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France Economics

2012 Elections Series –'Social VAT' - So What?

The 'Social VAT' will not be sufficient to restore the competiveness of French businesses and help job creation. Structural reforms that boost productivity and enhance the functioning of the welfare system as well as the labour market will be necessary.

The proposal: The French government aims to introduce a so-called 'social VAT', which shifts taxation from the labour inputs to consumption to finance social security. The proposal would also be complemented by an extra-tax on investment income. The objective of the reform is to reduce tax wedge on labour and to fund it by an increase in VAT, with the aim to improve competitiveness and job creation.

Uncertain result: We have some reservation about whether a 'social VAT' would materially improve France's cost competitiveness. We think that the cut in employer social security contribution, as currently planned by the government, is insufficient to reduce labour costs significantly and to generate a substantial improvement in competitiveness and employment. Rather, the 1.6 percentage point increase in the VAT would result in an immediate increase in inflation by ¾-percentage point. Possible second round effects on wages (private and public) and social transfers due to indexation may offset the initial effects, unless additional labour and welfare reforms accompany the 'social VAT'.

Corporate impact: Our equity analysts estimate the impact of a 4% reduction in employer social security contributions on French companies under coverage. Overall, major positive effects on competitiveness and job creation with a 'social VAT' alone are unlikely to materialize. Indeed, the reduction in the labour costs is fairly limited, except for corporates more highly exposed to France or more labour intensive. The improvement in operating profit is very small for all businesses. Finally, most of the corporates have a limited scope to reduce their prices.

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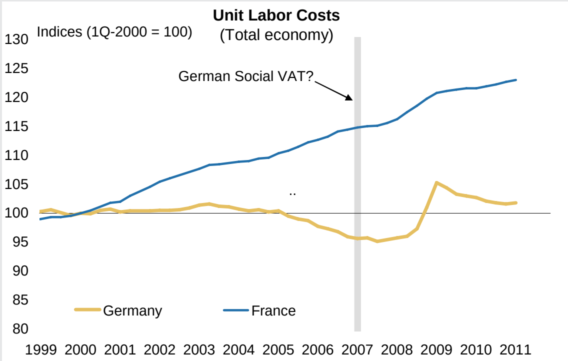
Rising unit labour costs



Source: OECD, Morgan Stanley Research:

For the upcoming elections in France, we will publish a regular series of in-depth reports dealing with economic policy topics and evaluations of the economic programmes of the main candidates/political parties.

For important disclosures, refer to the Disclosures Section, located at the end of this report.

'Social VAT' – So what?

The 'social VAT' is not a reform per se from candidates in the upcoming elections. Rather, the measure has been proposed by the current government and should be implemented after the elections. The Parliament is expected to vote on the reform before the elections though. Still, given the pre-election campaign context, the proposal has generated a lively debate across the political spectrum. In addition, the presidential candidate, Francois Hollande, has already said that he will reverse the reform if he is elected, as the VAT would weigh on household purchasing power.

The case for a 'social VAT'

Last Sunday, President Sarkozy announced the introduction of a 'social VAT' in France. The proposal aims at cutting employer social security contributions by €13bn and replacing them with a value added tax (VAT), raising the standard rate by 1.6 percentage point to 21.2% to finance social security. The measure would be completed by an extra-increase of 2 percentage points in social welfare tax (contribution sociale généralisée) on investment income.

