 4/	1994
France	9.0	12.4	9.3	9.7	19.1	26.3	38.0	39.5	23.5	14.7
Austria	3.2	4.4	4.9	5.4	4.8	6.9	n.a	25.6	3.1	4.9
Belgium	8.7	9.8	10.8	10.6	14.5	20.5	68.7	61.3	22.7	12.5
Finland	3.5	15.7	8.0	15.4	6.4	24.7	9.2	35.9	16.3	22.7
Germany	6.2	9.0	6.9	9.6	5.6	8.0	46.8	48.3	6.6	13.9
Ireland	13.3	12.3	16.0	12.8	17.6	18.2	66.0	59.5	40.8	18.9
Italy	11.5	12.0	9.7	10.6	28.9	34.1	69.8	65.6	32.8	8.4
Netherlands	6.0	6.3	7.0	6.3	11.1	11.4	49.3	49.0	15.7	8.2
Portugal	4.7	7.3	4.9	5.8	9.9	16.7	44.8	53.1	n.a.	6.0
Spain	16.3	22.2	19.8	20.9	32.3	42.0	54.0	55.7	33.8	21.3

Source: OECD, 1997.

1/ Standardized unemployment rate.
2/ Incidence of long-term unemployment in percent of total unemployment (based on labor force surveys).
3/ Less than upper secondary education.
4/ For the 15–19 age group.

FIGURE III.3
FRANCE

PHILLIPS CURVE 1971–97



Sources: Data from OECD database; and Fund staff calculations.

structural unemployment rate. For all its simplicity, this picture is misleading. It gives the erroneous impression that the NAIRU stands as an unchanging benchmark, immune from the cyclical influences that drive the (observed) rate of unemployment. In reality, the distinction between cyclical and structural unemployment is blurred: complex dynamics link one to the other and suggest that the structural rate of unemployment is best thought of as a moving equilibrium.

80. The basic intuition is that workers that lose their jobs in a down-turn may in time also lose the ability to influence the wage bargaining process: they become "outsiders." The moderating impact of higher unemployment—which in a friction-less world would restore full employment through real wage cuts—is fatally weakened when unemployment itself reinforces the outsider status and the equilibrium rate of unemployment—the NAIRU—ratchets up. This can happen through several channels.

81. First, the human capital of the unemployed may deteriorate: skills, and even basic work discipline, may be lost through lack of practice. As a result, the employability of the unemployed is reduced and the probability of their finding a job becomes a decreasing function of the length of the unemployment spell. An adverse signaling effect comes into play in these circumstances: the unemployment status conveys to a prospective employer information about a job-seeker's productivity that will deter a job offer. As an additional feedback, discouragement may set in and reduce the intensity of job search. A negative externality emerges then, if a growing number of inefficient job-seekers interferes with the matching process: more vacancies may co-exist with a given unemployment rate (a shift upward of the Beveridge curve), further lengthening the average unemployment spell and the structural rate of unemployment.

82. Another channel through which cyclical developments affect the NAIRU involves the wage-bargaining behavior of the employed insiders and convex adjustment costs. For example, when unions bargain mainly on behalf of incumbent members, a temporary adverse shock to employment will have persistent effects because real wage demands would not reflect the aspirations of disenfranchised workers. More generally, any factor that strengthens the bargaining power of groups facing little risk of unemployment (e.g., costs of adjusting the workforce that empower the currently employed with market power) reduces the wage moderating influence of higher unemployment, that is, it raises the NAIRU.

83. A third channel involves demographics and institutional factors. New job-seekers share many of the characteristics of the long term-unemployed (lack of experience, low productivity due to inadequate human capital, and, possibly, a weaker attachment to work.) So, a larger cohort of young workers will push up the structural rate of unemployment for the same reasons that a longer unemployment spell of an adult worker does. Institutional factors—linked to the benefit system, job-security legislation, or the degree of competition in the product market—play another important role, to be discussed in some detail in the rest of this chapter.

84. A better understanding of the NAIRU as a dynamic threshold has enhanced its usefulness in policy evaluation. At the same time, with that understanding has come greater awareness of the difficulty of pinning down with sufficient precision its value at any point in time. The empirical case against the NAIRU points to 30 years of failure in reaching an agreement within the profession not just on what the NAIRU might be in specific instances but, more fundamentally, on how to measure it. Both "parameter uncertainty"and "model uncertainty" cloud the picture. Confidence intervals around a point estimate are notoriously wide. Two examples make the point: the 1994 NAIRU for the United States has been put at somewhere between 4.8 and 6.6 with 95 percent confidence, and for Canada in 1992 a similar test produced the interval 4.42 to 9.88.[49] On the other hand, it could be noted that the uncertainty of NAIRU estimates is unlikely to lead to egregious errors in policy making, when unemployment is reduced gradually in a low inflation environment. In this situation, inflation is unlikely to suddenly soar out of control if unemployment is mistakenly pushed below the NAIRU, and there might be scope for "testing the water", especially if structural reforms in the labor market give hope that the NAIRU might have fallen. (It goes without saying that, in any event, the policymaker should stand ready to tighten demand management policies at the first signs of overheating.)

85. With this in mind, a Phillips curve model in the spirit of Tobin (1972) has been estimated using quarterly data for France.[50] The model consists of a wage equation and a price (or mark-up) equation. Let *W%* denote wage inflation, *P%* the rate of price change, *U* the unemployment rate, and *U%* its rate of change. All variables are dated and the notation *x{1}* stands for the variable *x* lagged once. Then, it is assumed that wages are set according to:

$$W\% = a_{11} + a_{12}\, W\%\{1\} + a_{13}\, P\% + a_{14}\, U + a_{15}\, U\% . \qquad (1)$$

Firms set prices according to:

$$P\% = b_{11} + b_{12} P\%\{1\} + b_{13}\, W\% + b_{14}\, TFP\% + b_{15}\, OIL\% + b_{15}\, UTIL\_DEV , \qquad (2)$$

where *TFP%* is (smoothed) rate of growth in total factor productivity, *OIL%* is the (smoothed) rate of change in energy component of the CPI, and *UTIL_DEV* is the deviation from trend of the rate of capacity utilization.

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[49]Staiger D, J.H.Stock, and M.W.Watson: *The NAIRU, Unemployment and Monetary Policy, Journal of Economic Perspectives*, Winter 1997, p.46, and Setterfield, M. and D. Gordon and L. Osberg: *Searching for the Will o' the Wisp: and Empirical Study of the NAIRU in Canada, European Economic Review* 36, 1992, p. 119-136.

[50]Tobin, J. *The Wage-Price Mechanism:Overview of the Conference*, in O.Eckstein (ed.) *The Econometrics of Price Determination Conference,* Washington, 1972.

86. Equation (1) links wage growth to contemporaneous price inflation, lagged wage inflation (reflecting perhaps wage-imitation effects), the unemployment rate and its rate of change (to introduce hysteresis in wage dynamics). Equation (2) makes price changes conditional on contemporaneous wage inflation, past price increases (to capture price stickiness), the rate of productivity growth, the rate of inflation in energy prices (as a proxy for material costs) and a cyclical indicator of pressure on capacity. If lagged wage growth stands for expected wage inflation, then substitution of (2) into (1) give a standard expectation-augmented Phillips curve, relating wage dynamics to the unemployment rate, its rate of change, and a vector of exogenous variables.[51] The requirement from theory that the long-run Phillips curve be vertical can be imposed with the following linear restrictions on the unknown parameters: $a_{12} + a_{13} = b_{12} + b_{13} = 1$. Under these restrictions and the assumption of stationarity, the model can be solved for the NAIRU.[52] Estimation gives values of the underlying structural parameters (and of their *t*-statistics, in parenthesis) as shown in Table III.3.[53]

87. The model fits the data reasonably well, although the overall explanatory power of the price equation is low, suggesting that the (linear) specification could be improved or that some regressors show relative little variation over the sample period.[54] Variables enter as a rule with the expected sign, except the rate of change in the unemployment rate in the wage equation, and trend productivity growth in the price equation. In the case of the latter, the restriction on the coefficients of wages and prices in the mark-up equation does not seem to be strongly supported by the data, possibly polluting the estimate of other coefficients in that equation. In this particular exercise, parameter instability has practical effects because small changes in their values lead to large changes in the estimated NAIRU. This can be calculated at about 9.85 percent using a growth rate for total factor productivity of 1.5 percent (as obtained with a Hodrick-Prescott filter applied to the Solow residual from an aggregate Cobb-Douglas

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[51]Inflation in France has been following pretty closely a random walk, which makes lagged inflation the optimal *k*-step ahead forecast in the Wiener-Kolmogorov sense, for any *k*.

[52]Details on the solution can be found in SM/95/141. A caveat: there sufficient differences between this specification and the one in SM/95/141 to avoid any direct comparison of the estimation results.

[53]Data comes from the quarterly data bases of the OECD and WEFA. Rates of changes are computed as year-on-year. Estimation is by restricted two-stage least squares with correction for first-order autocorrelation by Fair's method.

