Institut des Politiques Publiques

FRENCH BUDGET 2014: THE IMPACT OF THE NEW TAX MEASURES?

IPP Policy Brief

n°9

November 2013

Antoine Bozio
Malka Guillot
Marianne Tenand

www.ipp.eu

Summary

Released at the end of September, the 2014 French Budget aims to reduce the public deficit by restricting public spending. While the announced tax reforms are less radical than those implemented in the previous two years, they project an additional increase in revenue of 2.7 billion euros (that is, 0.1% of GDP). This note presents an overview of the evolution of public finances and an analysis of some of the announced tax measures that will affect expected revenues for the 2014 financial year. Changes to income tax are limited and mainly affect those in the highest income decile; the increase in VAT also has a mildly redistributive effect, thanks to the increase in the intermediate rate. There remain, however, a number of unknown effects relating to the impact on employment of the tax credits for competition and employment (CICE) scheme and the effectiveness of the announced spending cuts.

- The 2014 French Budget expects to reduce the public deficit by increasing tax and social security contributions (+ 0.1% of GDP) and cutting public spending (-0.3% of GDP). In comparison, the 2013 budget raised taxes by 1% of GDP.
- The changes to income tax are limited and chiefly affect only those in the top 10% of households, through the introduction of a cap on the tax advantage provided by the family quotient (through which number of children is taken into account when calculating the tax liability).
- The increase in VAT rates will affect all households but will have slightly more impact on higher-income families because the highest increase is to the intermediate rate.
- The CICE should push down the hourly cost of employment by at least 1.5% for 90% of employees on the lowest hourly rates. Its impact on employment and wages remains uncertain.

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.

www.crest.fr

www.parisschoolofeconomics.eu

After several years of marked increases in tax and social security contributions, despite which growth in revenues continued to be weak, the government has decided to prioritise spending cuts. However, in a context of what we might describe as general "tax fatigue", a significant part of the public debate has been about the expected changes to income tax. This is no doubt explained by the "salience" of that specific tax, and by the numerous reforms that it has undergone in recent years. In contrast, two other policy changes, adopted in 2012 – the tax credit for competitiveness and employment (CICE), and the VAT reforms – have been less present in recent debates despite the fact that the stakes involved are high.

In order to inform public discussion of Budget 2014, **this note presents an analysis of the redistributive impact of these tax reforms**. It also investigates the creation of the exceptional tax on high company salaries.

The major decisions of Budget 2014

Table 1 presents an overview of the macroeconomic situation and French public accounts for the years 2013 and 2014. The estimates of the aggregates of these accounts rest on the one hand on expectations of growth and inflation, and on the other, on changes to revenue and expenditure.

In Budget 2014 (*projet de loi de finances 2014*, or PLF 2014), the government announces economies in public spending of 15 billion euros, equal to 0.7% of GDP. This represents a relative saving compared with what total expenditure would have been if it had matched the rhythm of the "trend growth" in public expenditure. This concept, used by the European Commission and the *Cour des Comptes*[1] takes into account the fact that even without new policies, public spending increases (mainly because of changes to population structures, which affect costs for health, retirement pensions and other benefits).

1. The Cour des Comptes is an administrative body charged with assessing the conformity of French public accounts. Although its recommendations have no constraining power, it is quite influential.

The government assumes a trend growth in total expenditure of 1.5%. Under this assumption, without legislative intervention, public spending would have risen to 34 billion euros in 2014, while Budget 2014 declares that it should grow by only 19 billion euros between 2013 and 2014. The "savings" of nearly 15 billion euros does not mean that expenditures will decrease by 15 billion, but that they will amount to 15 billion less than they would have had spending followed its trend growth.

Matching the savings on the resources side is the income induced by the changes proposed in Budget 2014, relative to what it would have been in the absence of such legislative change. This year, the budget presumes **an increase in receipts thanks to new tax measures of around 3 billion euros** (2.7 billion to be precise; see Table 2 for details), **which is about 0.1% of GDP**. But the total tax income will rise by about 25 billion euros; of this total, **3 billion result from the measures announced in Budget 2014**, and **more than 22 billion euros are generated solely by the increase in revenue due to growth**, a rate of compulsory payments identical to that of 2013.

The "effort" to redress the public accounts, which can be defined as the sum of cuts to expenditure and new income policies, amounts to 18 billion euros (15 + 3), 85% of which comes from spending cuts and 15% from new receipts. By comparison, the 2013 budget effort amounted to 28 billion euros, 30% of which came from spending cuts and 70% from new tax revenues.

