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EDITORIAL

Taking the opportunity of my appointment as the Executive Chairman of the CAE, I would like first to pay homage to the work of my predecessors, Pierre-Alain Muet and Jean Pisani-Ferry.

The CAE must now put down roots in the French administration. It must go on fulfilling its missions by renewing the topics it tackles and diversifying products and events.

The report by Michèle Debonneuil and Lionel Fontagné is timely, using the tools of economic analysis to provide a vision of French competitiveness that is full of nuances, up-to-date and enlightening for public decision-makers.

Several of the recommendations in the Debonneuil/Fontagné report could be implemented fairly rapidly: a cut in the rate of corporate tax to attain the European range, the introduction of an 'impatriate' status for tax purposes, the necessary reinforcement of tax harmonisation within Europe and the construction of a 'scoreboard' of French competitiveness, bringing together 33 indicators under three headings (education, innovation, positioning as regards information and communication technologies).

Christian de Boissieu
Executive Chairman of the CAE

Competitiveness

Report by Michèle Debonneuil and Lionel Fontagné

Is France competitive? Does it deserve its poor position ascribed by some international rankings? Doesn't it suffer from a heavy and unstable regulation, a high tax burden for companies, and, in broader terms, excessively high compulsory contributions? Does it still have the capacity to attract capital and brains? In short would the French decline be confirmed?

The report by Michèle Debonneuil and Lionel Fontagné tackles these questions which recently widely feed public debate. It analyses France's competitiveness, founding its approach on the recent developments of international economics and rigorous statistical studies.

The report was presented to the plenary session held on October 24th 2002, and in the presence of the French Prime Minister on May 5th 2003. This letter, published under the authority of the permanent staff of the CEA, summarises the main conclusions of the report.

The starting point of Michèle Debonneuil and Lionel Fontagné is the definition of the competitiveness of a Nation used by international organisations, i.e. the capacity for a sustained rise and improvement in the standards of living. This definition was expanded further by the European Union's Lisbon Declaration of March 2000 which specifies the goal of 'more and better jobs and greater social cohesion'. They review their approach on the international trade theory and its recent developments: reviewing price-competitiveness, account for non-price competitiveness, product quality and innovation and emphasise the attractiveness of mobile factors –highly skilled workers and companies– and their determinants such as taxation, a tool to strengthen agglomeration forces.

French trade performance: satisfactory

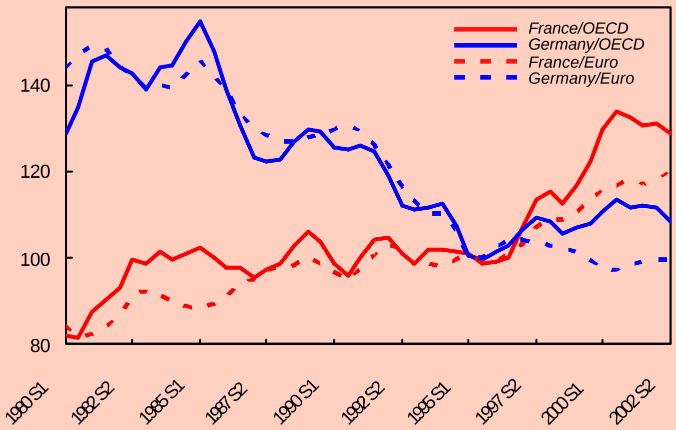
The authors first challenge France's position in different rankings. The controversy over the economic ranking of France within the European Union is now over: the French standard of living, in terms of per capita income (Purchasing Power Standard), does not fundamentally differ from that of other major industrialised countries in the European Union. INSEE and OECD recommend not classifying countries with a relatively close performance, given the statistical uncertainty. Moreover, widely known international rankings, based on composite competitiveness indexes, such as those calculated by the World Economic Forum, are founded on weak theoretical assumptions and unreliable statistical methods.

As regards traditional factors linked to international competition, French trade performance is satisfactory: long-term stability of global market share in manufactured products despite the emergence of new competitors, as opposed to a declining market share for the United States and Germany, specialisation in low value-added services such as tourism, which is admittedly a low-innovative sector, but creates jobs and satisfies the potentially growing demand for leisure in advanced societies.

