



Council of the
European Union

Brussels, 3 March 2015
(OR. en)

6632/15
ADD 10

ECOFIN 154
UEM 59
SOC 120
COMPET 79
EMPL 66
ENV 115
EDUC 55
RECH 49
ENER 64
JAI 127

COVER NOTE

From: Secretary-General of the European Commission,
signed by Mr Jordi AYET PUIGARNAU, Director

date of receipt: 26 February 2015

To: Mr Uwe CORSEPIUS, Secretary-General of the Council of the European
Union

No. Cion doc.: SWD(2015) 29 final

Subject: COMMISSION STAFF WORKING DOCUMENT Country Report France
2015 Including an In-Depth Review on the prevention and correction of
macroeconomic imbalances

Delegations will find attached document SWD(2015) 29 final.

Encl.: SWD(2015) 29 final



Brussels, 26.2.2015
SWD(2015) 29 final

COMMISSION STAFF WORKING DOCUMENT

**Country Report France 2015
Including an In-Depth Review on the prevention and correction of macroeconomic
imbalances**

{COM(2015) 85 final}

**This document is a European Commission staff working document . It does not
constitute the official position of the Commission, nor does it prejudge any such position.**

CONTENTS

<u>Executive summary</u>	1
<u>1. Scene setter: economic situation and outlook</u>	3
<u>2. Imbalances, Risks, and Adjustment</u>	10
<u>2.1. Competitiveness developments</u>	11
<u>2.2. Public and private indebtedness</u>	26
<u>2.3. Euro Area Spillovers</u>	34
<u>3. Other structural issues</u>	38
<u>3.1. Taxation, Sustainability of public finances and Fiscal framework</u>	39
<u>3.2. Labour market, social policies, skills and education</u>	45
<u>3.3. Improving the business environment and enhancing competition</u>	50
<u>A. Overview Table</u>	59
<u>B. Standard Tables</u>	68

LIST OF TABLES

1.1. Key economic, financial and social indicators	9
1.2. The MIP scoreboard	10
2.1.1. Decomposition of goods export market share, France	12
2.1.2. OECD Product Market Regulation in services, 2013	22
2.1.3. Profit margins in manufacturing per technology	25
2.1.4. Long-term elasticity of exports to cost-competitiveness	26
B.1. Macroeconomic indicators	70
B.2. Financial market indicators	71
B.3. Taxation indicators	71
B.4. Labour market and social indicators	72
B.5. Labour market and social indicators (continued)	73

B.6.	Product market performance and policy indicators	74
B.7.	Green growth	75

LIST OF GRAPHS

1.1.	Contribution to GDP growth (2007-2016)	3
1.2.	GDP in volume (2000=100)	4
1.3.	Composition of the external position	5
1.4.	Non-cyclical current accounts	6
1.5.	Composition of the net international investment position	6
1.6.	Debt decomposition, all sectors, consolidated	7
2.1.1.	Component contributions to change in CA balance 2007-2013	12
2.1.2.	Average yearly export market share loss/gains per sector (2001-2008)	13
2.1.3.	Average yearly export market share loss/gains per sector (2008-2013)	14
2.1.4.	Market share losses in goods 2012-2013	15
2.1.5.	Nominal unit labour costs (total economy)	16
2.1.6.	Decline in productivity growth in the market economy	17
2.1.7.	Spare capacity without additional recruitment in manufacturing	19
2.1.8.	Capital accumulation contribution to potential growth	20
2.1.9.	TFP growth in selected countries	20
2.1.10.	TFP growth in the tradable and non-tradable sector	20
2.1.11.	Product-times labour market regulation, 2013	21
2.1.12.	Price developments per sector	22
2.1.13.	Profit margins in selected European countries	23
2.1.14.	Profit margins	25
2.1.15.	Gross Fixed Capital Formation	25
2.1.16.	Equipment investment	26
2.2.1.	General government deficit and debt	29
2.2.2.	Net financial assets of the government	29
2.2.3.	Components of gross debt variation	30
2.2.4.	General government debt under various scenarios	30
2.2.5.	Spreads between France and selected euro area Member States(10-years maturity bonds)	31
2.2.6.	Correlation of the French 10-year sovereign rates with selected euro area Member States	32
2.2.7.	French bank's consolidated exposure to euro area general government securities	33
2.2.8.	Loan deleveraging pressure	35
3.1.1.	Effective marginal tax rate on equity and debt-funded new corporate investments, 2014	43
3.1.2.	Environmental tax revenue by type of tax (2012, % of GDP)	44
3.2.1.	Unemployment rates total and of people aged under 25 - comparison France EU average	47

LIST OF BOXES

1.1. Economic surveillance process	8
2.1.1. Distribution of export products by quality in France, Spain and Germany	27
2.3.1. The financial intermediation role of France	38
3.3.1. Main measures included in the draft Law on Growth and Economic Activity	56

EXECUTIVE SUMMARY

A modest recovery is expected in 2015. After three years of slow activity, GDP grew by 0.4 % in 2014 supported by public consumption and inventories. A modest recovery is expected in 2015 which will gain traction in 2016, on the back of stronger private consumption. The unemployment rate, at 10.2 % in 2014, is not expected to decline significantly in the coming years. The general government deficit and debt, at 4.3 % and 95.2 % of GDP respectively in 2014, continue to be at high levels. Investment contracted in 2014 as companies' profit margins remain under pressure, but is set to increase in the coming years. The euro depreciation and recent reforms will not be sufficient to reverse the losses in export market shares. Inflation is projected to decrease to zero in 2015 before increasing moderately to 1 % in 2016. France's recent price developments reflect external factors but also weak aggregate demand.

This Country Report assesses France's economy against the background of the Commission's Annual Growth Survey which recommends three main pillars for the EU's economic and social policy in 2015: investment, structural reforms, and fiscal responsibility. In line with the Investment Plan for Europe, it also explores ways to maximise the impact of public resources and unlock private investment. In March 2014, the Commission concluded that France was experiencing macroeconomic imbalances requiring decisive policy action, in particular regarding the deterioration in the trade balance and in competitiveness as well as the implications of the high level of public sector indebtedness. The Country Report also builds on the specific monitoring of policy reforms taken to unwind the macroeconomic imbalances, which was set in motion by the Commission in 2014. Finally, it assesses France in light of the findings of the 2015 Alert Mechanism Report, in which the Commission found it useful to further examine the persistence of imbalances or their unwinding. The main findings of the In-Depth Review contained in this Country Report are:

- **Despite some improvement since 2012, France has lost 13 % of its export market shares in the past 5 years.** The manufacturing industry has suffered export market share losses across all sectors, except for the high-tech sector. Overall, French exports seem sensitive to deteriorations in cost competitiveness indicating a lower ability of exporting firms to compete on non-cost factors. The low profitability of exporters limits their capacity to invest and to innovate and hence to improve their non-cost competitiveness. The industry's low profitability is in part due to the high cost of labour. The measures to reduce the labour cost, namely the tax credit for competitiveness and employment and the Responsibility and Solidarity Pact, may only have limited effects on competitiveness and be partially offset by sustained wage growth. The latter poses a risk of a further deterioration of cost competitiveness.
- **The high and rising overall indebtedness of the French economy, in a context of low growth and low inflation, increases the country's vulnerability to potential adverse economic events.** General government debt has increased rapidly since 2000, notably due to the high deficit recorded during the global financial crisis. Since then, expenditure growth has proved difficult to contain and the headline deficit remains high. In the private sector, the poor profitability of companies may affect their ability to service their debt.
- **Negative developments in France would have a significant impact on the other euro area countries.** The French economy has strong trade, financial and banking linkages with other Member States. Failure to effectively address the French structural challenges may thus affect adversely euro area partners. Conversely, a recovery of consumer confidence in France would benefit the euro area as a whole.

Other macroeconomic issues which point to particular challenges of the French economy are:

- **Services market rigidities, together with the high administrative burden, weigh on the business environment and, ultimately, on investment.** Regulatory and other barriers continue to limit competition in the services sector in general and in professional services, retail trade and network industries in particular. These have a detrimental impact on productivity both in services and in the manufacturing sector. Investment in research

and development in the private sector has increased, although it remains below the best EU performers.

- **At 57 % of GDP in 2014, public expenditure remains high, leading to a high tax burden** which weighs on investment and on economic activity. Taxes continue to increase from already high levels; labour taxes are high from an EU perspective and high corporate taxes weigh on investment and favour the build-up of debt over capital.
- **French unemployment has increased, with young people, older workers and the low-qualified being particularly hit.** The measures adopted by the government in 2013 to introduce some flexibility in the labour market have had a modest impact. The labour market remains segmented with increasing difficulties to move from temporary to permanent contracts and a constant reduction in the length of temporary contracts.

In a letter sent to the Commission in November 2014, the French authorities committed to a number of structural reforms implementing the 2014 country-specific recommendations issued by the Council in July 2014. These structural reforms were further specified in a communication on the National Reform Programme on 18 February 2015.

Overall, France has made limited progress in addressing the 2014 country-specific recommendations. During the past year, France has undertaken reforms aimed at reducing the cost of labour, mainly through the tax credit for competitiveness and employment and the Responsibility and Solidarity Pact. The draft Law on Growth and Economic Activity and the Reform of Local Administrations are currently discussed in Parliament. Efforts to simplify the regulatory burden have also been reinforced. These initiatives represent some progress in promoting competition in services, in particular in the retail sector, and for improving the business environment. Conversely, insufficient action has been taken to further improve the sustainability of the pension system. The effectiveness of the expenditure reviews has proved limited while beyond short-term savings, limited effort has been made to curb the long-term increase in healthcare expenditures. Moreover,

there is an insufficient policy response to improve the efficiency of innovation policies and of the tax system. Furthermore, there is little progress in combating labour market rigidity, reforming the unemployment benefit system or improving the employment opportunities for older workers. As regards recommendations related to active labour market policies, education and vocational training, some progress has been made.

The country report shows the policy challenges stemming from the analysis of macro-economic imbalances, namely:

- **Fiscal consolidation remains an important challenge for France. Together with the high tax burden, it weighs on France's economic prospects.** The expenditure review strategy has not resulted so far into a significant improvement in public spending efficiency and the long-term sustainability of the healthcare and pension systems faces challenges.
- **Rigidities and distortions on the labour market weigh on the competitiveness of the French external sector.** Given the current low inflation, the rigidities in the wage formation process and the indexation of the minimum wage contribute to the difficulty to adjust wages to productivity developments. The skills mismatches and the prevailing rigidities on the labour market result in a segmented labour market which makes it more difficult to improve productivity.
- **Despite the government's simplification strategy, complex regulation continues to weigh on the growth potential of firms and product market regulation limits competition in services.** Moreover, the current policies do not sufficiently support innovation and the shift towards a more knowledge-intensive economy.

In addition to the challenges related to macroeconomic imbalances, the impact of the reform on unemployment schemes appears to be limited, and adequate incentives to return to work are not yet in place. Moreover, the reform of education and training is on-going.

1. SCENE SETTER: ECONOMIC SITUATION AND OUTLOOK

A moderate acceleration in growth is expected

According to the 2015 winter forecast, GDP growth is expected to gain momentum after having stagnated for the last three years. The gradual economic recovery in 2015 and 2016 (1.0 % and 1.8 % GDP growth, see Graph 1.1) is set to be mainly driven by private consumption, as low inflation and sustained wage growth should support consumer spending. The steep fall in oil prices (almost 50 % since mid-2014) should improve the financial position of households and businesses, hence stimulating activity growth in 2015 and 2016.

A slight acceleration in investment is projected from 2015 onwards. Investment will mainly be supported by the gradual recovery of aggregate demand, against a background of favourable credit conditions, reinforced by measures recently announced by the European Central Bank (ECB). Policy measures to reduce labour costs and improve firms' profit margins, i.e. the EUR 20 billion tax credit for competitiveness and employment (CICE) and the EUR 10 billion additional cuts in employers' social contributions planned under the responsibility and solidarity pact (RSP), are expected to further boost investment only from 2016 onwards. However, equipment investment will not return to its pre-crisis level in the medium term, so the extent of the recovery will be limited.

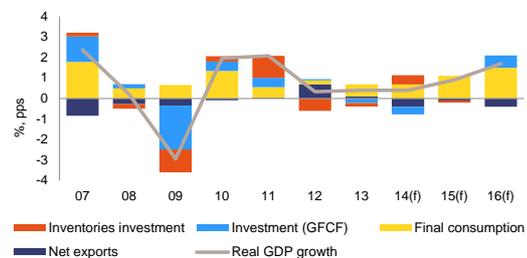
Despite a rebound in external demand, net exports are set to dampen growth in the medium term. The expected increase in foreign demand is projected to boost exports slightly from 2015, while the continued depreciation of the euro, together with the tax credit for competitiveness and employment and the responsibility and solidarity pact, is expected to gradually reduce the pace of losses in export market shares, but not reverse them. As a result, net exports will continue to weigh on GDP growth, as the rise in domestic demand leads to more imports.

Unemployment is expected to remain high in the next two years. The slow recovery and the measures to reduce labour costs referred to above are likely to have only a limited positive impact in the short term. The employment gains will not be

large enough to absorb the growth of the labour force, and unemployment is therefore expected to remain high.

Recent price developments in France reflect external factors but also weak aggregate demand. Inflation has gradually fallen since the last quarter of 2012 to 0.1 % in December 2014, driven by lower domestic demand and energy prices, though core inflation has not fallen and remains above 0.6 %. Inflation is thus projected to fall to zero in 2015, before rebounding moderately to 1.0 % in 2016, as the output gap starts to narrow down and inflationary pressures generated by the euro depreciation and the ECB's accommodative monetary policy are felt. These price developments are not likely to represent an immediate deflationary risk, especially against a background of dynamic wages. However, they make it more difficult to achieve the deleveraging necessary to ensure the sustainability of public and private finances.

Graph 1.1: Contribution to GDP growth (2007-2016)



Source: European Commission

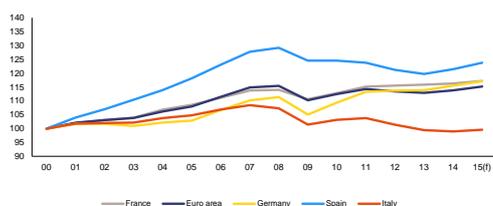
In the long term, growth prospects remain subdued, as the supply side of the economy has weakened

Growth is expected to remain subdued in the longer term, as France exhibits relatively low potential growth. Potential growth is expected to amount to 1.1 % in 2016 while the working age population would grow by 0.4 %. By comparison, the potential growth rate for Germany is projected at 1.5 % while its working age population is set to decrease by 0.1 %. The figure for France is markedly lower than the 1.9 % average annual growth between 2000 and 2007 and points to a lasting impact of the financial crisis. Much of this

slowdown comes from a fall in total factor productivity growth, from about 1.3 % in 2000 to 0.3 % in 2016. In addition, rising structural unemployment (see Section 3.2) has weighed on labour's contribution, partly offsetting the increase in the working age population and in the employment rate, caused by a rise in the number of older workers. Meanwhile, the contraction of investment in 2013 and 2014 has slightly affected the contribution of capital accumulation to potential growth.

Resilient demand helped the French economy weather the global economic crisis in 2008 and 2009. The absence of a credit boom and the relatively limited weight of exports in nominal GDP (27 % in 2007 compared with 42 % in the euro area) helped to limit the impact of the credit crunch and of the sharp slowdown in international trade on the French economy. Consumption (public and private), which increased steadily from 2007 to 2010 at an average rate of 0.8 %, acted as an automatic stabiliser. As a result, the fall in French GDP was more modest and it rebounded above its 2008 level as early as 2011 (see Graph 1.2).

Graph 1.2: GDP in volume (2000=100)



Source: European Commission

However, these domestic factors may now represent a drag on growth during the recovery phase. Economic growth has come to a standstill since the second quarter of 2011. As a result, unemployment has soared with the number of unemployed reaching three million in early 2013, business and household confidence declined while public and private indebtedness increased rapidly to 92 % and 137 % of GDP respectively by 2013, on the back of large general government deficits and the weak financial situation of corporations.

The persistent weakness of equipment investment points to the fragility of the

recovery. Equipment investment remains 12 % below its pre-crisis level and lower than in other countries. Several studies highlight the structural weakness of equipment investment, which declined as a percentage of total gross fixed capital formation from 28.5 % in 2000 to 21.5 % in 2013. In particular investment in modernisation, rationalisation, and innovation have fallen, although they are conducive to higher productivity. Weak profit margins of firms, particularly in manufacturing, continue to weigh on investment.

Drivers of growth should be diversified, in particular by supporting investment. In a globally competitive environment, consumption alone cannot support long-term growth, if not followed by a stronger supply side of the economy. Manufacturing industry, the main tradable sector contributing to exports, has seen its share of total value added contracting from 16 % in 2000 to 11 % in 2013, compared with a steady 17 %-18 % in Germany. This shows the fragility of French manufacturing firms and their decreasing ability to capture aggregate demand for goods. Productive investment, in France is too low to support productivity, potential growth and competitiveness.

The persistent fall in external competitiveness originates in cost and non-cost factors

The losses in market share over the last decade have coincided with a deterioration in cost competitiveness. Notwithstanding a temporary improvement in 2012 and 2013, export shares have declined steadily over the last few years (-13.0 % in the last 5 years), partly driven by cost factors (see Section 3.1). Indeed, France is among the euro area countries where the hourly cost of labour is highest mainly due to the high labour tax wedge (i.e. the level of the employees' and employers' social contributions taken together). Moreover, nominal wage growth has remained sustained since 2008 in spite of high and increasing unemployment and decreasing inflation. Recent policy measures implemented to reduce the cost of labour will have a more positive impact on employment than on competitiveness, as the benefit to non-exporting firms, which tend to pay lower wages, will be greater than the benefit to exporters. Together with the euro depreciation, they will have a significant positive impact, but it will not be sufficient to reverse the losses in export

market shares. The difference between unit labour cost ⁽¹⁾ developments, which also take into account productivity, in France and in Germany since 2000 shows a deterioration in France's cost competitiveness vis-à-vis Germany, equivalent to 18 % of the French unit labour costs. In addition, the strong deceleration of unit labour cost in certain euro area peers such as Spain since 2008 results in increasing divergence between the trends seen in France and in the euro area.

Non-cost factors are important in explaining the deterioration of the French export performance since 2000. Non-cost competitiveness encompasses a variety of micro-economic factors such as product quality, innovation, design, after-sale service and distribution networks. In France, companies' ability to perform well on these aspects is hampered by their low profit margins, which continued to decline in 2013 to 29.7 % of their value added, the lowest level in the euro area. Weak corporates' profit margins can partly be explained by low productivity growth in the non-tradable sector and an overall lack of pricing power in the tradable sector. This poor profitability of firms, in particular in the manufacturing sector, has not only weighed on corporate indebtedness, but more importantly has hampered companies' ability to invest and move upmarket. The manufacturing sector as a whole cannot fully compete on quality, with the exception of certain high-technology manufacturers. Furthermore, some purely non-cost factors such as the relatively unfriendly business environment together with the lack of innovation investment in the private sector and the complex tax system may be additional obstacles (see Sections 3.1 and 3.3).

The weak trade performance has resulted in increasing external deficits

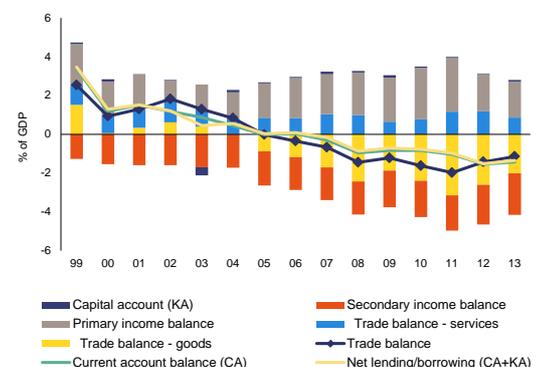
Despite some improvement in 2012 and 2013, the current account balance has been on a downward trend since 1997, following the deterioration of the trade balance for goods, only temporarily alleviated by foreign investment revenues. The trade balance account deteriorated in most of the past 12 years falling

⁽¹⁾ Unit labour costs measure the average cost of labour per unit of output and are calculated as the ratio of total labour costs to real output.

from a surplus of 2.5 % of GDP in 1999 to a deficit of 2.0 % in 2011. Most of this development is due to the rapid deterioration in the balance for goods. However, if increasing oil prices contributed to half of the rise in the trade deficit between 2004 and 2012, France also lost ground in non-energy goods and services. In 2012 and 2013, the trade balance deficit decreased from 1.4 % of GDP in 2012 to 1.2 % in line with a deceleration in imports following sluggish domestic demand, but the improvement of the euro area trade balance was larger (1.5 pps. in Italy and 1.8 pps. in Spain). The external deficits are expected to improve further until 2015 on the back of favourable terms of trade, before deteriorating again in 2016.

The downward trend in the current account reflects the developments in the trade balance, partly mitigated by incomes of foreign investments. The increase in the surplus of the primary income balance slightly reversed the decreasing trend from 2006 to 2011. Indeed, high incomes from French investment abroad brought the primary income balance to a record 2.8 % of GDP in 2011. In 2012, the lower profitability of direct investment abroad and the slump in net revenue from debt securities, which turned negative, contributed to a close to 10 % fall in net revenue from investment. Consequently, the primary income balance fell back to its 2000 level. Meanwhile, the persistent decrease in the balance of secondary income (from -1.3 % in 1999 to -2.1 % in 2013), which records the amounts transferred abroad by resident workers and contributions to the EU, steadily lowered the current account.

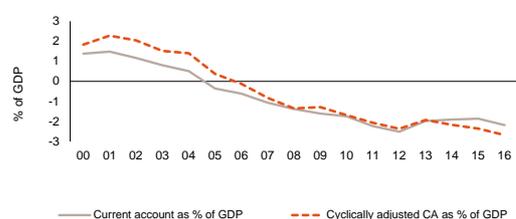
Graph 1.3: Composition of the external position



Source: European Commission

A breakdown of current account developments by sector shows that while households and financial companies are net lenders to the economy, the government and non-financial companies have continuously recorded deficits since 2000. Since the beginning of the 2000s, households have actually slightly increased their lending to the economy thanks in particular to the increase in precautionary savings. Most of the deterioration in the net borrowing position of the economy during that period came from the increasing borrowing needs of the government and of non-financial companies. The government budget has been in deficit every year since 1974. In 2009, as a result of the financial crisis, the government deficit peaked at 7.5 % of GDP in 2009 compared with 3.3 % the previous year. It has gradually fallen since then but remains high (4.1 % of GDP in 2013). The difficulties met by non-financial companies have also resulted in increasing borrowing needs and in a slowdown in investment.

Graph 1.4: Non-cyclical current accounts



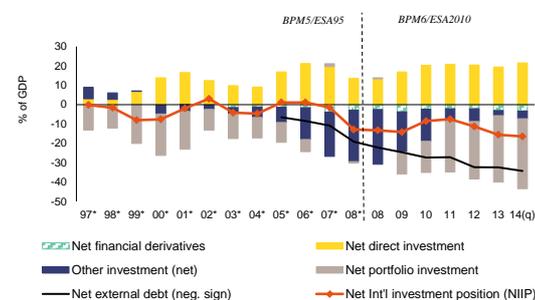
Source: European Commission

Cyclical conditions seem to have played a minor role in the deterioration of the current account (see Graph 1.4). France stands out as the only deficit country in the euro area where the structural deficit in the current account ⁽²⁾ has increased since 2008 (by 0.6 pp. of GDP, to 1.9 % at the end of 2013). By comparison, in Spain and Italy, while cyclical conditions have also supported the current account correction, the structural adjustment since 2008 has been large (8.5 pps. and 3.3 pps. of GDP respectively).

⁽²⁾ The structural current account balance is the current account balance which would prevail if a country's and its trade partners' output gaps are at zero, and therefore both domestic and external demand are at their potential.

The evolution of the current account is mirrored by a sharp decrease in the net international investment position over the past seven years (see Graph 1.5). The net international investment position, which measures the difference between external financial assets and liabilities, was still in surplus in 2006. It recorded a slump in 2008 due in particular to changes in valuation and, since then, it has deteriorated further due to the persistent current account deficit. In 2013, the net investment position posted a deficit of 15.6 % of GDP, while the net external debt represented 35.1 % of GDP. In terms of composition, the net stock of foreign direct investments continues to remain positive as, in the past, net flows of French investment abroad have been consistently higher than net flows of investment in France. Accordingly, most of the negative net international investment position is financed by portfolio investments.

Graph 1.5: Composition of the net international investment position



Note: In the absence of available data, figures for before 2008 are expressed in BPM5/ESA95, resulting in a slight breaking point in levels, but general trends remain consistent.

Source: European Commission

While the net foreign direct investment stock has been relatively stable, inward foreign direct investments, an indication of the attractiveness of France for foreign investors, is decreasing. In 2013, France was absent from the world Top 20 direct investors and investment receivers. Its ranking, mainly due to intra-firm foreign direct investment, has dramatically deteriorated compared to 2008, a year when France was the seventh largest receiver and the fourth largest investor. Between 2008 and 2013, France was outperformed in particular by some large

developing economies which attracted more investors.

Public deficits, which were already high before the crisis, remain excessive and affect the government debt adversely

Based on the 2015 winter forecast, the deficit is expected to remain well above 3 % of GDP between 2014 and 2016. More specifically, the general government deficit is expected to reach 4.3 % of GDP in 2014 and 4.1 % in 2015 and 2016. These figures are close to the government target for 2014 and 2015 (4.4 % and 4.1 % of GDP respectively). According to the programming law on public finances adopted in December 2014, the general government deficit would only come below the 3 % of GDP benchmark by 2017.

As a consequence, the general government debt has increased almost continuously since 1990, a trend which has accelerated since the crisis, with an expected debt-to-GDP ratio of 95.3 % in 2014 (see Section 2.2). This was slightly above the euro area average of 94.3 %. Despite this trend France has weathered the euro area sovereign debt crisis without experiencing major tensions on sovereign yields, and the latter have actually fallen below historical levels. This has helped contain interest expenditure and also prevented negative spillover effects to the financial sector and the real economy so far. According to the winter forecast, the debt ratio is set to continue increasing to 98.2 % of GDP in 2016.

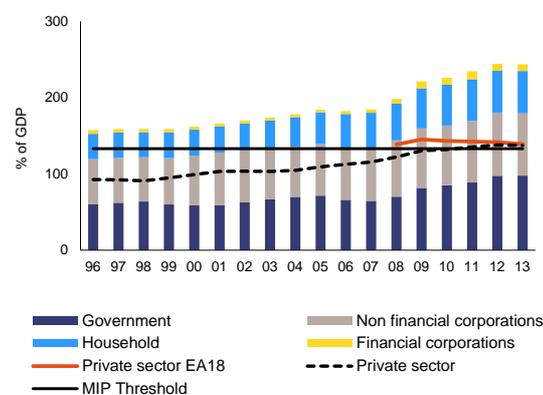
In relative terms, private debt does not appear excessively high

The level of consolidated private debt has continuously increased over the past decade to reach 140.7 % of GDP in 2012 (see Graph 1.6). While historically high, this ratio remains slightly below the euro area average. This is partly explained by the lower level of household debt in France compared with the rest of the euro area. However, household debt, which rose during the years leading up to the crisis, has not fallen since then as adjustments in the real estate sector are still ongoing. While household debt does not appear particularly worrying, the increasing debt service and potential deleveraging pressures could potentially affect private consumption. Finally, the continuous rise in unemployment and sluggish

GDP growth will weigh on household credit-worthiness over the medium term.