« The "effort" to redress the public accounts […] amounts to 18 billion Euros, 85% of which comes from spending cuts and 15% from new receipts »

Table 1 : Macroeconomic framing of the 2014 Budget

	2013	2014 (Budget 2014)	2014 (2013 Legislation)
Macroeconomic aggregates			
GDP (in billions of euros)	2 068	2 117	2 117
Growth in GDP (in volume)	0,1%	0,9%	0,9%
Inflation (excluding tobacco)	0,8%	1,3%	1,3%
State of public accounts			
Public expenditure (in billions of euros)	1 180	1 199	1 214
Compulsory deductions (in billions of euros)	951	976	974
Compulsory deductions (% of GDP)	46,0%	46,1%	46,0%
Public expenditure (% du GDP)	57,1%	56,7%	57,3%
Balance of public administration budget (% of GDP)	- 4,1%	- 3,6%	- 4,3%
Public debt (% of GDP)	93,4%	95,1%	95,8%
Changes in income and expenditure			
Expenses (in billions of euros)	+ 30	+ 19	+ 34
(% of GDP)	1,5%	0,9%	1,6%
Income (in billions of euros)	+ 37	+ 25	+ 22
(% of GDP)	1,8%	1,2%	1,0%

Sources : Budget 2014 and authors' calculations.
Lecture : The column "2013" gives the macroeconomic and budgetary aggregates for the budget year 2013. In the "2014 (Budget 2014)" column are the expected macroeconomic and budgetary data for the year 2014, assuming that the measures contained in the 2014 Budget (and in the 2014 social security budget, PLFSS 2014), are implemented. The column "2014 (2013 Legislation)" gives the expectations from the same macroeconomic conditions but assuming that the 2013 legislation continued to apply, without change, in 2014. The compulsory deductions do not constitute the total of public receipts because these also include non-tax income.

But such figures depend crucially on the trend growth of public expenditure being maintained: **an overestimate of this rate results in an overestimate of effective savings**. This was the case with Budget 2013, the Cour des Comptes having considered as excessive the rate of trend growth of 1.7% then assumed by the government. More immediately, the effort to cut public spending can be seen in the fact that the policies stated in Budget 2014 would lead to a decline in the ratio of public spending to GDP from 57.1 to 56.7%.

Table 2 details the income that results from the new measures affecting the public accounts for 2014. These measures come from Budget 2014 as well as the 2014 social security budget (PLFSS). They also include reforms of the amended budgets of 2013 and earlier, which will affect the 2014 budget. This is the case with the introduction of the CICE and the changes to VAT introduced in the amended 2013 budget (voted up in autumn 2012). **These two reforms had a significant impact on the public accounts**: the Ministry of Economic and Financial Affairs estimates the cost of the CICE at nearly 10 billion euros for 2014, while the VAT reforms should bring in 5.1 billion euros (compared with the 2 billion that will be brought in by the total of other measures related to income tax).

The total income gains resulting from these new changes will be, according to the government, 2.7 billion and may be broken down between the different public administrations. Only the central administration sees its income drop relative to 2013. The drop of 8.2 billion euros is chiefly due to measures related to taxes on firms, which total almost 13.7 billion. The measures that favour business are offset in part by increases in deductions from households, particularly the revenue raised from changes to income tax, (+2.3 billion) and changes to VAT.

> *« The total income gains resulting from these new changes will be […] 2.7 billion. Only the central administration sees its income drop relative to 2013 »*

The 6.6 billion euros increase in social security income is mostly due to the increases in contributions among retirees. Finally, 4.3 billion in supplementary income should be collected by local public sector agencies and by various central administration bodies (thanks to the heavy vehicles tax, carbon quotas, etc.)