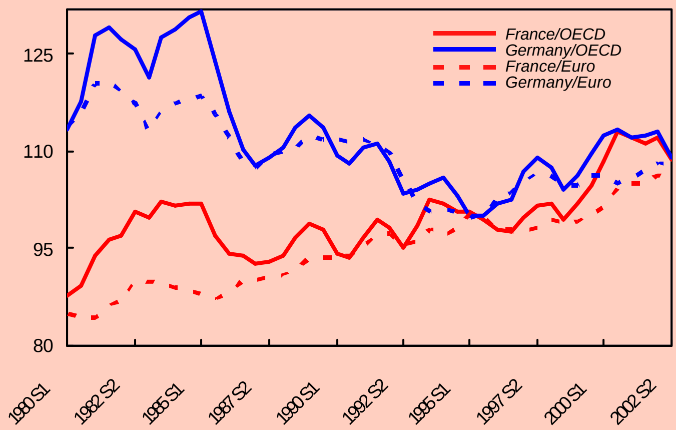
Cost and price competitiveness improved sharply in the past two decades to the end of 2000. Benefits of the successful disinflation policy started in the early 1980s and labour cost restraint, as well as the major appreciation in the dollar as of 1995 and the decline of the euro between 1st January 1999 (USD 1.17) and October 2000 (USD 0.83). This fall

1. Cost and price competitiveness in France and Germany compared with OECD countries and the rest of the euro zone
(An increase reflects an improvement in competitiveness)

a. Cost competitiveness (1995 = 100)



b. Price competitiveness (1995 = 100)



Note: Cost and price competitiveness indicators are related to manufactured products. Competitiveness is defined as the ratio of the export prices or unit labour costs of competitors to those of the country in question.

Source: Direction de la Prévision, Ministry of Finance, France.

staple consumer goods have a greater market share than their European, US and Japanese competitors. This is particularly true of French products given their higher reputation and better design. Moreover, the quality of French products has improved according to the latest surveys of the *Centre d'observation économique.*

However, France and to a greater extent Germany are net exporters of medium –to high-technology rather than high-technology goods, despite major success in the latter sector (aeronautics, etc.). This weak position reflects France's inadequate investment in R&D, which has delayed its progress in terms of the production and use of new information and communication technologies.

Attractiveness of the French 'site'…

The authors reject the various global attractiveness indexes such as those provided by UNCTAD. They prefer to emphasise the attractiveness of the French 'site' reflected by Foreign Direct Investment (FDI) statistics. Foreign groups account for a sizeable share of economic activity: 17% of French production across all sectors, 15% of employment. In 2002, against a background of a global economic slowdown and whereas the major OECD countries, particularly the US, register a big drop in inward FDI flows, France should improve its rank and become the second-largest host country of direct investments(1) within the world, after China, according to the present available national estimations.

How should we assess the French 'site', based on determinants of company location? Using a combination of market size and agglomeration factors, France falls within the European average thanks to certain regions which attract foreign investors, mainly Ile-de-France (greater Paris region) and the regions located near the core of Europe, along the eastern border of France. Costs also influence location, and therefore taxation, although it is far from being as exclusive as some would suggest: according to available studies, taxation does not influence the choice between export or foreign investment, but does affect the choice of where to set up operations once the decision to invest abroad has been made. This impact is all the better measured as it takes into account the agglomeration and market potential factors mentioned above as well as the diversity of tax schemes, full credit or exemption. A one-point rise in corporate taxes would reduce inward FDI by 3.3%, with an even stronger impact on greenfield operations.

(1) All foreign direct investment flows (equity stakes, mergers and acquisitions, re-invested earnings or new operations).

reflected the expected under-performance in financial returns of the euro zone (smaller productivity growth, etc.) After a phase of stabilisation, the dollar has depreciated since February 2002 as a result of the huge US trade deficit now associated with the budget deficit. The current euro-dollar exchange rate (USD 1.08), lower than its equilibrium value, leaves France with an hourly labour cost advantage, but may actually hinder Germany. In the second half of 2002, France's cost competitiveness was 23% above its long-term average (1980-2002), with price competitiveness at 9%.

High product quality, but weak positioning in high technology

The improvement in price competitiveness through depreciation in the exchange rate produces, all things being equal, a decline in the purchasing power of national income denominated in international currencies. In other words, selling more cheaply does not make the Nation richer. Therefore, the non-price dimension of competitiveness must also be emphasised. In this respect, France's positioning in terms of product quality seems satisfactory: nearly half of its exports are upmarket. By and large, French and German

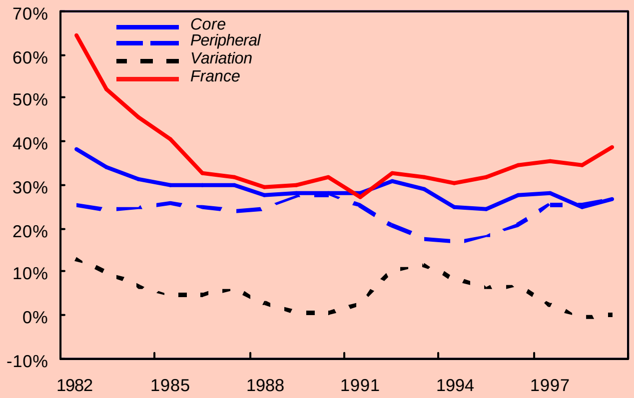
1. Contribution to the manufacturing trade balance by technology level (%, 1999)

