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FRENCH BUDGET 2013 : INCOME TAX REFORM

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Summary

Income tax reform is central to the French 2013 Budget. The goal is to increase tax revenues while restoring a “fiscal justice” judged to have been undermined in recent years. The guiding principle of the reform is to align capital income taxation with that imposed on labour income.

This note studies the redistributive implications of the announced tax reforms, by comparing the change in taxes imposed in 2012 and 2013. The new regulations will increase income tax receipts by seven billion euros and concentrate a large part of the tax burden on the most comfortably-off. Nevertheless, the alignment of taxation on capital and labour incomes is imperfect and may even create new distortions, which could reduce actual tax revenue and limit the redistributive impact of the reforms.

- The income tax reforms will increase taxation revenue by seven billion euros in 2013 – an increase in total tax receipts of 11 per cent
- This tax increase applies mainly to those on the highest incomes, but half of all tax-payers will see their taxes increase.
- Far from simplifying and equalising the tax schedule, the reforms may create new distortions.
- Those distortions risk reducing actual tax revenues and weakening the redistributive effects of the reforms.

The Institut des politiques publiques (IPP) is developed through a scientific partnership between the Paris School of Economics and the Centre for Research in Economics and Statistics. The aim of the IPP is to promote quantitative analysis and evaluation of public policy using cutting edge research methods in economics.

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Among the new measures announced in the French 2013 Budget, the most discussed are those relating to income tax. After several decades of decline in income tax revenues as a share of national income and a proliferation of measures that have reduced the tax base of the income tax, the 2013 Budget seems to signal a significant shift. With its announced substantial hike in income tax and reintegration of some capital income into the income tax base, is the French government in the process of introducing the "great tax reform" promised during the presidential election campaign?
This paper analyses the impact and effectiveness of the new income tax laws in the context of broader income tax reform in France.

Analysing tax policies: methodology

The Institut des politiques publiques (IPP), a joint scientific partnership between the PSE-Paris School of Economics and CREST, has developed TAXIPP, **a micro-simulation model** that allows us to analyse the redistribution effects of French tax and benefits system. The model simulates the effects of the announced income tax changes on a representative sample of the French population.

In order to isolate the impact of the reforms from the effects related to current economic conditions, a counter-factual simulates the state of the taxation system that would prevail were the reforms not introduced. We then compare the reformed tax system with the counter-factual case.

In order to highlight the redistributive effects of the tax, we must agree on **how to measure the capacity of individuals to contribute**. Choosing taxable income as defined by the income tax laws (the main income tax in France is called Impôt sur le revenu, IR) – the benchmarks as they appear on tax return forms – poses problems because that measure depends entirely on the policy choice of the tax base.
One solution, adopted for this study, is to **refer to economic income**, a close cousin of national income, in the national accounts. In this context, wages income and non-wages income are measured before any tax is imposed (i.e. measured as the labour cost) and therefore include employees' and employers' social security contributions. Likewise, capital income includes all income from property, whether real or imputed, distributed financial returns (capital gains, dividends, interest and life insurance) and non-distributed income (company earnings not distributed to individuals). More specifically, we consider secondary income, taking into account not only primary income but also replacement income (unemployment and retirement pensions). For consistency, we deduct the social security contributions used to fund these replacement incomes.

Secondary economic income can thus differ significantly from IR taxable income. Social security contributions and CSG-CRDS contributions form[1] an integral part of economic revenue insofar as they are already deducted from IR taxable income. A portion of capital income is also missed by the IR tax base, as is a portion of life insurance and the Equity Savings Plan (Plan d'epargne en actions, PEA), undistributed rental income, imputed rents and the like.

This note analyses the fiscal policies relating to income tax announced in the July supplementary Budget for 2012 and 2013 Budget, taking into account the amendments adopted during its first reading in the National Assembly[2].

The list of measures appears in Box 1.

Box 1: Fiscal policies relating to income tax

Modifications to the rates of tax

Adjustments to the income tax schedule
– The addition to the progressive income tax schedule of a rate of 45% on taxable income over 150,000 euros;
– the creation of a contribution of 18% on individual labour incomes (wages, salaries and bonuses) greater than one million euros. The sum of CSG, CRDS, and the contribution on high incomes is supposed to add up to 75% and it is this tax which is widely known as the "75% tax". This tax is supposed to last two years;
– A freeze on tax thresholds with a discount for the most modest tax payers leading to "fiscal drag".