Table 2 : Breakdown of supplementary income(1) (Budget 2014)

	(in billions of euros)	Income
Central administration		**- 8,2**
Impositions on households (excluding VAT)		
Budget 2014	Indexation of the schedule to inflation (not including tobacco)	- 0,7
	Revaluing of the discount on the income tax for low-income taxpayers	- 0,2
	Lowering of the family tax reduction ceiling	+ 1
	Abolition of the tax rebate for school-aged children	+ 0,4
	Abolition of the exemption from personal income tax of child-related bonuses in pensions	+ 1,2
	Reform of the tax on capital gains on real property	- 0,4
Budget 2014 and previous budgets	Other measures, including the taxing of overtime and changes to the tax rebate for sustainable development (CIDD)	+ 3,8
Impositions on businesses		
Budget 2012	Tax rebate for competitiveness and employment (CICE)	- 9,8
Budget 2014	Exceptional tax on high salaries (TEHR)	+0,3
	Tax on Gross Operating Income (*Taxe sur l'Excédent brut d'exploitation*)	+ 2,5
Previous budgets	Other measures (2)	- 6,7
Valued Added tax (VAT)		
Amended budget 2012	Increase in intermediate and standard rates	+ 6,4
	Lowering of the reduced rate	- 0,8
Budget 2014	Other changes to VAT	- 0,5
Other measures		
Social Security		**+ 6,6**
Social Security Budget 2014	Increase in retirement pension contributions (basic and complementary mandatory schemes: CNAV, ARRCO, AGIRC)	+ 2,6
	Lowering of family social security contributions	- 1
Other measures	including transfers of Central State income to other public bodies decided in the 2011 Amended Budget	+ 5
Local administrations		
Other sections of the central administration		
	Total effect of the new measures on public income	**+ 2,7**

Sources : Rapport économique social et financier, table 21

Note : (1) This table presents the new income measures, in billions of euros, as they appear in the Budget 2014 and Social Security Budget 2014, before their debate in the National Assembly and the Senate. (2) The measures correspond mainly to the consequences of the exceptional changes of 2013 that were not rolled over into 2014.

What will be the impact of changes to income tax?

Because they directly affect a majority of families, the measures related to the personal income tax (IR), have been the object of much commentary in public debate. After a two-year freeze of the IR tax schedule, the current government announced the indexation of the tax schedule brackets to inflation, which increased them by 0.8%. This indexation was introduced as a measure that would allow around 13,000 households to "exit" from the income tax "catchment zone". It would be more accurate to say that it prevents these households from "entering" the zone in which they are subjected to the income tax. In effect, the freeze on the tax schedule would have automatically driven a number of French households (whose average income continues to rise) above the taxable threshold for their 2013 income, though their 2012 taxable income had placed them below the threshold. In order to exempt further modest-income households from income tax, the discount was increased by 5% (on top of inflation)[2]. **The cost of the re-indexation of the tax schedule (compared with the freeze on it) has been estimated at 700 million euros and the increase in the discount at 200 million**.

Furthermore, the ceiling on the Family Quotient, which limits the tax reduction enjoyed by households with dependent children, should be lowered from 2,000 to 1,500 euros for each fiscal half-share, a policy carried over from Budget 2013 (The amount of IR, which is paid on a household basis, is calculated according to the number of "fiscal shares" in the household. Each child adds the right to an extra half-share, thereby reducing the tax bill – up to a certain ceiling.). At the same time, for those tax-payers who live alone with one of more dependent children and who benefit from a whole fiscal share for the first child, the ceiling of the Family Quotient is also to be reduced by 500 euros. **These measures would bring in nearly one billion euros**. Some changes, written into Budget 2014, were rejected by the National Assembly, including the removal of the tax reduction for school-age children.

Figure 1 presents an analysis of the redistributive effects of the changes to the IR, which **have been estimated with the help of the IPP micro-simulation model, TAXIPP**.

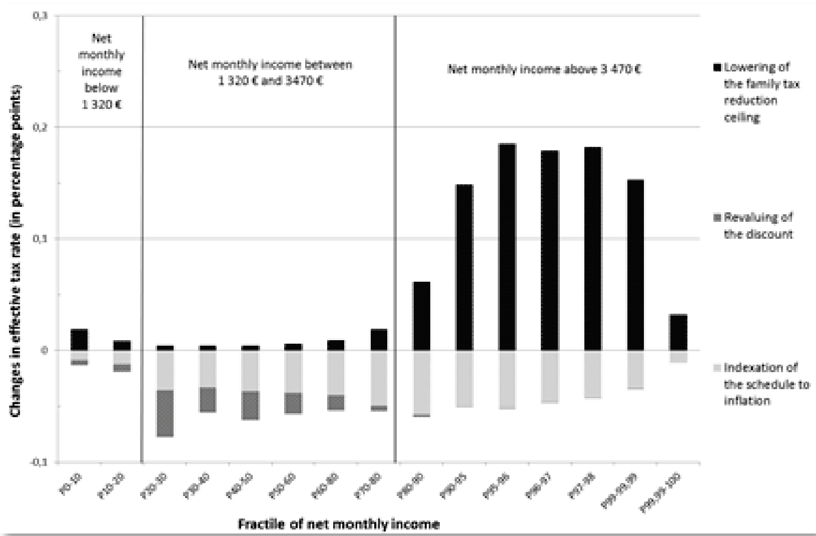
The two first deciles of net monthly income include a majority of individuals whose income is not taxable under the IR; on average, the increase in the discount and the end to the schedule freeze has, therefore, had a relatively limited impact on these households. Deciles 3 to 7, which group together individuals who receive roughly between 1,320 and 3,470 euros per month, are most affected by the increase in the discount and by the re-indexing of the tax schedule. The indexation of the tax schedule certainly reduces the average rate of imposition for the totality of taxable households, but the minor rises in the tax schedule mean that the resulting reduction in tax is also minor. We note that in times of low growth and inflation, the choice between indexation to inflation or to growth, rather than a freeze of the tax schedule, leads to similar, limited effects.