The main arguments in favor of introducing a 'social VAT' are essentially threefold:

i) Social security contributions in France are elevated and fall more heavily on the labor inputs, which discourage businesses from hiring new employees, but instead to use more capital-intensive technologies. In addition, assuming unchanged policies, population ageing is likely to put upward pressures on social expenditures in the years ahead, which is likely to even further raise social security contributions. Hence, other sources of financing, which would not weigh on the labour inputs, have to be mobilized to finance social security. In particular, a 'social VAT' would have the advantage of being applied to all income (labour and investment income). In addition, the measure would improve the competitiveness of domestic products compared to imports, which are subject to VAT. As the cut in social security contribution would reduce labour costs, it could also lower the costs of exports.

ii) The international evidence suggests a positive impact. The most often mentioned examples of countries that have replaced part of social security contributions with a VAT to finance social security are Denmark and Germany. For example, Denmark reduced social security contributions paid by employers (financing unemployment benefit and disability). In turn, the VAT has been increased by three percentage points to 25% between 1987 and 1989. The VAT increase had little impact on inflation over that period. Still, it is difficult to establish whether the strong performance of the Danish economy was due only to the reduction in social security contribution. Indeed, the reform was part of broad macroeconomic measures implemented to stabilize the economy and restore competitiveness. Germany increased the VAT rate by three points to 19%, on January 2007. However, in case of Germany as well, the aim of the measure was not to boost competitiveness of businesses. Only one-third of the receipts generated by the VAT hike have been used to finance the cuts in employer social security contributions (financing unemployment benefits), the remaining being used to reduce the fiscal deficit. In fact, the measure was part of reforms aimed at restoring the sustainability of public finances. As German businesses were already highly competitive compared to their European peers, it is difficult to establish whether the measure has further improved their competitiveness. In addition, inflation picked up after the introduction of the measure, though less than proportionally to the VAT hike, presumably because high profit margins of German companies allowed them to absorb part of the VAT increase, in a context of strong economic growth acceleration.

iii) Government reports, based on large macroeconometric models, have shown that the introduction of a 'social VAT' in France may improve the competitiveness of the French economy and support job creations. More specifically, the reports concluded that the impact on competitiveness would be larger if the cut in social security contributions was targeted at highly skilled workers. By contrast, the measure would generate more job creation if were targeted at low paid workers[1]. For example, reports published by the French ministry of finance showed that an increase in the standard rate of VAT of 1.5 percentage points (2 percentage points cut in

[1] See Lagarde, Christine (2007), "Etude sur la possibilité d'affecter une partie de la TVA au financement de la protection sociale en contrepartie d'une baisse des charges sociales pesant sur le travail, Note d'étape"; or Besson Eric (2007), TVA sociale, rapport pour le Premier Ministre.

employer social security) would lead to up to 300,000 new jobs (around 1.8% of total employments in competitive sectors) if targeted at the minimum wage workers (SMIC) in the medium term, compared to around 30,000 if it is generalized to all workers.

High social security contributions, a hurdle to job creation
In France, the financing of social security relies mainly on social security contributions from labour input. The amount of social contribution affected to the financing of social security was about € 390 bn in 2009 (64% of total resources). Among those, employer social contribution amounted to € 217 bn, while employee contribution amounted € 101bn. The high taxation on labour income in France is a problem, especially if compared to other developed countries. France has indeed one of the highest share of social security contributions from wages. In particular, social contributions paid by employers are one of the highest among OECD countries at almost 30% of total labour costs in 2010, compared to 14% for the average OECD or 16.2% in Germany, France's main trading partner.

The value added tax (VAT); a potential source of financing
In France (mainland), three VAT rates are applicable. Most goods and services sold are subject to the standard VAT rate of 19.6%. The reduced VAT of 7% applies to necessity items (food consumption and cultural products such as books). Finally, a super-reduced rate of 2.1% is applied to newspapers and some pharmaceutical products reimbursed by social security. Overall, the VAT is an indirect tax for which the receipts are affected in large part to the state budget. The net VAT receipts represented around €125.4bn in 2010, almost half of the state budget receipts. Hence, VAT receipts might be a potential source for financing social security, especially because the standard rate of VAT in France is slightly lower than the European average (see chart), suggesting that there is still some scope to raise it without creating distortion compared to EMU trading partners.