While the level of debt to GDP of French non-financial companies has kept rising over the past few years, their leverage is not particularly high compared to euro area peers. In 2012, the debt-to-GDP ratio of French non-financial companies increased to a level above the euro area average. In contrast, the debt-to-equity ratio (53 %) fell below the euro area average (67 %) in 2013. However, the moderate potential for further private consumption growth combined with the poor profitability of French companies is a potential source of concern. The reduction in non-financial companies' gross operating margins has indeed affected companies' ability to invest and innovate but may also make it more difficult for firms to service their debt as reflected in the increase in the number of bankruptcies in 2013.

Graph 1.6: Debt decomposition, all sectors, consolidated



Source: European Commission

Imbalances in France may generate spillovers to other Member States

The large size and the close economic and financial linkages of the French economy with the rest of the EU, in particular with the neighbouring euro area countries and with the United Kingdom, make it a potentially important source of spillovers to other Member States through the trade, banking and financial channels (see Section 2.3). Conversely, a recovery in consumer confidence and a reduction in policy uncertainty in France would have a positive impact

People at risk of poverty or social exclusion (% of total population)	18.5	18.5	19.2	19.3	19.1	18.1	.	.	.
At-risk-of-poverty rate (% of total population)	12.5	12.9	13.3	14.0	14.1	13.7	.	.	.
Severe material deprivation rate (% of total population)	5.4	5.6	5.8	5.2	5.3	5.1	.	.	.
Number of people living in households with very low work-intensity (% of total population aged below 60)	8.8	8.4	9.9	9.4	8.4	7.9	.	.	.
GDP deflator (y-o-y)	2.4	0.1	1.1	0.9	1.2	0.8	0.8	0.8	1.0
Harmonised index of consumer prices (HICP) (y-o-y)	3.2	0.1	1.7	2.3	2.2	1.0	0.6	0.0	1.0
Nominal compensation per employee (y-o-y)	2.6	1.8	3.1	2.5	2.3	1.6	1.4	0.4	0.7
Labour productivity (real, person employed, y-o-y)	-0.3	-1.8	1.9	1.4	0.2	0.5	.	.	.
Unit labour costs (ULC) (whole economy, y-o-y)	2.9	3.5	0.9	0.9	1.8	1.1	1.3	-0.3	-0.4
Real unit labour costs (y-o-y)	0.5	3.4	-0.2	-0.1	0.6	0.3	0.5	-1.2	-1.3
REER ⁽³⁾ (ULC, y-o-y)	1.3	0.6	-1.7	0.4	-2.5	2.9	0.9	-3.8	-1.3
REER ⁽³⁾ (HICP, y-o-y)	0.0	0.0	-4.4	-0.7	-2.7	1.4	1.2	-2.6	-0.9
General government balance (% of GDP)	-3.2	-7.2	-6.8	-5.1	-4.9	-4.1	-4.3	-4.1	-4.1
Structural budget balance (% of GDP)	.	.	-5.8	-5.0	-4.3	-3.3	-2.9	-2.6	-3.0
General government gross debt (% of GDP)	67.8	78.8	81.5	85.0	89.2	92.2	95.3	97.1	98.2

BOX 1.1 Economic surveillance process

(1) Domestic banking groups and stand-alone banks.
(2) Domestic banking groups and stand-alone banks, foreign-controlled (EU and non-EU) subsidiaries and branches.
(3) Real effective exchange rate
(*) Indicates BPM5 and/or ESA95

Source: Commission Annual Growth Survey, adopted in November 2014, started the 2015 European Semester, proposing that the EU pursue an integrated approach to economic policy built around three main pillars: boosting investment, accelerating structural reforms and pursuing responsible growth-friendly fiscal consolidation. The Annual Growth Survey also presented the process of streamlining the European Semester to increase the effectiveness of economic policy coordination at the EU level through greater accountability and by encouraging greater ownership by all actors.

In line with streamlining efforts this Country Report includes an In-Depth Review — as per Article 5 of Regulation no. 1176/2011 — to determine whether macroeconomic imbalances still exist, as announced in the Commission's Alert Mechanism Report published on November 2014.

Based on the 2014 In-Depth Review for France published in March 2014, the Commission concluded that France was experiencing macroeconomic imbalances requiring decisive policy action. In particular the deterioration in the trade balance and in competitiveness as well as the implications of the high level of public sector indebtedness deserve continued policy attention.

This Country Report includes an assessment of progress towards the implementation of the 2014 Country-Specific Recommendations adopted by the Council in July 2014. The Country-Specific Recommendations for France concerned ensuring the sustainability of public finances, reducing the cost of labour, improving the business environment and promoting innovation, enhancing competition in services, simplifying the tax system, reducing the labour market rigidities and improving the education and vocational training systems.

on the euro area confidence cycle. Structural reforms in France would also support activity in the euro area in general.

Table 1.2: The MIP scoreboard

			Thresholds	2008	2009	2010	2011	2012	2013
External imbalances and competitiveness	Current Account Balance (% of GDP)	3 year average	-4%/6%	-0.4	-0.7	-0.9	-0.9	-1.1	-1.3
		p.m.: level year	-	-1.0	-0.8	-0.8	-1.0	-1.5	-1.4
	Net international investment position (% of GDP)		-35%	-13.3	-14.1	-8.5	-7.5	-11.3	-15.6
	Real effective exchange rate (REER) (42 industrial countries - HICP deflator)	% change (3 years)	±5% & ±11%	1.5	2.6	-2.2	-4.4	-7.8	-2.3
		p.m.: % y-o-y change	-	1.6	0.4	-4.1	-0.7	-3.2	1.6
	Export Market shares	% change (5 years)	-6%	-20.1	-15.0	-18.2	-15.8	-17.4	-13.0
		p.m.: % y-o-y change	-	-2.8	1.1	-10.4	-2.1	-4.2	2.4
	Nominal unit labour costs (ULC)	% change (3 years)	9% & 12%	6.5	8.2	7.5	5.4	3.7	3.9
		p.m.: % y-o-y change	-	2.9	3.5	0.9	0.9	1.8	1.1
	Deflated House Prices (% y-o-y change)			6%	-1.8	-4.9	3.6	3.9	-1.9
Private Sector Credit Flow as % of GDP, consolidated			14%	9.8e	3.3e	4.6e	6.4e	4.4e	1.8e
Private Sector Debt as % of GDP, consolidated			133%	122.2e	130.5e	131.8e	135.3e	138.2e	137.3e
Internal imbalances	General Government Sector Debt as % of GDP		60%	67.8	78.8	81.5	85.0	89.2	92.2
Unemployment Rate	3-year average		10%	8.1	8.2	8.6	9.2	9.4	9.8
	p.m.: level year		-	7.4	9.1	9.3	9.2	9.8	10.3
Total Financial Sector Liabilities (% y-o-y change)			16.5%	1.9	0.1	3.3	6.7	1.2	-0.6

Flags: e: estimated.

Note: Figures highlighted are the ones falling outside the threshold established by EC Alert Mechanism Report. For REER and ULC, the first threshold concerns Euro Area Member States. (1) Figures in italic are according to the old standards (ESA95/BPM5). (2) Export market shares data: the total world export is based on the 5th edition of the Balance of Payments Manual (BPM5). (3) Unemployment rate i=Eurostat back calculation to include Population Census 2011 results. The unemployment rate has been revised downwards. The revision is mainly due to methodological changes to the LFS.

Source: European Commission.

2. IMBALANCES, RISKS, AND ADJUSTMENT

2.1. COMPETITIVENESS DEVELOPMENTS

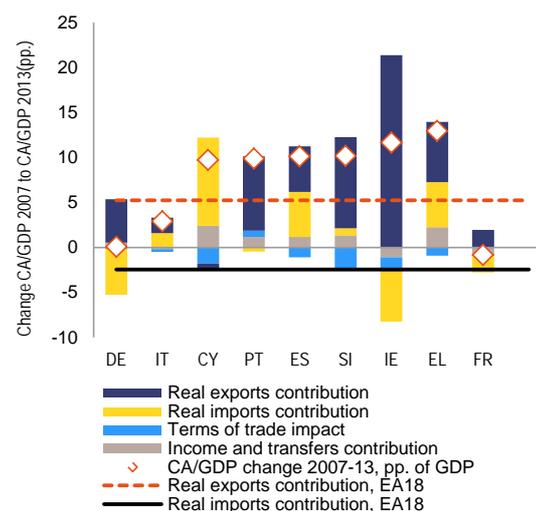
There is no sustainable improvement in export performance in France

The performance of French exports has been relatively weak over the past seven years. French exports have been growing since 2007 by an average annual rate of 2.1% per year, contributing to the change in the current account balance-to-GDP ratio by 1.9 pp, against an average contribution of 5.2 pp in the euro area, 4.8 pp in Germany and 4.1 pp in Spain (see Graph 2.1.1).

France's export market share for goods and services declined by 13% over the period 2008-2013 according to the Alert Mechanism Report 2015. The decline in France's export market share can be attributed mainly to goods, with goods exports representing about 60 % of total exports in France. While world goods exports grew by 15 % over 2008-2013, France goods exports declined by 5% over the same period. This can be decomposed into two effects which can be looked at from a product and a country destination perspective (see Table 2.1.1). From a product perspective, product markets in which France is exporting have grown 1 pp slower than the world export markets (this is called the market dynamism effect). Moreover, within these product markets, French exports have been growing 18 pp slower than the total growth of these markets. This indicates that French products were less competitive than those of their competitors on these product markets. Similarly, from a country destination perspective, country destinations to which France exported grew 8 pp slower than global export markets. So, first, France exported to country destinations that are less dynamic than worldwide trade (e.g. the euro area) and, second, in these country destinations, French exports grew 11 pp slower than the total growth in

these markets.

Graph 2.1.1: Component contributions to change in CA balance 2007-2013



Source: European Commission

Differentiating the export market share losses for the high tech (HT), medium tech (MT) and low tech (LT) sectors helps explain some of these developments. Graph 2.1.2 and Graph 2.1.3 provide a picture for the period 2001-2008 and 2008-2013 in France, Italy, Germany and Spain.

Table 2.1.1: Decomposition of goods export market share, France

Time	Share of France exports in world exports	Growth of France exports	Growth of World exports	Difference in growth rates (in pp)	Market dynamism by Country (in pp)	Competitiveness Gain/Loss by Country (in pp)	Market dynamism by Sector (in pp)	Competitiveness Gain/Loss by Sector (in pp)
	(A)	(B)	(C)	(D) = (B) - (C) (D) = (D1) + (D2) (D) = (D3) + (D4)	(D1)	(D2)	(D3)	(D4)
2001	5.2%							
2001-2006		65%	93%	-28.00	4.04	-31.80	-4.17	-23.59
2006	4.4%							
2006-2008		24%	32%	-8.05	3.33	-11.38	-2.95	-5.10
2008	4.2%							
2008-2013		-5%	15%	-19.41	-8.13	-11.28	-1.31	-18.10
2013	3.5%							

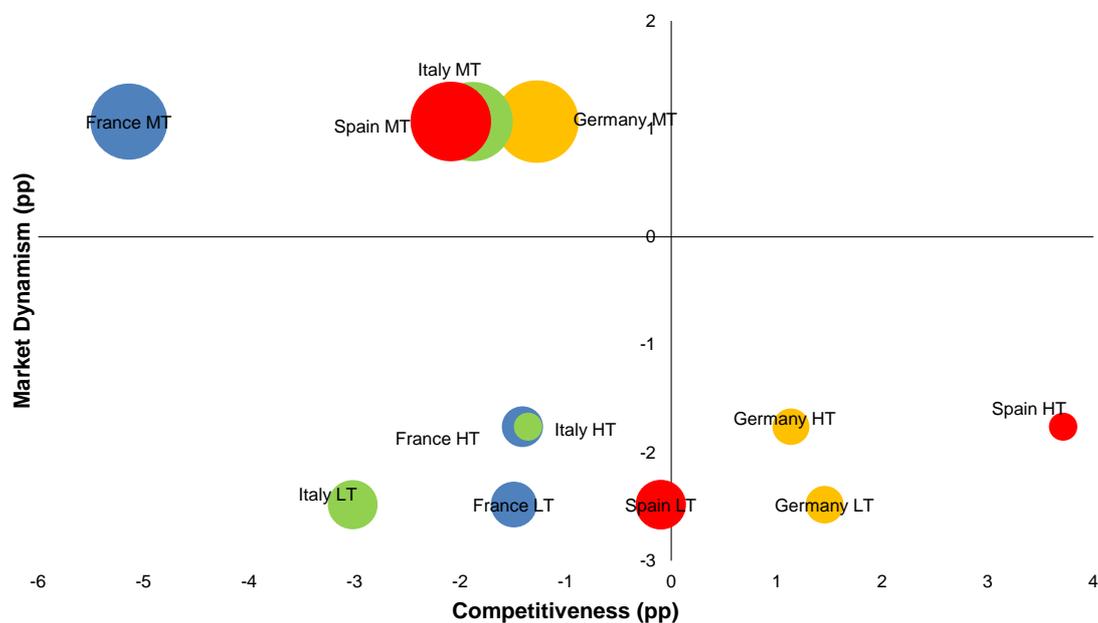
Source: European Commission Calculations based on the UN COMTRADE data (HS 1992 Commodity Classification), Nominal USD.

Note: The components of the decomposition should be interpreted as weighted market share gains (columns D2 and D4) or weighted dynamism of the specific market (columns D1 and D3).

France had an overall poor export competitiveness performance between 2001-2008, particularly in medium tech products where lower competitiveness offset by large the market dynamism (Graph 2.1.2). In medium tech and high tech products, France's export competitiveness was the worst of the four Member States. Comparing the performance across sectors, the high tech sector lost the least in terms of export competitiveness and the medium tech sector the most. The performance of the high tech sector in terms of competitiveness was nevertheless significantly better in Germany and Spain and slightly better in Italy. Moreover, in terms of market dynamism, the sectors performed in the same way across the four countries. Over 2001-2008, the fastest and slowest-growing categories in terms of market dynamism were respectively medium tech and low tech goods. As medium tech goods are the most important export products for the four countries, this was a favourable factor. Combining the competitiveness and the market

dynamism effects, though, all three French sectors had an annual market share loss between -3.6% (high-tech) and -4% (medium-tech).

Graph 2.1.2: Average yearly export market share loss/gains per sector (2001-2008)

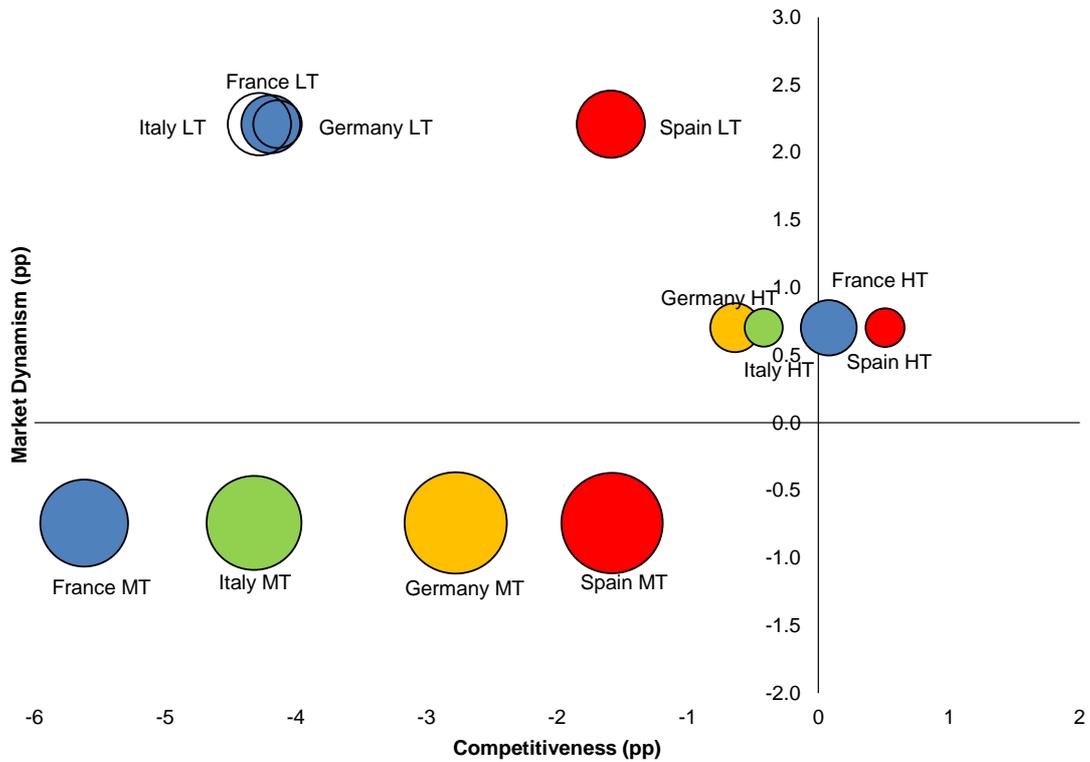


(1) On the x-axis the annual average gains or losses due to export competitiveness and on the y-axis the annual average gains or losses in market dynamism are presented, while the size of the bubbles reflects the share in total goods exports. High tech (HT), medium-tech (MT) and low-tech (LT).

(2) High tech exports include for instance most exports of "Pharmaceutical products" and of "Optical, photo, technical, medical, etc. apparatus" and of "Aircraft, spacecraft, and parts thereof". As well as a more minor share of "Electrical, electronic equipment". Medium tech exports include for instance most exports of "Nuclear reactors, boilers, machinery, etc.", all "Vehicles other than railway, tramway", most "Electrical, electronic equipment", all "Mineral fuels, oils, distillation products, etc.", almost all "Plastics and articles thereof". Low Tech exports include for instance almost all "Beverages, spirits and vinegar" and a minor share of "Optical, photo, technical, medical, etc. apparatus".

Source: European Commission.

Graph 2.1.3: Average yearly export market share loss/gains per sector (2008-2013)



(1) On the x-axis the annual average gains or losses due to export competitiveness and on the y-axis the annual average gains or losses in market dynamism are presented, while the size of the bubbles reflects the share in total goods exports. High tech (HT), medium-tech (MT) and low-tech (LT).

Source: European Commission

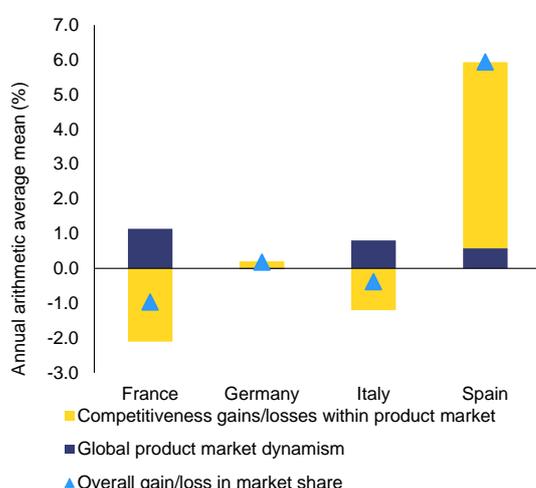
France's export competitiveness did not improve over the period 2008-2013, except for a small increase in the high tech sector due in particular to the aircraft industry (Graph 2.1.3). France suffered the biggest export competitiveness-related product market losses in medium-tech and large losses in low-tech, together with Italy and Germany. Comparing the performance across sectors, the high tech sector regained slightly in terms of export competitiveness. Excluding the aircraft industry, the export competitiveness of high tech would have decreased by more than 3 pp and performed worse than the three other countries. Furthermore, between 2008 and 2013, market dynamism was less favourable as the biggest sector (medium tech) became less important in world trade. Over this period, the most dynamic product markets were in low-tech, followed by high-tech products. Combining the competitiveness and the market dynamism effects, the medium tech sector had an

annual market share loss of 6.4%, whereas the low tech sector had an annual market share loss of 2% and the high tech sector had an annual market share gain of 0.8%. In relative terms, the high tech and, to some extent, the low tech sector have gained in overall importance for the exports of goods since 2008. While it is positive that the high tech sector is not losing export market competitiveness anymore, this sector only represents about 21% of goods exports. For the overall export market developments and competitiveness, the poor performance of the medium-tech sector which represents 6% of the value added of the economy and still 51% of the manufacturing exports, is a matter of concern.

The recent deceleration in export market share losses in the period 2012-2013 is not related to

an increase in export competitiveness ⁽³⁾. In 2012-2013, the average loss in export market share has been 1% in France, suggesting a deceleration in the export market share losses compared to the period 2008-2012. However, the stabilization is less pronounced than in other euro area countries (Graph 2.1.4). Moreover, France has been helped more than the other countries by the dynamic global growth of its product markets but has continued losing export market shares in its product markets at a relative faster pace than Italy, whereas Germany and Spain are gaining export-competitiveness in the product markets they serve. In addition, early data for 2014 suggest that France continued losing world export market shares in goods. For 2015, the low oil prices may improve the trade balance, and the euro depreciation may support French export growth. Nevertheless, according to the Commission 2015 Winter Economic Forecast, these factors will not be sufficient to ensure a turnaround in the export market shares losses.

Graph 2.1.4: Market share losses in goods 2012-2013



Source: European Commission based on COMTRADE

All in all, France has persistently lost export competitiveness across all technology sectors since 2001, with losses being most important in

⁽³⁾ This analysis focuses on goods exports, using COMTRADE data, which is necessary for most decompositions. However, according to Eurostat data, which are used for the scoreboard under the macroeconomic imbalances procedure, France experienced a slight improvement in goods export share in 2013.

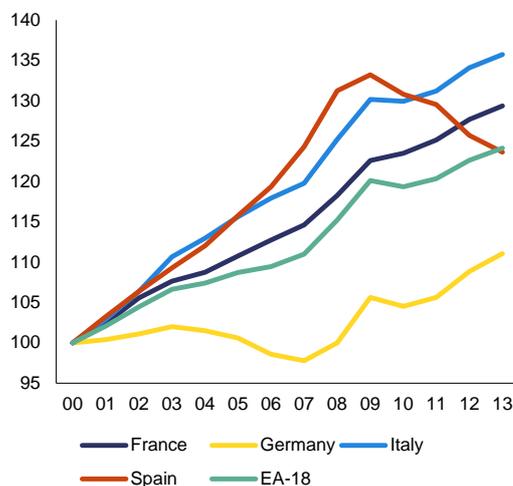
the medium-tech sector. Moreover, over the period 2001-2008 France's losses have been larger than those of Spain, Italy and Germany. For the period 2008-2013, losses have been more important than in Germany or Spain but similar to those suffered in Italy, at least for the medium-tech and low-tech sector. Based on the analysis presented above it is difficult to discern any sustainable improvement in export competitiveness.

Labour costs are high and unit labour costs have been increasing lately

France is among the euro area countries where the hourly cost of labour is the highest mainly due to non-wage costs. In the industrial sector, in 2013 the hourly cost of labour was the 3rd highest of the euro area (EUR 34.3 per hour), after Luxembourg (EUR 35.7) and Belgium (EUR 38.0). Decomposing the cost of labour in wage and non-wage costs, in 2013 wages and salaries in France (EUR 23.2) were on average in line with those faced by firms in other euro area countries with comparable income levels. Yet, both the overall labour tax wedge and the part of the cost borne by firms (i.e. the employers' social security contributions) are in France among the highest in the euro area, with only Belgium and Italy posting larger social security burdens for employers.

The reforms implemented to reduce the cost of labour will have a positive impact on employment, but part of their impact on competitiveness could be reduced by an increase in wages. France is among the euro area countries where the tax burden on labour is the highest. The tax credit for competitiveness and employment adopted in December 2012 and the cut in the cost of labour announced as part of the responsibility and solidarity pact in January 2014 are meant to close by half the gap in terms of labour tax wedge between France and the euro area average. Simulations using the QUEST III model indeed suggest that the reduction in the tax burden on labour gradually increases firms' labour demand, especially targeted towards low skilled employees. This increase in labour demand leads to a gradual increase in wages, which in turn attenuates the positive effects of the labour cost reduction on exports, investment and profits, especially in the long term (see box 2.1.1).

Graph 2.1.5: Nominal unit labour costs (total economy)



Source: European Commission

Unit labour costs have decoupled from the trend in the euro area since 2008 ⁽⁴⁾. Between 2001 and 2008, nominal unit labour costs grew by 2.0% per annum on average in France. The unit labour costs in Italy and Spain increased more rapidly due to faster wage growth and slower productivity growth in these countries, whereas wage moderation and somewhat faster productivity growth resulted in negative unit labour costs' growth in Germany. Since 2008, a divergence between unit labour costs' growth in France and the rest of euro area has emerged as wages grew faster in France. In the same period, Spain saw a relatively strong correction of its unit labour costs due to a stronger wage moderation and increase in productivity growth. The difference between unit labour costs' developments in France and in Germany since 2000 has resulted in a deterioration of the relative cost competitiveness of France vis-à-vis Germany with a gap which is now equivalent to 18% of the French unit labour costs. Also the gap between Spain and French unit labour costs is now equal to 5.7% of the French unit labour costs.

⁽⁴⁾ This picture is broadly confirmed when looking at the unit labour costs developments for the tradable sector. France nominal unit labour costs grew faster than in Germany but not as fast as in Italy or Spain. A detailed discussion of recent developments in unit labour costs is given in Ciornohuz C., Darmet-Cucchiari, M. (2015) Comment l'évolution des coûts salariaux unitaires en France se situe-t-elle par rapport aux partenaires de la zone euro? Septembre 2014, Trésor-éco, No. 134.

By contrast, the French unit labour costs are 4.9% lower than the Italian unit labour costs.

The developments in unit labour costs in France can be explained by wage rigidities ...

Since 2008, the lower price inflation and higher unemployment have only partially been taken into account in setting nominal wages. Over the period 2000-2013, real wage growth has remained on average relatively dynamic in spite of high and increasing unemployment levels. Even controlling for the fact that the crisis has mainly impacted the low- skilled and other workers with lower wages, real wages have reacted less to unemployment than historically observed⁽⁵⁾. Nominal wages seem to be particularly rigid in France due to rigidities in the wage setting process. Given the current low inflation environment and the slowdown in productivity, nominal wage rigidity holds a risk for a further deterioration of the unit labour costs' dynamics in the future. In what follows we will analyse the underlying factors.

The indexation of the minimum wage to real wage growth, on top of inflation, may be distortionary. The minimum wage is guided by an automatic indexation mechanism: the revaluation is based on the consumer price index plus half of the increase in the purchasing power of hourly average wages for workers and employees at the lower end of the wage distribution. This indexation system, while sound in normal times, may lead to an upward adjustment of minimum wage levels well beyond the preservation of purchasing power, as real wages are growing fast on the back of lower-than-expected inflation, while nominal wages proved relatively rigid. This could in the medium-term affect the employment opportunities of the low-skilled workers and make the whole wage distribution more compressed at the bottom, unless the next wage bargaining rounds at sector- and firm-level take into account the current macroeconomic environment, in particular lower-than-expected inflation.

⁽⁵⁾ Verdugo (2013) shows that controlling for compositional effects real wages declined by 0.8% over the period 2009-2011. However, a stronger correction of -1.5% could be anticipated based on historical data. Verdugo G. (2013), "Les salaires réels ont-ils été affectés par les évolutions du chômage en France avant et pendant la crise ?", Bulletin de la Banque de France n° 192, 2ème trimestre 2013.

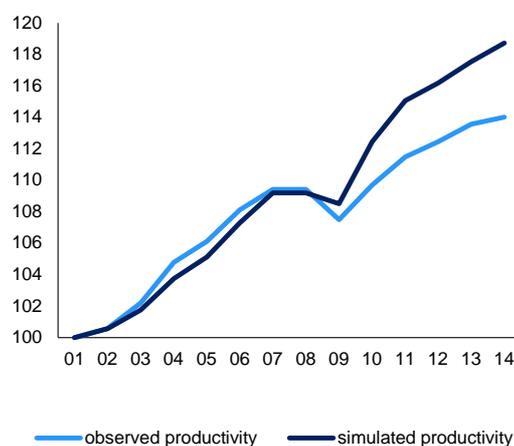
The wage bargaining process in France is characterised by the interaction of industry-wide agreements and company-level negotiations, with a relatively stronger role played by the industry-wide agreements and few possibilities to derogate by firm-level agreements. As already underlined in the 2014 In-Depth Review, such agreements apply to unionised and non-unionised workers and extension mechanisms are widespread. Recent reforms have created only limited flexibility for employers to depart from industry-wide agreements. Since 2004, a company-level agreement can deviate from the provisions of a sectorial agreement unless such derogations are explicitly forbidden in the sector-level agreement. However, the favourability principle remains in force in terms of minimum wages, job classifications, supplementary social protection and multi-company and cross-sector vocational training funds. In practice, reductions in overall wage costs were mainly obtained by departing from sectoral-level agreements in terms of working time ⁽⁶⁾.