The measures written into Budget 2014 lead, on the other hand, to an increase in the rate of tax payable by the most well-off 20% of individuals, but mainly because of the reduction of the family tax reduction. Generally, **the top decile is the most affected by the increases in income tax**, even if the increases are clearly less onerous than those introduced in the 2013 budget. This diagnosis does not take into account the introduction of the exceptional tax on high salaries, paid by the companies discussed in Box 1, and which should affect the general rate of deductions on the highest incomes.

The taxing of the pension bonus for children (see Table 2) is part of the program to reformulate family-related benefits, which the pension reform should make concrete. Because of insufficiently accurate data, the redistributive effects of this measure have not been estimated with the TAXIPP model. Theoretically, however, it can be said that since the pension bonus for children is proportional to the pension paid, its exemption from the IR constitutes a regressive tax policy. In view of the revenue expected from this reform (1.2 billion euros, making up more than half of the increases expected from personal income tax revenues), we can expect that it will have a non-negligible effect on the average rate of taxation of households that include well-off retirees who have had three or more children.

2. The discount is a reduction of the tax to be paid by those who, because of their modest incomes and their dependants, end up with a relatively small tax bill.

Figure 1 : Breakdown of the impact of measures relating to personal income tax (IR)



Sources : TAXIPP 0.3

Note: This figure shows the impact, in percentage points, of some IR reforms on the effective tax rate of personal income tax (expressed as a percentage of secondary economic income) according to individual monthly net income. The individuals are classified from the poorest (on the left) to the richest (on the right). The P0-10 group denotes the first 10 centiles, that is, the 10% of individuals with the lowest net monthly income; group P10-12, the following 10%, and so on. The group of the richest 10% is broken down into sub-groups: in particular, P99-100 corresponds to the 0.1% with the highest net monthly salary. The revaluation of the discount thus entails a lowering by 0.4 points the percentage of the average tax rate of personal income tax of individuals in the second decile.

Field: Total individuals aged 18 years or older.

Changes to the VAT

The different rates of the VAT were modified by the 2012 Revised Budget (loi de finances rectificative or LFR 2012). The changes apply from 1 January 2014. There remain four rates of VAT. The full or standard rate applies to most goods and services. The intermediate rate (also known as the reduced upper rate) applies to all products that were formerly subject to a reduced rate, except (among others) basic food stuffs, school canteens, gas and electricity charges, books, live performances and museum entry, which remain on a reduced rate. The full rate will be fixed at 20% instead of 19.5%; the upper reduced rate goes from 7 to 10%, while the highly reduced rate remains unchanged at 2.5%. **The government estimates the total income resulting from the increased rates at 6.4 billion euros**. The reduced rate, which was initially to be cut from 5.5% to 5%, will remain at 5.5%, following amendments made to Budget 2014 by the National Assembly.

The VAT is an indirect tax that affects the population in proportion to the goods that they consume, which are subject to different rates. The structure of consumption of each decile of disposable income thus determines the redistributive impact of the tax. The reduced rate is a greater burden on modest-income households and the intermediate rate weighs heavier on those with high incomes; the goods and services subject to the full rate are distributed proportionally among the different deciles.

Figure 2 shows the impact of the changes to the intermediate and full rates for the different disposable-income deciles. Changes to the intermediate rate have the greatest effect on the amount paid by households in VAT. While **the increase in the full rate has a relatively uniform effect on the population as a whole**, the intermediate rate affects the richest households the most.