Limitation on exemption and caps
- A cap on tax loopholes: the cap on reductions and tax credits is lowered from 18,000 euros + 4% of taxable income to 10,000 euros for all households;
- A lowering of the ceiling of the dependent's allowance from 2,336 euros to 2,000 euros per half-share of the "quotient familial".

Measures relating to taxation on capital income

- An increase in the rate of the flat tax on capital gains from 19% to 24% (its introduction into the IR income tax base, along with reductions depending on the length of time shares have been held, is scheduled for 2014);
- The integration of income presently subject to withholding tax (dividends and fixed-income products) to the progressive tax schedule, while maintaining a 40% deduction for dividends.

While the government announced in the 2013 Budget an increase in income tax of an estimated 3.8 billion euros (see Table 1), this figure did not take into account tax measures adopted in earlier budgets but which will have an impact on the 2013 accounts.

This is the case with the end of tax reduction for overtime hours, adopted in July 2012, that will bring – according to the French Treasury – an additional 500 million euros of revenues in 2013.

« The decision to re-evaluate tax thresholds is therefore normally renewed in every Budget »

It is also true for the "freeze on the tax thresholds", which the government does not consider one of its policies as it was first decided by the previous government. Usually, the tax thresholds increase from year to year; freezing the scale means not re-evaluating those thresholds. When incomes increase, such a freeze entails an increase in taxable income and therefore an increase in the amount of tax paid. The decision to re-evaluate tax thresholds is therefore normally renewed in every Budget.

1. CSG and CRDS are separate income taxes, with flat rates and large tax base, introduced in the early 1990s in order to finance social security expenses (mostly health spending). These taxes are not part of the French state's budget (Loi de finances) but part of the French social security budget (Loi de financement de la sécurité sociale).
2. This study is based on the text adopted by the National Assembly on 23 October 2012.

If freezing the income tax schedule is a tax policy, then we can focus debate on the choice of counter-factual: how could the tax thresholds be re-evaluated? According to Évaluations des voies et moyens, published as an annex to the French Budget, the freeze will bring in 1.5 billion euros. To arrive at this sum, the French Treasury re-evaluates the thresholds in line with the rate of inflation. The IPP believes that, on the contrary, the re-evaluation of the thresholds should be tied to the rate of growth in incomes, in such a way that the effective rates of tax are not changed. That leads to an estimation that the freeze on tax thresholds would bring in 2.8 billion euros.

According to the IPP, all the new measures together will result in an increase in income tax receipts of around seven billion euros. A summary of these changes is presented in table 1.

Table 1: Impact in 2013 of the income tax reforms

Measures		Estimated receipts (en milliards d'€)
Previous policies	>> Limitation of the half-share benefit for single people with children	**0,55**
2012 Budget	>> Re-imposition of tax on overtime	**0,47**
2013 Budget adopted by the National Assembly	- 45% tranche	0,44
	- Exceptional contribution «75% tax»	0,22
	- Reduction of the dependent's allowance ceiling	0,64
	- Elimination of withholding tax (on dividends and interest)	1,97
	- Increase in withholding tax on capital gains	0,28
	- Increase in the (tax schedule) discount	-0,37
	>> Total of the measures announced for 2013	**3,18**
	>> Freeze on scale	**2,81**
Total increase in income tax in 2013		**7,01**

Source : TAXIPP 0.2

Note : These estimates are made assuming no behavioural changes and also depend on government estimations.

Who is affected by the income tax increases?

While Table 1 specifies the change that each policy measure will bring, it does not show who will be affected by the changes. Table 2 presents more detail, by quantifying the impact of the reforms on tax payers in terms of their income.

The first point to note in Table 2 is the apparent weakness in effective tax rates. These are expressed in terms of economic income and are therefore automatically smaller than the effective tax rate presented on income tax returns (which are calculated in terms of taxable income).

« In terms of their redistributive impact then, the income tax reforms essentially involve the highest income group »

Second, the tax increase grows with economic income: it is minimal for the poorest 50 per cent of French, more substantial for the following 49 per cent (between three and five per cent increase) and clearly higher for the richest one per cent, with an increase in nine per cent. In terms of their redistributive impact then, the income tax reforms essentially involve the highest income group.