...but lower productivity growth is also weighing on unit labour costs' developments

Productivity growth declined sharply during 2008-2009 and seems to decelerate since then.

Even adjusting for the cycle and for employment policies, the level of productivity at the end of 2014 would be 5% below what it could have been expected based on the observed relation between labour productivity, employment and value added in the market economy (Graph 2.1.6). The initial crisis-period, seems to explain most of that difference but in the most recent period there seems to be a deceleration in the observed productivity growth.

Graph 2.1.6: Decline in productivity growth in the market economy



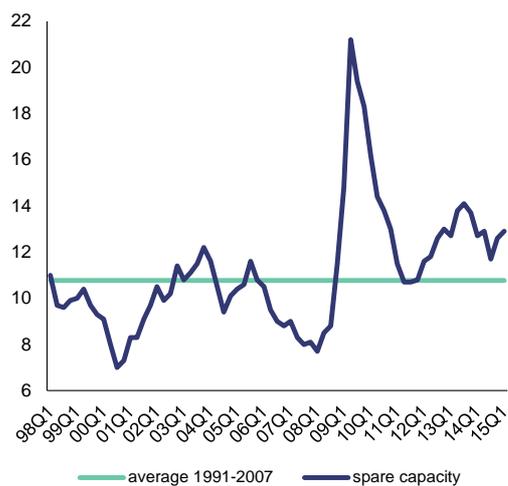
Source: Lequien and Montaut (2014), European Commission

One of the explanations for lower productivity growth could be that there is labour hoarding.

As Graph 2.1.7 shows, the hike in the spare capacity without additional hiring reported by firms in the manufacturing sector in the initial period of the crisis suggests that they clearly "under-used" labour, a phenomenon coined labour hoarding. This sharp under-use of labour explains the initial drop in labour productivity. However, the current level of spare capacity without additional hiring as remained higher than its long-term average since 2011. This could be one of the explanations why productivity growth is weaker than before the crisis.

⁽⁶⁾ Ramos-Martin N. (2011), " Sector-level bargaining and possibilities for deviations at company level: France", Eurofound.

Graph 2.1.7: Spare capacity without additional recruitment in manufacturing



Source: INSEE, European Commission

Prolonged periods of labour hoarding may be associated with the costs, faced by firms, to hire or dismiss workers. As firms observed a sharp contraction in demand a first reaction was to maintain more labour than strictly warranted. This is a rational reaction as it is costly to dismiss and costly to hire and train new workers when demand picks up again. The costs of firing and hiring depend on a number of factors such as the type of contract, the scarcity of the profile on the labour market and seniority ⁽⁷⁾. The longer the downward cycle lasts or in case the crisis results in a permanent lower potential growth, these firing and hiring costs can become less important than the cost related to keeping an employee on the payroll. Employees with the lowest firing and hiring costs, which are the low skilled, the young and those in precarious contracts, will be laid off first, whereas employees with the highest firing cost, which are the skilled employees with a permanent contract and high seniority, will remain in their job longest.

⁽⁷⁾ For a discussion of the economic consequences of firing costs and the reform of the justice prud'homale see Yazidi K. and Darmaillaq C. (2014), "Le traitement des litiges en droit du travail: constats et perspectives économiques", Trésor-Eco No. 137, October 2014.

The prevailing rigidities on the labour market, the scarcity of high skilled and the relatively difficult matching of jobs and workers has resulted in a segmented labour market and could explain why it takes time to fully adjust labour to the production needs ⁽⁸⁾.

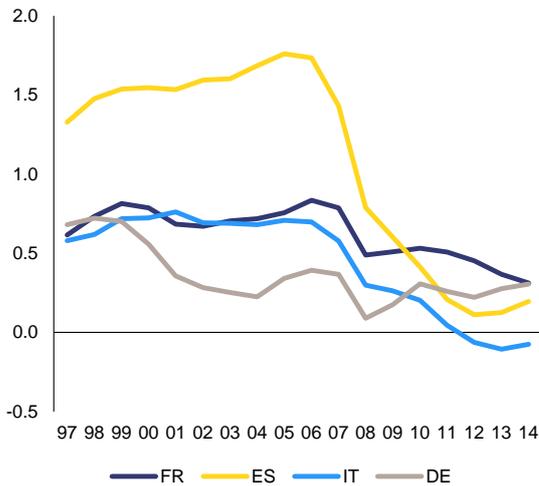
...However, factors other than unit labour costs' developments can explain France's weak export competitiveness

The high labour costs and the developments in the unit labour costs cannot fully explain the trends in export performance. The deterioration of the unit labour costs vis-à-vis Germany can be consistent with the differences in export performance of the two Member States, certainly over the period 2001-2008. Also, unit labour costs' developments between France, Italy and Spain over the period 2008-2013 could explain the export competitiveness developments, notably, the better competitiveness performance of Spain. However, the fact that unit labour costs deteriorated faster over 2001-2008 in Italy and Spain, whereas the export competitiveness performance of these two Member States was stronger than that of France, suggests that other factors, be it cost or non-cost, are weighing on France's competitiveness.

The capacity of French firms to innovate and become more efficient with the existing resource mix has declined.

⁽⁸⁾ In France both its labour shortage indicator and its unemployment rate had a tendency to increase between the first quarter 2010 and the first quarter 2014. See European Commission Employment and Social Developments in Europe 2014 (21/01/2015). The average incidence of educational mismatch among 25-64 year olds between 2001-2011 for the underqualified was the highest in the EU-27 (32% in FR versus 21% in the EU-27). See European Commission (2013) Employment and Social Developments in Europe 2012 (08/01/2013). Also Artus P., García-Peñalosa, C., Mohnenc P. (2014), "Redresser la croissance potentielle de la France", Les notes du Conseil d'analyse économique, No. 16, septembre 2014.

Graph 2.1.8: Capital accumulation contribution to potential growth



Source: Autumn Forecast

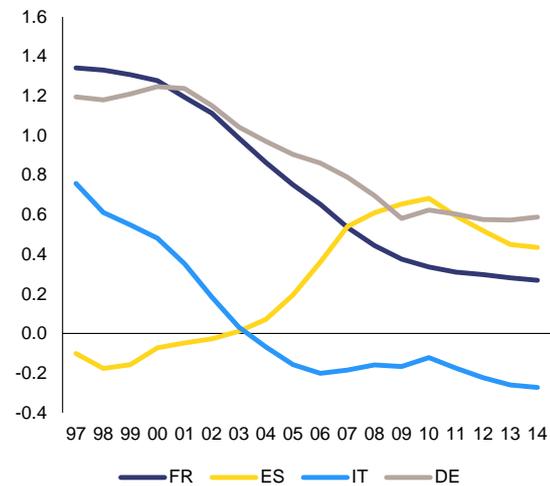
Capital accumulation is contributing less to the potential growth of the economy since the crisis, but is relatively strong from an international perspective. Graph 2.1.8 presents the contribution of capital accumulation. It shows that France's capital accumulation was relatively robust before the crisis and has come down since. In an international perspective, the current growth in capital accumulation is higher than in Germany, Spain and Italy. Below, we discuss in more detail the role of investment in France's competitiveness.

Growth of total factor productivity has declined significantly since 1997 ⁽⁹⁾. In the case of France, total factor productivity growth has declined continuously from 1.3% in 2000 to 0.3% in 2014. From an international perspective total factor productivity growth in France has decoupled from Germany and has been overtaken by Spain (Graph 2.1.9). Looking into the sectoral composition of

⁽⁹⁾ Total factor productivity measures the capacity to produce more with the same amount of labour and capital input over time. As there are limits to augmenting the capital and labour intensity of the economy, the endogenous growth theory argues that in the long run total factor productivity is the main determinant of the growth potential of an economy. Total factor productivity depends, not only on the capacity to innovate and use new technologies, to improve the quality of products and to enter new market but also on the capacity of the most productive firms to attract workers and investment from less productive firms. It is therefore closely linked to non-cost competitiveness.

total factor productivity growth using the EUKLEMS database, it appears that manufacturing, electricity production and Information and Communication Technology are the sectors with the highest total factor productivity growth between 1997 and 2009, all of which are traditionally included in the tradable sector, whereas total factor productivity growth is relatively modest in the non-tradable sector (Graph 2.1.10) ⁽¹⁰⁾.

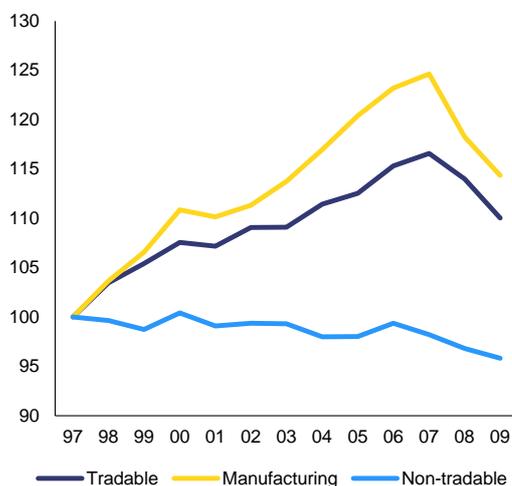
Graph 2.1.9: TFP growth in selected countries



Source: Autumn Forecast

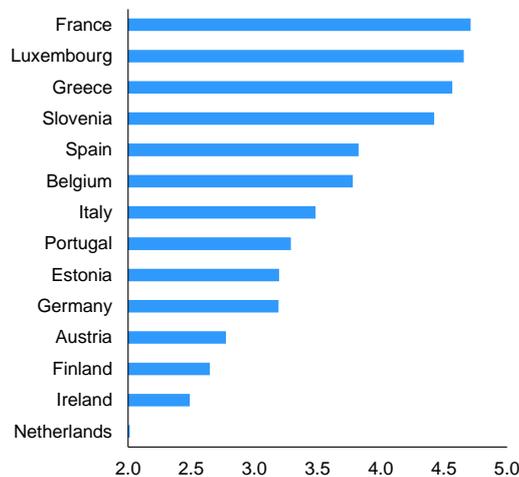
⁽¹⁰⁾ EU KLEMS (2011), Productivity in the European Union: A Comparative Industry Approach, Groningen Growth and Development Centre.

Graph 2.1.10: TFP growth in the tradable and non-tradable sector



Source: EUKLEMS, European Commission

Graph 2.1.11: Product-times labour market regulation, 2013



Source: OECD, European Commission

Labour and product market rigidities limit total factor productivity growth. At the aggregate level, the high overall level of rigidities in France weighs on productivity growth. Using the overall measure of rigidity of Aghion et al (2009) derived from the OECD indicators, Graph 2.1.11 shows that since the beginning of the crisis France has not made much progress in reducing its level of rigidity and has now the highest level of overall rigidity in the euro area⁽¹¹⁾. Aghion et al. (2009) demonstrate that for OECD countries close to the technology frontier the interaction and combined effect of product and labour market rigidities have a very significant negative effect on total factor productivity growth. As discussed in section 3, France has made some progress to reduce rigidities. However, this progress remains relatively modest and mostly focused on reducing product market rigidities, whereas a combined approach for reducing product and labour market rigidities would yield higher benefits.

⁽¹¹⁾ Aghion P., Askenazy P., Bournès R., Cette G., Dromel N. (2009), "Distance à la frontière technologique, rigidités de marché, éducation et croissance", *Économie et Statistique*, No. 419-420, August 2009.

French firms face difficulties to grow, which hampers overall productivity developments as smaller firms have lower growth of total factor productivity. While the number of created companies is relatively high, the survival rate of new firms is lower than in the United States, Germany or the United Kingdom⁽¹²⁾. The greater difficulty of French companies to survive and develop thus limit the potential productivity gains that could accrue from newly created firms. Moreover, as indicated in last year's In-Depth Review, France has relatively fewer medium-sized companies than other European countries such as Germany, due notably to the regulatory burden which constrains their growth potential. Typically, smaller firms are also less productive than larger firms. Reducing impediments to the growth of firms would thus also allow firms to become more productive⁽¹³⁾.

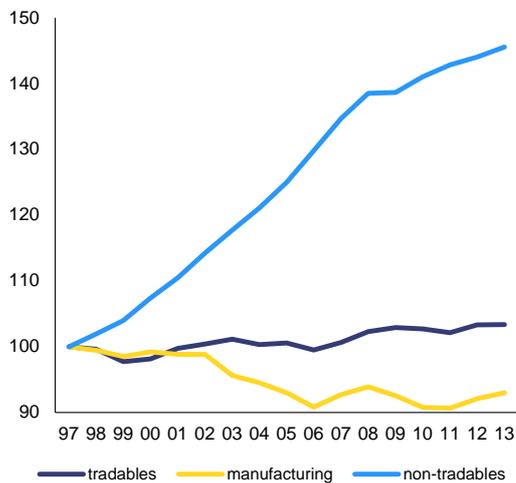
⁽¹²⁾ Dhont-Peltraut E. and Llense F. (2012), « L'entrepreneuriat en France. Volet 1 : Mythes et réalités en comparaison internationale », La Note d'analyse, n° 296, Centre d'analyse stratégique, October 2012.

⁽¹³⁾ Hallaert et al (2013) demonstrate that total factor productivity growth is strongly correlated with size, with total factor productivity growth by size between 2001 and 2007 varying from -0.2% for companies with less than 49 employees to +0.5% for firms with more than 500 employees. See Hallaert J., Pérez Ruiz E, Hélène, Poirson H., McCoy J., MacKinnon H. and Benes J. (2013) « France : selected issues paper accompanying the IMF art IV report 2013 », IMF Country Report No. 13/252.

Price developments are unfavourable for the tradable sector

The manufacturing sector was forced to reduce its prices to maintain market shares. Graph 2.1.12 shows the evolution since 1997 of the prices for tradables, manufacturing and non-tradables. The tradable sector, and in particular the manufacturing sector, has not been able to increase its prices. Sectors exposed to international competition in their export markets but also within France, decreased their prices to prevent a further deterioration in their cost competitiveness and to avoid losing additional export market shares. French manufacturing firms decreased their prices more than their European peers. For example, over the period 2001-2008, French manufacturers decreased their prices by 0.6% per year, whereas German manufacturers kept their prices stable and, Italian and Spanish manufacturers increased their prices (+2.8% and +3% respectively per year). These different price developments have translated in lower profitability for French manufacturing firms.

Graph 2.1.12: Price developments per sector



(1) deflator of value added
 Source: European Commission

Prices in the non-tradable sector has increased fastly putting an additional burden on the tradable sector. With a 30% share, France uses more domestic services than other EU industries in the production of its exported goods. The increase in prices in the non-tradable sector, and in services

in particular, added to the deterioration of French cost competitiveness vis-à-vis its peers.

Table 2.1.2: OECD Product Market Regulation in services, 2013

	Retail trade	Professional Services	Network Sectors
France	2.6	2.3	2.5
Germany	2.7	2.7	1.3
Italy	3.2	2.1	2.0
Spain	2.9	2.4	1.6
average 3 best EU-performers	1.2	0.7	1.2

Source: OECD, European Commission

The high level of regulation and protection of services from external competition results in insufficient price adjustments within the non-tradable sector. The OECD Product Market Regulation indicators in services sectors are often used to proxy countries' regulatory framework⁽¹⁴⁾. Table 2.1.2 presents the Product Market Regulation indicator for the different services sectors covered. Values span from 0 to 6 with a low value corresponding to a light regulatory burden. Despite the recent reform efforts (see section 3), Table 2.1.2 shows that there is ample room for improvement, given the distance between France and the average of the 3 best EU performers.

These different price developments are accompanied by a move of resources from tradables to non-tradables. The contrasted evolutions of prices and productivity between the tradable and the non-tradable sectors have set in motion a shift of resources from tradables to non-tradables. This can be seen in a reduction in the share of value added, employment, but to a certain extent also investment (see further) of manufacturing to the benefit of the services sector. This process which is observed in all developed countries has led to a smaller manufacturing sector in France than in other euro area countries. While it is normal that resources flow from sectors with high productivity growth to sectors with low productivity growth (Baumol effect), evidence suggests that the shift in resources in France is driven by a wrong incentive structure, notably by

⁽¹⁴⁾ The OECD's PMR translates policy action into a quantitative indicator. Though comprehensive and rich, its construction has some limitations.

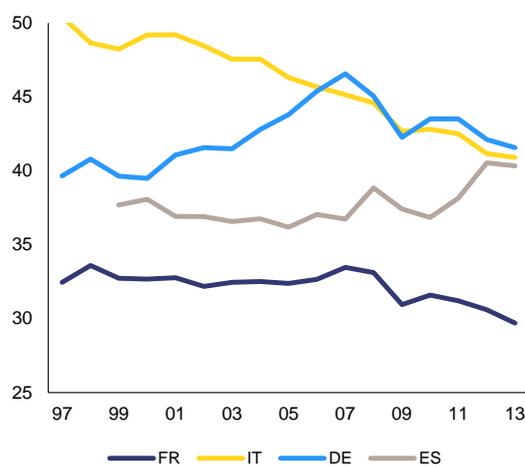
the internal exchange rate between tradables and non-tradables ⁽¹⁵⁾.

Simulations show that high markups in services hold back investment and weigh on the profitability of the tradable sector. Illustrative simulations done with the Quest III model (see Box 2.1.2) suggest that a reduction of the profit margins (or markups) in services could improve competitiveness. A decline in profit margins would stimulate exports and have a relatively high impact on investment and a differentiated impact on the profitability of the manufacturing sector and of the services sector. Finally, such a decline in profit margins in the services sector would be complementary to the impact of the tax credit for competitiveness and employment and the Responsibility and Solidarity Pact, also in terms of timing of their impact.

Profitability is affected by the high labour cost and the unfavourable evolution of prices in the tradable sector

The profit margins of French non-financial companies continued to decline in 2013 reaching 29.7%. In a European perspective French margins have always been lower for at least the last 15 years (Graph 2.1.13). However, the difference in profitability between French and German or Spanish firms seems to have grown in the last years and profit margins in France are now at historically low levels not seen since at least 1990. The high cost of labour and the high corporate tax burden (see section 3.1) are factors that explain a part of the difference in profitability levels whereas recent wage, productivity and price developments but also the loss in export market shares can explain a part of the recent developments.

Graph 2.1.13: Profit margins in selected European countries

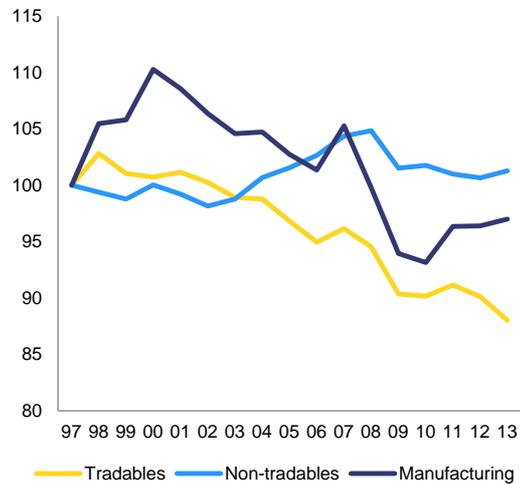


Source: European Commission

Profitability in the tradable sector seems to be lower than in the non-tradable sector. Graph 2.1.14 shows the evolution of profitability since 1997 in the manufacturing, the tradable and the non-tradable sector. Non-tradables have succeeded better in maintaining their profitability level of 1997 than tradables. The differences in price evolution and the losses in export market shares suffered by the tradable sector have probably contributed to these differences in profitability.

⁽¹⁵⁾ See Gallois, L. (2012) Pacte pour la compétitivité de l'industrie française, Sy M. (2014) Réduire le déficit des échanges extérieurs de la France : le rôle du taux de change interne, la note d'analyse, France Stratégie, Septembre 2014 and Enderlein-Pisani-Ferry(2014) Réformes, investissement et croissance: un agenda pour la France l'Allemagne et l'Europe, France Stratégie.

Graph 2.1.14: Profit margins



(1) gross operating surplus/value added
 Source: European Commission

The medium-tech sector that performs worst in terms of export competitiveness is also the one that has seen its profitability decline the most. Table 2.1.3 presents the different profitability levels in 2008 and 2012 for the manufacturing industry per technology intensity. The medium-tech sector had already a relatively low profit margin in 2008 but it decreased further to reach 18% in 2012. On the other hand the high-tech and low-tech manufacturing sector, which lost somewhat less market shares, have managed to keep their profitability level at the same level as in 2008 ⁽¹⁶⁾.

Table 2.1.3: Profit margins in manufacturing per technology

	Gross operating surplus/value added	
	2008	2012
High-technology	26%	27%
Medium high-technology	25%	18%
Medium low-technology	22%	18%
Low-technology	27%	27%

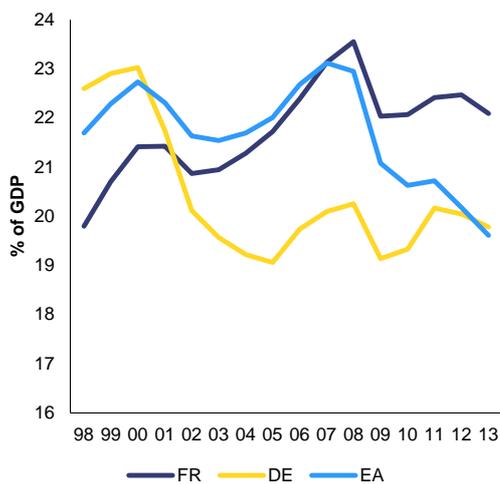
(1) value added at factor cost
 Source: European Commission

⁽¹⁶⁾ The definition of technology sector in this section is slightly different from the one used in section 3.1.1.

The low profitability of the tradable sector limits its capacity to invest and hurts its competitiveness

Overall, France invests more than the average of the euro area but investment in equipment is lower. In an international perspective France invests more than Germany or the euro area (Graph 2.1.15). Moreover, investment has been increasing since 1998 and has remained relatively robust during the crisis. France therefore does not suffer from an aggregate investment shortfall. However, equipment investment is lower in France than in Germany or the euro area (Graph 2.1.16)

Graph 2.1.15: Gross Fixed Capital Formation



Source: European Commission

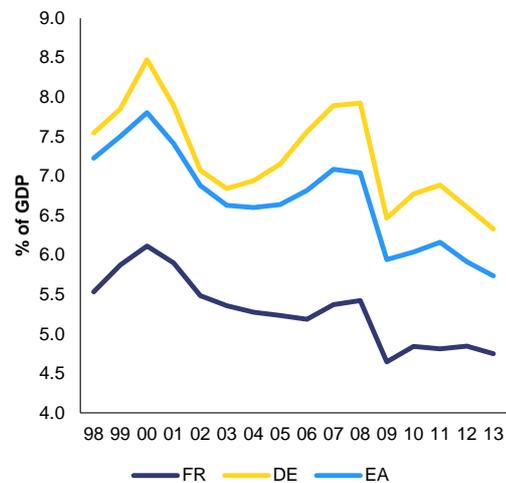
There is some evidence that productive investment in the manufacturing sector is lower than in other countries. The lower percentage of equipment investment in GDP could be due to the smaller manufacturing sector. Hallaert et al (2013) provide firm-level evidence that French manufacturing firms invested less than their counterparts over the period 2001-2009, with an average investment ratio of 8% in France compared to almost 12% in Germany and close to 9% in Italy and the United Kingdom⁽¹⁷⁾. INSEE surveys on investment in manufacturing suggest that since 2000, there is less equipment investment

⁽¹⁷⁾ See Hallaert J., Pérez Ruiz E, Hélène, Poirson H., McCoy J., MacKinnon H. and Benes J. (2013) « France : selected issues paper accompanying the IMF art IV report 2013 », IMF Country Report No. 13/252.

in modernisation and rationalisation of the production process, which are conducive for productivity developments, and that most equipment investment is related to the renewal of existing capacity. This is corroborated by statistics on the use of robots in manufacturing, which is lower in France (122 robots per 10 000 employees) than in Germany or Italy (respectively 261 and 159).

The weak profitability of firms, in particular in the manufacturing sector, weighs on investment, also because it limits the capacity of self-financing. As already argued in last year's In-depth Review, weak profitability of firms weighs on investment. This is confirmed by recent research of Pérez Ruiz and Hallaert (2014) which demonstrates that in the long run a decrease by 1 percent in the profit margin reduces investment by ½ percent⁽¹⁸⁾.

Graph 2.1.16: Equipment investment



Source: European Commission

Insufficient investment limits the ability of firms to improve their non-cost competitiveness. Insufficient investment limits the ability of companies to improve their product quality, innovation, design, after-sale service and distribution networks. This weighs on market shares and further erodes profits. Allowing firms to

⁽¹⁸⁾ Pérez Ruiz and Hallaert (2014) France: Selected Issues Paper accompanying the IMF art IV report 2013. IMF country reports 14/183, July 2014.

improve profitability would improve the ability to self-finance investment and innovation and to regain non-cost competitiveness.

Non-cost competitiveness factors seem related to the higher sensitivity of French exports to cost factors

French exports seem more sensitive to cost-competitiveness than those of other euro area countries. The long-term elasticity of exports to cost-competitiveness is higher in France than in its neighbouring countries. This suggests that even small changes in cost competitiveness can lead to relatively pronounced changes in exports. This makes France vulnerable to deviations in unit labour costs and implies that maintaining sound cost competitiveness is important for France.

Table 2.1.4: Long-term elasticity of exports to cost-competitiveness

FR	ES	IT	DE
1.1	1.0	0.6	0.1

Source: INSEE (2013)

This sensitivity to cost factors seems to be related to the non-cost competitiveness position of France. Relating non-cost competitiveness factors to export performance shows that France overall deterioration in the trade balance over the period 2002-2011 was due to a negative evolution in the trade balance for price sensitive "low-quality" and "medium-quality" goods, which was not compensated by the resilience of higher quality goods to the trade balance over that period. These trends were more pronounced towards the end of the period investigated. The distribution of the quality rank of export products in France, Spain and Germany tends to confirm this analysis (Box 2.1.3)⁽¹⁹⁾. France is increasingly specialised in medium-high quality export products. However, French exports in the medium quality segment seem unable to compete in terms of cost which could explain a relative shift of the distribution towards the high quality products. Germany is more specialised in middle-quality rank products, often built in value chains and increasingly sold on emerging markets where middle classes are

growing. Moreover, a stronger non-price competitiveness of German exports has sheltered the German industry from such price competition based on cost factors and entailed a stronger export performance led by a relatively higher quality and innovation content of German products compared to their cost.⁽²⁰⁾

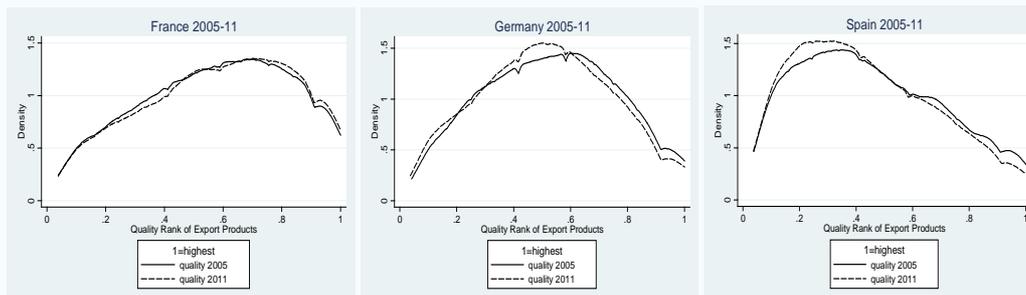
⁽²⁰⁾ Sautard, R., Tazi, A. and C. Thubin (2014), "Quel positionnement « hors-prix » de la France parmi les économies avancées ?", Trésor-Éco No. 122, January 2014.