« […] the intermediate rate affects the richest households the most »

In total, the changes to VAT are, therefore, mildly progressive. However, the impact of this reform must be seen in a broader perspective, since the supplementary VAT income will be dedicated to the financing of a tax credit designed to increase employment.

Box 1: Who will pay the High Salary Tax?

The exceptional social tax on high salaries (la taxe exceptionnelle de solidarité sur les hautes rémunérations, TEHR) affects all gross salaries greater than one million euros. Firms will be taxed at 50% of the gross individual salaries that exceed one million euros, with a ceiling equal to 5% of their turnover

This reform changes the marginal tax rate, that is to say, the increase in tax that results from an increase of 100 euros of income, for the very high salaries subject to this tax. The calculation of the marginal rate, of which the result is presented in Table 1, is made for an individual receiving only salary-related income. For firms not subject to the payroll tax[3]. Budget 2014 increases the marginal rate on net income from 66.1% to 75.7%, a difference of 10 percentage points. The tax on high salaries thus brings the marginal rate to 75%, the rate that was announced during François Hollande's presidential campaign in 2012, and even to a higher rate for firms that are subject to the payroll tax – the banking and insurance sectors (see Table 3)

Table 3 - Marginal tax rate for on employment income

Upper marginal Tax rate		
The firm is subject to the payroll tax	**Existing Legislation**	**Budget 2014 Legislation**
Yes	70,1%	77,8%
No	66,1%	75,7%

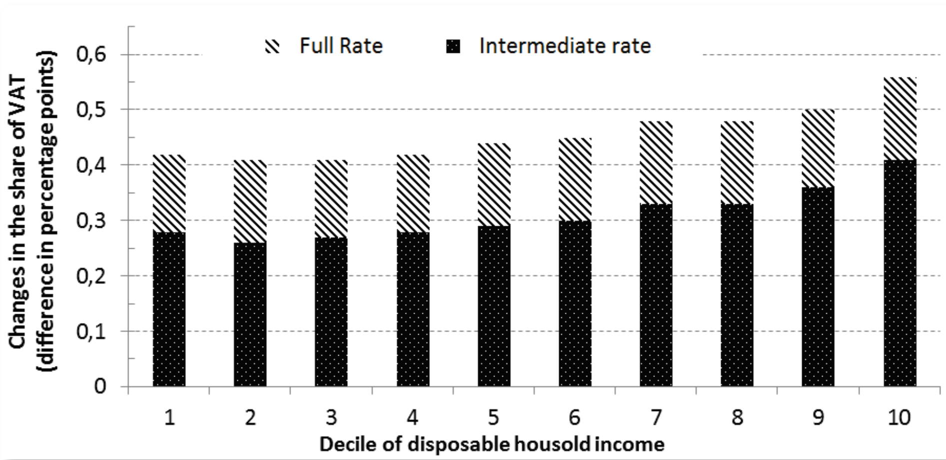
Note : For an individual receiving an annual salary of one million euros and working for a firm that is subject to the payroll tax, an increase in economic income of 100 euros entails an increase in net income after personal tax and the exceptional contribution for high salaries (TEHR) of around 30 euros (100 – 70.1) under existing legislation; this increase would be of 22 euros (100 – 77.8) under the TEHR proposed in Budget 2014.
Details of the calculation : The marginal tax rate is expressed as a percentage of economic income, which includes contributory and non-contributory social contributions, the CSG, the CRDS, the IR and the TEHR, introduced in 2012.

While this tax is paid by the employers, we still do not know by how much they are going to adjust for it in relation to salaries (by lowering them), to shareholders (by reducing dividends) or to consumers (by increasing prices). The government hopes to discourage firms from offering salaries of more than one million euros, but since the tax is temporary, it is difficult to imagine it having a lasting disincentive effect.

Above all, **this tax is liable to entail a multitude of evasive tactics**, whether it be delocalisation (tax havens, shifting financial operations off-shore), or tax avoidance (changes to salary reporting, forms of remuneration, etc.), all of which lead to a reduction of the desired receipts from the tax. The government estimates its return at a relatively small 260 million euros for 2014 and even that is probably an overestimation.

3. The payroll tax is paid only by those companies operating in some specific sectors

Figure 2: Effects of changes to VAT rates, by disposable-income deciles.



Sources : Enquête Budget des familles 2006 and TAXIPP 0.3.