	High	Med-high	Med-low	Low
United States	5,0	0,4	– 0,9	– 4,5
Switzerland	4,2	3,2	– 1,7	– 5,7
United Kingdom	2,4	1,0	0,6	– 4,2
Ireland	2,3	1,1	– 3,3	– 0,1
Mexico	2,0	2,8	– 5,3	0,5
Sweden	1,7	– 2,2	– 0,7	1,1
Hungary	1,1	– 1,2	– 2,1	2,3
Japan	0,7	14,4	– 0,8	– 14,3
Denmark	0,5	– 3,1	– 0,9	3,6
France	*0,4*	*1,6*	*– 0,6*	*– 1,6*
Korea	– 0,4	– 1,7	0,5	1,6
Germany	– 2,6	7,4	– 0,5	– 4,6
Spain	– 4,0	0,6	2,4	1,1
Italy	– 4,2	– 0,1	0,5	3,8

Note: Selected countries. CEPII specialisation indicator.

Source: OECD, 2001.

2. Implicit corporate tax rates[*] in the 'core' and 'peripheral' European Union



Note: (*) Ratio of full tax charge for companies to earnings subject to corporate taxation; 'Core' Europe = Germany, Benelux, France and Italy; 'Peripheral' Europe = Austria, Denmark, Spain, Finland, Greece, Ireland, Portugal, United Kingdom and Sweden.

Sources: Complement by Bénassy-Quéré,Lahrèche-Révil, Madiès and Mayer, Data OECD.

... despite a very high corporate tax rate

French corporate tax rates rank among the highest in Europe, even though the complexity of the system enables tax optimisation which reduces ex post the effective tax rate for companies in the manufacturing sector located in France. However, part of this difference compared with other European countries can be justified by the quality of infrastructure and ease of access to the European market.

French taxation on high income is not unfavourable, contrary to conventional wisdom: tax level is competitive up to a gross taxable income of EUR 300,000 per year, regardless of the employee's family structure. The French tax regime on stock options is also rather favourable, ranking within the average of other European countries. The only drawbacks relate to the lack of international tax agreements, particularly on wealth tax[2], the absence of a special regime for 'impatriated' executives[3], contrary to other European countries, and the non-harmonisation of the tax treatment of stock options, in terms of tax events (allocation, exercise or sale of the option).

The comparison of tax wedges[4], although seemingly very unfavourable for France, is in fact difficult to interpret, as the required social security contributions finance services which are paid for through private insurance in other countries.

For a co-operative European policy...

The authors conclude that Europe has not completed the integration process or reaped the benefits thereof, and that it has also lost sight of the technological frontier represented by the United States. Only co-operative European structural policies –life-long training and education, research policy and public support for innovation, protection of intellectual property, taxation, etc.– can promote long-term economic competitiveness. For the most part, these policies have been left till now to individual States, based either on unanimous agreement (in the case of taxation) or subsidiarity (for the labour market).

The authors illustrate their idea of competitiveness policies using the topic of taxation. They are opposed to tax competition between European States, as it may breach the European social model. Despite positive supply effects, it has the major drawback of shifting the tax burden to less mobile factors, particularly unskilled labour, by increasing costs and hindering employment. This stance must not however prevent the correction of major distortions or remove the concern over the 'publicity effect'.

In the short run, the authors recommend focusing on a small number of low-cost adjustments to taxation, which would improve France's image. They believe that taboos on the taxation of individuals must be lifted: the most skilled people must be attracted and retained, while respecting equal rights and maintaining equity. They therefore recommend the introduction of an 'impatriate' package[5], which would provide for the exemption of additional compensation, thus balancing the existing regime for expatriate French executives, the extension of international agreements on the wealth tax and finally, the extension of social agreements for all countries investing in France. They then recommend a European agreement on the standardisation of tax rules on stock options in terms of tax events. Finally, the authors advocate greater clarity and foresight in the corporate tax system, since investment decisions are not based on the duration of a Finance Law.

... notably on corporate tax…

In a longer-term perspective, the authors favour closer European tax co-operation, which implies a qualified majority vote at the European level, and recommend that France should support a European reform on corporate tax entailing:

- consolidation of tax bases at the European level based on a common tax code, which would be relatively favourable for companies in order to encourage the latter to use it in preference to the existing national code;
- allocation of the tax base among Members on the basis of a single rule to be mutually agreed;
- adoption of a target floor tax rate (depending on the convergence process), which would not prevent the advanced 'core' countries, or those best endowed with infrastructure or presenting different collective preferences, from exceeding this minimum rate. The second step would involve the establishment of an EU corporate income tax.