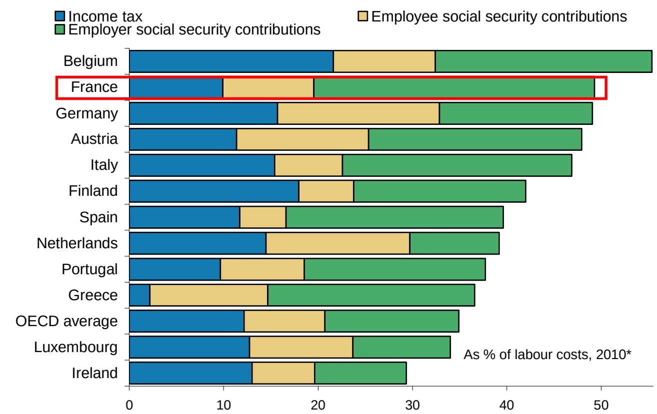
Exhibit 1
Large VAT receipts

Net tax receipts in the general budget
(Euros Bn)

	2009*	2010**	2010 (% of total)
Personal income tax	56.0	54.7	20.5
Corporate tax***	48.2	50.4	18.9
Tax on petroleum products	14.9	14.5	5.4
Value-added tax***	117.0	125.4	46.9
Other net tax receipts	-4.6	22.2	8.3
Total	**231.4**	**267.2**	

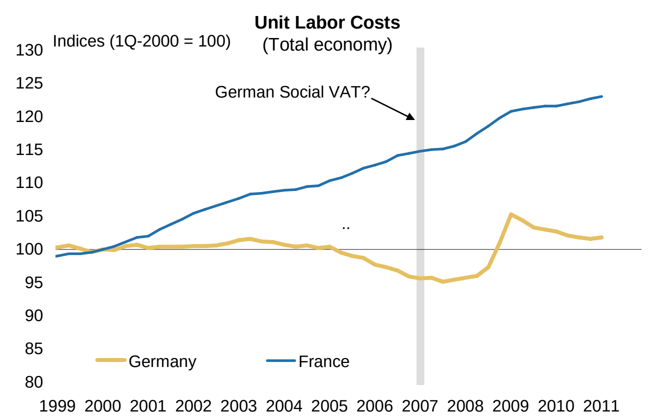
Source: The Ministry of Budget, Morgan Stanley Research
* 2009: Revised Finance Bill; ** 2010: Draft finance bill;
***Net proceeds from payments and refunds.

Exhibit 2
High tax wedge weighs on labour costs



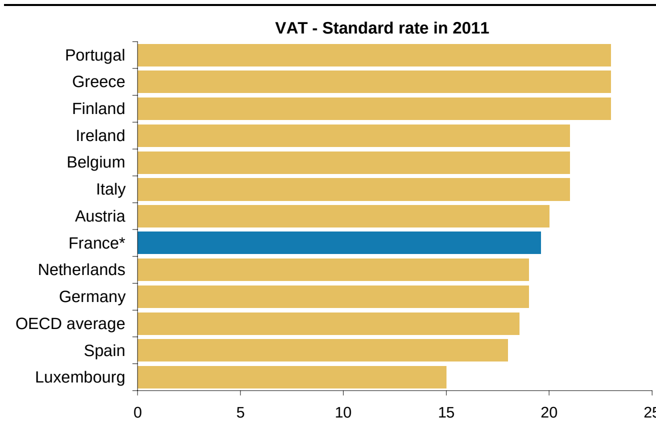
Source: OECD, Morgan Stanley Research
Single individual without children at the income level of the average worker.

Exhibit 3
Rising unit labour costs



Source: OECD, Morgan Stanley Research

Exhibit 4
Some scope to increase the VAT



Source: OECD, Morgan Stanley Research
*Before the reform

The 'Social VAT': weighing costs and benefits

The objective of the proposal is to cut social security contributions. In turn, a fraction of the VAT receipts would be transferred to finance social security. This measure increases the tax base to finance social security, as the VAT is levied on all consumed products (domestic and foreign), while social security contributions are only levied on gross salaries. In addition, increases the social welfare tax (contribution sociale généralisée) on financial income follows the same logic of shifting away from taxation on labour income. Ultimately, a cut in social security contribution is expected to reduce production costs, which should allow a reduction in prices net of VAT.