[54] This is especially true of the filtered variables. The model has also been estimated with two alternative methods hoping for better efficiency: Generalized Instrumental Variables, and Three-Stage Least Squares. The estimates of individual parameters from the first method are broadly comparable to the ones in the Table and are nor reported. Estimates from Three-Stage least Squares are somewhat unstable, suggesting a flat likelihood function.

production function over the period 1973–96), and a "steady state" rate of energy price inflation of about 2 percent. The "short-run" NAIRU corresponding to (more or less) current values of these variables is slightly lower at 9.7 percent, and is put at about 9.5 four years ago, broadly in line with earlier staff estimates. A formal test of equality of the parameters in the Table with the ones obtained from a re-estimating the model through 1994, does not reject the null hypothesis of equality of the coefficients with very high confidence, suggesting "stability" of the NAIRU since then.[55]

Table III.3. Wage and Price Equations for France
(1976:2 1997:4)

Wage Inflation		**Price Inflation**	
Constant	0.0245 (3.62)	Constant	-0.0004 (0.15)
W%{1}	0.3625 (3.61)	*W%*	0.1548 (2.68)
P%	0.6374 (3.61)	*P%{1}*	0.8451 (2.68)
U	-0.0035 (-3.52)	*OIL%*	0.1026 (2.45)
U%	-0.005 (-0.38)	*TFP%*	0.0082 (0.06)
		UTIL_DEV	0.0012 (2.75)
Rho 1/	0.60 (3.54)	*Rho*	0.49 (3.67)
Box Score 2/	3/4	*Box Score*	4/5
R-Squared	0.93	R-Squared	0.30
D-W	1.85	*D-W*	1.82

Sources: Data from OECD and INSEE; and staff estimates.
1/ Estimated autoregresssive parameter.
2/ Ratio of the number of statistically significant variables with the expected sign to the number of regressors (excluding the constant.)

[55]The F-test on zero coefficients for dummy variables capturing differences in the intercept and slope parameters of the two regression has marginal significance on the order of 95 percent.

88. Upon reflection, this result is not surprising. With downward wage and price rigidities a cyclical asymmetry in the behavior of wages and prices emerges: only when the unemployment rate has fallen enough, and the NAIRU is approached from above, do wages and prices start responding. By contrast, even prolonged unemployment gaps may fail to affect price dynamics significantly. As a result of this asymmetry, the information content of the data is highest at the top of the cycle—a juncture which France has not reached since the late 1980's. Thus, the sample is understandably silent as to the recent evolution of the NAIRU.[56]

89. More broadly, the figures are at best suggestive and need to be interpreted with caution. First, parameters uncertainty has amplified effects on the NAIRU estimate which is a nonlinear function of those parameters. Second, the methodology used does not lead naturally to the construction of confidence intervals for the NAIRU estimate. More formally, the asymptotic distribution of non-linear functions of least-squares estimators—let alone their sampling properties—is unknown.[57] Thirdly, the model—a workhorse in macro-econometrics—ignores key institutional factors that must play an important part in evolution of the NAIRU over time—and can directly be influenced by policy. In light of these considerations, the preceding exercise is intended above all to motivate an analysis of these factors in the following sections.

C. A Bird's-Eye View of the Literature on Structural Unemployment in Europe

90. The economic literature identifies the following factors as sources of structural unemployment: generous unemployment benefit systems and other welfare entitlement programs that discourage job search; high social insurance contributions that discourage employers from seeking employees (especially for low-paying jobs) and workers from seeking jobs; job security legislation that insulates incumbent employees from the forces of demand and supply; union power and collective bargaining arrangements; and minimum wage laws that make wages unresponsive to market forces, prevent wage differentials from reflecting productivity differentials, and encourage the substitution of capital for labor.

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[56]Following this line of thought, it could be claimed that the data generation process itself—and not a particular estimation method or specification—is likely to frustrate any attempt to fine-tune the NAIRU estimate, based on the information set used here. This situation contrasts sharply with that in the United States or even in the Netherlands, which are in a more advanced cyclical position.

[57]Asymptotic standard errors for nonlinear functions of the parameters can be obtained by taking a first-order Taylor expansion of that function and assuming asymptotic normality. Standard errors are then computed using estimated first derivatives. There are reservations on the robustness of this approach. As a crude proxy for a more rigorous procedure, the NAIRU has been recomputed with parameters values that are increased (or decreased) uniformly by one standard deviation. The calculated values span an implausibly large interval.

91. These institutional arrangements hamper the labor market in basically three ways: (a) by weakening the demand for labor, making it less attractive to hire a worker by explicitly pushing up the wage costs or by introducing a negative shadow price for labor, (b) by distorting the labor supply; and (c) by impairing the equilibrating function of the market mechanism. For example, the demand for labor is determined not only by the conventional market elements such as output prices and the productivity of labor, but also by specific regulations relating to work time or layoffs, and by taxes that raise the cost of paying workers. The supply of labor is partly determined by the reservation wage of potential workers, which in turn is shaped by such institutions as the minimum wage, and the level and duration of unemployment, welfare, and social security payments.

92. The interactions between institutional factors and the structural unemployment are best captured by a wage-price spiral derived from wage bargaining models à la Layard-Nickell-Jackman. These models derive wage-setting and price-setting behavior as the solution of an optimization program. The price-setting relation determines the real wage paid by firms as a function of the markup of price over cost $m(V)$, which is typically a function of other variables, such as antitrust legislation and product market competition, denoted by the vector V. The wage-setting relation determines the real wage chosen by wage setters as a (negative) function of the rate of unemployment, as well as a set of institutional factors denoted by Z (which typically includes factors such as the generosity of unemployment benefits, the relative strength of unions and the overall characteristics of the wage bargaining process, the minimum wage legislation, as well as the tax wedge on the use of labor). The natural rate of unemployment is derived from the equilibrium condition in the labor market, which requires that the real wage implied by wage setting be equal to the real wage implied by price setting,

$$U^* = \Phi(Z, m(V)) \qquad (1)$$

93. This equation makes clear the implications for structural unemployment of changes in labor market institutions. Any development that exogenously boosts wage-push factors Z or labor demand shifts V (through a higher markup) would raise structural unemployment. Take, for example, measures that increase the generosity of unemployment benefits. Such measures, by enhancing the bargaining power of workers, would lead to a rise in the real wage chosen in wage setting at a given rate of unemployment, leading to an increase in the equilibrium unemployment rate.

94. There is a considerable amount of empirical work based on some versions of equation (1), which has been designed to shed light on the importance of institutional factors on the equilibrium rate of unemployment. The evidence available on European data, however, is not overwhelming; one reason is that the structural unemployment rate itself is not an observable variable. This problem is nonetheless less severe in cross-country study or panel data, and empirical results using these data are somewhat stronger and more persuasive. In an influential study, Layard, Nickell, and Jackman (1991) present estimates of structural unemployment in 19 countries for the period 1956–88, which is explained by variables such as the duration and generosity of unemployment benefits, some measure of the collective

bargaining structure, and the proportion of employees whose job tenure is less than two years (a proxy of job security legislation). In the European context, studies by Bean (1989), Layard, Nickell, and Jackman (1991), and Layard and Nickell (1992) found a positive association between structural unemployment and the replacement ratio and the duration of benefits. There is also an extensive literature that mainly points to a significant effect of benefits on unemployment duration (OECD, 1994), and gives support to the hypothesis that search intensity declines with longer unemployment spells (Pedersen and Westergaard-Nielsen, 1993).

95. While minimum wages are widely seen as an important institutional factor behind the high level of structural unemployment in Europe, empirical research on the employment effects of statutory minimum wages has yielded mixed results. Some recent empirical studies have suggested low or no employment responses to changes in statutory minima, although this may be reflecting the low level of the minimum wages (relative to average wages) in the countries considered. This suggests that the extent of unemployment effects varies, depending on many factors such as how high the floor is set, the groups of workers affected, and the distribution of skill levels. Several studies (e.g., Nickell, 1978; Bertola, 1990; Bentolila and Bertola, 1990; Lazear, 1990) have investigated the extent to which unemployment can be explained by employment protection provisions. With the exception of Lazear (1990), these studies suggest that firing costs cannot be blamed for the rise in unemployment, although they are likely to have reduced employment variation.

96. Cross-country evidence provided by Nickell (1997), which is in agreement with the findings of Bean, Layard, and Nickell (1986), suggests that the overall tax burden may raise unemployment and reduce labor supply. In a time-series analysis, Knoester and van der Windt (1987) report large long-run effects of employee taxes on labor costs for 10 OECD countries. However, the impact on unemployment of different systems of wage determination has proven very difficult to assess in empirical work, not least because of the complexity of the interactions among the different components of each system, and difficulties in measuring them precisely. Nonetheless, an empirical analysis using cross-sectional data for 20 countries during the period 1983–88 (Layard, Nickell, and Jackman, 1991, Nickell, 1997) confirms that unemployment rises with the coverage of collective bargaining and union density, although the relationship is often weak (Scarpetta, 1996).