Table 2 – The impact of the income tax reforms on the rate of tax

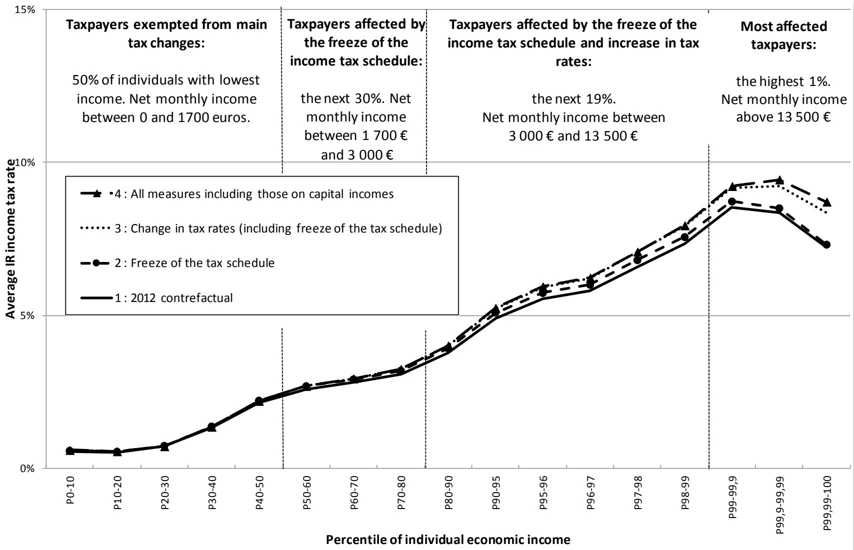
Fractile	Average annual individual income	Rate of tax before the reforms (as % of gross income)	Average net monthly individual income	Rate of tax after the reforms (as % of net income)	Increase in tax from 2012 to 2013 (as % of the tax rate)	Variation in the amount of income tax paid before inflation (as %)
P 0-50	11 230 €	1,45%	730 €	1,86%	0,04	0,7%
P 50-80	35 410 €	2,85%	2 140 €	3,93%	0,14	3,03%
P 80-99	75 450 €	4,99%	4 490 €	7%	0,36	5,25%
P 99-100	468 200 €	8,30%	32 500 €	9,97%	0,91	9,02%

Source : TAXIPP 0.2

Field : All individuals over the age of 18.

Note : The individuals are ranked from the poorest to the richest in terms of their secondary income. Individual income is each individual's own income, with the exception of capital that is shared between each member of a household. To facilitate the comparisons, the corresponding net monthly income is specified. The group P0-50 denotes the poorest 50 per cent, P0-50-80 the next 30 per cent, and so on.
The increase in taxation is expressed in two ways. First, it is calculated as the difference between the average rate for each fractile before and after the reforms. Second, it is expressed as a variation of the amount of income tax paid before and after the reforms, and after an expected inflation rate for 2012 of 1.9 per cent.

Graph 1 – The effect of the tax reforms on the distribution of the income tax rates



Source : TAXIPP 0.2

Field : All individuals over the age of 18.

Note : Graph 1 presents the rate of taxation on income (withholding tax + tax schedule) by economic income group. The individuals are ranked from the poorest (on the left) to the richest (on the right). The group P0-10 denotes the poorest ten per cent, P0-10-20 the next ten per cent, and so on. The group of the richest ten per cent is broken down into sub-groups: P99.9, for example, represents the richest 0.1 per cent.

Curves :
Curve 1 is the counterfactual – the rate of taxation that would have prevailed in 2012 without the reforms.
Curve 2 is the taxation rate for 2013 after the freeze of the tax schedule.
Curve 3 is the taxation rate for 2013 after the freeze on the tax schedule and the implementation of the tax rate increases (see Box 1).
Curve 4 is the taxation rate for 2013 taking into account all the new measures, including those relating to capital income (as per the 2013 Budget).

Graph 1 illustrates the impact on redistribution of each measure proposed by the new government since July 2012. It groups tax-payers in terms of their individual economic income and calculates the average rate of taxation by income group. We can thus compare the counterfactual (curve 1), the impact of the tax schedule freeze (curve 2), the effect of the measures classified in Box 1 as increases in the tax rate (curve 3) and the impact of the changes related to capital income (curve 4). We deliberately zoom in on the highest incomes in order to highlight the fiscal reforms that affect this very heterogeneous group in particular.