⁽¹⁹⁾ Vandebussche, H. (2014), "Quality in Exports, European Economy, Economic Papers 528, September 2014.

Box 2.1.1: Distribution of export products by quality in France, Spain and Germany

This box analyses the quality positioning of French export products compared to those in Spain and Germany. Quality positioning can be analysed using density frequency distributions. These graphs give an insight into the type of quality goods a country is exporting. It is important to stress that high quality is not necessarily the same as high-tech. For example, French wines are considered high quality whereas it is produced in a sector that is considered low-tech. The quality of a good is given on the horizontal axis by normalised quality rankings, between 0 and 1, and these have been determined within narrowly defined export products. In the case of Spain, a distribution skewed to the left (towards 0) is observed, which indicates that it is specialised in low-quality goods exports. On the other hand, in the case of France a distribution slightly skewed to the right, towards 1, is found, which indicates that France mainly concentrates in medium-high quality goods. German exports are located between France and Spain in terms of quality of its exports. Using this quality indicator, it is possible to observe any developments in the quality of exports. The bold line gives the quality rank distribution in 2005, whereas the dotted line gives the quality rank of exported goods in 2011. By comparing these two lines, one can see the quality dynamics in exports of a country over time. One can see that France specialises in high quality products whereas Spain specialises in low quality goods and Germany is in between. These specialisation patterns were amplified between 2005 and 2011, as indicated by the shifts in the distribution of quality ranks by exports products to the right, for France, and to the left for Spain and Germany.

Quality ranks of exports products in France, Germany and Spain



Source: Vandebussche (2014).

France suffers from a lack of competitiveness

The capacity of French firms to innovate and become more efficient with the existing resource mix has declined significantly since 1997. Also price developments have not evolved favourably for the tradable sector, as it saw its prices decline whereas the prices of its services inputs increased significantly. These different price developments, point to an incentive structure in favour of the non-tradable sector in France.

French firms are less profitable than their peers. High labour costs and dynamic wages, high taxation for corporates, low productivity and unfavourable price developments are the main explanatory factors. As these factors affect tradable and non-tradable firms differently, it is no surprise that tradable firms are less profitable. Moreover, the sectors that have lost most export

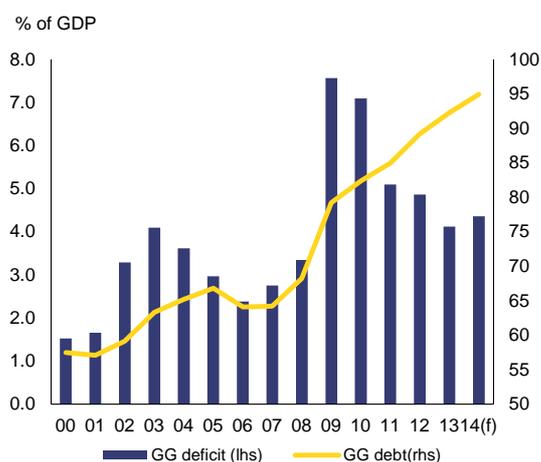
market shares, in particular the medium-tech sector, are also those that have the lowest profitability. The low profitability of the tradable sector limits its capacity to invest in product or process improvements which in turn hurts its competitiveness.

2.2. PUBLIC AND PRIVATE INDEBTEDNESS

Public debt is on a rapidly increasing trend since 2009

France's general government debt is expected to continue increasing in 2014, reaching 95.3 % of GDP. Based on past developments there are risks of sustainability of public finances. Nonetheless, a forward-looking analysis puts the emphasis on the need to maintain the fiscal consolidation effort in order to bring public debt on a downward path. In the meantime, the low interest, together with the sound structure of the public debt financing, are stabilising factors for debt developments.

Graph 2.2.1: General government deficit and debt

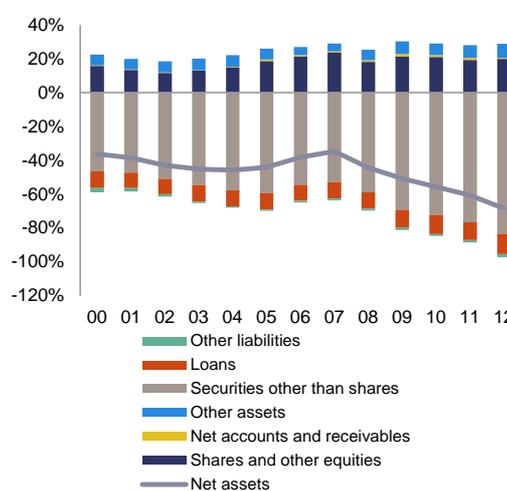


Source: European Commission

The French debt level is clearly above the reference value of 60% of GDP specified in the Alert Mechanism scoreboard. Public debt has been above the threshold every year since 2003 and almost continuously on an upward trend since then. After a sharp increase in 2009 (+11 pp), the debt ratio has continued to increase at a steady pace of close to 3 pp a year. In relative terms, the debt ratio of France is estimated to be above the euro area average in 2014 (94.3 % of GDP) as, despite low interest rates, France continues to record a large general government deficit (4.3 % of GDP in 2014 compared to 2.6 % of GDP in the euro area).

The level of net debt, taking into account financial assets, has also increased sharply since 2009. Over most of the 2000s, the net debt remained relatively stable, close to 40 % of GDP, with the variation in financial assets mitigating the impact of increasing liabilities. Since 2009, financial assets have increased little as a share of GDP, while gross debt has been increasing rapidly. As a consequence, the net financial liabilities of the government have increased, reaching 70 % of GDP in 2012 compared to 51% in 2009.

Graph 2.2.2: Net financial assets of the government



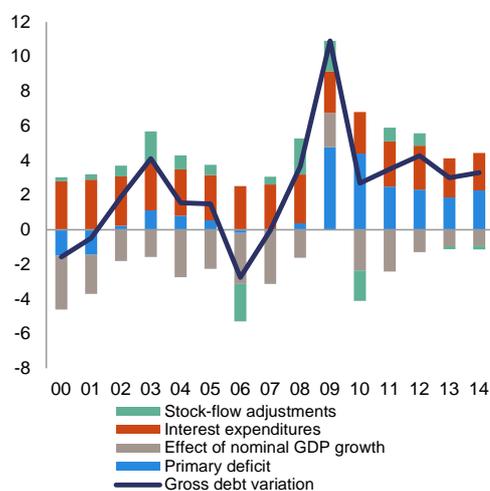
Source: European Commission

The slowdown in nominal GDP growth since 2009 has also weighed on debt developments. In terms of components, the persistently high primary general government deficits since 2009 have been the main factor driving gross debt developments (see Graph 2.2.3). On the other hand, interest rates on the French sovereign debt have decreased strongly since 2009, notably in line with low inflation, although this effect was attenuated by the relatively long maturity of the French debt (7 years). Meanwhile, the slowdown in nominal GDP growth has translated into an increasing snowball effect on public debt.

Public debt is expected to continue increasing up to 2016, coming close to 100 % of GDP. According to the Commission 2015 winter forecast the general government deficit is expected to

decrease slightly to 4.1% of GDP in 2015 and in 2016 – under a no policy change scenario. The modest pick-up in GDP growth and inflation, together with still low interest rates, will also decrease the upward pressure on debt in 2015 and 2016. However, the still significant primary deficit expected in the winter forecast (1.9 % of GDP in 2015 and 1.8 % in 2016) clearly shows the challenge that putting the debt on a downward path represents.

Graph 2.2.3: Components of gross debt variation



Source: European Commission

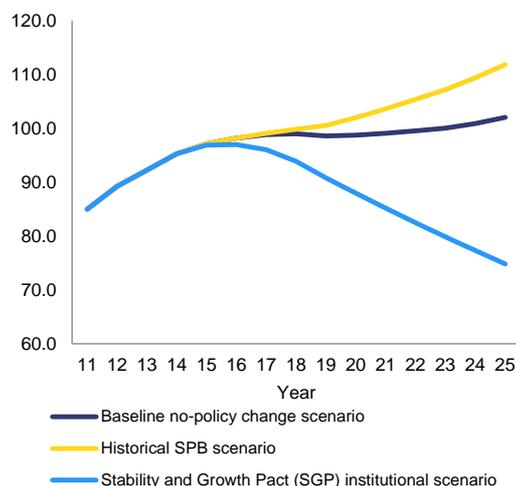
The level of net debt (taking into account financial assets) has also deteriorated sharply since 2009. Over most of the 2000s, the net debt remained relatively stable, close to 40 % of GDP, with the variation in financial assets mitigating the impact of increasing liabilities. Since 2009, financial assets have little increased as a share of GDP, while gross debt has been increasing rapidly. As a consequence, the net financial liabilities of the government have deteriorated, reaching 70 % of GDP in 2012 compared to 51% in 2009.

Fiscal consolidation efforts are required to put public debt on a downward path

France is facing important medium and long-term fiscal sustainability risks which call for continued fiscal restraint. Empirical analysis based on historical data points to significant

challenges for the sustainability of public debt ⁽²¹⁾. Based on a composite index computed by the European Commission to predict short-term stress, risks for France appear to be low. However, based on a no-policy-change scenario, general government debt is expected to continue increasing by 2025 (see Graph 2.2.4) to above 100 % of GDP. In the same manner that past developments in the primary deficit have been the main driving force to the French public debt build-up, future developments are critical to ensure a sustainable public debt path. If the primary deficit were to revert to historical trends, general government debt would expand rapidly to above 110 % of GDP in 2025. Conversely, if France were to meet the structural targets set in the Stability and Growth Pact, its debt would start decreasing already in 2017. Altogether, the forward-looking analysis of public debt developments appears very sensitive to the assumptions related to the fiscal deficit, putting the emphasis on the need to rigorously implement the expenditure cuts planned in order to ensure that debt developments remain sustainable.

Graph 2.2.4: General government debt under various scenarios



Source: European Commission

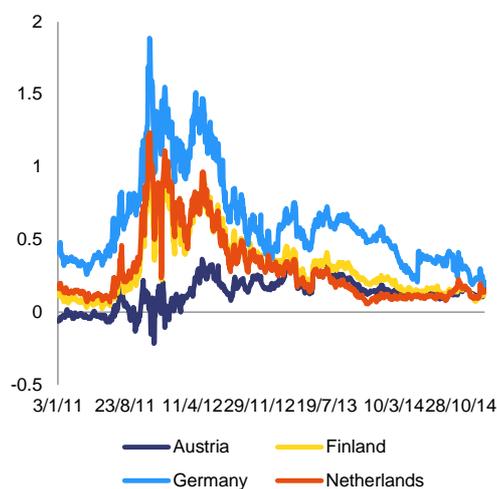
⁽²¹⁾ Boissinot, J., L'Angevin, C. and B. Monfort (2004), "Public Debt Sustainability: Some Results on the French Case", INSEE, Document de travail G 2004/10.

Financing of the French public debt is a factor of stability

The structure of the French debt attenuates the impact on public finances of potential shocks on interest rates and inflation. The outstanding amount of French sovereign debt reached slightly over EUR 1500 billion (71 % of GDP) in December 2014, representing the largest part of the general government debt. In that respect, the characteristics of the holdings and issuance of the French debt by the Agence France Trésor is a key component of the stability of public finances. First, the maturity of the French debt, which had decreased significantly in 2008 and 2009 due to investors' risk aversion, has increased since then to close to 7 years, significantly above the maturity of the debt in Spain, Italy or Germany. While the government does not have explicit objectives in terms of maturity, the relatively long maturity means that a shock on interest rates would only have a gradual impact on public finances. As 12 % of the outstanding debt consists in inflation-linked securities, inflation developments only have a minor impact on the cost of debt.

Holdings of the negotiable government debt are well diversified. Foreign investors hold 63.7 % of French debt in the 3rd quarter of 2014. This ratio, which is comparable to what is observed in other EU economies, has increased strongly between 2000 and 2010 and has stabilised since then. The base of investors is well diversified, both in terms of geographical origin and of type of investors, with central banks representing a large share of holdings. This reflects in particular the strategy of the government to diversify as much as possible the type of instruments traded, to insulate the debt demand from shocks which would affect one specific type of investors. Reciprocally, it also reduces the risks which could result from an excessive exposure to sovereign bonds.

Graph 2.2.5: Spreads between France and selected euro area Member States(10-years maturity bonds)



Source: Global Insight, European Commission

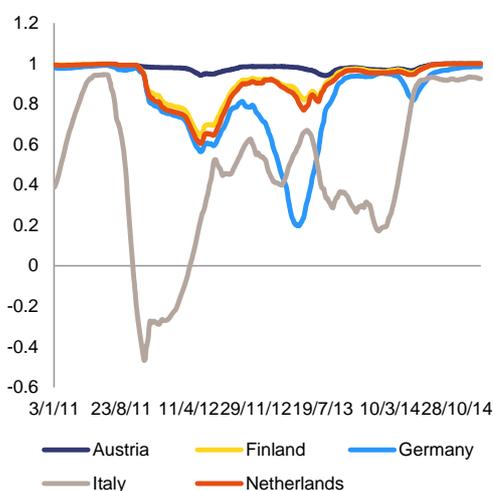
The yield on French bonds has decreased significantly in 2014 to a record low. Short-term bonds are now trading on negative yields⁽²²⁾. Meanwhile, the yields on long-term bonds have also plummeted between 2012 and 2014. While the slowdown in inflation prospects has weighed on rates, yields have also decreased in real terms, showing that risk premiums have also decreased. The low, and in some case negative, correlation between the French sovereign yields and that of countries which were faced with speculative episodes on their sovereign debt suggest that French negotiable debt actually benefitted from a flight to quality. In terms of public finances, the reduction in the interest rate means that, despite the increasing debt ratio, the cost of interest as a share of GDP has continued to decrease, reaching its lowest level since the early 90's.

Despite occasional tensions since 2009, French sovereign bonds continue to be very well-perceived by external investors. In relative terms, while France is no longer within the group of AAA-rated euro area economies, spreads have narrowed in 2014, notably with Germany. As another sign that the French debt is now considered by investors as belonging to the same

⁽²²⁾ -0.09 % for 2-year maturity bonds and 0.64 % for 10 year bonds on 20 January 2015.

asset class as the debt of AAA-rated economies⁽²³⁾, the correlation between the yields for sovereign bonds of these countries and those for France, which had diverged since 2011, has come back to almost perfect correlation in 2014⁽²⁴⁾. However, in section 2.3, analysis is presented that suggests that in extreme market circumstances France, together with Finland and Belgium, has the highest spill-over impact on other Member States.

Graph 2.2.6: Correlation of the French 10-year sovereign rates with selected euro area Member States



1-year rolling correlations based on daily average yields
 Source: Global Insight, European Commission Calculations

Private indebtedness

While a number of economies in the EU have experienced significant deleveraging since 2008, private indebtedness in France in 2013 reached 137.2 % of GDP, which is above the threshold set in the Alert Mechanism Report of 133 % of GDP. Although this is a slight decrease compared to 2012, the level of private indebtedness is 15 pps. above its 2008 level.

⁽²³⁾ Austria, Finland and the Netherlands have an AAA rating for 2 of the 3 major rating agencies.

⁽²⁴⁾ In that respect, the announcement in October by Standard and Poor's to maintain the AA rating of France with a now negative outlook and the decision by Fitch in December to downgrade the French sovereign bonds' rating from AA+ to AA did not have a significant impact on spreads.

Stability of the banking sector and credit conditions.

The profitability and capitalisation of French banks appears in line with that of peers in the euro area. Like their counterparts in the rest of the euro area, French banks, of which four are considered as systemic by the Financial Stability Board, are suffering from relatively poor profitability, with a return on equity of 3.3 % in June 2014, a net decrease from 6.8 % in June 2013. With an average Tier 1 ratio of 12.8 % in June 2014, the capitalisation of French banks appears to be in line with that of their euro area counterparts (13.4 % Tier 1 capital ratio). Their loan portfolio appears slightly less risky, with non-performing loans representing 4.4 % of the total portfolio in June 2014 compared with 5.6 % in the euro area as a whole, although a comparison of the ratios of non-performing loans across countries remains difficult given the differences in definition. This ratio has been relatively stable in recent years, while it has increased in the euro area as a whole.

French banks performed well in the ECB stress test, showing resilience to a difficult economic environment. The ECB's latest comprehensive assessment demonstrated that the French banking system was robust. The Asset Quality Review suggested that only minor adjustments of French bank balance sheets were necessary. The stress test showed that French banks were capable of resisting the simulated shock. In a stressed environment, the Common Equity Tier 1 ratio of French banks would decline by 231 basis points to 9 % by 2016 (compared to a decline of 300 basis points for the euro area). All banking establishments passed the stress test except one credit institution which was recapitalised in the first half of 2014 in response to the results of the stress test.

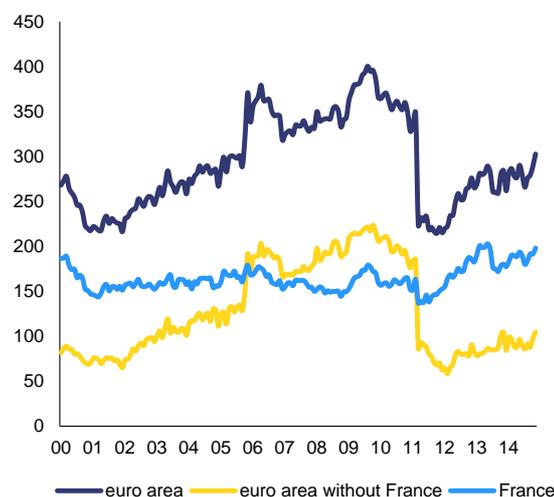
One of the potential vulnerabilities of French banks is their dependence on short-term wholesale funding. Loans to non-bank euro area residents represented 116.3 % of deposits from non-bank euro area residents in May 2014⁽²⁵⁾. This relatively large loan-to-deposit ratio is partly explained by the banks' customers placing a significant portion of their savings in non-banking

⁽²⁵⁾ Non-bank euro area residents include the government sector, non-financial corporations and households.

products (i.e. life insurance and mutual funds). Consequently, French banks depend significantly on short-term interbank funding. Such dependence can prove a weakness when interbank markets experience difficulties. Since 2011, French banks have engaged in significant deleveraging in order to reduce their loan-to-deposit ratio. Part of the reduction in loan-to-deposit ratio is related to cyclical conditions. Indeed, the demand for credit from both companies and households is not very strong and the saving rate is high because of precautionary savings. Nonetheless, structural measures were adopted too to reduce the loan-to-deposit rate. Emphasis was put on developing the domestic retail banking activities and credit activities in US dollars were reduced. According to Fitch's 2015 outlook for major French banks, the focus of French banks on stable funding sources should help them move towards compliance with the net stable funding ratio under the Capital Requirements Regulation. They will probably continue to have modest recourse to short-term market funding balanced by satisfactory liquidity buffers in 2015. These buffers should exceed the banks' one-year short-term wholesale funding at all major banks. Large French banks have also been bolstering their stock of high-quality liquid assets, so that reaching a 100 % liquidity coverage ratio should not be an issue for any of them.

French banks are substantially exposed to French general government securities. This exposure, which stood at nearly EUR 200 billion (10 % of GDP) in November 2014, has been increasing since March 2011 and represents 65.5 % of French banks' exposure to euro area general government securities (see Graph 2.2.7).

Graph 2.2.7: French bank's consolidated exposure to euro area general government securities



Source: ESCB

French banks have a high exposure to neighbouring countries, in particular Italy. Exposure to Russia is relatively limited. French banks' exposure to foreign countries (to all sectors, public and private, including other banks) stood at EUR 2 317.9 billion (123 % of GDP) in June 2014, and mainly consisted of exposure to neighbouring countries. Exposure to Italy, Spain, Greece, Portugal and Ireland was stable at 19.5 % of French GDP, mainly to Italy (12.78 %), the largest foreign exposure of French banks. Consequently, if there is a material degradation of the economic situation in Italy, this would adversely impact French banks' profitability and solidity. With 1.65 % of French GDP, exposure to Russia is fairly limited, although some banks' individual exposure is greater, which could result in direct losses in the event of further deterioration of the situation in Russia. However, these losses would be insufficient to threaten French banks' stability.

Household financial situation

The indebtedness of French households has continued to increase (2013) although the pace of increase has slowed down significantly since 2010. Household debt represented 55.6 % of GDP in 2013. The increase in the household debt ratio has been slowing down in recent years, with an increase of 1.9 pps. between 2010 and 2013, compared with 7.2 pps. between 2007 and 2010. By contrast, the household debt ratio in the euro

area peaked in 2009, and has been falling since then, to 60.7 % of GDP in 2013.

The increasing indebtedness should be seen in the context of a relatively sound net financial asset position and low interest burdens on households. In 2013, net financial assets, which comprise financial assets and liabilities, were expected to reach 152.6 % of GDP, more than 10 pps. above their pre-crisis level and above the level in the euro area (139.3 %). Moreover, on average, the interest burden represented 1.4 % of gross disposable income, less than that in the euro area. However, the holders of the financial assets are not necessarily those who bear the debt burden, and the interest burden has proved to be a weak predictor of deleveraging pressures during the crisis. Nonetheless, the French indicators offer some reassurance as the distribution of debt to income and debt service to income across income quintiles is not alarming.

The real estate market is cooling off and the expected correction of real estate prices is relatively sizeable. The driving force behind household indebtedness dynamics over the last 10 years has been the continuous growth in real estate credit. Growth in real estate lending was sustained by rising housing prices and low interest rates. However, since 2011 there has been a deceleration in the growth of real estate credit (from an annual growth of 9.2 % in May 2011 to 2.5 % in November 2014). From the third quarter of 2011, housing prices also started declining steadily, falling by 1.9 % in 2013. Prices in France rose by about 120 % from the last trough in the first quarter of 1997 to the last peak in the first quarter of 2007. Since then, prices have corrected by 6 %, whereas in the previous house price cycle an eventual correction of 30 % was required. Indeed, using the methodology of Cuerdo et al. (2012)⁽²⁶⁾, the average house price misalignment was of the order of magnitude of 20 % in 2013⁽²⁷⁾. The International Monetary Fund provides an overview of model-based price misalignment measures that range between 10% and 20 % but arrives at the

same conclusion that the pre-crisis misalignment has not unwound to the same extent as in other countries yet⁽²⁸⁾. The correction in house prices is accompanied by a contraction in investment in housing, with a 2.6 % decline in residential investment recorded in 2013. The contraction in residential investment is expected to continue into 2015.

The real estate price correction is expected to proceed smoothly and the risks for household deleveraging are relatively contained but could weigh on residential investment. As stated in last year's In-Depth Review, strong demand for housing supported by positive demographic trends and the absence of excess housing supply, together with prudent credit supply by banking institutions, suggests that the current soft landing of real estate prices should continue. Moreover, in the event of a rise in interest rates on loans or a more abrupt price decline, the impact on overall deleveraging pressures should be relatively contained, as real estate credit is mostly at fixed interest rates (83 % of the market). However, in the current low-inflation environment, the fact that most mortgages are fixed-interest and that renegotiation of mortgages is less common in France increases the real burden of interest and capital repayments. As credit ratings are based on income rather than asset value, the mortgage repayment capacity of households is normally sound. The banking system in aggregate also appears solidly positioned to absorb any increase in loan delinquency rates that may emerge from a fall in housing prices. However, confidence could decline and investor perceptions of real estate as a safe haven could shift, triggering asset allocation changes and further price declines⁽²⁹⁾. Moreover, even a gradual decline in real estate prices could hold back residential investment, weighing on construction activity.

Activity in construction is also being hampered by regulation and distorted incentives. In an assessment of the French housing market, distortions caused by regulations such as rent

⁽²⁶⁾ Cuerdo, C., M. Demertzis, L. Fernández and Pontuch P., (2012), 'Assessing the dynamics of house prices in the euro area', Quarterly Report on the Euro Area, 11(4).

⁽²⁷⁾ European Commission (2014). European Economic Forecast — Spring 2014, European Economy 3 2014. European Commission.

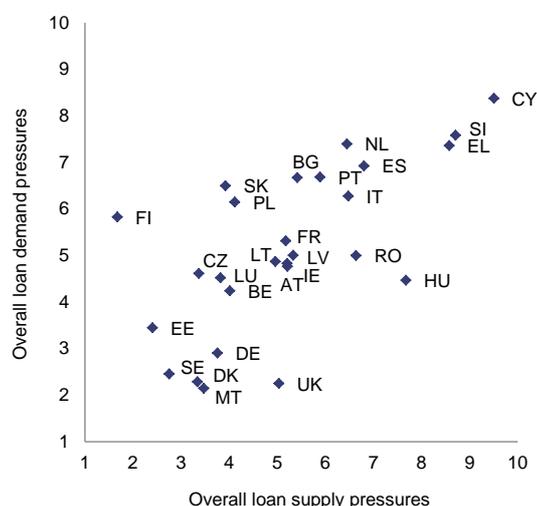
⁽²⁸⁾ IMF (2013) France: Financial Sector Assessment Program — Technical Note on Housing Prices and Financial Stability, IMF FSAP, July 2013.

⁽²⁹⁾ IMF (2013) France: Financial Sector Assessment Program — Technical Note on Housing Prices and Financial Stability, IMF FSAP, July 2013.

controls, taxation and subsidies, are found to limit the responsiveness of supply and may tend to hinder a fluid and transparent market development⁽³⁰⁾. In this context, French housing policies seem too much oriented towards stimulating demand and not enough supply oriented.

Current debt reduction by households is mostly passive and gradual. Using two different methodologies⁽³¹⁾, French households' deleveraging needs are estimated at around 15 % of GDP⁽³²⁾. The first method determines a sustainable level of debt by estimating debt that is consistent with households' and firms' assets corrected for valuation effects. This method takes into account country- and time-specific factors such as the starting level of debt and the extent of the asset price boom in the pre-crisis period. The second method is based on the typical extent of deleveraging in past episodes, and is a function of the preceding debt increase. While deleveraging needs are relatively sizeable, current deleveraging pressure is relatively low. Indeed, France currently faces moderate deleveraging pressures stemming from credit supply and demand (see Graph 2.2.8) and as suggested above the deleveraging in the housing market is also fairly gradual. Therefore, if any deleveraging is to be expected, it is likely to be mostly passive and gradual. However, should overall economic conditions worsen in France, for instance because of a change in market perceptions of the sustainability of public finances, a more active deleveraging of household indebtedness could ensue.

Graph 2.2.8: Loan deleveraging pressure



(1) This graph suggests that there are no deleveraging pressures due to credit but does not provide information on deleveraging needs

Source: European Commission

Additional pressure on households to reduce indebtedness could stem from uncertainties about cyclical conditions and the trajectory of public finances. While disposable income is expected to grow relatively robustly in 2015 and 2016, unemployment remains high and uncertainty about economic growth remains quite high. This could lead households to reduce indebtedness by increasing their savings rate, although this is not the main scenario. Also, given high public indebtedness, consumers could anticipate future tax hikes or lower transfers. Faced with these uncertainties about future revenues, households may be prone to reducing their indebtedness by increasing their savings rate.