97. In the French case, empirical studies by Jackman and Leroy (1996), Habermeier and Henry (1996), and Cotis, Meary, and Sobzack (1997) based on estimates of wage and price equations have been reasonably successful in demonstrating a tendency for the nonaccelerating inflation rate of unemployment (NAIRU) to be strongly influenced by variables such as the replacement ratio, the ratio of the minimum wage to average wage, and the tax wedge, but weakly correlated with union density and employment protection legislation. An alternative approach by the OECD (1997), based on a reduced-form structural unemployment equation, also concludes that over the long run, the tax wedge contributed most to the rise in structural unemployment, followed by the relative minimum wage and the unemployment insurance generosity.

D. Role of Institutional Factors: The French Case

98. This section focuses in detail on the benefits system and the minimum wage as factors of unemployment in France. As noted above, the tax wedge remains a crucial problem for labor market performance, but this issue has been addressed in separate staff studies in the context of medium- and long-term policies to slow the growth of public spending and cut the tax wedge, and undertake tax reforms.[58] There is little evidence that hiring and firing costs remain important inhibiting factors at present, as stringent administrative procedures that delay and prevent layoffs have been relaxed to a considerable degree since the mid-1980s.

The benefits system

99. The French labor market is characterized by an elaborate system of social protection aimed at safeguarding living standards for the unemployed and those without income. It consists of three types of entitlements: (1) the unemployment insurance benefits—which are related to previous earnings and paid to people with a record of prior employment; (2) the assistance benefits—which are unrelated to previous income, not conditional on previous employment, of unlimited duration, but are means-tested; and (3) the minimum social benefit or *revenu minimum d'insertion* (RMI)—which provides social assistance of unlimited duration. Some of these entitlements have little to do with the malfunctioning of the labor market, e.g., the minimum allowances for old age (*minimum vieillesse*), disability (*minimum invalidité*), surviving widows (*allocation d'assurance veuvage*), single parents (*allocation de parent isolé*) and handicapped adults (*allocation des adultes handicapés*). Others, however, (*e.g., allocation de solidarité spécifique, allocation d'insertion, allocation chômage, RMI*), have some relevance. In what follows, the focus will be on the unemployment benefit and the minimum social benefit, because these are designed in principle to promote the re-integration of the beneficiaries into the labor market, so as to avert the danger of "inactivity traps."[59]

100. The unemployment benefit system in France comprises an insurance element and a solidarity component. The unemployment insurance system is financed by social contributions and is managed by the social partners. It pays benefits only to people with a record of previous employment, with the level of benefits related to previous earnings and of limited duration. Depending on family circumstances, these benefits are supplemented by unemployment assistance (e.g., *allocation de solidarité spécifique*), financed by state transfers. Following the 1993 reforms, the level of benefits is set to decline the longer the recipient is unemployed; benefit reductions are now smaller, but they occur in several more steps—nine—than previously. The payment period of the benefit varies from 4 months to 60 months. The benefit amount is calculated by taking a percentage of daily reference pay plus

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[58]For a discussion, see SM/97/235.

[59]A situation in which recipients remain perpetually on welfare rolls because they have no incentives to take jobs, given the small income differentials between work and inactivity.

a supplement (minimum FF 131.01 per day) and is reduced every four months. It also varies according to age and length of prior affiliation with the unemployment insurance scheme and it is higher for people over 50 years old.[60]

101. For a 25- to 49-year old person having worked at least 14 months over the two years prior to becoming unemployed, benefits are paid at an initial rate of 57.4 percent of the gross reference wage for 9 months, but they cannot fall below a minimum payment of FF 4,267. Benefits are then reduced to 32.8 percent, but cannot fall below a minimum payment set at FF 2,766 per month. For a 25- to 49-year-old having worked previously at the minimum wage, the initial gross replacement rate is 66.6 percent and it falls to 43.2 percent after 18 months. Having reached its minimum level, the benefit stays at that level. The corresponding net replacement rates are 81.5 percent and 52.5 percent. Replacement rates are higher for older workers and lower for workers who were previously paid high wages. People who voluntarily quit their job are disqualified from unemployment insurance.

102. Despite the 1993 reform, the unemployment insurance system remains generous compared with the OECD average. An index of benefit entitlement constructed by the OECD (1995), taking into account both eligibility conditions and benefit duration, indicates that benefits in France became more generous over the last two decades (Table III.4). For instance, in 1997 the unemployment insurance benefit alone amounted on average to FF 4,234 a month, with about 37.5 percent of beneficiaries receiving less than FF 3,000, and more than a quarter receiving more than FF 5,000.

Table III.4. France: Generosity of Unemployment Benefits

(In percent of the average wage)

	1960s	1970s	1980s	1991
France	25	24	34	37
Germany	32	30	29	28
Spain	15	18	32	34
United Kingdom	28	26	24	20
United States	10	13	15	12

Source: OECD Jobs Study (1995), Chart 16.

[60]See OECD (1997) p. 80 and following pages.

103. The financial incentives and rewards for work are particularly weak for many with low potential earnings, such as single parents, partners in couples where one spouse is not working, and persons for whom part-time employment is the only realistic alternative to welfare. As an example, for a single-earner household with no children, the net replacement at a level of two-thirds of the average production worker's earnings was 79 percent in 1994, compared with an average for the OECD of 68 percent. The unemployment trap for families with children can also be pronounced, reflecting society's concern to ensure a reasonable standard of living for children. For a couple with two children, the net replacement is 81 percent, and 88 percent when housing benefits are included, compared with 73 percent and 77 percent for the OECD average. The situation is more acute for households with low incomes, high housing costs, and children, who receive various additional allowances (housing, family, child care subsidies) that boost considerably their net replacement rates. The net replacement rate remains relatively high after 60 months of unemployment, (65 percent) because the unemployed are still eligible for social assistance beyond the 60-month maximum duration of unemployment benefits (Tables III.5 and III.6).

104. When unemployment benefit entitlements are exhausted, the long-term unemployed in France typically qualify for the *revenu minimum d'insertion* (RMI), which is a guaranteed minimum income that was introduced in 1989 for persons without income. As in many other countries, the RMI was designed as a "final safety net," which operates when the household is unable to apply for other more advantageous kinds of benefits, the amounts of which must not exceed that of the main specialized benefits paid to retired adults or adults without access to employment (unemployed, disabled, or sick persons, etc.). The calculation of the amount of the allowance is similar to the practice followed elsewhere. It is a differentiated allowance that depends on the size and composition of the household and the level of other resources available to its members. Its payment is not subject to any time limitation (provided the beneficiary periodically shows evidence of the low level of his other resources). The RMI may be granted to any person without resources, including foreign nationals in certain conditions. On the other hand, it is not payable to persons under the age of 25 if they have no dependent children.

105. As an allowance designed to provide a minimum income, the RMI is a benefit of a general nature, unlike the single parent allowance (*allocation de parent isolé*) or the handicapped adult allowance (*allocation aux adultes handicapés*), and it is this open eligibility that explains the heterogeneity of the recipients. RMI beneficiaries are generally young, with half of them (54 percent) between 25 years and 40 years of age, while almost 12 percent are over the age of 55. As regards the family structure, nearly one recipient out of two lives alone and without any children (a third of single men and 20 percent of single women). However, the presence of single-parent families (amounting to 20 percent of total) and large families (i.e., a couple with children, who represent 10 percent of the total) is significant. In sociodemographic terms, almost 70 percent of the recipients are either single, divorced, widowed, or separated. Total expenditure on RMI amounted to only FF 26 billion in 1995

Table III.5. France: Replacement Rates for Single-Earner Households, 1994

(Replacement rates at the average production worker (APW) wage)

	Replacement in First month of Unemployment				60th Month of Unemployment Including Social Assistance
	Gross Replacement Rates (Before Tax)	Net Replacement Rates (After Tax and Other Benefits) 1/			Net Replacement Rates (After Tax and Other Benefits)1/
	Couple, No Children	Couple, No Children	Couple, 2 Children	Couple, 2 Children, Housing Benefits	Couple, 2 Children, Housing Benefits
France	57	69	71	80	65
Denmark	60	69	73	83	83
Finland	53	63	75	88	98
Germany	42	60	71	78	71
Netherlands	70	77	77	84	80
Sweden 2/	80	81	84	89	99
United Kingdom	26	35	51	77	77
OECD Average (unweighted)	52	60	68	73	67

Source: *OECD, Employment Outlook*, 1996.

1/ Benefits can include housing allowances, child and family allowances.
2/ Benefit amounts for couples are calculated on the basis of both spouses actively seeking work.

Table III.6. France: Replacement Rates for Single-Earner Households, 1994

Replacement rates at ⅔ of the average production worker (APW) wage

	Replacement in First Month of Unemployment				60th Month of Unemployment Including Social Assistance
	Gross Replacement Rates (Before Tax)	Net Replacement Rates (After Tax and Other Benefits) 1/			Net Replacement Rates (After Tax and Other Benefits) 1/
	Couple, No Children	Couple, No Children	Couple, 2 Children	Couple, 2 Children, Housing Benefits	Couple, 2 Children, Housing Benefits
France	65	79	81	88	83
Denmark	86	92	93	95	95
Finland	60	67	83	89	100
Germany	44	60	70	77	80
Netherlands	70	79	78	84	95
Sweden 2/	80	82	85	89	121
United Kingdom	39	52	67	90	90
OECD Average (unweighted)	60	68	73	77	80

Source: *OECD, Employment Outlook*, 1996.