In total, we can distinguish between four groups of tax payers:

• The first group, which includes all tax payers whose net **monthly income is less than 1,700 euros** (half of all individual tax payers), will for the most part be untouched by the tax increases. Their incomes are too small to be affected by the reforms and the boost in the discount (i.e. la décote) means that they will escape the increases caused by the freeze of the tax schedule. The average income tax increase paid by this group will be small: 0.7 per cent after inflation.

• The second group, comprising those whose net monthly earnings are **between 1,700 and 3,000 euros** (30 per cent of individual tax payers), will be moderately affected by the income tax increases. The tax schedule freeze will directly concern this group but their incomes remain too low to be touched by the tax rate changes (to the dependent's allowance, the creation of the 45% tranche, etc.). Their income tax will rise by an average of three per cent (after inflation) between 2012 and 2013.

• The individuals whose net monthly income is **between 3,000 and 13,500 euros** (representing the richest 20 per cent, excluding the very richest one per cent) form the third group. For these tax payers, the increase in income tax will have the most significant effects (a hike of around five per cent after inflation). They will see their taxes increase more thanks to the freeze of the tax schedule than to the actual increases in the tax rates. The five per cent of this group with the highest incomes (still excluding the richest one per cent) will see their taxes rise more significantly because of the rate increase.

• The last group is the richest one per cent of tax payers, who are most affected by the fiscal reforms. On average, their taxes will increase by nine per cent after inflation between 2012 and 2013. These individuals with net monthly incomes of **more than 13,000 euros** will be directly affected by the introduction of the new tax bracket of 45%. A small section of them will also be affected by the 75% tax payable on earned income. Furthermore, these tax payers essentially have capital income. The reintegration of some such incomes to the income tax base will increase taxes almost exclusively for the most comfortably-off one per cent. However, among these incomes, we must distinguish between interest (which will be subject to a substantial tax hike), dividends (whose increase will be marginal thanks to the maintenance of the 40% discount) and capital gains (which will continue to benefit from tax exemptions).

« The richest one per cent of tax payers are most affected by the fiscal reforms. On average, their taxes will increase by nine per cent after inflation »

Although the highest income group is the one the most affected by the tax reforms contained in the 2013 Budget, **this does not restore the progressive character of income tax laws for the highest income earners**. This can be explained by the fact that capital gains, which represent a significant part of the incomes of the richest (up to 20 per cent of the total income of the richest 0.01 per cent), will not be included in the income tax base in 2013 and will continue to be liable to a tax rate lower than that on the income tax table.

A major tax reform?

During the presidential election campaign, François Hollande promised “a major tax reform” if he were elected, based principally on the alignment, for the purposes of taxation, of capital income and labour income. To what extent will the reforms announced in the 2013 Budget achieve this goal?

The first point to highlight is that **the alignment between taxes on capital income and labour income is far from being achieved**. On the contrary, the government’s tax reforms will have the effect of reinforcing the heterogeneity of the rates of tax that apply to different categories of income (see Table 3). The announced reforms lead to a sharp increase in the rate of taxation on interest, for example, which is substantially higher than the rate that applies to dividends. Although the rate of taxation on capital gains on securities will be increased by five points, in 2013 they will continue to benefit from the system of a flat rate withholding tax. From 2014, on first view, it seems that the tax rate on capital gains will be greatly increased, but this could be significantly reduced for long-term gains because capital gains from securities benefit from reductions of up to 40 per cent. Finally, there are no changes to the present special dispensation for incomes from life insurance contracts and capital gains from real estate.

We might fear that the differences in how the capital income categories are treated will encourage certain tax payers to adopt **tax avoidance strategies**. The recourse to life insurance will probably be reinforced, as will the tendency to hold on to capital gains in order to maximise the benefit of tax reductions. Such behaviour will lead to a narrowing of the base of the progressive tax schedule, thus limiting the redistributive impact of the reforms and resulting in a reduction in the expected tax receipts.

Box 2: How should capital gains be taxed?