Non-financial corporations

Credit growth is relatively weak, while credit conditions are favourable. Credit growth to non-financial companies was flat in 2013 but picked up somewhat during 2014, growing at an annual rate of 2.1 % in November 2014. Overall, the cost of finance is not a significant burden on French firms, which continue to borrow at rates slightly higher than in Germany but considerably lower than in Spain and Italy. However, as in the rest of the euro area, big companies have systematically enjoyed better funding conditions, and are able to access capital markets, while smaller ones have primarily

⁽³⁰⁾ Boulhol H. (2011) 'Making the French Housing Market Work Better,' OECD Economics Department Working Papers 861, OECD Publishing. A similar analysis is made by Enderlein, H. and Pisani-Ferry J (2014) 'Reforms, investment and growth: An agenda for France, Germany and Europe', 27 November 2014.

⁽³¹⁾ C. Cuerpo, Drumond, I., Lendvai, J., Pontuch, P., and Raciborski, R. (2014), 'Private sector deleveraging in Europe', Economic Modelling, forthcoming and Bornhorst, F. and M. Ruiz-Arranz (2013), 'Indebtedness and Deleveraging in the euro area', 2013 Article IV Consultation on euro area policies: Selected Issues Paper, Chapter 3, IMF Country Report 13/232.

⁽³²⁾ European Commission (2014 c), Quarterly Report on the Euro Area — Volume 13, Issue 3. European Economy, European Commission.

relied on the banking system to finance their needs. This reliance on bank loans could make it more difficult for SMEs to finance long-term investment.

Indebtedness of French non-financial companies is above the euro area average but the leverage is lower. The non-consolidated debt of non-financial companies stood at 119.6 % of GDP in 2013, well above the euro area average (94.6 %). Netting out intercompany loans, the consolidated debt level of non-financial corporations amounted to 81.6 % of GDP in 2013 (compared to 78.5 % in the euro area). Net assets of non-financial corporations were somewhat more negative in France than in the euro area in 2013 (at -102.9 % versus -95.1 % of GDP). The picture for leverage was more positive, with company leverage, as measured by the debt-to-equity ratio, at 53.6 %, still well below the euro area average of 66.7 %. Moreover, using the same methodologies as for households, there is no evidence that non-financial corporations need to deleverage.

The declining profitability of non-financial companies may also affect companies' ability to service their debt. Although the financial structure of non-financial corporations does not point to specific weaknesses, the continuous erosion of their profit margins is a source of concern. The financial difficulties experienced by firms are partly reflected in the historically high number of bankruptcies in 2014, at similar levels to 1994. However, the increase in the number of bankruptcies has slowed down, with the total number of bankruptcies over the last 12 months to October 2014 rising by only 1.5 % compared to October 2013. Overall, the low and deteriorating profitability of French non-financial companies compared with those of other euro area countries, together with the increasing number of bankruptcies, points to potential vulnerabilities. Moreover, based on simulations with the QUEST III model described above, the tax credit for competitiveness and employment and the responsibility and solidarity pact will only provide temporary, limited relief for firms with low profit margins.

High public and private indebtedness make the entire economy more sensitive to potential adverse economic events. The banking sector seems stable although its continued dependence on

short-term wholesale funding is a potential vulnerability. French private indebtedness has continued to rise and together with high public indebtedness makes the entire economy more sensitive to potential adverse economic events. Overall, there is little loan deleveraging pressure and the house price correction is gradual. However, should overall economic conditions worsen further the indebtedness of households could lead to active deleveraging, with a detrimental impact on the economy. Finally, companies' poor profitability may affect their ability to service their debt.

2.3. EURO AREA SPILLOVERS

Trade linkages between France and the euro area are substantial

France is a major export market for several Member States. In particular, exports to France account for more than 10% of the GDP of Belgium and Luxembourg ⁽³³⁾. Trade linkages with large euro area economies such as Germany, Spain and Italy are likewise strong. France's economic size gives it an important role within the euro area. Indeed, developments in French domestic demand have the potential for strong spillovers to other euro area partners via trade.

France exports large volumes of final and intermediate goods and services to other euro area countries. Total exports of goods and services represent approximately 28% of French GDP. French exporters depend to a great extent on the German market where imports account for more than 4% of French GDP, on Belgium (more than 2%) and on a group of four medium-to-large EU economies: the United Kingdom, Italy, Spain and the Netherlands (roughly between 1% and 2%). Outside the EU, the United States is a sizeable export market (2%), followed by Switzerland and China (close to 1% each) ⁽³⁴⁾.

While net Foreign Direct Investment stock has been relatively stable, inward Foreign Direct Investment, an indication of France's attractiveness to foreign investors, is decreasing. In terms of composition, the net stock of Foreign Direct Investment continues to remain positive as, in the past, net flows of French investment abroad have been consistently higher than net inward flows. Accordingly, most of the negative Net International Investment Position is financed by portfolio investments. In 2013, France was not among the world's 20 largest direct investors and investment receivers. Its position has deteriorated compared to 2008, when France was the seventh largest receiver and the fourth largest investor. Between 2008 and 2013, France was outperformed in particular by some large developing economies which attracted more investors. However, the picture is distorted due to intra-company flows.

⁽³³⁾ Commission staff calculations based on UN data for 2012.

⁽³⁴⁾ See previous footnote.

Financial linkages between France and the euro area are important

France is one of the most important nodes in the network of financial linkages within the euro area, playing a very important role in financial intermediation. Box 2.3.1⁽³⁵⁾ shows how France had systematically acted as a major funding intermediary for the economies of southern Europe before reducing its holdings in 2011, leaving an external funding gap that needed to be bridged by official flows. The box illustrates that changes in market participants' perception or anticipation of economic fundamentals leading to a reassessment of the vulnerability of the French economy would have significant spillover risks affecting the euro area as a whole.

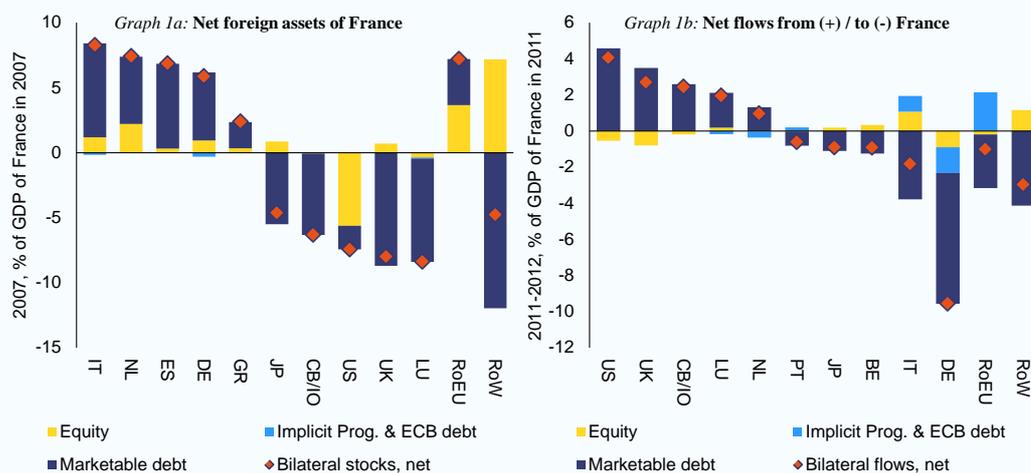
Interlinkages are strongest with Ireland, Belgium and the Netherlands. In 2012, Ireland, Belgium, the Netherlands and Malta had gross financial exposures to France via equity and debt instruments amounting to more than 50% of their respective GDP. Exposure to French equity assets is particularly high in Belgium and the Netherlands, while debt-type instruments were worth 68% of Irish GDP. Five additional Member States, including the United Kingdom and Germany, had exposures greater than 10% of GDP.

⁽³⁵⁾ This box is reproduced from European Commission (2014), Quarterly Report on the Euro Area — Volume 13, Issue 4. European Economy, European Commission.

Box 2.3.1: The financial intermediation role of France

Capital flows from and to France played a central role throughout the crisis. Before the crisis, France acted as an intermediary between euro area debtors, on one side, and creditors from outside the euro area, on the other. Apart from Japanese and UK investors, foreign central banks were particularly keen to hold French bonds, presumably as a reserve asset. On the eve of the crisis in 2007, France found itself in a net debtor position to non-EU countries, while French investors were in a net creditor position to most of the euro area, in particular Italy, Spain and Greece, but also Germany (see Graph 1a).

In the first stage of the crisis, until 2010, French bonds were sought after as a safe-haven asset. Foreign central banks increased their holdings of French bonds considerably. At the same time, German investors shifted out of Italian and Spanish debt and used part of the proceeds to purchase French debt assets, turning the French net asset position vis-à-vis Germany from positive to negative. In return, French investors had to invest their savings into assets abroad, and significantly increased their exposure to Italian and Spanish debt. Italian and Spanish investors sold off their holdings of French debt, which compounded the increase in net French exposure to those two countries. Consequently, France intermediated financial flows and financial risk from Germany and outside the euro area to Spain and Italy, which still ran sizeable current account deficits at the time.



Notes: In Graph 1a, CB/IO corresponds to aggregate of SEFER central banks and international organisations, as reported by IMF CPIS. RoEU: Remaining EU countries. RoW: Remaining non-EU countries. In Graph 1b: a positive sign means net outflows from France, while a negative sign means net inflows to France. Note that asset sell-offs are included in the figures. For instance, the capital inflows from Italy to France in 2011-12 actually stem from French investors selling off their exposure to Italian debt instruments.

Source: Hobza A. and S. Zeugner (2014): 'Current accounts and financial flows in the euro area', Journal of International Money and Finance, vol. 48.

In late 2011, the situation changed, as there were market concerns about the exposure of French investors to Spain and Italy. In response, foreign central banks followed investors based in the United States and the United Kingdom in selling off their holdings of French assets. German investors continued to buy up French debt, but that did not suffice to relieve pressure on French bonds. Consequently, the French financial sector reduced its exposure to Italy and Spain, which it did by selling off its bond holdings there (see Graph 1b). With that, the euro area periphery countries lost the last large-scale investor willing to refinance their external debt. As market participants from outside the euro area periphery were reluctant to purchase Italian or Spanish bonds during late 2011 and 2012, the Spanish and Italian financial sector had to rely on central bank funding in order to cover their own refinancing needs, but also to purchase domestic bonds.

Foreign banks' exposure to France is large. It stood at EUR 898.5 billion in June 2014 with Swiss and Dutch banks' exposure representing 12.8% and 11.8% of their countries' GDP respectively. Expressing their exposure in terms of capital and reserves shows that Dutch banks' solvency might potentially be more affected by any deterioration in the French economy than those of other countries, although the exposure of German banks is also quite high when using this benchmark. Conversely, France is a major funding partner and investor in Ireland, Belgium and the Netherlands, where it has important debt and equity claims. French foreign assets represented approximately 110% of Irish GDP, and 74% of Belgian and Dutch GDP. The French banking sector is major financier of the Belgian economy, in particular of the non-bank private sector. For 10 Member States, including the large economies of the United Kingdom, Spain, Italy and Germany, French investments represented 10% to 30% of local GDP⁽³⁶⁾.

France has high potential to create negative spillovers to the euro area

In the long term, failure to tackle structural challenges in France may adversely affect its euro area partners. Last year's in-depth review, using an input-output framework, demonstrated that there were significant negative spillover effects on other euro area countries of a deterioration in final demand in France: a 10% decline in French domestic demand would reduce total exports in the euro area by 0.8%, with the highest impact on Spain (-1.6%), Belgium (-1.1%) and Portugal (-1.1%)⁽³⁷⁾.

The negative spillovers of a possible French sovereign debt crisis would be high. A further increase in public indebtedness and the risks of a reversal in market perceptions of the sustainability of public finances would entail significant negative spillovers to the rest of the euro area. Based on systematic shock simulations for 41 international

banks and 23 sovereigns from Europe, the United States and Japan, Gross and Kok (2013) identify and rank the banks and sovereigns which are most vulnerable to shocks arising elsewhere in the system and those which are influential in exerting the most widespread and intense responses when shocked. The results suggest that France is vulnerable to shocks elsewhere but also exerts the most widespread and intense propagation effects, together with the US and Portugal⁽³⁸⁾. Analysis by the European Commission points in a similar direction for France⁽³⁹⁾. French sovereign spreads have significant potential to negatively affect spreads in other Member States. Moreover, out of 11 euro area Member States studied, together with Belgium and Finland, France has the highest spillover impact on other Member States in extreme market conditions. One interpretation of this result is that Member States that are commonly counted among the 'core' euro area Member States but have high debt and/or very weak growth, have a relatively strong negative effect on other economies in the euro area.

The relatively high policy uncertainty in France has the potential to create uncertainty in the rest of the euro area as well. Klossner and Sekkel (2014) demonstrate that spillovers account for more than a quarter of the dynamics of policy uncertainty. Of the three euro area countries studied (France, Germany, Italy), France has the highest spillover impact on all other countries⁽⁴⁰⁾. This suggests that reducing policy uncertainty in France would have a bigger impact on overall policy uncertainty than a similar reduction in uncertainty in Germany and Italy. In this context, it should be noted that policy uncertainty in France rose somewhat less than the aggregate EU indicator from the beginning of the crisis to the culmination point of the euro area crisis, but has decreased markedly less since then. French policy uncertainty, as measured by the Baker et al. (2013) index, increased by 312% between August 2008, the start of the crisis, and November 2011, which

⁽³⁶⁾ Source: BIS consolidated banking statistics (ultimate risk basis, Q2-2014), and Hobza, A and Zeugner, S. (2014), Current accounts and financial flows in the euro area, *Journal of International Money and Finance*.

⁽³⁷⁾ European Commission (2014b), *Macro-Economic Imbalances France 2014*, European Economy Occasional Paper 178, March 2014, European Commission.

⁽³⁸⁾ Gross M. and Kok C. (2013), 'Measuring contagion potential among sovereigns and banks using a mixed-cross-section GVAR', ECB Working Paper Series.

⁽³⁹⁾ European Commission (2014), *Quarterly Report on the Euro Area — Volume 13, Issue 4*, European Economy, European Commission.

⁽⁴⁰⁾ Klossner S. and Sekkel R. (2014), 'International spillovers of policy uncertainty', Bank of Canada, working paper 2014-57, Bank of Canada.

marked the peak of European policy uncertainty (compared to an increase of 333% for the EU aggregate indicator) and has since declined by 28% (compared to a decline of 52% for the aggregate EU indicator) ⁽⁴¹⁾.

Conversely, a strengthening of consumer confidence in France would accelerate the euro area confidence cycle. French consumer confidence, based on the European Commission's consumer survey, ended 2014 at 3.6 points below its long-term average. This contrasts with consumer confidence in the euro area, which ended the year 2.2 points above its long-term average. Real consumption and measures of consumer confidence appear to be strongly correlated in the euro area and there are confidence spillovers across euro area countries, suggesting that foreign confidence can positively affect domestic confidence and thereby consumption ⁽⁴²⁾. Moreover, a typical positive confidence shock in the euro area has the most pronounced effects on consumption for the United States, the United Kingdom, and France, indicating that the euro area confidence cycle is predominantly associated with French confidence shocks ⁽⁴³⁾.

Economic spill-overs and euro area macroeconomic policy

The euro area faces a fundamental challenge to support the nascent economic recovery and deal with macroeconomic vulnerabilities ⁽⁴⁴⁾. The economies of the euro area remain at different positions in the adjustment process and for the most crisis-affected euro area Member States the challenges they face limit their ability to contribute to growth. This is the background for pursuing differentiated policies. To avert the risk of halting the economic upswing and the rebalancing process, coordinating the policy stance at euro area

⁽⁴¹⁾ Baker S., Bloom N. and Davis S. (2013) 'Measuring economic policy uncertainty', Chicago Booth Research Paper.

⁽⁴²⁾ European Commission (2014), Quarterly Report on the Euro Area — Volume 13, Issue 3. European Economy, European Commission.

⁽⁴³⁾ Déés S. and Güntner J. (2014), 'The International Dimension of Confidence Shocks', ECB Working Paper Series.

⁽⁴⁴⁾ For more details see European Commission (2015), Assessment of the 2015 national reform programmes and stability programmes for the Euro Area.

level can play a key role. It is in this context that economic and fiscal conditions in France and their impact on other economies of the euro area are of particular importance.

Higher growth in France would be particularly beneficial for some of the vulnerable economies.

QUEST simulations show that reforms in France would have the highest benefits for countries such as Portugal, Spain and Greece in the first two years ⁽⁴⁵⁾. This is confirmed by Poirson and Weber (2011), who show that a French growth shock generates higher spillovers for the periphery than if the growth shock would emanate from other euro area countries such as Germany. Also, the impact of a growth shock in France on Italy, Germany and Spain is higher than the other way around ⁽⁴⁶⁾.

All in all, this section demonstrated that France is highly interconnected with the rest of the euro area and has the potential to create significant spillovers. French sovereign bonds would have a high spillover impact on the sovereign bonds of other Member States in extreme market conditions. If France were to disinvest because of domestic weaknesses, as in 2011, this could create external funding gaps in other Member States, given its role as a financial intermediary. Conversely, structural reforms in France could support activity in the euro area in general, and in the vulnerable Member States in particular.

⁽⁴⁵⁾ For more details see European Commission (2014), Cross-border spillovers in the euro area', Quarterly Report on the Euro Area Vol 13 No 4. and European Commission (2014), Structural reforms at the zero lower bound', Quarterly Report on the Euro Area Vol 13 No 3.

⁽⁴⁶⁾ Poirson H. and Weber S., (2011) "Growth spillover dynamics from crisis to recovery", IMF working paper, IMF.

3. OTHER STRUCTURAL ISSUES

3.1. TAXATION, SUSTAINABILITY OF PUBLIC FINANCES AND FISCAL FRAMEWORK

France has high taxes that weigh on economic activity

France has a high and rising overall tax burden.

In 2014, the tax-to-GDP ratio stood at 45.8 %, one of the highest in the EU and 3.6 pps. higher than in 2010. The French tax system is characterised by high statutory rates of personal and corporate income tax combined with some inefficient tax expenditures and exemptions.

France is among the Member States with the highest tax burden on labour.

The high tax burden on labour affects firms' competitiveness and weighs on employment despite moves to reduce it by increasing the tax credit for competitiveness and employment and adopting a 'responsibility and solidarity pact'. In addition to the measures described in Section 2, the lowest bracket of personal income tax, 5.5 % below EUR 9 690 for a single person, has been abolished in the budget law for 2015 ⁽⁴⁷⁾.

The effective average and marginal corporate tax rates are relatively high and could make French investments less attractive.

France's effective average corporate tax rate (EATR), a measure of the effective tax rate paid by a company on 'average' projects, stands at 38.3 %, among the highest in the EU-28. Similarly, the effective marginal tax rate (EMTR), which influences investment decisions, is among the highest in the EU, at 32.5 % ⁽⁴⁸⁾. Moreover, capital taxation is particularly heterogeneous and complex. Marginal tax rates vary across different types of investment as a large number of special arrangements exists, hence potentially distorting investment decisions. It is therefore important to limit exemptions or special treatments where externalities are clearly identified and to ensure the efficiency of the established special tax scheme ⁽⁴⁹⁾. A first step was taken to reduce the high taxes on corporations in 2014. In particular, the social

solidarity contribution to be paid by companies (C3S) will be gradually phased out. Moreover, a reduction in the standard corporate income tax rate to 28 % by 2020 has been announced.

The debt bias in corporate income taxation remains high.

As shown in Graph 3.1.1, the difference between the effective marginal tax rate (EMTR) for new equity- and debt-funded investment shows that the French corporate tax system has the highest debt bias in the EU. This bias may have important implications for the economy as a whole, as it may affect the cost of capital and hence investment decisions. Finally, it can leave scope for profit shifting. From 2014, interest deductibility has been limited to 75% of net interest above the threshold of EUR 3 million. While this measure reduces the debt bias, it is mostly aimed at large companies and could penalise innovative companies and start-ups, which are often financed through equity-raising and which usually have difficulties in obtaining bank credit. Wider application of the rule limiting interest deductibility would help to reduce the debt bias, as shown in Graph 3.1.1: France would move from the first to the tenth position in the EU.

In 2014, few measures were taken to simplify and secure the tax system and to make it more efficient.

Two ongoing examples are the advanced tax ruling procedure (*'rescrit fiscal'*) and the principle of non-retroactivity ⁽⁵⁰⁾. However, more work is needed, in particular to simplify tax rules and obligations. The *Inspection générale des finances* drew attention in 2014 to more than one hundred inefficient taxes which yield little or no revenue, yet the 2015 draft budgetary plan envisaged abolishing only seven, worth EUR 29 million. In the end, the budget law for 2015 only deleted the '*Grenelle II*' taxes, which have never been implemented in practice, and the tax on fruit and vegetables, which will be replaced by a compulsory contribution. A new tax on parking areas and an additional property tax in Ile-de-France have also been introduced. The commitment in the public finance programming bills to regularly assess tax expenditure has had little effect. Exemptions have recently been

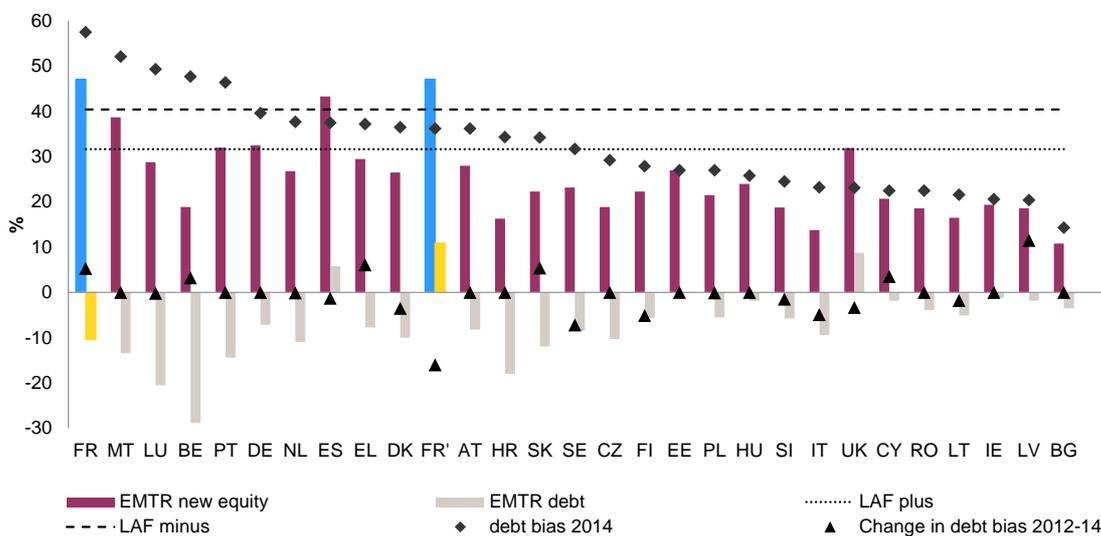
⁽⁴⁷⁾ Abolishing the lowest bracket of income tax would reduce total personal income tax revenue by 11 %, at a budgetary cost of approximately 0.4 % of GDP, all other things being equal. Source: European Commission, Joint Research Centre, based on the EUROMOD model.

⁽⁴⁸⁾ For an overview of EATR and EMTR data, see ZEW (2014), *Effective Tax Levels using the Devereux/Griffith methodology*.

⁽⁴⁹⁾ Taxation of capital income, *Note n° 9 du Conseil d'Analyse Economique* (Septembre 2013).

⁽⁵⁰⁾ An advance tax ruling is a tool used by multinational corporations and individual tax-filers to clarify particular taxation arrangements and ensure they are compliant.

Graph 3.1.1: Effective marginal tax rate on equity and debt-funded new corporate investments, 2014



(1) FR reflects the situation in France when the limited interest deductibility rule is disregarded, as normally assumed in the ZEW model. FR' reflects instead the situation in France when the limited interest deductibility rule is taken into account.

Source: ZEW(2014)

introduced or widened in the housing renovation and construction sector and in the film industry. These are expected to erode the tax base by EUR 2 billion (0.1 % of GDP), while tax expenditures, excluding the tax credit for competitiveness and employment, stand at EUR 72 billion, according to the government. Interest-free loans, which represent the main tax expenditure in corporate taxation, have been extended until the end of 2017.

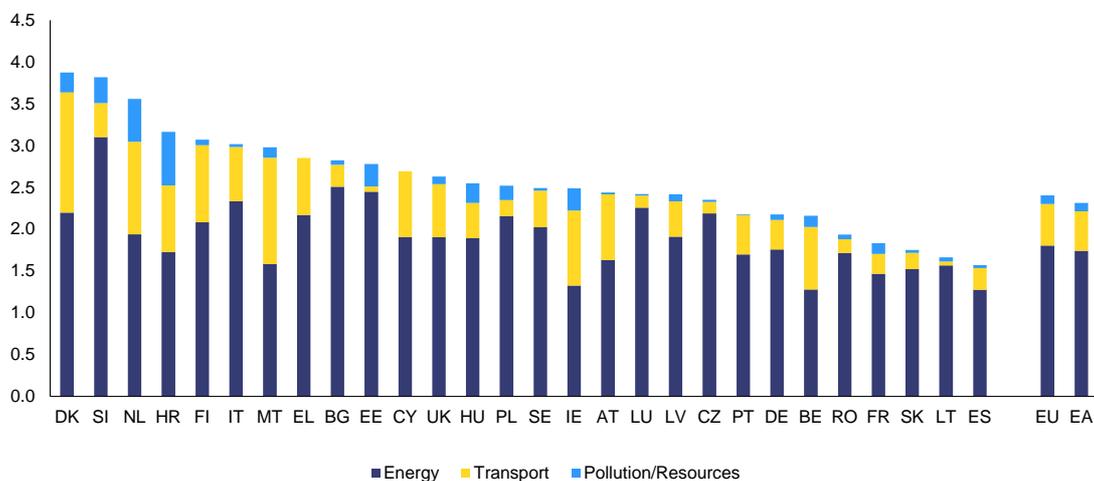
The French tax system is geared toward a narrow tax base, in particular on consumption. Indeed, the VAT policy gap, which measures the extent of VAT reduced rates, was among the highest in the EU over the period 2009-2012 (latest available data) ⁽⁵¹⁾. Moreover, consumption taxes are slightly below the EU average as a percentage of GDP (FR: 11.1 %, EU-28: 11.2 %, 2012) and among the lowest in terms of total taxation (FR: 24.7 %, EU-28: 28.5 %, 2012), confirming that there is scope for rebalancing the tax structure and for shifting some taxation from business and labour to consumption. However, no new measures have been taken to improve the efficiency of the VAT system since the increase in the reduced rates

that came into effect on 1 January 2014. On the contrary, the 2015 budget law widens the scope of the reduced tariff of 5.5% to supplies of works of art. Moreover, there has been no systematic evaluation of the impact of the measures on reduced VAT rates adopted in 2014.

France has a low proportion of environmental taxation and some environmentally-harmful subsidies remain. In France, environmental taxation accounts for the lowest percentage of revenue from taxes and social contributions in the EU-28 (at 4.08 % of total revenue) and the fourth lowest percentage of GDP (at 1.8 % of GDP in 2012, as shown in Graph 3.1.2). In 2014, a number of environmental taxation measures entered into force, such as the introduction of a new CO2 component in excise duties on energy products (the 'carbon tax'). Moreover, excise duties on diesel have been increased by EUR 0.02 per litre. Environmental taxes are not indexed and energy products are not taxed at the standard VAT rate and current taxation and subsidies negatively impact the resource efficiency. As an example, the way the pesticide tax is implemented does not provide any incentive for users of pesticides to reduce their use.

⁽⁵¹⁾ CPB/CASE. (2014). 2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU-27 Member States.