1/ Benefits can include housing allowances, child and family allowances.
2/ Benefit amounts for couples are calculated on the basis of both spouses actively seeking work.

(of which FF 21 billion was paid by the central government and the remainder by the departments), equivalent to 0.3 percent of GDP.

106. Since its introduction in 1989, the number of recipients of the RMI has risen steeply to reach nearly 1 million in 1997. While data on the exit rate from the RMI are limited, the degree of reintegration to the workforce, as measured by the ratio of beneficiaries having access to job or training, has been remarkably stable at 30 percent, with nearly half of those involved in public job schemes (CES, CEC).[61] One recent French study (Afsa, 1995) found that the exit rate is strongly influenced by such factors as seniority, marital status, age, and proximity to workplace, and the extent of local unemployment; the longer beneficiaries remain on assistance, the more difficult it is for them to exit; couples and young people tend to have higher exit rates than single people and adults, respectively. The growing number of RMI recipients can also be explained by factors such as a gradual decline in the social stigma associated with claiming the benefit as claiming becomes more common, the appearance of intergenerational transmission of welfare dependency, and a ratchet effect arising from the presence of "loopholes" in the original legislation. But, to a large extent, the relatively low RMI exit rate is due to the failure of the integration policy that was supposed to accompany it. This is attributed to the fact that the return to work is not necessarily a rewarding experience for beneficiaries, in light of the sharp benefit withdrawal and the high payroll tax.

107. Although RMI payments are very low (currently FF 2,500 per month), they are supplemented by family allowances and housing benefits.[62] Prior to recent policy changes (see paragraph 125), the combination of the minimum income payments on the one hand, and additional benefits and taxation on the other, implied very high marginal effective tax rates, which dampened incentives for those interested in re-entering the labor market. For example, a single person living on the RMI had a disposable income (net of housing cost) of FF 1,915 per month. Upon taking a full-time job at the SMIC, his net income would increase to FF 3,458, corresponding to a net gain of FF 1,543 (81 percent increase) per month, or equivalently, FF 9 additional income per hour worked (Table III.7). This calculation is based solely on the monetary gain, which is not the only factor affecting the individual's decision to take a job offer. Other determinants include the forgone leisure time, the loss of in-kind transfers linked to the RMI (e.g., day care, food stamps, free health care, and subsidized transportation fares), and the costs associated with work (transportation, special clothing, etc.), against which must be weighed the deferred replacement income (pension), and an improved social status. When these other factors are taken into consideration, the seemingly large pecuniary gain from employment could be reduced to the point that the incentive effect would vanish. The situation is even more acute for couples with children with marginal effective tax rates exceeding in some cases 100 percent (Table III.8).

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[61]Dossiers de la Dares, No. 8–9, November 1996.

[62]Some 41 percent of recipients are lodged free of charge with their families; others pay rent in subsidized state housing or receive a housing allowance.

Table III.7. France: Net Monetary Gains from RMI to SMIC for Single Persons

Starting Position	New Situation 1/	Net Gain per Month	Net Gain per Hour	Relative Gains (%)
RMI	1 SMIC	1,543	9	81
RMI	1/2 SMIC w/o e.d.	-216	-3	-11
RMI	1/2 SMIC w/ e.d.	1,324	16	69
1/2 SMIC w/ e.d.	1/2 SMIC w/o e.d.	-1,540	...	-48

Source: French authorities.

1/ e.d. denotes earnings disregard.

Table III.8. France: Net Monetary Gain from RMI for Single Parents and Couples

	1/2 SMIC w/o Earnings Disregard	1/2 SMIC with Earnings Disregard	1 SMIC
Single Parent with			
1 Child	-284	1,563	1,718
2 Children	302	2,140	2,406
Couples			
No Children	0	1,324	823
1 Child	0	1,324	617
2 Children	0	1,664	705
3 Children	0	2,540	1,644

Source: French authorities.

108. There was practically no financial incentive for leaving the RMI welfare system until the recent introduction of the "*intéressement*" mechanism (see paragraph 125). For a single

recipient of the RMI, this move would typically lead to a net income loss of about FF 216 per month, owing essentially to the way housing subsidies are computed (when a beneficiary of RMI is receiving an additional allowance, income from work activity is not taken into account in deriving his/her housing benefits (see Table III.7)).

Minimum wage legislation

109. The statutory minimum wage was instituted in France in 1950, with a law establishing the SMIG (*salaire minimum interprofessionnel garanti*) which was raised in line with prices whenever the inflation rate exceeded 5 percent per year. In 1970, the SMIG was converted to the SMIC (*salaire minimum interprofessionnel de croissance*). There are three mechanisms for revising the SMIC. First, a rise of 2 percent or more in the CPI automatically triggers an equivalent rise in the SMIC. Second, in July of every year, the SMIC is revised by at least half the increase in the real hourly wage in industry. Third, the government can raise the SMIC at its discretion (*coup de pouce*). The 10 percent increase following the election of President Mitterrand in May 1981 had a major impact on the proportion of the work force receiving the SMIC. Shortly after the present government took office in June 1997, the minimum wage was increased by 4 percent. A similar adjustment was legislated by President Chirac following the 1995 elections. These three mechanisms ensure that the real value of the SMIC never falls by more than 2 percent at any time during the year, and that the SMIC is regularly adjusted, so that its real value increases when real average earnings rise.

110. The proportion of people paid the SMIC rose from 8.6 percent in 1991 to over 11 percent in 1997 (Table III.9). In particular, the proportion of workers earning the SMIC is quite high among youth, with one-third of the minimum wage earners being under 26. The growing number of "SMICards" in France (particularly among the young workers) is an indication that the minimum wage has a significant impact on large segments of the labor force. The SMIC is not the only form of minimum wage in France, however; the laws also allow wage floors to be set by collective bargaining agreements (these apply only if they exceed the statutory minimum wage). These sectoral minima, however, have grown less rapidly than the SMIC since the early 1980s. Currently, the monthly minimum wage is FF 5,280 on a take-home basis, and FF 6,664 including social security contributions by employees.

111. A commonly used measure to gauge the magnitude of the minimum wage is the Kaitz index (often weighted to allow for the fact that not all workers are covered by minimum wage laws), which expresses the minimum wage as a fraction of average earnings.[63] Table III.10 presents estimates of this index for a group of countries, showing that in most European countries, including France, minimum wages are about 50 percent to 70 percent of average

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[63]The international comparison of minimum wages is a daunting task, because the real level of the minimum wages by itself may be not be the appropriate indicator in comparisons between countries with differing productivity.

wages, significantly higher than in the United States. While the ratio of the minimum wage to the average wage has fallen in most other countries, it has remained practically unchanged in France since 1988 (see Figure III.4).

Table III.9. France: Proportion of Workers Paid at the SMIC

	1991	1996	1997
Total 1/	8.6	11.0	11.0
Male	5.1	7.5	7.8
Female	14.2	16.5	16.3
Youth 2/	...	33.5	33.5
Male 3/	...	38.9	38.8
Female 4/	...	29.7	29.6

Source: Dares.

1/ In percent of total workforce.
2/ In percent of total SMICards.
3/ In percent of total male SMICards.
4/ In percent of total female SMICards.

112. One distinguishing feature of the French minimum wage is its wider legal and effective coverage of the workforce compared with other EU countries. The minimum wage, at least in theory, applies to anyone aged 18 or above. In several other European countries, younger workers are entitled to a reduced adult rate, based on the argument that a high minimum wage for teenagers and inexperienced young workers may negatively affect their employment opportunities. Indeed, while the empirical literature tends to disagree about the overall employment effects of the minimum wage, many studies confirm that a high minimum wage has detrimental effects on youth employment (see below). Moreover, distributional arguments for a minimum wage may be less relevant in the case of young workers since low-paid jobs for many of them are often a stepping stone to better ones in the future.[64] For example, in the Netherlands, the full minimum wage applies only to those aged 23 and above; for 16-year-olds, it is set at about one-third of the adult minimum, rising to 84 percent for 22-year-olds. This appears to be one of the features that accounts for the favorable labor

[64]OECD, 1997.