Note: With the reform, the top disposable-income decile will pay, because of the increase in the upper reduced rate of VAT, an extra 0.2 points on its consumption (excluding housing costs).

Nb: The share of VAT is expressed here in proportion to consumption not including accommodation, this being the closest measure to the VAT base of an individual's capacity to pay.

Field: All French households.

Le Crédit d'impôt pour la compétitivité et l'emploi (CICE)

Unveiled by the government in the fourth quarter of 2012, the tax credit for competitiveness and employment was presented as one of the flagship measures of the "national pact for growth, competition and employment". Indeed, the government intends to dedicate 20 billion euros (1.7% of GDP) each year to this policy that aims both to save and create jobs, especially in the sectors exposed to international competition, where labour costs are a particularly sensitive variable.

The CICE is a tax credit on the sums paid as corporate income tax by companies. Each salaried employee whose gross income for the calendar year does not exceed two-and-a-half times the minimum wage makes his employer eligible for a tax credit equal to 6% of his salary. The government plans a progressive development of this measure, as it will start with a rate of reduction of 4% for the tax paid in 2014 on 2013 earnings, the cost to the public purse of which is estimated at around 10 billion euros for 2014 (see Table 2).

Formally, the CICE reduces the tax for private companies. **The CICE is, however, comparable to a reduction in social contributions on low wages** insofar as it relates to wages paid to workers below a certain threshold. One of the government's explicit aims with the creation of this tax discount is to reduce the difference between the cost of labour in France and Germany.

Our simulation model allows us to estimate, for 2013 incomes, the impact that the CICE would have on the cost of labour (see Figure 3). **The hourly wage rate** is the amount the employer must pay to employ a worker, divided by the number of hours she worked. Thus, it corresponds to **an hourly "super-gross" wage rate**, which adds payroll contributions, the CSG and CRDS, employer contributions and the tax on wages if the employee works in a sector not subject to VAT (the banking sector, for example), to the net hourly rate the worker receives. For this graph, the reduction of labour costs is expressed in terms of **the hourly wage rate**, since that is what is used when calculating eligibility for the CICE.

Gross salary, which is generally the basis for salary negotiations, corresponds to the super-gross rate from which are subtracted employer contributions and the various payroll taxes.

> *« The effect of the CICE, therefore, is not limited to the least qualified workers »*

Employees see their labour costs dropping all the way to the 9th gross-salary decile, where the gross wage is still less than 2.5 times the gross minimum wage. The effect of the CICE, therefore, is not limited to the least qualified workers, since the labour costs of the first eight deciles goes down more than 1.5%. The second and third deciles are those which benefit the most from the CICE, with their labour costs dropping by almost two percent. But in the longer term, t**he redistributive impact of this policy measure depends on the manner in which the drop in charges will be distributed within the firm**: will it result in an increase in wages covered by the exemption or an increase in company margins? Will the savings generate an increase in hiring? Over what time period are the results likely to be most effective? The answers to all these questions await an ex post assessment of the impact of the CICE.

In conclusion…

While debates about the budget decisions have mostly been about tax increases, analysis of Budget 2014 shows that these are relatively limited. Even if the increases were partially reduced thanks to the protests of the so-called "Pigeons", the 2013 budget resulted in a substantial increase in the effective rate of taxation at the top of the income distribution. While the government proposed the end of the tax schedule freeze and the revaluing of the discount as a way to support the purchasing power of the French, the tax savings from these reforms are minor and amount to less than the increases that come from the changes to VAT rates.

Beyond the tax reforms of limited significance, **the main impact of Budget 2014 is the reduction of public expenditure as a percentage of national income**. The effectiveness of these expenditures, like their redistributive effects are largely unknown at this moment. Similarly, the impact of the CICE on employment, a key reform plank in this government's program, remains uncertain, thanks to its complexity.

Figure 3: Reduction of labour costs 2013 due to the CICE for workers in the private sector, by decile of gross hourly wage.

Source: TAXIPP 0.3.

Note: For the individuals in the second highest gross wage decile, the cost of labour goes down by nearly 2% with the introduction of the CICE (at the rate of 4%).

Nb1: The total labour cost is measured by the super-gross hourly wage rate, comprising the gross hourly rate, employer contributions and payroll tax where applicable.

Nb2: Monthly gross earnings are calculated on the basis of a full-time job.

Field: Total individuals aged 18 years and over receiving income from work, in the private sector.