Graph 3.1.2: Environmental tax revenue by type of tax (2012, % of GDP)



Source: European Commission

The fiscal framework has been strengthened although the efficiency of corrective procedures has yet to be tested

The creation of the High Council for Public Finances (HCPF) increases the credibility of the fiscal framework. The task of this Council is to assess the plausibility of the macroeconomic scenario underlying the various budgetary plans and check that draft budgets are consistent with the structural deficit reduction path set in the current multiannual programming law for public finances. The influence of the High Council for Public Finances, whose opinions are taken into consideration by the French Constitutional Court and can in principle lead to a veto on a budget law, has contributed to draft budgets for 2014 and 2015 being founded on realistic macroeconomic assumptions. In particular, in the multiannual programming law for 2014-19 adopted on 29 December 2014, the government revised its potential growth estimate markedly downwards. On the other hand, for the years beyond 2015, the macroeconomic scenario is considered over-optimistic by the High Council for Public Finances.

Despite recourse to the correction mechanism, the structural adjustment targets set in the programming law for 2012-17 will not be met and new targets have now been set. In May 2014, the High Council for Public Finances identified risks of serious deviation from the

structural adjustment path set in the programming law for 2012-17 and consequently triggered the correction mechanism. Under the 2012 organic law, the government had to present corrective measures to reduce the gap with a view to meeting the structural targets. However, the government instead lowered its structural deficit targets for 2014 and 2015 in the new multiannual programming law, making them consistent with the expected outcomes for 2014 and 2015. Although the gap with the previous programming law is set to widen further, the revision in multiannual targets means that no correction is expected.

Some progress has been recorded in curbing the rise in local government spending. In 2014, the Council recommended that France introduce a ceiling on the increase in local government tax revenue. The government has expanded its effort to rein in local government, with a decrease of EUR 3.7 billion in the grant from central government planned in 2015, following an effective reduction of EUR 1.5 billion in 2014. Local administrations are, however, expected to partly offset the grant reduction by increasing tax revenue, mainly through the scope for increasing taxes on second homes. On the expenditure side, a yearly growth objective for local government expenditure has been introduced: the '*objectif national d'évolution de la dépense locale*' (ODEDEL). At this stage, the objective is only indicative and will differ according to the type of

local administration (commune, department or region) from 2016 on.

The main public spending review has generated little savings so far

Public expenditure has continued to rise, to 57 % of GDP in 2013. After having let automatic stabilisers play at the height of the crisis in 2008-2010, a number of euro area Member States have engaged in a reduction in public expenditures. On average in the euro area, public expenditures decreased by 1.7 % in real terms between 2010 and 2013. By contrast, they continued to increase by 3.5 % in France over the same period, with social benefits, at 26 % of GDP in 2013, driving the increase. In 2014, significant efforts have been done to curb the increase in public expenditures, notably through the freeze in public wages and more ambitious healthcare expenditure targets. These expenditure cuts were partly offset by the increasing cost of the tax credit for competitiveness and employment. To amplify these efforts, the French government plans expenditure cuts of EUR 50 billion between 2015 and 2017. In 2015, savings of EUR 21 billion (1.0 % of GDP) are to be made, split between central government (EUR 7.7 billion), social security (EUR 9.6 billion) and local government (EUR 3.7 billion). According to the 2015 winter forecast, these measures are expected to effectively slow down the growth in public expenditures in 2015, to only 0.7 % in real terms.

Savings generated by the *Modernisation de l'Action Publique* remain limited so far. The government launched its general review of public expenditure in 2007. This approach was followed in 2012 by the *Modernisation de l'Action Publique* (MAP) which sought to increase efficiency in all subsectors of public administration. The *Modernisation de l'Action Publique* was strengthened at the end of 2013 and saving targets were set. Specific issues are currently under investigation (day surgery, generic medicines, housing, subsidies to business and the role of the chambers of commerce, and a possible joint purchasing scheme for local authorities) on which reports will be published in the coming months. In general, it is still unclear whether the *Modernisation de l'Action Publique* process can deliver clear, operational recommendations and actions for modernising the administration and

there have been few savings so far. It is expected that the process will contribute only marginally to achieving the spending cuts planned over 2015-17⁽⁵²⁾. In addition to the *Modernisation de l'Action Publique*, the programming law for public finances introduces a spending review as part of the budgetary cycle. The review is intended to identify potential spending cuts and its findings and related proposals will be submitted to parliament by 1 March each year. There are no details yet about the results to be expected from this new procedure.

Reform of local administration is ongoing

The reform of the local administration seeks to increase efficiency in a context of lower grants from central government. France has a large number of communes or municipalities. French communes accounted for nearly 41 % of all municipalities in the European Union in 2012. This municipal fragmentation may reduce the effectiveness of public policies. In addition, local government in France is split between a number of layers of organisation (*intercommunalités*, *départements*, *régions*) with potentially overlapping powers. Against this background, the government has begun to reform local administration by reducing the number of local government organisations, notably by merging regions and by increasing the minimum number of inhabitants for an inter-communal body. The reform also clarifies the responsibility of the various layers of the local administration. In particular, the general competence clause, which gave the possibility for *départements* and *régions* to take actions beyond their area of competence, was abolished (only communes retain that possibility). In addition, to ensure a consistent approach to the largest urban areas in France, a bill adopted in January 2014 provides for the creation of integrated inter-communal structures (the *métropole* or metropolitan area) with a broad range of responsibilities. Eleven metropolitan areas have been created as of 2015, including the special Lyon area which, within its territory, will notably take on the responsibilities of the *département*. Marseille and Paris should follow in 2016. While

⁽⁵²⁾ The inter-ministerial committee on the MAP estimated that the MAP had yielded EUR 3 billion in 2014 and expected EUR 5 to 7 billion in additional savings over 2015-17.

critical, the reform of local administration will yield efficiency gains only in the medium term. In a context where grants provided by central government to local government are being reduced sharply, by close to EUR 11 billion between 2015 and 2017, these reforms will not directly support spending cuts by local government. There is also a risk that administrative costs increase in the short term due to the implementation of the reform. This could further constrain the budget of the local authorities, with a possible negative impact on local investment and infrastructure.

Limited progress has been made on improving the long-term sustainability of public finances

As pointed out in Section 2.2, the high and still rising level of government debt raises the question of the long-term sustainability of public finances. This is affected in particular by policies to address the long-term impact of an ageing population on healthcare and pension costs, so these are discussed here.

Limited progress has been made in tackling the projected medium-term and long-term rise in public expenditure on healthcare. Costs have been kept under control in the last few years thanks to improved monitoring, with public expenditure on health planned to be below the target set in the initial finance law for the fifth consecutive year in 2014. Additional savings in healthcare expenditure for 2015 are expected to total EUR 3.2 billion. This is the first step in a planned EUR 11 billion reduction in public healthcare expenditure between 2015 and 2017, aimed at limiting the yearly increase in public health expenditure to 2 % on average during that period. For 2015, the measures include a further cut in pharmaceutical prices and support for the use of generic medicines, efforts to eliminate prescriptions and treatments that are considered medically unnecessary and further optimisation of hospital spending. Savings in administrative costs are also planned. A draft law on public health has been presented which seeks to increase the efficiency of healthcare expenditure by applying a ‘clinical pathway’ system and encouraging a shift towards outpatient care. The budgetary impact of the draft law, which will depend critically on the text adopted, will likely be mostly felt in the medium term. Despite these measures, the projected increase in healthcare expenditure

remains significantly higher than GDP growth. According to the 2012 Ageing Report, public spending on health as a proportion of GDP was projected to increase above the EU-28 average by 2060⁽⁵³⁾.

No further measures have been taken to strengthen the long-term sustainability of the pension system. As pointed out in the Commission’s 2014 staff working document, the impact of the 2013 pension reform is unlikely to eliminate the deficit in the system, and official projections are that it will only halve the system’s total deficit by 2020. The monitoring committee set up as part of the reform gave its initial opinion in July 2014. The committee pointed out that additional work was needed to ensure fair treatment between employees in the public and private sectors. It has also warned that the system’s sustainability depends on the accuracy of macroeconomic assumptions stated in the stability programme, but these assumptions have been revised downwards in the draft budgetary plan. In particular, based on updated estimates of the steering council on pensions (*‘Conseil d’orientation des retraites’*) released in December 2014, and assuming that prudent assumptions are made about long-term macroeconomic developments, the overall system is still expected to run a deficit of close to 0.5 % of GDP in 2040⁽⁵⁴⁾.

The financial situation of complementary pension schemes calls for decisive action by social partners. In its opinion, the steering council on pensions (*Conseil d’orientation des retraites*) warned that social partners would need to take action in 2015 to restore the financial health of the complementary pension scheme. A specific report on the issue by the Court of Auditors⁽⁵⁵⁾ confirmed that, mainly due to the deterioration in the macroeconomic situation, the financial reserves of the complementary pension scheme will be exhausted by 2023 unless decisive action is taken. In particular, the Court of Auditors is calling for

⁽⁵³⁾ These results will be updated in the 2015 Ageing Report, to be published in the first half of 2015.

⁽⁵⁴⁾ This estimate is based on a long-term increase in labour productivity of 1.3 % per year (scenario C of the COR).

⁽⁵⁵⁾ Cour des comptes (2014), ‘Garantir l’avenir des retraites complémentaires des salariés (Agirc Arrco)’, Cour des Comptes.

measures amounting to at least EUR 5 billion by 2018 to ensure financial sustainability up to 2030.

3.2. LABOUR MARKET, SOCIAL POLICIES, SKILLS AND EDUCATION

Labour market performance

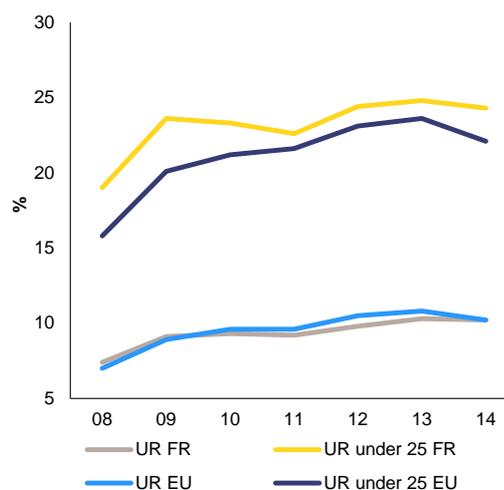
The French unemployment rate remained high in 2014 and long-term unemployment deteriorated, reflecting poor economic growth. The labour market remains segmented, with a limited transition rate from fixed-term to permanent contracts. At the same time, a number of rigidities reduce firms' adaptability to crisis. Young people and the low-qualified are the hardest hit by unemployment, while the low employment rate of older workers remains a structural problem. Educational outcomes are also showing signs of deterioration.

The active population continues to rise, with the number of workers between 20 and 64 years old increasing by 600 000 between 2008 and 2013, all of them being workers over 50 years old. Since 2011, both employment and unemployment rates have increased. The overall employment rate grew steadily from 69.3 % in 2011 to 70.1 % in the third quarter of 2014 as an increased number of older workers stayed in employment: the employment rate of workers aged 55 to 64 rose from 41.5 % in 2011 to 47.1 % in the third quarter of 2014, which shows the positive effects of the 2010 pension reform. However, the figure is lower than that of the EU as a whole mainly because the employment rate among people aged 60-64 is particularly low (10 points below the EU average).

In a time of weak job creation, the overall unemployment rate remained high at 10.2 % in 2014, compared to 10.3 % in 2013 and 7.5 % in 2008, particularly hitting young people, older workers and the low-qualified. Without an economic recovery, long-term unemployment has risen as a percentage of total unemployment, from 40.4 % in 2013 to 43.2 % in the third quarter of 2014. This risks weakening the skills and employability of the workforce. The youth unemployment rate rose from 19 % in 2008 to 24.3 % in 2014 (above the 22.1 % EU average). Young people with low levels of qualifications are particularly at risk: at ISCED 0-2 levels (International Standard Classification of Education, developed by UNESCO) they face a 37.6 % unemployment rate (far above the EU's 31.1 %). In France, low-qualified people of all ages face greater difficulties in the labour market, with a significantly higher unemployment rate for

ISCED levels 0-2, at 16.2 %. The number of recorded jobseekers over the age of 50 has also been rising, by 11.1 % between November 2013 and November 2014.

Graph 3.2.1: Unemployment rates total and of people aged under 25 - comparison France EU average



Source: European Commission

Targeted active labour-market policy measures prevented a further increase in the youth unemployment rate, but have not succeeded in reversing the trend yet. The *emplois d'avenir* scheme, after creating 100 000 jobs by the end of 2013, was extended to support an additional 70 000 new jobs in 2014 and further extended to cover 65 000 planned jobs for 2015. Although these contracts have a positive short-term effect on employment, there are concerns about whether they allow sustainable inclusion in the labour market. In fact, 75 % of the *emplois d'avenir* are signed in the non-market sector, and the training component included in the scheme is often delayed and leads to a qualification in only a third of cases. The budgeted cost of the *emplois d'avenir* for commitments made in 2015 is EUR 1.08 billion for the 50 000 *emplois d'avenir* proposed in the draft finance law.

The implementation of the Youth Guarantee remains challenging in terms of outreach, information and coordination strategies. The percentage of young people not in employment, education or training remains high, at 11.2% in 2013. The latest national records on the

implementation of the Youth Guarantee in France put the number of beneficiaries involved in a Youth Guarantee action at 738,000. At this stage, challenges remain regarding the coordination between actors and the quality of offers for such young people, especially from public employment services. Moreover, communication on the European Youth Guarantee could be strengthened to ensure dissemination of adequate information to all parties concerned. Efforts to improve outreach are under way with the creation of an inter-ministerial working group to connect existing databases. The coordination process is being reviewed and the role of *Pôle emploi* should be strengthened. To support young people facing multiple obstacles in the labour market, the experimental scheme 'Youth Guarantee', launched in October 2013 and managed by the *Missions locales*, with the aim of supporting 10 000 young people in 2014, will be progressively extended to reach 50 000 young people in 2015 and 100 000 in 2017.

Older jobseekers account for a rising proportion of unemployment, as several reforms have kept them in the labour market longer, thus increasing their risk of falling into long-term unemployment. The impact of targeted measures remained limited. The unemployment rate of older workers over the past years has significantly increased, from 4.6 % in 2008 to 7.0 % in 2013, decreasing slightly at 6.8 % in the third quarter 2014. The government introduced a 'Plan senior' in June 2014 and reformed the 'contrats de génération' that were introduced back in 2013, as presented in last year's report, doubling the size of the support provided to firms that employ jobseekers aged 55 years or more. Older workers and long-term unemployed people will benefit from specific targeting of 80 000 subsidised contracts in the competitive sector together with more active counselling. The unemployment benefit insurance convention that entered into force in July 2014 continues to allow unemployed people over 50 to qualify for longer-lasting benefit payments (36 months compared with 24 months in general). Overall, France has made some progress in promoting older workers' employment, mostly thanks to reforms in the pension system.

Public employment services face the challenge to step up support for an increased number of jobseekers and prioritising the most vulnerable

jobseekers in a context of stable resources. The new tripartite convention between the French State, the Unédic (National Interprofessional Union for Employment in Industry and Commerce), and *Pôle emploi* provides for doubling specific, reinforced counselling for jobseekers most in need, from 230 000 people covered in 2014 to 460 000 at the end of 2017. Support for companies by *Pôle emploi* will also be improved by prioritising support for companies offering the greatest opportunities for registered jobseekers. *Pôle emploi* has made some progress in tailoring its counselling to the job seeker's need, but there is scope to make referrals and connections between different categories of services and services delivered to companies smoother.

The long-lasting deterioration in the labour market has affected the unemployment benefit system, calling into question the sustainability of the model. The 'unemployment trap' remains relatively high in France ⁽⁵⁶⁾ although the gap between the French and EU average has been reduced in the last few years. The new convention on the unemployment benefit system was introduced on 1 July 2014, making individual rights 'transferable', and enabling jobseekers to keep previously acquired rights to unemployment benefits in future periods of unemployment, so increasing incentives to take up work. However, the level of benefits for the most highly paid workers has been maintained. Adjustments to the specific systems for older workers and for workers in the entertainment industries were limited. The different measures introduced by the agreement will produce EUR 0.3 billion in savings in 2014. Its impact on 2015 is expected to reduce the deficit by a further EUR 0.8 billion, from EUR 5.2 to EUR 4.4 billion, leading to a further increase in the system's debt to EUR 25.9 billion. The unemployment benefit scheme is due to be reviewed again in 2016. Overall, limited progress has been made in restoring the sustainability of the scheme, while the results in terms of getting people back to work remain uncertain.

France suffers from labour-market segmentation, with open-ended contracts steady but shorter, fixed-term contracts accounting for

⁽⁵⁶⁾ JAF Eurostat 2012 77.3 % (74.7 % EU).

an increasing share of new hires. Transition between temporary and permanent employment is strikingly low, at a rate of 10.9 % compared with 23.9 % across the EU in 2012. Open-ended contracts accounted for a steady 87 % of employment in the competitive sector between 2000 and 2012. At lower qualification levels, young people and women are more likely to be employed on temporary contract. The French labour market appears, however, open to maintaining or improving work status, recording a higher transition rate to similar or better employment security, at 89.7 % in 2012 compared with an EU average of 86.6 %. The transition rate from permanent employment to unemployment was 2.7 %, slightly above the 2.5 % EU average.

The law on securing employment, adopted in a period of weak growth, has not enabled the trend towards increased labour-market segmentation to be reversed. Fixed-term contracts rose from 80 % to 87 % as a percentage of new hires on a 10-year basis. Fixed-term contracts of less than one month accounted for 80.4 % of new hires in the third quarter of 2014, an increase of 10 points in 10 years. Precarious work status increased, as the median length of fixed-term contracts fell from 14 to 10 days between 2012 and 2013. So targeted efforts to reduce the level of segmentation, notably through higher social contributions for very short-term contracts, have failed to curb the increase in the proportion of fixed-term contracts for new hires. This may be due to improper declaration, as short contracts for seasonal work and temporary replacement are exempted from higher contributions.

France has made limited progress in combating labour-market rigidity. Only six companies have used the company-level agreements created by the new law (*Accords de maintien de l'emploi*), with others preferring to sign similar 'competitiveness agreements' outside the new framework. However, the law also modified the rules framing collective dismissals to reduce legal uncertainty by reducing the time allowed for taking a dispute to court. In addition, the draft law on Growth and Economic Activity will improve the efficiency of *prud'hommes* (work contract joint jurisdictions) and reduce the length of the related procedures (see Box 3.3.1).

Social policies

The social situation in France remains better than the EU average, with 18.1 % of the population at risk of poverty or social exclusion in 2013 (-0.4 pp. compared to 2008) against 24.5 % for the EU. France fares much better than the EU average for the three EU 2020 poverty and social exclusion indicators, with 13.7 % of its population at risk of poverty after social transfers (16.7 % on EU average), 5.1 % severely materially deprived (9.6 % for the EU) and 7.9 % living in households with very low work intensity (10.7 % for the EU). The impact of social transfers on poverty reduction remains high, at 43 %, compared with an EU average of 35 %. The intensity of poverty has slightly decreased since 2011. The Gini coefficient also decreased in 2012 and 2013 though its level is still rather high (30.1 compared with 26.6 in 2007). However, while the poverty rate among unemployed people decreased slightly in 2013 (to 35.7 %), the increasing proportion of part-time workers, particularly those who earn close to the statutory minimum wage, means that in-work poverty was stable (8 % in 2012 and 7.9 % in 2013 compared to 6.5 % in 2010). Also, the situation for the most vulnerable categories, including children, young people and single-parent families, despite a slight decrease compared with 2012, remains worrisome, with poverty rates of 18 %, 22.7 % and 34.9 % respectively in 2013, similar to the EU average for young people and even higher for single-parent families (by 3.1 pps.).

Employment and social outcomes remain marked by significant inequalities, particularly affecting women and migrants. The employment rate for women remains well below that of men (65.6 % compared with 73.7 % in 2013). Moreover, women are 4.3 times more likely to work part-time and the gender pay gap remains large though below the EU average (15.4 % compared with 16.5 %), leading to a wide gender gap in pensions (39 %) close to the EU average. France is one of six Member States where activity rates differ most between non-EU citizens and nationals (aged 20-64 years), at 64.8 % for non-EU citizens, compared with the EU's 71.4 % in 2013, and 77.5 % for French citizens. The gap is even wider for the non-EU female population, whose employment rate in France is the lowest except for Belgium, at more than 10 pps. below the EU average. Non-EU nationals also face a higher

unemployment rate, 25 % (EU average 21.5 %), against 8.9 % for French citizens in 2013. In 2012, 76 % of the population considered discrimination on the grounds of ethnic origin to be widespread in France, the highest percentage in the EU.

The implementation of the multiannual anti-poverty plan adopted in January 2013 is underway. Despite real progress, some major reforms are still overdue. A second assessment of the government's action plan against poverty, published in January 2015, acknowledges that significant actions have been taken since the last report (2014). However, it also draws attention to the delay in the introduction of certain measures, for example simplifying the rights of benefit recipients. It also recommends to strengthen and to better manage emergency shelter solutions, to increase the supply of affordable social housing for the very low-income households and to better target single-parent families through childcare facilities and pathways towards employment. The President announced in August 2014 his intention to merge current wage support schemes, i.e. the '*revenu de solidarité active*' and the '*prime pour l'emploi*', as they can both be complicated to use, suffer from delays, or be difficult to access. Moreover, the take-up rate for the '*revenu de solidarité active*' among the working poor is disappointing. The measure, to be implemented from January 2016, should cover all the active population over 18 and is due to support wages of up to 1.2 times the minimum wage, at a budgetary cost of EUR 4 billion, equivalent to the two currently existing schemes. In parallel, according to the commitments in the multiannual plan, the amount of the '*revenu de solidarité active*' was raised by 2 % in real terms in September 2014. These measures are also intended to extend measures taken in 2014 to reduce income taxes on lower revenues, with a tax credit on low incomes applicable from 2014, to be followed from 2015 with the abolition of the bottom layer of income tax. Combined, both measures would reduce tax for up to 9 million households, supporting demand and meeting social expectations.

Education and lifelong learning

France is facing a widening gap in educational attainments with a consistent increase of low achievers. Inequality linked to the socioeconomic background is among the highest in OECD

countries. The 2013 reform of compulsory education is underway and most measures are implemented according to the planning. This includes general measures to raise the basic skills and specific ones to reduce the educational inequalities. General measures encompass the reform of the school calendar in primary education, which has been widely implemented, the reform of curricula, which is still in an initial phase and the improvement in initial training of teachers. The monitoring of some key measures (e.g. 'More teachers than classrooms') highlighted room for improvement.

The initial phase of a new 'Priority Education' plan targeting schools in disadvantaged area started in September 2014, with a view to contribute reducing to less than 10% the differences in basic skills attainment between such areas and the average. Measures include the revision of the 'priority education' map and networks finalised by end 2014, the reinforcement of appropriate pedagogical approaches, increased teachers support via the roll-out in priority education of the 'More teachers than classrooms' scheme and more financial incentives for teachers. Full implementation of the priority education plan and networks is foreseen for 2015-16.

The crisis has brought additional difficulties for youngsters with at most a low secondary level diploma to enter the labour market. The unemployment rate of young people with no qualifications three years after exiting the education system increased by 16 pps between 2007 and 2013, compared to 8 pps on average for young people from the same generation. Despite a decrease in the early school leaving rate to 9.7% in 2013, the proportion of pupils leaving school with poor qualification stagnates close to 17%, still far from the ambitious objective to halve their number by end 2017.

New measures have been taken to develop a more comprehensive and efficient early school leaving policy, which remain to be implemented. As a follow-up to a 2014 evaluation report on the measures against early school leaving implemented in recent years, the national authorities adopted an action plan to fight early school leaving entering into force in 2015, supported by an annual budget of EUR 50 Million and focused on three areas: the mobilisation of all

actors, increased prevention, and acquisition of qualifications for early school leavers. The implementation of the plan should be accelerated according to a recent declaration of the national authorities. Key measures foreseen in the reform of compulsory education to raise the early childhood education and care participation rate of 2-3 years old to 30% by 2017 support specifically the most disadvantaged group and contribute also to prevent early school leaving ⁽⁵⁷⁾.

Vocational education and training and apprenticeship are underdeveloped and links between the education system and the labour market are still insufficient. Around 27 % of students in vocational education and training are involved in work-based learning, but the number of new apprenticeships fell by 8.1 % in 2013 and by 12 % in the first half of 2014, at odds with the government's target of 500 000 apprentices by 2017. The number of apprentices whose highest qualification is the *baccalauréat* or an equivalent diploma, whose transition from school to work is more problematic, fell by 13 % between 2005 and 2013, while the added value of apprenticeship for entering the labour market is greater at lower levels of qualification. Various measures have been taken across the different levels of compulsory and higher education to develop guidance systems, to support the development of entrepreneurial skillsets and to improve links between education and economic actors. Measures include a new national 'Education-Economy Council', still in its infancy, while the implementation of 'campuses of professions and qualifications' has progressed. The number of vocational qualifications (the *baccalauréats professionnels*) has increased since 2011, notably as a result of the 2009 reform of upper secondary schools.

The law on vocational training includes specific measures, entering into force in 2015, to promote apprenticeship, such as introducing open-ended apprenticeship contracts and providing more secure funding for apprenticeships for those with fewer qualifications. The government announced a plan to allocate EUR 200 million to reintroduce from September 2014 a subsidy of

EUR 1000 per new apprentice for companies with up to 249 employees and to amend the apprenticeship tax to benefit companies. Employers will also be better involved in the definition of apprenticeship training to make it fitter for purpose, and a specific 'apprentice' status will be created. The government also committed to increase from 40 to 60 000 the number of apprentices in vocational high schools. France has made limited progress towards improving the transition from school to work, especially for the low-skilled.

France ranks low in adult basic competencies and entrepreneurial skills. The level of adult literacy and numeracy in France for those with at most lower secondary education is among the lowest in the EU (OECD, PIAAC 2014). Access to lifelong learning is more difficult for older people, the unemployed and those with low levels of skills. France also falls short of delivering the entrepreneurial competences that could enhance innovation, job creation and self-employment. Only 33 % of French adults (18-64) believe they have the required skills and knowledge needed to start a business, compared with an EU average of 42 %.

The vocational training reform will provide additional funds for jobseekers and companies with fewer than 10 employees and the creation of a personal training account should facilitate access to training for both jobseekers and employees. Following the 2013 success of a scheme providing 30 000 specific training places for jobseekers in sectors with medium-term labour force needs, the scheme has been extended to 100 000 in 2014 and will be continued in 2015, focusing on the long-term unemployed.

The impact of the training reform will depend on the quality of training offered, its relevance to the needs of the labour market and the resources allocated to gearing access to the system towards jobseekers (who in 2012 accounted for only 8 % of vocational training expenditure) and the less qualified. Overall, France has made some progress in modernising its vocational education and training system.

⁽⁵⁷⁾ [Plan de refondation de l'éducation prioritaire, Ministère de l'Éducation Nationale, 2014](#)

3.3. IMPROVING THE BUSINESS ENVIRONMENT AND ENHANCING COMPETITION

Complex regulation continues to weigh on the business environment despite ongoing simplification efforts

The French business environment is not sufficiently conducive to growth. France ranks 31st worldwide and 13th among the EU-28 according to the World Bank *Doing Business Report* ⁽⁵⁸⁾, ranking particularly low for registering property (126th), paying taxes (95th) and dealing with construction permits (86th). In last year's in-depth review, it was suggested that the relatively business-unfriendly environment in France may weigh on firms' growth potential and that, for instance several regulations, in particular those associated with specific size thresholds may hamper the growth of French firms and play a role in SMEs' difficulty in expanding to a size that would allow them to export, as well as to innovate. Against this background, the Council recommended in 2014 that France simplify companies' administrative, fiscal and accounting rules and eliminate regulatory impediments to company growth.