An almost (theoretically) inflationary/fiscal neutral reform
The net impact of the 'social VAT' is deemed to be almost neutral for both inflation, at least for domestic products, and public finances. Assuming, for instance, a generalized cut in social security contributions financed by an increase in the VAT rate, Exhibit 5 shows a simplistic illustration of the expected benefit from that measure.

We assume that a 1.6 percentage point increase in the standard VAT rate to 21.2% is used to finance the cut in social security contributions. In turn, firms would lower their prices net of VAT by the same amount in order to preserve their competitiveness. In this example, the level of prices inclusive of VAT remains unchanged. So there are no negative effects on consumers of domestic products and wages (see table). However, as imports are subject to VAT and do not benefit from the cut in labor costs, the aggregate price level should go up.

Exhibit 5
A (theoretically) neutral reform

1.6 ppts increase in the standard rate of VAT rate to 21.2%			
Before		**After**	
Ex-vat price	100.4	Ex-vat price	98.8
VAT	19.6	VAT	21.2
VAT-inclus. price	120	VAT-inclus. price	120

Source: Morgan Stanley Research estimates

For public finances, the reform is deemed to be neutral as well, as the taxation on consumption is used to compensate the cut in social security contributions in order to finance social security.

Still, this illustration is quite simplistic, as we assume that companies have no pricing power and will be cutting their gross operating surplus. In practice, the impact on prices of domestic products would depend on how businesses adjust their prices net of VAT.

The pros
The expected positive effects of shifting taxation from labour income to consumption are as follows:

- Stimulates employment in all the sectors (tradable and non-tradable) and increase the attractiveness of France for foreign companies, as the costs of labour and production are reduced;

- Improves competitiveness of French products, as the cuts in social security contributions lower export prices, while the VAT hike raises import prices (exports are not subject to the VAT). The decline in export price improves price competiveness, while the increase in the VAT benefits domestic products relative to import products, provided they are highly substitutable.

The cons
The social VAT is likely to lead to an increase in the level of prices though, if companies do not reduce prices net of VAT. In turn, that would likely lead to:

- A rise in inflation, which would erode household purchasing power and dampen consumption and growth;

- Lower employment in the medium term, as higher inflation would push up wages, in particular the minimum wage (SMIC), which is indexed to inflation, as well as the levels of wages around it;

- A deterioration in public finances, as the rise in inflation, through indexation mechanisms, induces an increase in social transfers, pensions, unemployment benefits and public wages;

- A transfer of profit within sectors, in particular from businesses with lower pricing power to those with a higher pricing power that have the ability to pass the VAT hike on to consumers.

The uncertainties
Besides these negatives effects, even the expected positive impacts are surrounded by high uncertainty.

- Even if firms were able to absorb part of the increase in the VAT, easing inflationary pressures, that may, on the other hand, weigh on their profits and ultimately their investment;

- The benefit in terms of competitiveness gains is likely to be limited. In particular, the gap of production costs between France and many countries, especially emerging economies, is so large that the cuts in social security contribution would not be enough to reduce those costs significantly. The competitiveness against developed countries with similar production costs structures is likely to improve though. But that gain is likely to be short-lived, as the main trading partners may implement the same measure.

In practice, what are the likely effects on inflation?

The 1.6 percentage point increase in the standard rate of VAT, planned for October 1 this year, is likely to push up inflation. Indeed, the standard rate of VAT applies to most of goods and services sold in France. Therefore, the impact of the VAT hike is likely to be visible on the level of overall prices. In addition, we believe that a rise in prices seems almost inevitable in the short term:

- The increase in VAT would push up the prices of imports;

- Prices of domestic products would increase, as the VAT hike would apply to goods produced before the implementation of the reform;

More importantly, the impact on prices would depend on companies' initial financial situations and the degree of competition on markets:

- Some companies may seek to restore their profit margin, especially SMEs, instead of reducing their prices net of VAT';

- The lack of competition in some sectors may lead businesses to maintain high margins.