During the earliest debates about the government’s proposed Budget, the question of the treatment of capital gains was the most controversial. A movement of young entrepreneurs (calling themselves “les Pigeons” - the Suckers or Dupes) protested against the taxing of capital gains realised when they close their businesses).
The integration of capital gains into the progressive income tax schedule does indeed pose a problem: a capital gain can represent the income of several years, even a whole life. To treat a capital gain of one million euros, which sometimes represents the fruits of a lifetime of work, like the income for a year is clearly problematic.
There is a smoothing mechanism called a “spreading system” (i.e. système de l’étalement) for certain exceptional income categories (for example, retirement benefits), which allows the income to be spread over a four-year period. In 2014, the government will introduce a system of tax reductions for capital gains whose value depends on length of holding but does not take into account the occasional or repeated character of that income. A more effective solution to the problem would be to introduce a real smoothing mechanism, similar to the spreading system but that would allow those who have made exceptional capital gains one year to spread the tax burden over several years (five to ten years, for example).

Indeed, it should be noted that the figures related to the proposed reforms listed in table 1 were arrived at assuming, as the Economics ministry does, that the base of taxable income will not be modified by the tax increases.
However, in view of the remaining multiple possibilities for tax avoidance, it is unlikely that this hypothesis will be proven, even if the extent of behavioural responses is difficult to calculate at this stage. **The only way to limit tax avoidance is to further broaden the income tax base**.

Table 3 – Marginal tax rates on different income categories before and after the 2013 Budget

Income form	Before	After		
		Marginal rate of 30%	Marginal rate of 41%	Marginal rate of 45%
Interest	39,5%	44%	54,4%	58,2%
Dividends	36,5%	32%	38%	40,2%
Capital gains on securities in 2013	34,5%	39,5%		
Capital gains on securities in 2014 (investments held for less than 2 years)	34,5%	44%	54,4%	58,2%
Capital gains on securities in 2014 (investments held for 7 years or more)	34,5%	32%	38%	40,2%
Real estate capital gains (held for 10 years)	33%	29,2%		
Real estate capital gains (held for at least 30 years)	15,5%	15,5%		
Life insurance	23%	23%		
Gross salary	-	35,3%	40,6%	42,5%
Net salary (after social security contributions)	-	74,1%	79,4%	81,3%

Note : The marginal tax rates indicated in this table include social security contributions and income tax. The integration of interest income into the tax schedule is expected only for interest amounting to more than 2,000 euros per annum.

Details of the calculations : For capital gains from both securities (in 2013) and property, and for life insurance, the marginal tax rate equals the rate of withholding tax reduced by possible discounts and added to the social security contributions of 15.5 per cent.
For interest, dividends and capital gains from securities (in 2014), the taxation rate corresponds to the income tax marginal rate reduced by possible discounts and the deductible CSG, and added to social security contributions of 15.5 per cent.
For wages before contributory defined pension payments, the tax rate corresponds to the marginal income tax rate (less the social security contributions, reductions on the wages and the deductible CSG) to which we add non-contributory pension payments and the CSG-CRDS. Contributory payments are added in the last row.

Which way to reform?

While we may debate the merits of aligning the taxing of capital income with the taxing of labour income, the basic argument in favour of such an alignment is that all forms of income should be treated in the same way. **The challenge is to limit tax avoidance behaviour**, that is, behaviour that seeks to modify the nature of income in order to avoid it rising into a higher tax bracket.

Graph 2 presents the various hypotheses for broadening the tax base without changing the income tax schedule and their redistributive consequences. Curve 2 corresponds with the 2013 Budget as adopted by the National Assembly. Curve 3 takes into account the initial Budget for 2013 with the integration into the income tax schedule of capital gains from securities, modified by various reductions. Curve 4 represents the total integration of all capital gains (from securities, real property, business sales, etc.), without any reductions. Finally, curve 5 simulates a broadening of the base from that of the income tax schedule to that of the CSG, the flat rate income tax.

Two main points emerge from this graph. First, the treatment of capital gains radically changes the profile of average tax rates for the highest incomes, because of their strong concentration at the top of the distribution. Second, the amendments made following the protests by the "Suckers" (curve 2) practically nullify the effects of reform of the capital gains from securities, as we see by comparing it with the original version (curve 3). **From the government's original estimate of receipts of one billion euros from this measure, capital gains taxes will now bring in less than 200 million euros**[3]. The integration of capital gains from securities into the income tax schedule has been pushed back to 2014.