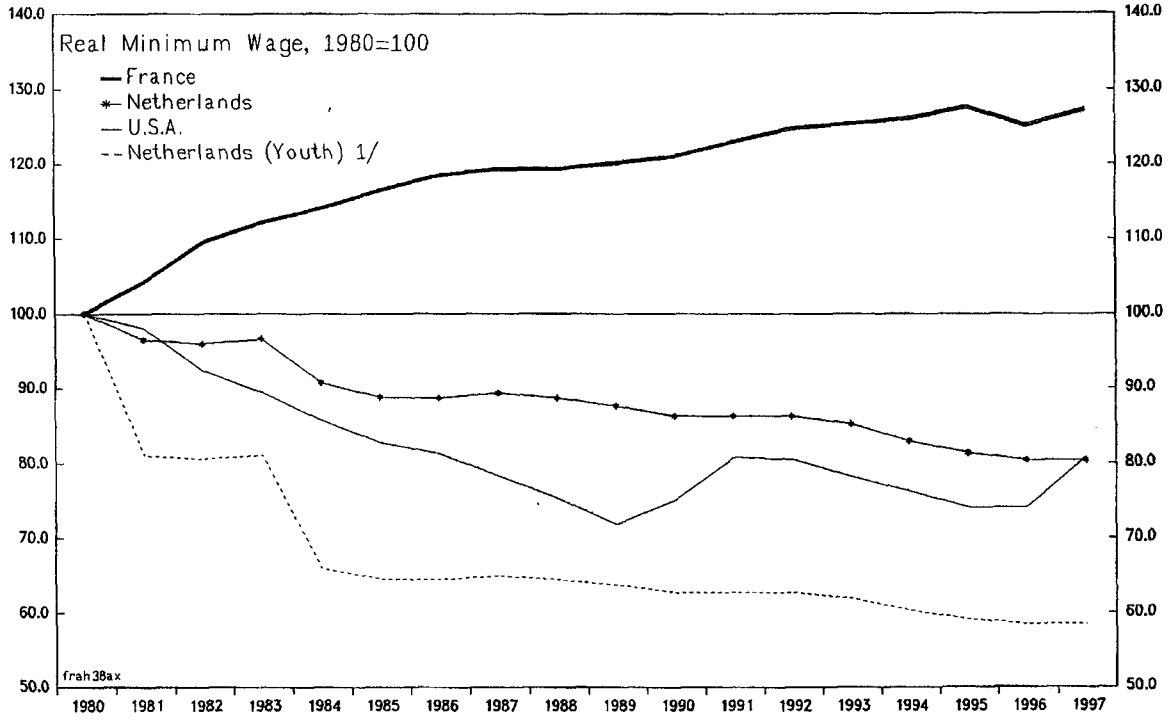
Table III.10. France: Minimum Wage Systems in Europe

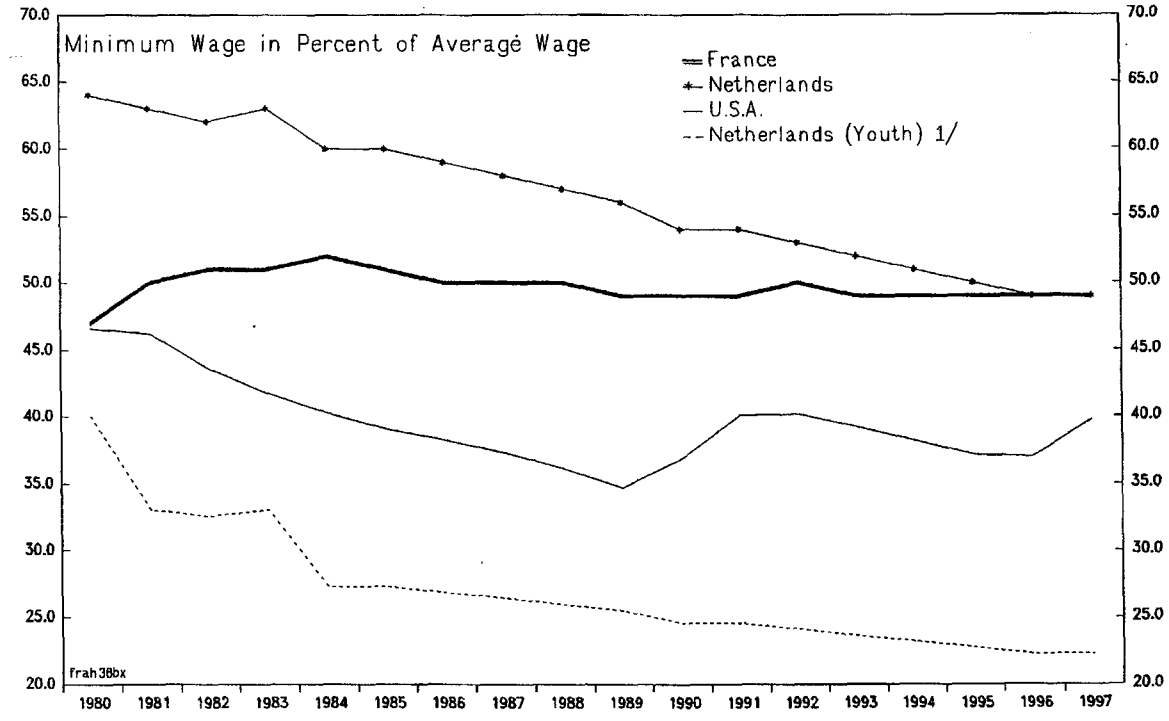
Country 1/	Determination	Variation by	Kaitz 2/ Index (year)	Percent of Workers at or Near Minimum	Youth Minimum as Percent of Adult Minimum	Replacement Ratio
France	Set by government constrained by formula	Age, training	0.50 (1993)	11%	80% (age 16); 90% (age 17) + schemes + 30-75% for trainees	0.57
Belgium	Negotiated by unions and employers as part of national agreement	Age, job tenure	0.60 (1992)	4%	Small reduction for <23 (lower rates for short job tenure)	0.6
Denmark	Negotiated as part of collective agreements	Industry, age	0.54 (1994)	6%	40% (<18)	0.9
Finland	Negotiated as part of collective agreements	Age, industry, occupation, region	0.52 (1993)			0.63
Germany	Part of collective agreements, then extended	Age, qualifications, trainee status, region	0.55 (1991)		Embodied in industry agreements	0.63
Italy	Extension of collective agreements	Age, industry, job tenure	0.71 (1991)		Embodied in industry agreements	0.20
Luxembourg	Statutory minimum wage	Age, skill, family characteristics	0.56	11%	70% (<21)	
Netherlands	Statutory minimum wage	Age	0.55 (1993)	3.2%	34.5% (age 16) rising to 84% (age 22)	0.70
Spain	Statutory minimum wage	Age, home workers, casual workers	0.32 (1994)	6.5%	66% (<18)	0.70
United Kingdom	Pre-1993 set by Wages Councils by industry; now only agriculture	Age, industry (more complex pre-1996)	0.40 (1993)		0% (<21) (1986-93)	0.38

Source: Dolado et. al, 1996.

1/ Effective April 1999, the U.K. will introduce a minimum wage of £3.60 for people aged 21 and over and £3.00 for young people.
2/ Kaitz index: minimum wage as a fraction of average earnings.

FIGURE III.4
FRANCE
Minimum Wages and Employment in Selected Countries





Sources: IMF, Datafund; data provided by the authorities; and staff calculations.
1/ Minimum wage at age 18.
2/ In percentage points.

market performance of the Netherlands—in particular, low youth unemployment—in relation to other EU countries.[65] In Belgium, the full minimum wage applies to those aged 21, and above and there are lower rates for those under 21, although the reduction is not as sharp as in the Netherlands.

113. The main concern about the minimum wage is its possible effects in aggravating unemployment, particularly among young and unskilled workers. At the theoretical level, the predicted effect of minimum wage laws is based on the standard neoclassical analysis of labor markets. In a competitive labor market, any increase in the wage of low-productivity workers above the market-clearing level will lead to lower equilibrium employment. The detrimental effects on employment depend on the level of the minimum wage and other specific features (e.g., whether the minimum wage is indexed or not, and if so, whether the link is to prices or earnings). For France, the OECD *Jobs Study* (1995) concluded that "the link between minimum wages and youth wages does tend to indicate the potential for a negative impact on employment of statutory wage floors."

114. Empirical evidence from a number of other studies indicates that the SMIC appears to have an appreciable impact on employment of the least-skilled and especially the young. Among the most recent studies, Martin and Bazen (1991) found a significant negative impact of the SMIC on youth employment, with an elasticity ranging from -0.23 to -0.1. Skourias (1992) used different approaches to analyze the effects of the SMIC on youth employment, unemployment, and labor force participation. The estimated employment effects of the SMIC were somewhat below those of Martin and Bazen, albeit statistically significant. In a more recent study, Skourias (1993) obtained elasticities of youth employment with respect to the SMIC in the range between -0.12 and -0.15. On the basis of these results, the author estimates that the rise in the SMIC over the period 1970–90 led to the loss of between 93,000 and 375,000 jobs for young workers. Following a similar approach, Benhayoun (1993) confirms the results for male youth employment, but not for total youth employment.

E. Recent Policy Measures

115. The French authorities are aware of the problems caused by these and other institutional features of the labor market, and they have taken several steps to alleviate their impact on unemployment. Over the past few years, the authorities have introduced a wide range of labor market initiatives, with great emphasis on reducing the cost of hiring people with little training or experience, or whose human capital has been adversely affected by long-term unemployment. (See Table III.11).

116. The discussion that follows is mainly concerned with reforms undertaken since mid-1997, but it is important to remember that, to some extent, these initiatives were an adjustment of existing programs. Attempts to address the concerns about labor market

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[65]See Kingdom of the Netherlands—Netherlands: Selected Issues Paper (SM/97/139).