- The increase in the VAT would take place at a moment when businesses' financial position will still be weak, following a recession and in a context of tighter financial conditions.

Overall, French inflation will be higher than our current forecast.

If we assume that, given the weakness of the domestic demand, companies do not reduce their prices net of VAT, which would increase headline inflation by around ¾ percentage points. Headline inflation would pick up above 2%, to 2.5 %Y in October 2012 and remain above 2.0%Y throughout most of 2013. In that scenario, annual average inflation would reach 2.1% in 2012, the same level as in 2011. All things being equal, euro area headline inflation would remain almost unchanged on average in 2012 (but would go up by 0.2pp in October), and increase by 0.2 percentage point on average in 2013.

However, if companies absorb part of the increase in the VAT, the initial rise in inflation would be slightly lower, around ½ percentage point – and around 0.1 percentage point in the euro area.

What are the corporate impacts?

The macroeconomic impact will depend on whether the cut in social security contribution would be significant to push down production costs. In addition, the positive impact on employment and competitiveness would depend on whether businesses are more labour or capital intensive. Also, their initial financial position as well as the degree of competition on their markets is crucial to assess their ability to reduce their prices net of VAT.

Overall, the impact on corporates will depend on:

- The pricing power;
- The labour intensity;
- Bargaining power of unions;

We have estimated the potential impact of a 'social VAT' on a number of European companies in different sectors under Morgan Stanley coverage that have the most exposure to France.

Based on the number of employees those corporates have in France, we estimate the impact of a 4 percentage reduction in employer social security contributions (around 1.2 percentage reduction in the labour costs in France) and the implications on their operating profit (IBITDA/EBIT). The results show that, given the small cut in the labour costs, overall, major positive effects on competitiveness and job creation are unlikely to materialize with a 'social VAT' alone. More specifically, there are three key conclusions:

1/ The reduction in the labour costs is fairly negligible for most of corporates under coverage, except the ones that have a higher exposure to France and labour intensive.

2/ The impact on operating profit is very small for all businesses, in particular because, for most of them, their exposure to France is, on the whole, limited. Even for labour-intensive corporates, the impact on their operating profit is very limited.

3/ Most of the corporates have a limited scope to reduce their prices, essentially because their profit margins are already under pressure from rising costs (energy, maintenance) and/or high competition. That suggests that even for businesses, for which the reduction in the labour costs might be relatively significant, they may pass, at least partly, the VAT increase on to consumers.