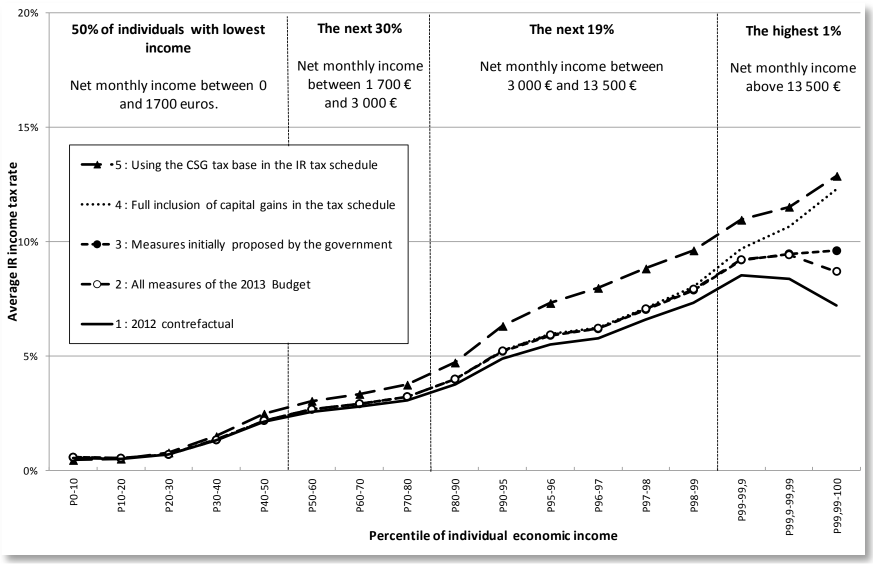
Broadening the base of the income tax schedule to that of the CSG-CRDS would have the advantage of minimising the possibilities of tax avoidance, because it includes all capital income[4]. Life insurance contracts and savings accounts benefitting from advantageous tax conditions are mostly owned by the highest ten per cent of incomes; the tax increase would not affect only the richest one per cent, but would be spread among the richest ten per cent of tax payers. Such a scenario would allow a significant increase in tax receipts and/or an accompanying decrease in the tax rate, which would achieve the desired progressive profile.

To conclude…

The 2013 Budget promises a substantial boost in income tax receipts for the state, thereby countering a long-standing trend in the opposite direction. These tax increases will touch the richest 50 per cent of tax payers but only significantly affect those with the very highest incomes. We are far from a "major tax reform" that simplifies the existing system and allows an equal treatment of different forms of income. The government risks not only recreating the kinds of exemptions and derogations that it denounced before the election, but also compromising the promised recovery of public finances.

«The government risks not only recreating the kinds of exemptions and derogations that it denounced before the election, but also compromising the promised recovery of public finances »

Graph 2 – Ways to broaden the income tax base (without changing the tax schedule)



Source : TAXIPP 0.2

Field : All individuals over the age of 18.

Note : Graph 2 presents the rate of tax on income (withholding tax and income tax schedule) by economic income group, in terms of five different reform scenarios.

Curves :
Curve 1 represents the tax rate that would have been effective in 2012 in the absence of any reform (the counterfactual).
Curve 2 represents the tax rate for 2013 after implementation of the reforms and the increase of the tax imposed on capital gains between 19 per cent and 24 per cent (as currently envisaged by the 2013 Budget).
Curve 3 represents the tax rate for 2013 after implementation of the reforms and partial integration of capital gains from securities into the income tax schedule (as currently envisaged by the 2013 Budget).
Curve 4 represents the tax rate for 2013 after the implementation of the reforms and the complete integration of capital gains into the tax schedule (hypothetical scenario).
Curve 5 represents the tax rate for 2013 after the implementation of the reforms and the total adoption of the CSG-CRDS base into the income tax schedule (hypothetical scenario).

3. Estimations presented by the Government, "amendement I-846"

4. The base of the CSG includes all capital income (dividends, capital gains, interest, life insurance) but excluding the products from certain tax favoured saving vehicles such as "livret A", "livret jeune", "livret d'épargne populaire" or "livret de développement durable". Basing the IR income tax schedule on the CSG tax base would bring income from life insurance, and interest from savings accounts back into it.