"exclusion" have led to a proliferation of programs focused on integrating the young, re-integrating the long-term unemployed, and providing public work for those with a low earning potential. Despite these measures, unemployment continued to increase, prompting the new government in 1997 to shift the emphasis of labor market policies toward streamlining the numerous employment support programs and targeting them better, reforming the employment and training agencies, and making headway in addressing the unemployment traps. There has also been discussion of further reductions in employers' social contribution for low wage earners.

Streamlining employment support programs and maintaining programs that cut the SMIC for youth workers

117. Existing labor market programs can be grouped into three sets of measures; those involving the use of fiscal transfers in the market sector (e.g., the *ristourne dégressive*, the *contrat initiative emploi*, CIE), those involving minimum-wage concessions (e.g., *contrats d'alternance*), and job schemes in the nonmarket sector involving public subsidies (e.g., *contrat emploi solidarité, emploi-jeunes)*. Moreover, in response to growing concerns about the SMIC's possible adverse effects on youth employment, the authorities introduced numerous schemes offering rebates to employers, often in the form of exemptions from payroll taxes. The growth in the number of people in these schemes has been dramatic; the proportion of people paid below the SMIC, which had represented only 1 percent in 1981, surged to 8.6 percent in 1997. All in all, there were over 50 job schemes offering subsidies, rebates, and training in 1997 (see Boxes III.1 and III.2). Public spending on these employment programs has risen considerably, with total budgetary costs estimated at FF 156 billion (about 2 percent of GDP).

118. There is a growing recognition that the existing schemes suffer from a number of shortcomings. First, there are too many programs; this implies high information costs, and heavy compliance and controls costs, especially for small firms. Second, many schemes are very generous without much gain in overall employment.[66] Third, a number of public job schemes involving fiscal transfers have had only limited success in getting people back into

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[66]For example, the *Rapport Pericard* estimated that the monthly budgetary cost for a person under the *contrat-initiative-emploi* was about FF 3,519 and FF 4,218 for a worker under the *contrat-emploi-solidarité*, considerably more than the public contribution to training schemes (FF 1,500 for the apprenticeship contract and FF 2,500 for the qualification contract), see OECD, 1997.

Table III.11. France: Labor Market Policies Since the Early 1980s in Selected Countries

	France	Denmark	Netherlands	United Kingdom
Minimum wage	Real increases amounting to 16 percent during 1980-85, 4 percent during 1985-90, and 5 percent during 1990-95 and 3 percent in 1996-97.	No statutory minimum wage (or legal extension of minimum wages in collective agreements).	Nominal adult minimum cut by 3 percent (1984) and frozen for much of 1985-95; youth minimum twice reduced and frozen for much of period (minimum wage for 18-year-olds thus declined by more than 40 percent in real terms in 1980-95).	A minimum wage of £3.60 will be effective as of April 1999 with a lower rate (£3.00) for young people.
Non-wage labor costs	Social security costs among the highest in advanced economies, although initial steps taken to shift toward general taxation (CSG, RDS in mid-1990s). Significant cuts in contributions introduced for those at or close to minimum wage.	Among lowest in advanced economies—social security mainly financed by general taxation.	Employer contributions significantly reduced for the low-skilled, and almost eliminated (1996-98) for the low-skill long-term unemployed. Cuts in employee contributions and taxes (1983-96) amounted to the equivalent of 12 percent of real net wage of average production worker.	Social security financed mainly by general taxation; state pension is modest, and private schemes play a major role.
Unemployment benefit	Benefits—typically on the order of 60 percent—are geared to contribution record. For young people benefits are thus relatively limited. A reform in 1993 scaled back benefits as a function of length of unemployment.	Maximum duration cut to 5 years and eligibility tightened (1994-96). Unskilled youths without formal education and unemployed for at least 6 months must participate in 18-month educational program at half benefit (or lose benefit).	Benefit ratio cut from 80 to 70 percent; duration of full benefit cut to 6 months for youths and eligibility tightened (1986). Planned introduction of common front office for all benefits, job-search and training services, with financial incentives for agencies to achieve results and use of private employment agencies.	Criteria for receiving benefits progressively tightened, and now include active job-search requirement. Average replacement rate is 18 percent.
Minimum social benefit	In principle, designed to foster reinsertion in the labor market; job search/training requirements have not generally been applied effectively in practice.	Means-tested benefit equivalent to 60 percent of maximum unemployment benefit (80 percent if dependent children); in principle conditioned on job-search: practical screening has not been effective thus far.	Nominal adult benefit cut by 3 percent (1984) and frozen for much of 1985-95; minimum benefit for youths fell by more than 40 percent in real terms in 1980-95. Parity between minimum benefit and minimum wage impairs incentives. However, plan to provide stronger financial incentive to municipalities to cut benefit dependency, and participation in common front office (see above).	None.
Other benefits	Generous state-financed early retirement schemes have generally been made available in connection with industrial restructuring.	Early retirement scheme for unemployed aged 50-59 introduced in 1992 but abolished in early 1996. Compensation on child care leave/sabbaticals introduced 1992, but ratio cut from 80 to 60 percent over 1995-97.	Disability benefit rate cut from 80 to 70 percent and eligibility tightened (1985). Responsibility shifted to firms for first 5 years (1998). Sickness benefit rate cut in stages from 100 to 70 percent, and privatized (1997).	Invalidity benefit replaced by incapacity benefit with tighter criteria (1995).
Employment protection/flexibility	For collective dismissals, administrative approval ended in 1986 but legal process untransparent. Fairly liberal regime for individual dismissals.	Severance procedures have long been very liberal.	Severance regime fairly liberal; dismissal periods shortened (1996). Temporary workers can now be hired for more than 6 months and successive contracts.	Major reforms of labor union law in 1980s. Severance procedures very liberal.
Training	Measures taken in mid-1990s to encourage apprenticeships and *stages* with some adjustment of wages to reflect costs of training; but success limited so far. Closer integration needed between firms and educational institutions.	Official training initiatives in recent years have included a focus on the young and the long-term unemployed; tightening of training requirements on all unemployment benefit (q.v.) recipients, especially the unskilled young, should strengthen impact.	1995 Law on Education and Vocational Training created Regional Training Centers, with a view to strengthening adult vocational training and raising the number of apprentices by 18,000 over three years.	Training targets job-search skill of long-term unemployed. Welfare-to- Work program includes youth employment programs with substantial job training component.

Box III.1: Examples of Employment Programs Involving Fiscal Transfers

In the Market Sector

The ***contrat initiative emploi*** (CIE) is an employment-support scheme in the market sector providing an exemption equal to employer social security taxes at the level of the minimum wage plus a monthly subsidy ranging from F 1,000 to F 2,000, thus reducing labor costs for a person earning the minimum wage by up to 40 percent. Initially, the CIE was designed only for those unemployed for more than one year and certain other categories (people over 50 years old, the handicapped, beneficiaries of the **contrat emploi solidarité** (CES), and those on welfare), but in May 1996, it was extended to youth having difficulty in finding work and not registered with the unemployment office. Presently, they represent about 22 percent of employment under this scheme. In September 1996, eligibility for the CIE of those unemployed for fewer than two years was eliminated, while the monthly subsidy for those unemployed between two and three years was reduced from F 2,000 per month to F 1,000 per month. The number of people covered under this scheme amounted to 210,000 in 1997.

The ***ristourne dégressive*** reduces the employers' social contributions for wages below 1.3 times the SMIC (with the reduction declining to zero as the wage increases), thus providing a reduction in labor costs equivalent to 12.6 percent at the level of the SMIC. Over half a million people were covered under this scheme in 1997, with a total budgetary cost of FF 40 billion.

In the NonMarket Sector

The ***contrats emploi solidarité*** (CES) is a subsidized employment scheme of limited duration (3 to 12 months) in the nonmarket sector designed to provide part-time jobs (a 20-hour workweek) for young people having difficulty in finding jobs. Employers' social security payments are waived and wage costs are largely covered by the State (generally 65 percent to 95 percent of the SMIC) and a compensation fund. Young people, the long-term unemployed, and women are the main beneficiaries of this program. In 1996, youths represented 29 percent of total employment under this scheme, with female youth accounting for about 62 percent. There were over half a million people under this program in 1997, at a total budgetary cost of FF 25 billion.

The ***contrat-emploi-jeunes*** (NS-NE) is a scheme providing public employment for young people in activities where few private providers operate (cultural activities, sports, education, environment), with the State providing financial support equivalent to 80 percent of the SMIC for five years.

The ***contrats emploi-consolidés*** (CEC) is a subsidized five-year employment program with local entities, covering 200,000 adults over three years.

Box III.2: Examples of Schemes Involving Minimum Wage Concessions/Training

The apprenticeship system (***contrat d'apprentissage***) is a special employment contract whose duration varies from one to three years. It is intended for young people between 16 and 25 years old who have no qualifications, in order to give them some vocational experience. The apprentice is considered as an employee of the firm that hires and pays him. His wage varies between 25 percent and 78 percent of the legal minimum wage level, according to his age and his seniority in the contract.[1] A firm engaged in an apprenticeship contract is exempt from the payment of social security contributions during the contract. At the end of the contract, the employer is under no obligation to hire the apprentice permanently, or even temporarily, nor is the employer bound to give any notice or severance pay. There is also a hiring bonus of F 6,000 and an annual subsidy of F 10,000.