Exhibit 6

Small impact on corporates

Impact of a 4 percentage reduction in employer social security contribution

		% Exposure (FY11e)		EBITDA/EBIT*				
Name	MS Industry	Revenue	EBIT	in m€	% change/base case 2012	Analyst	Labour-intensive/capital-intensive	Scope to reduce prices
Carrefour	Retailing - Food	43	39	169	7.0%	Aubin, Edouard	Labour intensive	No scope to reduce prices
EDF	Utilities	NA	62	93	1.0%	Turpin, Emmanuel	Capital intensive	No scope to reduce prices
Casino	Retailing - Food	55	47	91	5.0%	Aubin, Edouard	Labour intensive	No scope to reduce prices
Bouygues	Telecommunications Services	69	69	77	4.7%	Purewal, Saroop	Capital intensive (Telecoms and capital goods)/labour intensive (construction)	Scope to reduce prices in telecom but not in construction
Air France-KLM	Airlines	60	NA	60	10.0%	Butcher, Penelope	Skewed to labour intensive	No scope to reduce prices
Renault	Autos & Auto Parts	27	25	60	17.0%	Lembke, Laura	Capital intensive	No scope to reduce prices
France Telecom	Telecom Services	51	59	59	0.7%	Delfas, Nick	Capital intensive	Scope to reduce prices
Veolia	Utilities	NA	40	54	2.0%	Turpin, Emmanuel	Capital intensive	No scope to reduce prices
GDF Suez	Utilities	NA	25	37	0.0%	Turpin, Emmanuel	Capital intensive	No scope to reduce prices
Peugeot	Autos & Auto Parts	22	30	34	10.0%	Lembke, Laura	Capital intensive	No scope to reduce prices
St Gobain	Building & Construction	30	20-21	30	1.0%	Pereda, Alejandra	Skewed to labour intensive	No scope to reduce prices
Adecco	Business Services	30	23	20	3.0%	Hancock, David	Labour intensive	No scope to reduce prices
Capgemini	Technology	22	27	16	2.0%	Wood, Adam	Labour intensive	No scope to reduce prices
Suez Environnement	Utilities	NA	37	15	1.0%	Turpin, Emmanuel	Capital intensive	No scope to reduce prices
Randstad	Business Services	21	17	14	2.0%	Hancock, David	Labour intensive	No scope to reduce prices
ADP	Surface Transportation	95	100	10	1.0%	Butcher, Penelope	Skewed to labour intensive	No scope to reduce prices
Accor	Leisure and Hotels	35	51	9	1.8%	Lewis, Vaughan	Skewed to labour intensive	No scope to reduce prices
Abertis	Transport	32	35	8	0.3%	Rowbotham, Jaime	Capital intensive	No scope to reduce prices
PPR	Brands	30	20	8	0.5%	Singlehurst, Louise	Skewed to labour intensive	No scope to reduce prices
Rentokil	Business Services	13	20	7	2.0%	Hancock, David	Labour intensive	No scope to reduce prices
Air Liquide	Chemicals	15-20	15-20	6	0.2%	Mackey, Peter	Capital intensive	No scope to reduce prices
TF1	Media & Internet	100	100	5	2.3%	Rossi, Julien	Skewed to labour intensive	No scope to reduce prices
Groupe Eurotunnel	Surface Transportation	50	50	5	1.0%	Rowbotham, Jaime	Skewed to capital intensive	Some scope to reduce prices
Logica	Technology	22	31	5	2.0%	Wood, Adam	Labour intensive	No scope to reduce prices
Steria	Software & Services	31	29	4	4.0%	Wood, Adam	Labour intensive	No scope to reduce prices
Kesa	Retail	49	NA	4	5.4%	Ruddell, Geoff	Skewed to labour intensive	No scope to reduce prices
Kingfisher	Retail	40	49	4	0.4%	Ruddell, Geoff	Capital intensive	Some scope to reduce prices
M6	Media & Internet	100	100	3	1.3%	Rossi, Julien	Skewed to labour intensive	No scope to reduce prices
Havas	Media & Internet	21	25	3	1.3%	Rossi, Julien	Skewed to labour intensive	No scope to reduce prices
JC Decaux	Media & Internet	25	30	2	0.7%	Rossi, Julien	Skewed to labour intensive	No scope to reduce prices
Iliad	Telecom Services	100	100	1	0.3%	Purewal, Saroop	Capital intensive	Scope to reduce prices
Edenred	Leisure and Hotels	16	15	1	0.3%	Lewis, Vaughan	Skewed to labour intensive	Some scope to reduce prices
Rexel	Capital Goods	29	40	Negligible	Negligible	Uglow, Ben	Capital intensive	No scope to reduce prices
Schneider	Capital Goods	16	20	Negligible	Negligible	Uglow, Ben	Capital intensive	No scope to reduce prices
Alstom	Capital Goods	15	18	Negligible	Negligible	Uglow, Ben	Capital intensive	No scope to reduce prices
Legrand	Capital Goods	26	30	Negligible	Negligible	Uglow, Ben	Capital intensive	No scope to reduce prices

Source: Company data, Morgan Stanley Research estimates

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