The government has set an ambitious simplification agenda which is starting to yield results. The initiative aims to simplify regulations with an impact on enterprises and to improve the business environment, by both addressing administrative procedures and modernising the public administration. The simplification agenda has resulted in a continuous stream of proposals. The simplification council adopted 50 proposals each half year in 2014, mostly in April and October. Of the proposals included in the April package, about a quarter have been fully implemented and some action has already been undertaken on the rest. Of the proposals in the October package, 30 % were included in the draft law on economic activity, with a number of proposals that simplify the rules for obtaining construction permits. Overall, the government estimates that the measures taken since the launch of the strategy yielded gross savings of EUR 2.4 billion (0.1 % of GDP) for companies and consumers ⁽⁵⁹⁾. Flagship measures include the

principle of tacit consent for about one third of administrative procedures and the principle of zero additional charges for business, although the creation of an independent authority in charge of monitoring the effect of that principle has been delayed.

The simplification agenda has positive impacts on smaller companies but other important barriers remain in place. As suggested in Section 2, growth appears to be a persistent problem for smaller companies. Support for the creation and growth of new companies is provided through measures such as the Young Innovative Enterprises tax incentive, the creation of Bpifrance and more recently also the *Crédit d'Impôt Innovation* and France Brevet. Moreover, in addition to other burdens, regulatory thresholds in the labour law and accounting regulations that limit the growth of French firms remain an important burden on companies. Although the exact impact of these thresholds on firm growth may be difficult to assess, as it may vary according to firm data sources, it is significant. A survey conducted by INSEE ⁽⁶⁰⁾ pointed that, while the impact of thresholds seemed limited based on firms' social security database, it was more significant when using firms' tax databases, showing an accumulation of companies with employees located just below the threshold. In particular, there are 2.6 times fewer companies with 50 employees than with 49 employees and 1.7 to 1.8 times fewer firms when the "20" or "10" thresholds are reached respectively. Furthermore, the Commission 2014 in-depth review pointed to significant effects at the 50 employees' threshold also according to the INSEE's SIRENE corporate directory (24 % fewer firms of "50-54" employees than companies of "45-49"). In the absence of an agreement between social partners on improving social dialogue, the government has announced that it will legislate in the second quarter to streamline the employee representation in companies. In addition, France does not systematically take into account the impact of new laws on SMEs. For example the current tax credit for competitiveness and employment is less effective for the smallest firms, because the

⁽⁵⁸⁾ World Bank (2014), *Doing Business in 2015 - Economy Profile - France*.

⁽⁵⁹⁾ Secrétariat d'état chargé de la réforme de l'état et de la simplification (2014) Bilan d'étape

⁽⁶⁰⁾ INSEE Analyses n°2 (2011), "les seuils de 10, 20 et 50 salariés: un impact limité sur les entreprises françaises" (Ceci-Renaud and Chevalier).

formalities necessary to receive it and the delay for payment do not suit very small firms, notwithstanding the pre-financing instrument that has been set up through the public investment bank.

Bankruptcy laws are being amended. The draft law on economic activity creates specialist courts for large companies in difficulties and would allow judges, as a last resort, to transfer ownership from shareholders to investors with a credible rescue plan. The intention is to reduce the loss of firm-specific value added and save jobs in bankruptcy proceedings. In the same context of making legal proceedings more efficient, the draft law provides for greater specialisation of commercial courts, which could reduce the length of the procedures and improve the predictability of the outcomes.

R&D intensity and innovation capacity have not kept pace with innovation leaders

R&D intensity has increased somewhat over the last 10 years but remains below that of innovation leaders in the EU and progress towards the Europe 2020 objective of a 3 % GDP target is insufficient. R&D intensity in France stood at 2.2 % of GDP in 2013, up from 2.1 % of GDP in 2000. Public investment in R&D has stagnated since 2000 at 0.8 % of GDP but this has been complemented by indirect support to private R&D activities, which has increased significantly since 2008, in particular through the '*Crédit d'Impôt Recherche*', with an expenditure of around EUR 5.3 billion in 2012 (0.3 % of GDP). Some progress has been made in private sector expenditure, which stood at 1.4 % of GDP in 2013 compared with 1.3 % of GDP in 2000. However, in an international perspective, France's R&D intensity is well below that of Germany (2.9 %) and the Scandinavian countries (above 3 %). The gap with the innovation leaders is largely due to lower private sector spending on R&D.

The R&D intensity of the manufacturing industry is relatively high but innovation is relatively low The R&D intensity of the manufacturing industry, i.e. the ratio of R&D expenditure to value added, is 8 %. This is the sixth highest in the EU. As suggested in last year's in-depth review, the declining share of the manufacturing sector in the overall economy and the lack of medium-sized companies are lowering

the R&D intensity of the economy. Moreover, France is lagging behind in innovation capacity. According to the European Commission's Innovation Union Scoreboard (2014) France is ranked tenth in innovation and is classified as an "innovation follower" with relative weaknesses in non-R&D innovation expenditure, Community trademarks and in knowledge-intensive service exports⁽⁶¹⁾. This is corroborated by Eurostat statistics which demonstrate that French manufacturing firms, were 20 % less likely to engage in product or process innovation than their German counterparts in 2012 (only 43 % of total firms in France versus 63 % in Germany). Last year's in-depth review attributed this lower ability to innovate to the relatively small firm size, the low proportion of researchers among staff and companies' low profit margins and to an environment that insufficiently enables the diffusion of innovation⁽⁶²⁾. Improving innovation potential in France therefore implies both boosting the innovation capacity of existing firms and taking measures to encourage new innovative firms to emerge. The recent shift by Bpifrance with reference to financing innovation-oriented and not just R&D oriented companies is welcome.

The French research and innovation landscape is complex and there is a clear risk of fragmentation and overlap between different policy instruments. The system of public support for research and innovation is excessively complex and insufficiently geared towards quality and efficiency. In this context, there has been no evaluation of the efficiency of the complete portfolio of policy instruments in support of research and innovation as recommended in last year's Council recommendation. The new National Commission for the Evaluation of Innovation Policies will be a vital tool in this respect.

A high-quality public research base contributes to the attractiveness of France as a location for carrying out research and innovation and

⁽⁶¹⁾ European Commission (2014) Innovation Union Scoreboard. European Commission

⁽⁶²⁾ The latest OECD review on innovation policy in France also makes the link with overall framework conditions for economic activity not being particularly favourable to innovation in France, detracting from corporate ability to finance investment and to mobilise the human resources required for innovation, OECD (2014), OECD Reviews of Innovation Policy: France 2014, OECD publishing.

encouraging new innovative firms to emerge. The average performance of French public research is a factor of continuing concern. Important bottlenecks are the low level of competitive funding, the lack of quality-related criteria in allocating funding to public institutions and a failure to modernise the research profession.

The pôles de compétitivité, launched in 2005, have only had a limited impact and do not sufficiently target innovation. The *pôles de compétitivité* are R&D and innovation clusters generated by national and local authorities which gather on an identified territory research laboratories and universities together with small and large firms focusing on specific technologies. They aim at promoting the development of collaborative projects in research and development and to favour linkages between these public and private entities. In total, 71 *pôles* have been created. The assessment of these *pôles* is mixed. On the one hand, the policy has encouraged genuine partnerships between firms and public research actors, and members' R&D expenditure has increased somewhat as a result of their participation. On the other hand, the *pôles* have until recently had a strong focus on R&D, with only limited impact on innovation, growth or job creation⁽⁶³⁾. An INSEE study⁽⁶⁴⁾ emphasises that the participation in a pole yields no significant effect in terms of turnover or patent registration. In addition, governance of some of them has been poor and only a few have effectively generated a network dynamics⁽⁶⁵⁾. Therefore, limited progress has been made with respect to the recommendation made by the Council in 2014 to ensure that resources are focused on the most effective *pôles* and further promote the economic impact of innovation developed in them. In a context where support from the State budget has been reduced, efforts have been made to focus these resources on the most successful *pôles*. Nevertheless, no reduction in the total number of *pôles* is currently envisaged.

⁽⁶³⁾ Erdyn-Technopolis-Bearing point (2012), "Etude portant sur l'évaluation des pôles de compétitivité, Rapport global"

⁽⁶⁴⁾ INSEE Analyses n°14 (2013), La participation aux pôles de compétitivité : quels effets pour les PME et ETI ? (Dortet-Bernadet V.)

⁽⁶⁵⁾ Cour des Comptes (2011) Rapport public annuel.

The *crédit d'impôt recherche* has only had a limited impact on the creation of new research activity. Tax incentives granted to research and innovation are quite well-designed in France. The broad eligibility criteria for the *crédit d'impôt recherche* avoids creating a 'picking-the-winner' policy. In particular, the main deductible expenditure remains the cost of researchers, which can be expected to bring about strong knowledge spillovers⁽⁶⁶⁾. However, the *crédit d'impôt recherche* has mainly served to maintain existing private research rather than creating new research activity – a fact raising some concerns about its efficiency when assessed against its budgetary costs of around 0.3 % of GDP. Large companies consume the bulk of the tax credit (0.6 % of all declarations account for 35 % of the total credit granted compared with 33 % in 2011), although aid intensity is largest for small companies. The cost of preparing the tax file also absorbs a substantial amount of the benefit although it has decreased over the past years.

Little has been done to assess and improve the performance of the *crédit d'impôt recherche*. An evaluation of the *crédit d'impôt recherche* was recently conducted by the Ministry for Higher Education and Research⁽⁶⁷⁾. Although the evaluation reports that the overall impact of the *crédit d'impôt recherche* was positive, it suggests that its effectiveness varies depending on the amount of tax credit received. Important to note is that the data coverage is limited to the period 2004-2009 with consolidated results over that period. This coupled with the lack of causal explanation and of an evaluation of the impact on growth and job creation limits the usefulness of the study. Moreover, no amendment of the *crédit d'impôt recherche* is planned, to maintain continuity of the tool.

Although an efficient IT network is among the key framework conditions for business innovation, high-speed broadband development is relatively slow. Next Generation Access broadband which enables high-speed downloads

⁽⁶⁶⁾ CPB, "Study on R&D tax incentives" (2014), Final report, Study commissioned by the European Commission.

⁽⁶⁷⁾ Lhuillery, Marino et Parrotta, (2014), "Evaluation de l'impact des aides directes et indirectes à la R&D en France"; Rapport pour le Ministère de l'Enseignement Supérieur et de la Recherche (December 2013).

only covered 41 % of French households at the end of 2013, well below the EU average of 62 %. While progress has been made (from 23 % in 2011) it is still insufficient to catch-up with the rest of the EU and to achieve full coverage by 2020. Also, mobile broadband take-up at 48 subscriptions per 100 persons in 2013, is well below the EU average of 62 %. In order to tackle the problem of the coverage of high-speed broadband, the French government has adopted the "Plan Très Haut Débit" and set up the "Mission France Très Haut Débit" with a view to ensure integral coverage of the national territory by 2022 by means of planned investment of EUR 20 billion from both public and private sources.

Product market rigidities are high in France

As discussed in Section 2 rigidities in product and labour markets hamper productivity growth. Rents in the services sector are high and can be associated with product market rigidities. Low productivity growth combined with higher wage growth has resulted in price increases which are passed through to downstream industries and consumers. More productivity and lower prices in the services sector would create extra value added and jobs not only in the services sector but also in the manufacturing industry. Although its economic impact remains uncertain at this stage, the draft Law on Growth and Economic Activity (see Box 3.3.1) includes measures which are set to reduce rigidities on product markets and to enhance competition in a number of services.

Competition in regulated professions is low

A number of regulations and tariffs for regulated professions in France constrain economic activity. A report from the *Inspection Générale des Finances* (IGF) on regulated professions investigated 37 regulated professions, out of over 200 registered regulated professions, with a total annual turnover of about EUR 235 billion accounting for 6.4 % of GDP in 2010⁽⁶⁸⁾. The report suggested that a number of regulations and tariffs were no longer justified. These regulatory barriers led to excessive rents. On average, the net profit before tax for the

37 professions was 19.2 % of their turnover, which is 2.4 times higher than for the French economy as a whole. To end these excessive rents, the report proposed regulatory changes for all the 37 professions which, if adopted, could increase GDP by 0.5 pp. and create more than 120 000 jobs over five years according to estimates by the French Treasury cited in the IGF report. For the legal professions, an analysis by the Competition Authority broadly confirms that there are regulatory barriers that can create economic rents in these sectors⁽⁶⁹⁾.

The report has led to a number of isolated, smaller reforms in the course of 2014. In February, a decree was adopted that allowed notaries to have two salaried associates and that allowed lawyers at the "Conseil d'Etat" and the "Cour de Cassation" to engage salaried workers⁽⁷⁰⁾. In March, the Consumption Law was adopted, abolishing pharmacies monopoly on the sale of certain products, e.g. pregnancy tests, and allowing the sale of glasses and lenses on the internet⁽⁷¹⁾. The same law also introduced more general measures to improve competition such as class action procedures. In May, the provision that the capital and voting rights of accounting firms needed to be at least 50 % owned by accountants registered in France was replaced by a provision that European accountants need to hold at least two thirds of the voting rights⁽⁷²⁾, which could facilitate the development of branches of international accounting offices in France. In general these reforms go in the right direction. In particular, allowing the sale of glasses and lenses via the internet can have a significant impact in terms of increasing competition and lowering prices. However, in most cases reforms are only very partial and do not significantly change the existing barriers in these professions.

⁽⁶⁸⁾ Inspection Générale des Finances (2013) Les professions réglementées Rapport n°2012 M 057 03, mars 2013.

⁽⁶⁹⁾ See Avis n° 15-A-02 du 9 janvier 2015 relatif aux questions de concurrence concernant certaines professions juridiques réglementées.

⁽⁷⁰⁾ Ordonnance n°2014-239 du 27 février 2014 relative à l'exercice des professions d'avocat au Conseil d'Etat et à la Cour de cassation et de notaire en qualité de salarié

⁽⁷¹⁾ Loi n°2014-344 du 17 mars 2014 relative à la consommation

⁽⁷²⁾ Ordonnance n°2014-443 du 30 avril 2014 modifiant l'ordonnance n°45-2138 du 19 septembre 1945 portant institution de l'ordre des experts-comptables et réglementant le titre et la profession d'expert-comptable

Box 3.3.1: Main measures included in the draft Law on Growth and Economic Activity

The draft Law on Growth and Economic Activity was presented on 10 December 2014. The law was adopted on 17 February 2015 in first reading by the National Assembly and will then be discussed in the Senate. Based on the text adopted by the National Assembly, the draft law includes measures on:

- Regulated professions: Mechanisms to better align tariffs with costs will be implemented for 6 legal professions. Steps will also be taken to increase the freedom of establishment for 4 other legal professions, including notably notaries. Finally, restrictions on the capital ownership of legal professions will be reduced.
- Retail sector: City mayors can allow retailers to open up to 12 Sundays per year. International Touristic Zones will be created, on the proposal of the government, in which Sunday work and evening work would be possible throughout the year. Criteria for mayors to create commercial zones opened on Sunday have been made more flexible.
- Sunday work: More generally, the labour rules that apply to Sunday and evening work will be simplified and streamlined
- Prud'hommes: The duration of the procedures will be reduced through a three-month deadline for the initial decision and the legal training given to judges appointed by the social partners will be improved.
- Transport sector: The coach transport market will be fully deregulated for interregional and long-distance services distances. Authorities will retain the possibility to prohibit the creation of a new route or to impose a limit in terms of time schedule or capacity to maintain the economic equilibrium of the public service provider upon advice of the transport regulator for local routes below 100km.

Although it leaves aside some regulated sectors (e.g. in the health sector), the draft law is a positive step. The measures considered at this stage are expected to reduce regulatory hurdles and to improve competition. In any case, the economic impact of the draft law will depend on the final design and implementation of the reforms.

New regulations on taxis further restrict competition. In France taxi drivers need to pass a professional examination and acquire a licence. Licences can be obtained for free from local authorities but the waiting list is up to 20 years in Paris. It is possible to buy a licence but an average licence costs more than EUR 200 000 in Paris, indicating that demand is much greater than supply. Taxis have a monopoly on picking up passengers without prior reservation. For passengers who book in advance, taxis compete with tourist vehicles. While there were about the same number of taxis per 10 000 inhabitants in Paris (25), London (16) and New-York (28) in 2011, the number of taxis and tourist vehicles is four times lower in Paris (27) than in the two other cities (on average 77), suggesting that the system of tourist vehicles is underdeveloped in Paris. Given the shortage of taxis, and the use of internet for booking, the system of tourist vehicles has

grown significantly in recent years⁽⁷³⁾. In this context, France has proposed a new regulatory framework in October 2014 that limits mobile electronic booking to taxis and forbids tourist vehicles from waiting at train stations and airports after a ride, obliging them to return to their depots. The same law also forbids the re-sale of taxi licences granted in the future, which all else being equal will further increase the price of current licences.

The draft Law on Growth and Economic Activity proposes a number of measures to reform legal professions, while a forthcoming reform of health professions is also planned. The draft Law on Growth and Economic Activity

⁽⁷³⁾ Autorité de la Concurrence : Avis du 16 décembre 2013 concernant un projet de décret relatif à la réservation préalable des voitures de tourisme avec chauffeur

(see Box 3.3.1) modernises some of the rules pertaining to legal professions. For six legal professions⁽⁷⁴⁾, the prices for simple acts will be regulated. In specific cases, discounts will be applicable. Four of these professions⁽⁷⁵⁾ will also experience a greater freedom of establishment, with notably an increase from ¼ to ½ in the ratio of notaries that own their practice to wage-earner notaries. The draft law also proposes to open up the capital of the legal professionals. In the health sector, the draft law on healthcare, which is expected to be discussed in Parliament in the first half of 2015, should notably lead to a revision in the regulations for some health professions. However, based on the information included in the current draft, presented on 15 October 2014, the ambition of the government seems limited in this respect.

France has started to make some progress in reforming the regulated professions. The six legal professions covered by the draft law had a turnover of EUR 8 billion (0.4 % of GDP) in 2010. They therefore account for only a limited proportion of the total turnover of the professions covered by the report of the *Inspection Générale des Finances*. Moreover, the proposals in the draft law go less far in liberalising the legal professions than the report of the *Inspection Générale des Finances* suggested⁽⁷⁶⁾. Nonetheless, the proposed reforms should improve the functioning of these legal professions. Adjusting the tariffs to real costs should reduce prices for consumers and businesses. The draft law addresses those regulated professions where rents are the highest but does not touch at the other professions identified in the report of the *Inspection Générale des Finances*. Beyond formal legal provisions, France has not carried out an extensive analysis of the practice of public authorities when granting authorisations for access and exercise of regulated professions, and assessed whether it is done in a transparent manner.

⁽⁷⁴⁾ « Administrateurs judiciaires », « greffiers de tribunaux de commerce », « notaires », « huissiers de justice », « commissaires-priseurs judiciaires » and « mandataires judiciaires »

⁽⁷⁵⁾ « Notaires, huissiers de justice, commissaires-priseurs judiciaires et mandataires judiciaires »

⁽⁷⁶⁾ The competition authority has also proposed a number of additional reforms. Avis du 9 janvier 2015 relatif aux questions de concurrence concernant certaines professions juridiques réglementées.

Entry barriers in the retail sector are diminishing

Entry barriers in the retail sector are limiting competition, which can result in higher prices for consumers. The price-cost margin or mark-ups in the retail trade sector have decreased significantly in France between 1996 and 2013 but remain relatively high in an EU perspective. Requirements imposed on retailers for the establishment of retail outlets have been creating barriers to enter the market, affecting the structure of the market and therefore competition in the sector to the detriment of consumers. Nonetheless, entry in retail is important because in the retail sector nearly half of the productivity gains stem from new companies that replace existing less productive firms⁽⁷⁷⁾.

Progress has been made to remove regulatory barriers to entry but they are not yet implemented on the ground. The '*Loi relative à l'artisanat, au commerce et aux très petites entreprises*' adopted on 18 June 2014, aims at simplifying the procedure for the establishment of trade outlets. It foresees a streamlining of the procedures and also a more efficient appeal process. However, some of the provisions in the law remain general with a broad margin of interpretation. Therefore, the implementation will be crucial to ensure that regulatory barriers do not hamper market entry. The draft law on Economic Activity proposes that the Competition Authority can provide advice on local planning documents to ensure that they are not unduly limiting entry. Moreover, the draft law proposes to empower the Competition Authority with the right, if certain conditions are fulfilled, to ask commercial operators having a market share higher than 50 % to take action or ultimately run the risk of having to divest. The new measures, if adopted, would further improve the functioning of the retail sector.

In spite of the simplification brought by the draft law on Growth and Economic Activity, rules on Sunday opening would remain complex. While the measures to extend the possibility for retailers to open on Sundays (see

⁽⁷⁷⁾ Turner L. (2013), « La productivité dans le commerce : l'impact du renouvellement, de l'innovation et de l'appartenance à un réseau », in Bacheré H. (coord.), *Les entreprises en France - Insee Références - Édition 2013*, octobre.

Box 3.3.1) are a positive step, uncertainties remain on their actual implementation. A few "International Touristic Zones" are going to be created where the opening rules will be the most flexible (Sunday and evenings). "Touristic zones", in larger number, are also foreseen where new rules will only concern Sunday openings. For the rest of the country, the main rule prevails which foresees decisions to be taken by the local authorities to open up to 12 Sundays. Overall the system of the Sunday work is expected to increase the possibilities for retailers to open on Sundays but it is likely to remain complex as different zones with unclear delineations are envisaged.

The retail sector continues to face regulatory barriers and low competition. The ban on sales below costs still remains in place and the periods during which clearance sales can take place are heavily regulated.

Entry barriers in the transport industry remain high

Market entry barriers in the railway sector are still preventing an efficient market functioning. France has not opened up its domestic rail passenger market to competition, except for international services, where there are few new entrants. This includes public service obligation contracts that are awarded directly rather than tendered which hampers the opening of this market. For freight, new entrants' market share rose to 36 % in 2013 (32 % in 2012). France has launched a reform of its railway system with a view to preparing the French rail system to the market opening and making it more financially sustainable. A vertically integrated structure has been created with a holding (SNCF) and two subsidiaries: the incumbent operator (SNCF Mobilités) and the infrastructure manager (SNCF Réseau)⁽⁷⁸⁾. France is in the process of drafting and adopting a set of implementing decrees which will specify in greater detail the functioning of the new structure. These decrees could alleviate the concern that this new structure may jeopardise the independence and impartiality of the infrastructure manager, thus hampering network access for alternative operators, but could also guarantee an

⁽⁷⁸⁾ LOI n° 2014-872 du 4 août 2014 portant réforme ferroviaire

accounting separation to avoid lack of transparency between the three entities and then potential cross-subsidisation⁽⁷⁹⁾.

France is liberalising the market for domestic coach transport. The market for domestic transport is traditionally subject to very strict authorisation procedures in France. Typically, authorisations for operating a regular coach connection are refused where they could potentially compete with train services run under public service obligations. Only a few lines are operated on the French territory, and the share of coaches in inter-regional transport of passengers is negligible. According to the French Competition Authority's analysis⁽⁸⁰⁾, coaches would in fact be mostly in competition with the private use of passenger cars, rather than with trains. Coach transport has the potential in France to transport many more people than today and can contribute to a more sustainable transport of people on medium and long distances. The draft law on Economic Activity proposes to liberalise the coach transport market. The proposal is to deregulate the coach travel business completely with authorities only being able to prohibit the creation of a new route or to impose a limit in terms of time schedule or capacity that takes place within a region upon advice of the transport regulator. These measures can only be taken if there would be competition with a publicly organised line for infra-regional transport, be it by train or by coach, in order to maintain the economic equilibrium of the public service provider. The liberalisation foreseen by the draft Law on Growth and Economic Activity is a step in the right direction but the remaining restriction is stricter than in Germany, where the market was liberalised in 2013 and the authorities can only prohibit coach lines that are shorter than 50 km. Moreover, the development of coach services can be hampered by the low number of

⁽⁷⁹⁾ Both the transport regulator (ARAF) and the Competition Authority have issued critical opinions on the implementing decrees. See Avis n° 2014-025 du 27 novembre 2014 sur le projet de décret relatif aux missions et aux statuts de SNCF Mobilités and Avis n° 15-A-01 du 6 janvier 2015 relatif à des projets de décrets pris pour l'application de la loi portant réforme ferroviaire.

⁽⁸⁰⁾ Avis du 27 février 2014 relatif au fonctionnement concurrentiel du marché du transport interrégional régulier par autocar

coach stations as only 50 % of French prefectures have a coach station ⁽⁸¹⁾.

The powers of the rail regulator have been extended to bus transport and motorway concessionaries. Motorway concessionaries have been privatised in 2006. According to an opinion of the Competition Authorities, tariff increases since 2006 have not been justified by costs suggesting a problem of regulatory oversight ⁽⁸²⁾. To remedy this situation the draft Law on Economic Activity extended the competences of the rail regulator to motorway concessionaries and on coach transport, in particular to supervise the setting of tariffs.

Concerning investment in the transport network, France's transport system has not reached its full potential to best serve the needs of the economy, although investments and maintenance for roads and railways are on an increasing since about 2007 after years of under-investments ⁽⁸³⁾. Due to limited available financial resources, France has redefined its priorities in terms of investment in transport infrastructure to focus on on-going national projects and the maintenance of the secondary network. It is unclear whether these are the right priorities as more resources could be attributed to infrastructure investment in urban areas and freight and passenger capacity remains limited on cross-border connections, in particular with Spain and Italy.

French ports perform unevenly and remain exploited below their potential. French ports are losing market share in freight to road transport and have seen a fall in freight tonnage over the last 10 years. The main drivers of the poor performance of ports include the absence of proper connections to the land transport networks, in particular rail transport, and the inefficient organisation of ports in France with port facilities owned and operated by French publicly owned companies. The 2008 port reform allowed in principle for privatisation

and opened the merchandise handling to competition but the reform has not been able to reverse the situation. In this context, a lack of transparency in public funding also holds back the further development of the port activities.

Energy markets remain concentrated.

The energy market remains heavily concentrated. Competition has increased but the market share of alternative suppliers remains relatively low, especially in electricity. At the end of the first quarter of 2014, the alternative electricity suppliers accounted for 8 % of the generation capacity and 15 % of the retail markets, whereas the market shares in gas were 15 % of generation capacity and 40 % of retail markets ⁽⁸⁴⁾. New investments are relatively low given the current wholesale electricity prices and energy demand.

The most problematic regulated prices are being phased out but there remains a tariff deficit. The phasing-out of the regulated electricity prices for medium and large consumers such as industrial consumers and some SMEs is foreseen by the end of 2015. These were the most problematic segments, as prices were not ensuring cost coverage. In gas, the regulated prices for industrial consumers are being progressively phased out between June 2014 and January 2016. The level of regulated gas prices for non-industrial consumers ensures cost coverage. In electricity, an electricity tariff deficit was identified in France as the tariffs for the regulated components of the retail electricity price were set below the corresponding costs borne by the energy companies ⁽⁸⁵⁾. Setting retail prices at levels that does not cover costs makes it more difficult for new suppliers to enter the market and therefore limits the contestability of the market. Methodologies for setting regulated electricity prices are undergoing further changes to ensure

⁽⁸¹⁾ OECD (2015), 2015 Economic Review – France, OECD publishing

⁽⁸²⁾ Avis n° 14-A-13 du 17 septembre 2014 sur le secteur des autoroutes après la privatisation des sociétés concessionnaires.

⁽⁸³⁾ European Commission (2014) – Infrastructure in the EU: Developments and Impact on Growth, Occasional papers 203.

⁽⁸⁴⁾ CRE (2014), “Marché de détail”, Observatoire des marchés de l'électricité et du gaz naturel”, Vol. 2014 Q1, Commission de Régulation de l'Énergie.

⁽⁸⁵⁾ European Commission (2014), “Market Functioning in Network Industries –Electronic Communications, Energy and Transport”, European Economy, December 2014, European Commission.

full cost coverage ⁽⁸⁶⁾. However a cumulative tariff deficit remains.

The interconnection capacity the Iberian Peninsula and France has not been achieved.