The qualification contrat ***(contrat de qualification)*** is a special employment contract with a limited duration (from 6 to 24 months) aimed to give young workers a chance to acquire formal training to boost their qualifications. Its target is the same as the apprenticeship contract but its implementation is simpler. It is intended for young workers aged between 16 and 25 years old, who are unqualified or long-term unemployed. The contracts, which cannot be undertaken by public services, and involve on-the-job training and a more theoretical training period in a training center. The length of the training period specified by the contract must be higher than 25 percent of the contract's duration, which is generally between 6 and 24 months. The wage paid by the firm to a young worker employed under the contract is fixed as a percentage of the SMIC, depending on age and seniority in the contract.[2] The firm undertaking a qualification contract is exempt from paying social security contributions for the portion of the wage not exceeding the SMIC. At the end of a contract, the State provides financial help equivalent to FF 5,000 per contract (fewer than 18 months) and FF 7,000 per contract (more than 18 months).

The orientation contact (***contrat d'orientation***) is an alternative training program designed to facilitate the integration of two categories of unemployed youth: those between the ages of 16 and 22 years, who have not completed secondary education and have no technical or professional diplomas, and those younger than 25 years old who have dropped out of college and have no other professional diploma. For the first group, the contract is generally of nine months' duration, and the orientation period must exceed 25 percent of the contract's duration. For the second group, the contract is of six months' duration and is nonrenewable; the orientation period has to exceed 75 percent of the contract period. The wage paid to youth under this program varies according to age: 30 percent of the SMIC for 16–17 years old, 50 percent of the SMIC for 18–20 years old, and 65 percent of the SMIC for those over 21 years old. Employers benefit from an exemption from social security contributions for accident and family allowances.

The adaptation contrat (***contrat d'adaptation***) is either a limited duration contract (from 6 to 12 months) or an unlimited duration contract. It is aimed toward youth less than 26 years old, who already possess some qualifications but who have yet to find an appropriate job, offering them complementary training adapted to the firm. The training is given alternatively: the practical part of the training is taken on the job, the theoretical part is given by a training center or by the firm itself. The wage level may be equal to 80 percent of the SMIC if the contract is of limited duration, and no lower than the SMIC after the training period if the contract is of unlimited duration. Employers are no longer exempted from social security contributions under this scheme, but training costs may be reimbursed up to FF 50 per hour.

1/ For young people 16–17 years old, the wage is 25 percent, 37 percent, and 53 percent of the SMIC for the first, second and third year, respectively. For those 18–20 years old, the proportions are 41 percent, 49 percent, and 65 percent of the SMIC, and for 21–25 years old, the proportions increase to 53 percent, 61 percent, and 78 percent of the SMIC.

2/ During the first year, the wage is equivalent to 30 percent, 50 percent, and 65 percent of the SMIC for young people 16–17 years old, 18–20 years old and 21–25 years old ,respectively. In the second year, wages as a proportion of the SMIC become 45 percent, 60 percent, and 75 percent for the respective age groups.

regular work. As a result, some existing programs in the market sector are being trimmed and retargeted to cover only persons in particular difficulties. For example, eligibility for the CIE is now limited for those unemployed for more than two years, and youth having particular difficulty in finding jobs, which would lead to a substantial drop in the number of people covered under this scheme in 1998. In general, resources are being freed to expand the more successful programs, including those that cut social contributions to encourage employment (e.g., the *ristourne dégressive*). In the nonmarket sector, the authorities are also cutting back ineffective schemes (e.g, the *contrat emploi solidarité*) and are putting in place new public sector job-creation schemes for adults (*contrats emploi-consolidés)* and for young workers (*emploi-jeunes)*, to serve both as a staging post for learning basic job skills, and as a means to provide socially useful services, where employees cannot aspire to a market job.

119. With labor costs still an obstacle to hiring people with low skills and experience, the authorities are also contemplating maintaining existing programs, which blend action to increase skills with provisions for remuneration below the minimum wage. Indeed, they are planning to extend tax breaks.

Reforming employment and training agencies

120. The government signed a first Progress Agreement (*Contrat de Progrès*) with the national employment agency (ANPE) for the years 1990–94, followed by a second agreement covering the period 1994–98 (see OECD, 1996). The objective of both agreements was to transform the ANPE into a modern, client-oriented service provider, thereby enhancing its effectiveness. These agreements contain a number of qualitative targets such as widening the range of services, fighting against social exclusion, modernizing the computer equipment, and decentralizing budget management. In addition, the following quantitative targets are specified: increasing the ANPE share of notified vacancies in total vacancies in the economy to 40 percent, tripling the number of notified vacancies for executive staff, and reducing the incidence of very long-term unemployment by 1 percentage point each year. Within the framework of these national targets, a series of operational indicators are established on an annual basis at decentralized levels. As long as target indicators conform broadly to the national objectives agreed with the government in the Progress Agreement, the ANPE has considerable leeway in varying its targets from year to year. Regional employment agencies participate in the annual negotiation process in which detailed performance targets are set, including a number of quantitative indicators such as vacancies filled. Once these targets have been agreed, their implementation is followed up by regular meetings, and monthly and quarterly reports at the national and regional levels. Some financial incentives are offered to offices that meet their targets, but there are no sanctions for those that fail to do so. Nonetheless, the present system has insufficient incentives for agencies, and the management of resources is still strongly centralized.

121. In June 1994, conversion agreements (*conventions de conversion*) were introduced. Under this scheme, firms are obliged to offer all their redundant employees who are below the age of 57, and who have more than two years' tenure, the possibility of signing a conversion

agreement, with the aim of helping them get back to work by means of individualized measures. Workers who opt for this scheme forgo their rights to severance benefits and regular unemployment benefits. Instead, they receive a special allowance that is higher than their unemployment benefit entitlement and they are not included in the job-seeker register. They are counseled by special technical units within the ANPE offices, which are equipped with the necessary personnel to offer individualized guidance. On the basis of a detailed evaluation of their competencies, workers are offered specific retraining programs or other redeployment assistance for a period of six months. Financial support for employers who hire these workers is also available.

122. Currently, a number of changes are under consideration, including the following: giving regional employment agencies targets in reintegrating the jobless into the labor force and, in parallel, discretion to switch funding between job programs. In the past, such decisions had been made centrally, and considerable scope existed to improve efficiency by directing resources to those programs that were proving most effective in relation to local conditions. Also, to better coordinate support, one-stop offices (incorporating benefit, job-search, and training services) have been introduced for those receiving unemployment benefits—but not yet for those receiving the minimum social benefit. More generally, a high priority is to follow the current EU policy of promoting a more intensive dialogue with those—especially the young—at risk of joining the long-term unemployed (see below).

Reforming the benefit system

123. Following a major reform of unemployment benefits in 1993, the authorities have recently introduced a number of additional supply side measures, focused on strengthening incentives for reintegration into the labor market. The RMI, for example, was not meant to be simply limited to financial assistance to the most needy, but was also supposed to provide them with the support they needed to achieve social and economic integration. In order to prevent this support from being a disincentive to work, the government managed initially to set the level of the allowance in such a way that, whatever its composition, the household would reap a significant benefit if at least one of its members worked full-time, even when paid at the SMIC, rather than simply being satisfied with the allowance.

124. Recently, this approach has been extended to promote the reintegration of recipients of unemployment benefits, with the mechanism of "*intéressement,*" which allows claimants to maintain a part of their entitlement rights and income from any other activity, up to a ceiling and for a certain period. The unemployment benefit—or, more formally, the degressive allowance[67]—may continue to be granted if the recipient (1) undertakes a part-time salaried job (up to 136 hours per month), providing him an income

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[67]Prior to 1993, the unemployment insurance scheme distributed a basic and end-of-entitlement benefits, and also an exceptional benefit, both of which were replaced by a single degressive benefit (the *allocation unique dégressive*).

not exceeding 70 percent of gross remuneration previously taken into account in calculating the amount of the entitlement; or (2) loses a job and keeps one or several other activities providing him income not exceeding 70 percent of total gross income prior to that job loss. This extension of benefits is possible for a maximum period of 18 months; it does not apply to participants in the CES and recipients who are aged 50 and over.

125. An *intéressement* mechanism exists also for people contemplating moving from welfare to work. It allows 50 percent of earnings to be disregarded (28 percent for those on CES) in benefit calculations during the first 750 hours of activity. With this mechanism in place, there is a substantial net income gain upon taking a job paid at the SMIC, at least for a single person (about FF 1,324 per month or FF 16 per hour worked), but such a gain is temporary (the first 750 hours of work, nine months on an equivalent full-time basis). After the first 750 hours, there is a net income loss amounting to FF 1,540. Thus these existing earnings disregard provisions have not entirely solved the high marginal effective tax rate problem for some segments of the population on welfare (see Tables III.7 and III.8).

126. In March 1998, new legislation (*Projet de loi contre l'exclusion*) was put forward by the government, allowing beneficiaries to continue to receive 100 percent of the RMI for the first three months, 50 percent for the next six months, and 25 percent for the last three months of the working year. The proposed measure would go a long way toward addressing the high effective marginal tax rates facing beneficiaries of the RMI.