... and regular monitoring of indicators

Following the example of various countries such as Ireland and the United Kingdom, the authors advocate the establishment and yearly publication of a 'scoreboard' on competitiveness, through indexes on education, innovation, information and communication technologies, for France and its G7 partners. Building on the in-

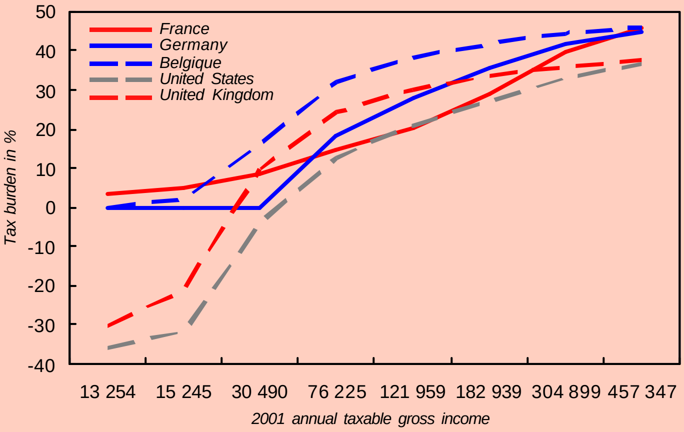
(2) Regarding the deductibility of assets located abroad and the deductibility period currently restricted to five years.

(3) Expatriates from foreign countries working in France.

(4) Wedge between company labour costs and net income after the employee's income tax.

(5) See recommendations in the Charzat Report.

3. Comparisons of tax burden: Income Tax, CSG Tax, CRDS Tax and Earnings Income Tax Credit[*] (married with two children)



Notes: (*) Before the decrease of 5% income tax in 2002 and 1% in 2003; CSG Tax: Supplementary Social Security Contribution Tax; CRDS Tax: Contribution to the Repayment of Social Security Debt Tax.

Source : DLF, CAE Group.

novation indicators established by the Ministry of Finance in 1999, it would provide broad information on the *ex ante* determinants of competitiveness and avoid the pitfalls of composite indexes.

Comments

Jean-Paul Fitoussi and Jean-Luc Tavernier agree with the authors' standpoint to refer to the large definition of competitiveness, but emphasise as they do the inherent drawback of this concept: it reflects the multiple sides of the political economy.

Jean-Paul Fitoussi reassesses the gap in Europe relative to the United States in the production and use of new technologies: a 'cultural' handicap of the European societies, a cultural handicap of economic policies (strong currencies, fiscal balance) which are too dogmatic, or rather major structural mutations: German unification, Single Market and Single Money –intangible investments with an expected high return rate in the long-term?

Jean-Luc Tavernier regrets that the equilibrium exchange rate theory wasn't applied to the present value of the euro-dollar. Moreover, regarding the fiscal attractiveness, he thinks it is unfortunate that the recommendation of the implementation of a special 'impatriate' regime is not justified by positive externalities embodied in the international labour mobility.

Complements

Stéphane Grégoir and ***Françoise Maurel*** challenge the validity of country rankings based on composite indexes on competitiveness published by established organisations and emphasise the main inadequacies of these indexes: inaccurate theoretical base and questionable methodology. They thus illustrate the statistical unreliability of the GCI (Growth Competitiveness Index) of the 'World Economic Forum': the weightings of its elementary variables are pre-selected rather than estimated so as to maximise the correlation between these variables and the variable to explain.

For ***Marc Fleurbaey***, *per capita* GDP (in Purchasing Power Standard), is merely a rough indicator of the well-being of an economy. It should be adjusted to account for each economy's degree of aversion to inequality and individual preferences (value attributed to leisure, health, public goods, etc.).

Pierre-Philippe Combes, ***Gilles Duranton*** and ***Laurent Gobillon*** highlight the major impact of the endowment of human capital on productivity and wage differences in 341 employment regions in France, which can be used as a 'laboratory' for a fully integrated economy.

Agnès Bénassy-Quéré, ***Emmanuel Bretin***, ***Amina Lahrèche-Révil***, ***Thierry Madiès*** and ***Thierry Mayer*** stress the importance of taxation in business location. By dismissing both tax competition between States, which increases inequality between taxpayers and contributes to labour market distortions, and tax harmonisation, which ignores the natural or inherited from past handicaps of States and the differences of national preferences, they advocate tax co-operation between European States.

Thierry Madiès advises to adopt a moderate policy for local business tax rates and expresses a preference for intercommunity co-operation.

Finally, ***Stefano Scarpetta*** gives his explanation to the medium-term growth gap between Europe and the United States: European regulations favour the development of so-called cumulative technologies (e.g. the automotive industry) and hinder so-called 'Schumpeterian' technologies, such as information and communication technologies. He also argues that European regulations have slowed down the dissemination of new technologies across the economy, including the services industry.

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