The current low level of interconnections between the Iberian Peninsula and France has been identified as a major obstacle to create a regional market in the South Western region. Some progress has been made with the new electricity interconnection through the Catalan Pyrenees, which is now operational and will bring the interconnection capacity from its current 1.4 % to 2.8 % level in Spain. Increasing interconnection capacity in electricity will be beneficial to French businesses and households as it will ensure delivery to the market of clean electricity from the Iberian Peninsula, thus avoiding additional generation investments in France and in South West Europe, and lowering costs of curtailment. It will enhance the possibility of commercial exchanges thus increasing the benefits of European market integration. In gas, the additional interconnection capacity between France and Spain would contribute to increasing security of supply and provide French consumers with more competitive gas prices, ensuring also better price convergence between the North and South of France.

A joint strategy is being developed between Spain, France and Portugal and priority projects have been selected.

On 6 January 2015 the Transmission System Operators of Spain, France and Portugal signed in Brussels a common strategy paper for the development of interconnection of the Iberian Peninsula with the internal electricity market. The common strategy paper lists common goals and indicates which options for projects can increase the current interconnection capacity. This strategy is a further step to reach the minimum interconnection level of 10 % agreed by the European Council last October.

The energy intensity of the French economy improved less than the EU average,

although the French manufacturing sector is relatively energy efficient. Improvements are necessary to meet France's EU 2020 target. France already put in place a set of measures in both the transport and residential sectors and defined ambitious objectives and additional measures in the Draft-'Energy transition' law, including the renovation of 500 000 houses as of 2015. The successful implementation of the law, once adopted, will be determinant to meet these objectives.

⁽⁸⁶⁾ In particular, a recently adopted Decree sets up a methodology for setting regulated electricity prices by summing up the different costs incurred by a supplier together with a normal remuneration. (*Décret n° 2014-1250 du 28 octobre 2014 modifiant le décret n° 2009-975 du 12 août 2009 relatif aux tarifs réglementés de vente de l'électricité*).

ANNEX A

Overview Table

Commitments	Summary assessment ⁽⁸⁷⁾
2014 Country specific recommendations (CSRs)	
<p>CSRI: Reinforce the budgetary strategy, including by further specifying the underlying measures, for the year 2014 and beyond to ensure the correction of the excessive deficit in a sustainable manner by 2015 through achieving the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. A durable correction of the fiscal imbalances requires a credible implementation of ambitious structural reforms to increase the adjustment capacity and boost growth and employment. After the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0,5 % of GDP each year, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path. Step up efforts to achieve efficiency gains across all sub-sectors of general government, including by redefining, where relevant, the scope of government action. In particular, take steps to reduce significantly the increase in social security spending as from 2015 as planned, by setting more ambitious annual healthcare spending targets, containing pension costs, and streamlining family benefits and housing allowances. Set a clear timetable for the ongoing decentralisation process and take first steps by December 2014, with a view to eliminating administrative duplication, facilitating mergers between local governments and clarifying the responsibilities of each layer of local government. Reinforce incentives to streamline local government expenditure, by capping the annual increase in local government tax revenue while reducing grants from the central government as planned. Beyond the need for short-term savings, take steps to tackle the increase in public expenditure on health projected over the medium and long term, including in the area of pharmaceutical spending, and</p>	<p>CSR 1: France has made limited progress in addressing this Council recommendation (this overall assessment of CSR 1 excludes an assessment of compliance with the Stability and Growth Pact):</p> <ul style="list-style-type: none"> • Limited progress has been made in achieving efficiency gains. The inter-ministerial committee for the <i>Modernisation de l'Action Publique</i> (MAP) was last convened in December 2013. In 2015, savings in the government's operational expenditure of EUR 2.1 billion are planned, compared to current expenditure trends. In addition, the programming law for public finances provides for a yearly spending review involving all public administrations, with the results systematically communicated to parliament and used as inputs into the draft budget. • Some progress has been made in significantly reducing social security spending. Savings in healthcare expenditure are expected to total EUR 3.2 billion in 2015. The government also plans to make savings in social benefits, including pensions, of above EUR 10 billion between 2015 and 2017. • Some progress has been made on the reform of local administration. Metropolitan areas have been introduced and the number of regions will be reduced. A further draft law streamlining the responsibilities of the various layers of local government is being discussed in

⁽⁸⁷⁾ The following categories are used to assess progress in implementing the 2013 country-specific recommendations:

No progress: The Member State has neither announced nor adopted any measures to address the CSR. This category also applies if a Member State has commissioned a study group to evaluate possible measures.

Limited progress: The Member State has announced some measures to address the CSR, but these measures appear insufficient and/or their adoption/implementation is at risk.

Some progress: The Member State has announced or adopted measures to address the CSR. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases.

Substantial progress: The Member State has adopted measures, most of which have been implemented. These measures go a long way in addressing the CSR.

Fully addressed: The Member State has adopted and implemented measures that address the CSR appropriately.

<p>take additional measures when and where needed to bring the pension system into balance by 2020 in a sustain able manner covering all schemes, with a special focus on existing special schemes and complementary schemes.</p>	<p>parliament. An expenditure norm for local authorities has been introduced, but it is only indicative.</p> <ul style="list-style-type: none"> • Limited progress has been made, however, on addressing medium- and long-term increases in healthcare expenditure. The law on financing social security includes measures to curb the cost of pharmaceuticals through a managed entry agreement. A draft law on public health is to be discussed in parliament in early January. It proposes the development of the clinical pathway concept and a shift in the balance of the system from hospitals to ambulatory care with a view to increasing efficiency, while guidelines to reinforce prevention could also achieve cost-effectiveness in the longer term. • No progress has been made on the pension system. The latest projections by the pensions monitoring committee show a deficit of EUR 1.4 billion in 2018 for the basic pension schemes. No new agreement on complementary pension schemes has been signed.
<p>CSR2: Ensure that the labour cost reduction resulting from the ‘crédit d’impôt compétitivité emploi’ is sustained. Take action to further lower employer social security contributions in line with commitments under the responsibility and solidarity pact, making sure that no other measures offset its effect and that the targeting currently envisaged is maintained. Further evaluate the economic impact of social security contribution exemptions, putting the emphasis on employment, wage developments and competitiveness and take appropriate measures if necessary. Further reduce the cost of labour in a budget neutral way, namely at the lower end of the wage scale in particular through targeted reductions in employer social security contributions taking into account the various wage support schemes.</p>	<p>CSR 2: France has made some progress in addressing this Council recommendation.</p> <ul style="list-style-type: none"> • Substantial progress has been made on the implementation of the tax credit for competitiveness and employment and the responsibility and solidarity pact and no measures have been adopted that would counteract its effects. Nonetheless, some of this progress could be eroded by rising wages. • Some progress has been made on assessing the economic impact of social security exemptions with the second monitoring committee report on the tax credit for competitiveness and employment. • Limited progress has been made in reducing the cost of labour at the lower end of the wage scale. No targeted reduction in the cost of labour for specific groups of workers (e.g. youth, long-term unemployed, older unemployed workers)

	<p>has been announced. The government announced and began a merger of the two wage support schemes for low-wage earners (without an effect on the cost of labour or the budget).</p>
<p>CSR3: Simplify companies' administrative, fiscal and accounting rules and take concrete measures to implement the Government's ongoing 'simplification plan' by December 2014. Eliminate regulatory impediments to companies' growth, in particular by reviewing size-related criteria in regulations to avoid thresholds effects. Take steps to simplify and improve the efficiency of innovation policy, in particular through evaluations taking into account latest reforms and if necessary an adaptation of the 'crédit d'impôt recherche'. Ensure that resources are focused on the most effective competitiveness poles and further promote the economic impact of innovation developed in the poles.</p>	<p>CSR 3: France has made limited progress in implementing this Council recommendation.</p> <ul style="list-style-type: none"> • Some progress has been made on the simplification plan, with a range of measures being proposed, e.g. in the draft law on economic activity, adopted and implemented. However, the overall complexity of the system remains high and progress may be counteracted by new regulations being passed or entering in to force, as the 'SME test' is not yet systematically used and the independent authority in charge of monitoring the principle of zero additional charge has not yet been created. • No progress has been made in reviewing size-related criteria in regulations. Failing an agreement between social partners on improving social dialogue, the government will adopt a law on improving social dialogue, including points that could make up for size-related thresholds, in the second quarter of 2015. • Limited progress has been made in simplifying and improving the efficiency of innovation policy. A monitoring report on the implementation of the '<i>crédit d'impôt recherche</i>' (CIR) in 2012 and a report on the evolution and impact of the CIR between 1983 and 2011 have recently been published and a new National Commission for the Evaluation of Innovation Policies has been set up. • Limited progress has been made in focusing resources on the most effective <i>pôles de compétitivité</i> and promoting their impact. The third phase has a stronger focus on impact and support from the State budget has been reduced in order to focus resources on the most successful <i>pôles</i>.

<p>CSR4: Remove unjustified restrictions on the access to and exercise of regulated professions and reduce entry costs and promote competition in services. Take further action to reduce the regulatory burden affecting the functioning of the retail sector, in particular by simplifying authorisations for the opening of trade outlets and removing the ban on sales at a loss. While maintaining affordable conditions for vulnerable groups, ensure that regulated gas and electricity tariffs for household customers are set at an appropriate level which does not represent an obstacle to competition. Strengthen electricity and gas interconnection capacity with Spain; in particular, increase the gas interconnections capacity to fully integrate the Iberian gas market with the European market. In the railway sector, ensure the independence of the new unified infrastructure manager from the incumbent operator and take steps to open domestic passenger transport to competition in line with the provisions of, and the calendar that will be decided by, the forthcoming directives.</p>	<p>CSR 4: France has made some progress in implementing this Council recommendation.</p> <ul style="list-style-type: none"> • Some progress is beginning to be made on regulated professions, particularly pharmacies and opticians. With regard to certain legal professions, the draft law on economic activity proposes to reform the establishment regulations and tariff governance framework, but the detailed rules that determine the ambition of the proposed reforms depend on the implementing decrees. Further efforts are necessary to remove unjustified restrictions fully and for all professions. • Some progress has been made in promoting competition in services. In addition to the proposals on regulated professions and the retail market, the draft law on economic activity contains proposals to promote competition such, as the liberalisation of coach transportation and better regulation of the tolls on motorway franchises. • Some progress has been made in reducing the regulatory burden affecting the retail sector with the ‘Loi relative à l’artisanat, au commerce et aux très petites entreprises’ (ACTPE), aimed at simplifying the procedure for the establishment of retail outlets and the draft law on economic activity giving more powers to the Competition Authority. The ban on selling at a loss has not been removed. • Some progress has been made on regulated gas and electricity tariffs for household consumers but there is still a cumulated electricity tariff deficit. • Some progress has been made on interconnection capacity. Some interconnection projects are under way, a joint strategy is being developed between Spain, France and Portugal and new priority projects have been selected.
--	---

	<ul style="list-style-type: none"> • Some progress has been made on the railway sector. France has created a new structure but the implementation decrees need to further clarify whether network access for alternative operators can be hampered. No progress has been made on opening up the domestic rail passenger market to competition.
<p>CSR 5: Reduce the tax burden on labour and step up efforts to simplify and increase the efficiency of the tax system. To this end, starting in the 2015 budget, take measures to: remove inefficient personal and corporate income tax expenditures on the basis of recent assessments and the ‘Assises de la fiscalité’ initiative while reducing the statutory rates; take additional measures to remove the debt bias in corporate taxation; broaden the tax base, in particular on consumption; phase out environmentally-harmful subsidies.</p>	<p>CSR 5: France has made limited progress in implementing this Council recommendation.</p> <ul style="list-style-type: none"> • Some progress has been made on reducing the tax burden on labour with the actions described under CSR 2. Moreover, the bottom bracket of personal income tax (5.5 %) was abolished in the budget bill for 2015; so a single person whose net earnings are below EUR 9 690 will be tax-exempt. • Limited progress has been made on simplification and efficiency. The C3S for SMEs has been deleted in the 2015 budget at a cost of EUR 1 billion. On tax expenditures, there has been no progress as new fiscal measures in the 2015 budget law erode the tax base by EUR 2 billion. • No progress has been made on removing the debt bias in corporate taxation or on broadening the tax base. • Limited progress has been made with the introduction of an increase in excise duties (EUR 0.02/l of diesel) as a first step to phasing out environmentally harmful subsidies, and some progress is planned on the carbon tax. Remaining preferential taxation regimes for fuels, particularly diesel and especially for certain categories of users still constitute substantial environmentally harmful subsidies.
<p>CSR 6: Take further action to combat labour-market rigidity, in particular take measures to reform the conditions of the ‘accords de maintien de l’emploi’ to increase their take up by companies facing difficulties. Take additional measures to reform the unemployment benefit system in association with</p>	<p>CSR 6: France has made limited progress in implementing this Council recommendation.</p> <ul style="list-style-type: none"> • Limited progress has been made in combating labour-market rigidity with the proposed reform of the ‘justice

<p>social partners, in order to guarantee its sustainability while ensuring that it provides adequate incentives to return to work. Ensure that older workers benefit from adequate counselling and training and re-assess the relevant specific unemployment benefit arrangements with respect to their situation on the labour market.</p>	<p><i>prudhomale</i> in the draft law on economic activity, with the aim of reducing uncertainty related to individual labour regulation disputes. No action has been taken to reform the conditions of the <i>'accords de maintien de l'emploi'</i>.</p> <ul style="list-style-type: none"> • No progress has been made on unemployment benefit systems. The new unemployment insurance convention will be negotiated by the end of 2016. • Limited progress has been made on older workers. The government has announced a <i>'Plan senior'</i> to address unemployment among older workers and started to implement it. The 80 000 subsidised contracts to encourage employment in the private sector, included in the budget law for 2015, are also aimed at older and long-term unemployed workers. Another 80 000 public employment services counselling actions will be also aimed at older and long-term unemployed workers. The specific arrangements for unemployed workers over 50 have not been changed.
<p>CSR 7: Pursue the modernisation of vocational education and training, implement the reform of compulsory education, and take further actions to reduce educational inequalities in particular by strengthening measures on early school leaving. Ensure that active labour market policies effectively support the most vulnerable groups. Improve the transition from school to work, in particular by stepping up measures to further develop apprenticeship with a specific emphasis on the low-skilled.</p>	<p>CSR 7: France has made some progress in implementing this Council recommendation.</p> <ul style="list-style-type: none"> • Some progress has been made on the modernising vocational education and training; implementation of the reform of the vocational training system started on 1 January 2015. • Some progress has been made on the reform of compulsory education. The reform process is only about half way, as it covers 2013-17. While many measures have already been taken, it is unclear whether it will be possible to implement the entire, ambitious reform in the remaining period. It might also be difficult to reach some of the ambitious quantified objectives, which are nevertheless important drivers of implementation. • Some progress has been made with two new plans and measures targeting educational inequalities and early school leaving. Their progressive implementation

	<p>is in its initial phase.</p> <ul style="list-style-type: none"> • Some progress has been made on active labour-market policies. The ‘jobs for the future’ scheme was further reinforced. Experimental targeted counselling and support to young people, ‘Youth Guarantee’, have been introduced. The new convention organising work for the main public employment services ‘<i>Pôle emploi</i>’ for 2015-2018’ set as an objective to strengthen support for jobseekers furthest away from the labour market, including the long-term unemployed and low-qualified, by doubling reinforced counselling measures from 230 000 in 2014 to 460 000 in 2017. • Limited progress has been made on the transition from school to work. The government set up a national plan to relaunch apprenticeships, reestablishing an incentive for SMEs and simplifying the tax on apprenticeships. More outreach to young people not in employment, education or training, and better coordination between key players, is necessary.
Europe 2020 (national targets and progress)	
<p>Employment rate 20-64 target set out in France:</p> <p>75 %.</p>	<p>The age 20-64 employment rate was:</p> <p>69.4 % in 2012</p> <p>69.6 % in 2013, and</p> <p>69.4 % for the first quarter and 70.1 % for the second and third quarters of 2014</p> <p>In view of the relatively stable trend and challenges on the French Labour Market, the Europe 2020 employment rate target of 75 % appears ambitious without additional signs of economic recovery being translated into jobs.</p>
<p>Europe 2020 R&D target: 3.0% of GDP</p>	<p>Although there has been some progress in recent years, France is not on track to meet its target of spending 3 % GDP on R&D by 2020. R&D intensity in 2013 stood at 2.23 % GDP, up from 2.02 % in 2007, with an average annual growth rate of 2.3 % over the 2007-13</p>

	period, mainly due to an increase in private R&D.
Greenhouse gas (GHG) emissions target: -14 %, compared to 2005 emissions in the sectors not covered by the Emissions Trading Scheme (ETS).	According to preliminary estimates, the change in non-ETS greenhouse gas emissions between 2005 and 2013 was -8 %. According to the latest national projections, and taking into account existing measures, non-ETS emissions will decrease by 16 % between 2005 and 2020. The target is consequently expected to be met, with a margin of 2 pps.
2020 Renewable energy target: 23% Share of renewable energy in all modes of transport: 10%	The share of renewable energy in gross final energy consumption amounted to 14.4% in 2013. Despite good initial progress and renewable energy sources potential, France could have difficulty meeting its 2020 renewables target. The new 2014 draft law on energy transition could trigger the necessary growth in renewables. The new law is intended to clarify and improve support conditions for renewables, paving the way for relevant community projects and administrative simplification.
Energy Efficiency target. France has set an indicative national energy efficiency target of 17.4% reduction of final energy consumption in 2020, which implies reaching a 2020 level of 236.3 Mtoe primary consumption and 131.4 Mtoe final energy consumption.	France has ambitious energy efficiency policies in place but, without extra work and successful implementation, it will be difficult to further decrease its current primary energy consumption (245.8 Mtoe in 2013) and to keep it at this level so as to reach its 2020 target if the economy continues to grow in the next six years. The National Assembly passed the energy transition law in October 2014. The law aims mainly to halve France's final energy consumption by 2050 compared to 2012. It addresses key sectors in reducing the country's final energy consumption, such as the renovation of building stock. A final vote is expected to take place in spring 2015.
Early school leaving target: 9.5%	The French early school-leaving rate declined significantly in 2013 and is now below the EU average (9.7 % compared with 12 % in 2013). However, 2013 data is not comparable with data for previous years due to a methodological change specific to France. The overall rate hides large disparities linked

	to socioeconomic and cultural factors and between regions. At the same time, the proportion of young people leaving school with at most low secondary level qualification (<i>diplôme national du brevet</i>) stayed close to 17%.
Tertiary education target: 50% higher education attainment for 17-33 year olds, the age group is defined differently from the one of the EU target	France's tertiary education attainment rate remains well above the EU average (44.1 % in 2013 for 30-34-year-olds, compared with 36.9 %, with females clearly outperforming males), although it increased by only 0.6 pp. over the 2010-13 period. The French target is expected to be reached in 2015.
Target for reducing the number of people at risk of poverty or social exclusion: - 1 900 000	The number of people at risk of poverty or social exclusion was: 11 840 000 in 2011 11 760 000 in 2012 and 11 229 000 in 2013. These figures represent 483 000 fewer people at risk of poverty and social exclusion between 2010 and 2013, mostly due to a significant fall between 2012 and 2013, following the fluctuating trend seen between 2010 and 2012. However, reaching the target of reducing by 1 900 000 (one third) the number of people at risk of poverty or social exclusion appears difficult at a time of hesitant economic recovery for France as for other EU Member States.

ANNEX B

Standard Tables

Table B.1: Macroeconomic indicators

	1996-2000	2001-2005	2006-2010	2011	2012	2013	2014	2015	2016
Core indicators									
GDP growth rate	2.9	1.7	0.8	2.1	0.3	0.3	0.4	1.0	1.8
Output gap ¹	-0.2	1.7	0.6	-0.4	-1.0	-1.7	-2.3	-2.3	-1.6
HICP (annual % change)	1.3	2.0	1.7	2.3	2.2	1.0	0.6	0.0	1.0
Domestic demand (annual % change) ²	2.9	1.9	1.1	2.0	-0.3	0.2	0.7	1.0	2.1
Unemployment rate (% of labour force) ³	10.0	8.4	8.5	9.2	9.8	10.3	10.3	10.4	10.2
Gross fixed capital formation (% of GDP)	20.2	21.2	22.6	22.4	22.5	22.1	21.6	21.4	22.0
Gross national saving (% of GDP)	22.8	22.4	21.6	21.0	20.2	20.0	20.0	20.3	20.4
General government (% of GDP)									
Net lending (+) or net borrowing (-)	-2.6	-3.0	-4.4	-5.1	-4.9	-4.1	-4.3	-4.1	-4.1
Gross debt	59.9	62.9	71.3	85.0	89.2	92.2	95.3	97.1	98.2
Net financial assets	-39.3	-43.3	-44.7	-60.6	-68.4	n.a.	n.a.	n.a.	n.a.
Total revenue	50.2	49.3	49.8	50.8	51.8	53.0	53.4	53.5	53.2
Total expenditure	52.7	52.3	54.2	55.9	56.7	57.1	57.7	57.5	57.3
of which: Interest	3.1	2.8	2.5	2.6	2.5	2.3	2.2	2.2	2.2
Corporations (% of GDP)									
Net lending (+) or net borrowing (-)	0.8	0.0	-0.2	-1.0	-1.3	-1.5	-2.2	-1.8	-1.9
Net financial assets; non-financial corporations	-82.3	-85.6	-108.0	-107.5	-113.1	n.a.	n.a.	n.a.	n.a.
Net financial assets; financial corporations	13.2	7.5	13.8	21.5	25.7	n.a.	n.a.	n.a.	n.a.
Gross capital formation	11.1	11.6	12.3	13.1	12.6	12.1	12.8	12.9	13.6
Gross operating surplus	17.7	17.9	17.9	17.5	17.0	16.7	16.6	17.4	18.2
Households and NPISH (% of GDP)									
Net lending (+) or net borrowing (-)	4.0	3.6	3.3	3.9	3.5	3.6	4.7	4.6	4.5
Net financial assets	121.9	121.8	130.2	129.0	135.5	n.a.	n.a.	n.a.	n.a.
Gross wages and salaries	37.2	38.0	38.2	38.6	38.7	38.7	38.9	38.6	38.2
Net property income	6.1	5.8	5.8	5.6	5.3	5.3	5.2	5.3	5.6
Current transfers received	23.8	23.9	24.8	25.9	26.4	26.9	27.2	27.2	27.0
Gross saving	9.6	9.8	9.8	10.0	9.7	9.6	10.0	9.8	9.6
Rest of the world (% of GDP)									
Net lending (+) or net borrowing (-)	2.2	0.6	-1.3	-2.2	-2.7	-2.0	-1.8	-1.2	-1.5
Net financial assets	-11.4	1.7	11.9	22.8	25.6	n.a.	n.a.	n.a.	n.a.
Net exports of goods and services	2.1	0.8	-1.4	-2.6	-2.0	-1.5	-1.4	-0.9	-1.2
Net primary income from the rest of the world	1.5	1.5	2.0	2.3	1.6	1.7	1.7	1.7	1.7
Net capital transactions	0.1	-0.1	0.0	0.0	-0.2	0.0	0.0	0.2	0.2
Tradable sector	39.8	38.7	35.4	34.5	34.5	34.1	n.a.	n.a.	n.a.
Non-tradable sector	49.6	51.3	54.6	55.3	55.3	55.7	n.a.	n.a.	n.a.
of which: Building and construction sector	4.3	4.7	5.5	5.5	5.5	5.4	n.a.	n.a.	n.a.

(1) The output gap constitutes the gap between the actual and potential gross domestic product at 2010 market prices.

(2) The indicator of domestic demand includes stocks.

(3) Unemployed persons are all those who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source: European Commission 2015 winter forecast; Commission calculations

- energy	1.7	1.6	1.4	1.4	1.5	1.5
- other (residual)	1.7	1.6	1.6	1.7	1.8	1.9
Labour employed	20.9	21.0	20.8	20.8	21.2	21.7
Labour non-employed	1.4	1.4	1.5	1.6	1.7	1.8
Capital and business income	5.5	6.1	5.9	5.1	5.5	5.8
Stocks of capital/wealth	4.4	4.7	4.5	4.4	4.7	4.8
<i>p.m.</i> Environmental taxes ²	2.1	1.9	1.8	1.8	1.8	1.8
VAT efficiency³						
Actual VAT revenues as % of theoretical revenues at standard rate	50.2	51.3	49.8	47.0	47.7	47.4

(1) Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2014), Taxation trends in the European Union, for a more detailed explanation.

(2) This category comprises taxes on energy, transport and pollution and resources included in taxes on consumption and capital.

(3) VAT efficiency is measured via the VAT revenue ratio. It is defined as the ratio between the actual VAT revenue collected and the theoretical VAT revenues raised if VAT was applied at the standard rate to all final (domestic) consumption expenditures, which is an imperfect measure of the theoretical pure VAT base. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services (policy gap), or a failure to collect all tax due to e.g. fraud ('collection gap'). It should be noted that the relative scale of cross-border shopping (including trade in financial services) compared to domestic consumption also influences the value of the ratio.

Source: European Commission (2012), Tax Reforms in EU Member States, p. 10. For a more detailed discussion, see European Commission (2012), Tax Reforms in EU Member States, p. 10. For a more detailed discussion, see European Commission (2012), Tax Reforms in EU Member States, p. 10.

Share of assets of the five largest banks (% of total assets)	47.2	47.4	48.3	44.6	45.9	n.a.
Foreign ownership of banking system (% of total assets)	10.1	9.7	9.6	10.4	8.4	8.8
Financial resources (total) (% of total loans)	4.0	3.8	4.3	4.3	4.5	4.5
- capital adequacy ratio (%)	12.4	12.7	12.3	14.5	15.4	15.4
- return on equity (%)	7.2	12.0	8.3	6.0	8.4	8.4
Bank loans to the private sector (year-on-year % change) ¹⁾	-0.6	5.0	2.4	2.0	0.9	-0.1
Lending for house purchase (year-on-year % change) ¹⁾	3.7	8.0	6.1	2.8	3.6	-2.6
Loan to deposit ratio ¹⁾	120.2	118.0	113.4	111.2	107.8	107.8
Central Bank liquidity as % of liabilities ²⁾	2.7	1.0	3.6	4.0	2.2	1.8
Private debt (% of GDP)	130.4	131.9	135.3	138.1	137.2	n.a.
Gross external debt (% of GDP) ³⁾						
- public	49.5	51.0	51.9	56.1	58.8	61.4
- private	43.1	45.4	54.1	53.1	51.1	51.4
Long-term interest rate spread versus Bund (basis points)*	42.8	37.5	71.2	104.2	63.4	50.3
Credit default swap spreads for sovereign securities (5-year)*	35.4	57.6	94.9	85.7	38.9	31.0

(1) Latest data November 2014.

(2) Latest data September 2014.

(3) Latest data June 2014. Monetary authorities, monetary and financial institutions are not included.

* Measured in basis points.

Source: IMF (financial soundness indicators); European Commission (long-term interest rates); World Bank (gross external debt); ECB (all other indicators).

Table B.4: Labour market and social indicators

	2008	2009	2010	2011	2012	2013	2014
Employment rate	70.4	69.5	69.3	69.3	69.4	69.6	69.9

Table B.7: Green growth

Green growth performance		2003-2007	2008	2009	2010	2011	2012
Macroeconomic							
Energy intensity	kgoe / €	0.16	0.15	0.15	0.15	0.14	0.14
Carbon intensity	kg / €	0.32	0.30	0.29	0.29	0.27	0.27
Resource intensity (reciprocal of resource productivity)	kg / €	0.50	0.50	0.46	0.44	0.44	n.a.
Waste intensity	kg / €	n.a.	0.19	n.a.	0.20	n.a.	0.19
Energy balance of trade	% GDP	-2.0	-2.9	-2.0	-2.4	-3.1	-3.4

ANNEX B
Standard Tables