Averting long-term unemployment by giving a "fresh start" to the unemployed

127. In line with the Luxembourg Jobs Summit, the authorities have put forward a National Action Plan, which is aimed at giving young people and adult job-seekers the opportunity to make a fresh start before they sink into long-term unemployment. The goal of the government is to offer a program to all young people and adults registered as unemployed for 6 to 12 months within five years, and to reach 50 percent of this target by 2000. To reach these targets, use will be made of the resources of the public employment service and local partnerships; 350,000 new jobs for young people in new service careers are planned over the next three years in the public sector (the so-called "*Nouveaux Services-Nouveaux Emplois*" or "*Emploi-Jeunes*"), with 150,000 jobs already created in 1998. The program will also include a new blueprint called "*TRACE*" which will offer a route for integration to young people facing severe family, social, and cultural problems. This scheme is expected to cover 60,000 young people in three years. The fresh start program includes: drawing up an individual action plan (and follow-up interviews), followed by a training proposal or a job offer, as well as career guidance and help in job prospecting, or individualized social assistance for people with difficult social problems.

F. Possible Policy Options

128. The new measures highlighted above are steps in the right direction, but much more remains to be done to achieve a well-functioning labor market. Incentive problems remain on the supply side, as employment-conditional benefits have not been viewed as acceptable. On the demand side, labor costs remain an obstacle to hiring the inexperienced and the low-skilled, a situation likely to be exacerbated by the continuing impact of real minimum wage increases (some 3 percent in 1997, followed by a further real increase of 1 percent in 1998). Moreover, the legislation to cut the legal workweek from 39 to 35 hours could have serious implications for those paid at the minimum wage level, because of the political commitment to safeguard monthly income. One approach under consideration is to introduce a monthly minimum wage in addition to the hourly one. This monthly SMIC approach would increase the hourly labor costs at the level of the SMIC by 11½ percent, which would seriously worsen the employment prospects of the low-skilled; it would also compress differentials and thus reduce incentives for the low-paid to enhance their skills. (See the accompanying paper and the Appendix to SM/98/229 for a discussion of these issues).

129. A difficult policy question is how to encourage wage flexibility in the public and private sectors to further reduce labor costs particularly for the low-skilled.[68] A dilemma arises because some measures that would enhance labor-market flexibility—such as deep reforms of the benefit and minimum wage systems—involve changes regarded as politically unpopular or socially disruptive. Nonetheless, the experience of the Netherlands suggests that significant structural labor market reforms can be introduced through a consensual process, involving the social partners and clearly not threatening social cohesion. In the Netherlands, the real minimum wage was indeed reduced, youth minimum wages were cut, and benefits scaled down in the context of a comprehensive but gradual reform, which included a cut in public spending so as to reduce the tax wedge. There were strikes, but the Dutch authorities succeeded in changing the rules of the game, in part through careful coordination of, and consultation on, the reforms—albeit because of a sense of national crisis.

130. In this section, a limited number of measures, focused on strengthening incentives for reintegration into the labor market and reducing obstacles to recruiting youth, are suggested as a promising avenue to improve the performance of the French labor market, while maintaining consistency with the government's social objectives. These reforms (to be presented as a package of measures) would need to be complemented with a range of other reforms aimed at developing entrepreneurship, creating a propitious climate for starting

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[68]Distributional issues are best dealt with in other ways. See OECD Employment Outlook, 1994, 1995, 1996, where it is recommended that more weight be placed on the market-clearing role of wages, while pursuing equity objectives through other policy instruments.

new businesses, increasing the number of innovative undertakings, and promoting product market competition.[69]

131. **As part of policies aimed at reducing disincentives to find a job, both the unemployment benefit (*allocation chômage*) and the social minima (*revenu minimum d'insertion*, RMI) could be made less attractive by tightening the eligibility criteria for continued receipt of benefits, including through job-search testing.** One suggested avenue is a much stronger insistence on job-search, training, or public sector work. The goal of such pro-active policies is to help keep the unemployed in permanent touch with the labor market. Such policies have been implemented in varying ways in the Netherlands, the United Kingdom, and Denmark. In Denmark, for example, participation in an approved training or education program is required after four years of benefits, to continue receiving assistance in the form of an education allowance equal to the unemployment benefit level to which the person was entitled. Unskilled youth unemployed for at least 6 months are required to participate in an 18-month educational program, and their unemployment benefits are halved.[70] In addition to shortening the maximum duration for unemployment benefits, tougher eligibility for continued payment of benefits was introduced.

132. Tighter enforcement of eligibility rules and improvements in the efficiency of benefits administration can have a favorable impact. Ineffective administration, involving payment of benefits to people who are not seeking work or are in "concealed employment" breeds a great deal of inefficiency in resource allocation. While the national employment agency (ANPE) offers a range of training and job-search assistance measures to all unemployed as soon as they register at the public employment office, the system could be improved in ways that could enhance incentives for moving from inactivity to work. First, the job-search requirement, which already exists for recipients of unemployment benefits, should be extended to recipients of social minima. Second, after a certain period, recipients of unemployment benefits could be given a choice between participating in an active education program or accepting some kind of job offer. Third, following the 60-month period after which the insurance benefits are no longer available and the unemployed persons become eligible for social minima, there could be, as a complement to receiving the allowance (*RMI*), a

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[69]The policy complementarity proposition has been made by Coe and Snower (1997), who argue that labor market reform measures are more likely to succeed if pushed through in tandem with other reforms than if implemented in isolation.

[70]An important feature of the reform also included measures to reintegrate the long-term unemployed via "individual action plans" (IHP) based on intensified counseling and job brokering, with efforts graduated according to the length of the unemployment spell. IHP procedures, which are mandatory after two years (six months for youth under age 25), start with an interview in which advice on the availability of active labor market policies is provided and the individual's employment problems are assessed, leading to an agreement on suitable measures to be taken.

requirement that the unsuccessful job-hunters participate in an active training program or fulfill some kind of public service/community jobs in order to enhance the recipient's employability.

133. **There is a need to deepen the reforms of the unemployment agency.** Presently, the ANPE has a dominant position as a job placement agency, which carries the risk of an inefficient provision of public services. Certain public establishments or jointly managed organizations may engage in public placement activities, but they must be approved by, or sign an agreement with, the ANPE.[71] In addition, the effectiveness of support for job-search and training is poorly coordinated between state, departmental, and local agencies. A new blueprint, along the lines being tried in the Netherlands, and already in place for the *allocation chômage*, is needed to channel contacts with beneficiaries of the RMI through one "front office;" this change could be useful in toughening the conditionality of benefits. As in the Netherlands, it could also be desirable to broaden the role of private agencies.

134. **As a part of the policies aimed at mitigating "unemployment traps" and improving work incentives, it is important that newly proposed measures—aimed at gradually phasing out the minimum social benefit when recipients take up employment—be fully implemented, and comparable approaches extended to the "*allocation chômage*" and benefits in kind. Alternatively, an earned income tax credit could be introduced.** As seen above (paragraphs 125 and 126), some progress has been made in improving the financial incentives for a passage from welfare (RMI-support) to work. The situation is different for a move from unemployment to employment, where a sharp withdrawal of the *allocation chômage* and other in-kind benefits (e.g., the housing allowance) can still result in very high marginal effective tax rates. The *intéressement* mechanism of earnings disregard and the safeguard of previous entitlement rights (paragraph 124) are steps in the right direction. However, while it has increased the attractiveness of taking up part-time occupation, they have done little to encourage the acceptance of full-time jobs or "short-term employment." A broader strategy of allowing a newly employed worker to maintain means-tested benefits while earning a salary up to a threshold has proved viable in many countries, including in France, for the RMI, and charts a path to follow. It is recommended that measures in this spirit be extended selectively to recipients of unemployment insurance (and, perhaps, locally provided in-kind benefits such as housing) in cases where high effective marginal tax rates create a powerful disincentive to reintegration in the labor market. An alternative, or complementary, measure would be the introduction of an earned income tax credit as a broader approach to increasing the differential between benefit income and income from employment.

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[71]A bond in the form of a bank guarantee must be provided by establishments operating as temporary employment agencies.

135. **For workers without any training or recent work experience, independently of their age, the minimum wage is a hindrance rather than a protection. For them, the objective should be to have automatic access to a package of apprenticeship and training schemes, preferably on-the-job, with remuneration below the SMIC, to reflect their low productivity and the cost of training.**

G. Conclusion

136. The strong employment growth experienced over the recovery so far has not been sufficient to bring France's unemployment to an acceptable level yet, and in spite of an extensive social protection system, there remains an ever-present danger that labor market exclusion will turn into poverty and dependency. Unemployment remains at double-digit levels, with the share of long-term and youth unemployment still high by European standards; meanwhile, the number of people on social assistance continues to increase. This situation has prompted the new government recently to start reorienting labor market policies. One direction is the controversial 35-hour workweek initiative, which is addressed in an accompanying paper. This paper has focused solely on aspects of the French labor market institutions that continue to impinge on employment performance. Complementing the reforms already underway, the targeted measures suggested here should help to improve incentives affecting the labor market, without breaching the government's social objectives.

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