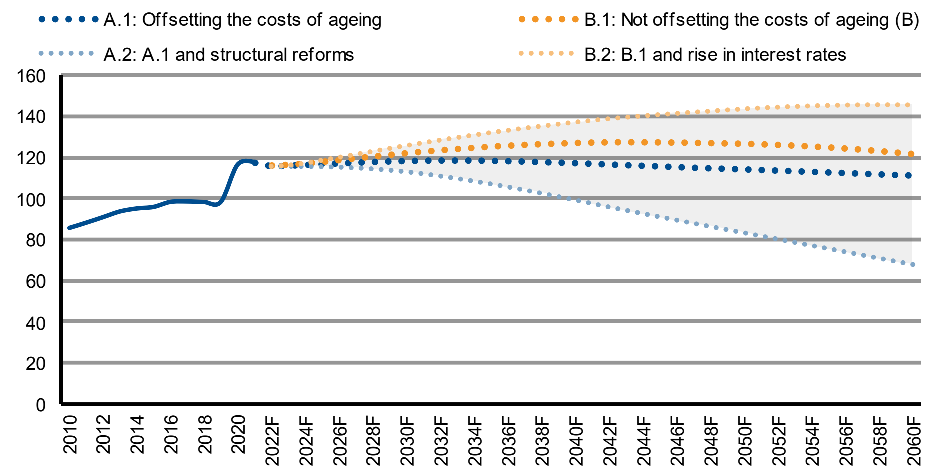
# France: welfare state faces fiscal squeeze if no change in policy under next president

**Social spending in France (AA/Stable) is high, representing a significant fiscal challenge in the context of the Covid-19 pandemic and the country's ageing population. From a credit perspective, this calls for greater attention to the social and fiscal reforms envisaged by France's next president. Can France maintain its large welfare state without delivering ambitious fiscal consolidation – and for how long?**

France's social spending is among the highest in the world and is an important source of budget rigidity and cyclicality. The Covid-19 crisis has further exacerbated the vulnerabilities of the system as spending on health and unemployment benefits shot up while revenue declined. In addition, the costs of population ageing, albeit less significant than for some other advanced economies in the long run, will structurally increase fiscal pressures, while room to increase fiscal revenue is limited by an already elevated tax burden.

As a result, reforming the overall welfare state post Covid-19 will be critical for France's public finance and credit outlook, given the importance for the budget balance and public debt (**Figure 1**). Among the different pillars of the social security system, we focus on those having an important impact on public finances (i.e., pensions, health, unemployment) and highlight the main challenges ahead from a credit perspective.

**Figure 1. France's public debt trajectory under various policy scenarios**
% of GDP




Note: The different scenarios and associated assumptions are detailed in the Appendix.
Source: OECD Economic Surveys: France 2021

The main conclusions from our analysis are:

- France's large welfare state shields households and businesses from external shocks such as the Covid-19 pandemic, but it raises important fiscal challenges in the long run.
- France spends more than its peers in almost all components of social spending, which results in elevated budgetary rigidity and sensitivity to economic shocks.
- Long-term fiscal pressures from the rise in age-related costs are lower than many advanced economies but remain a tangible risk to the trajectory of France's public debt given the increase in social debt.
- France's pension, health and unemployment insurance systems result in strong social outcomes for the elderly at a high cost. Reforming them to address inefficiencies and enhance financial sustainability are critical to France's credit outlook, particularly because the country's high tax burden curtails the government's ability to address fiscal pressures with additional tax revenues.

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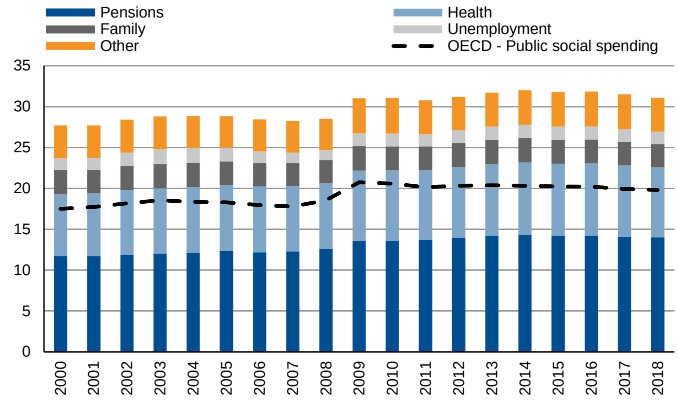
## France’s welfare state is large and more generous than peers, and faces structural pressures amid population ageing

**Structurally large social expenditures**

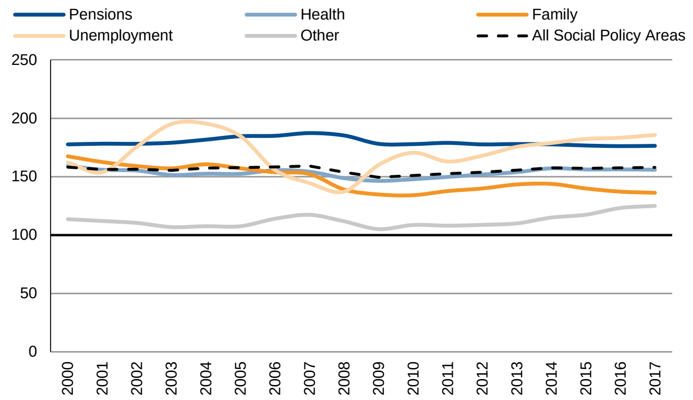
Social spending represents one of France’s largest expenditure items. In 2019, it totalled 31% of GDP, well above the OECD average (20% of GDP) and the highest among OECD countries (**Figure 2**). Spending for all social components are above the OECD average, in particular spending on pensions, unemployment, and health (**Figure 3**). In addition, the social security system has been severely impacted by the Covid-19 crisis. Its deficit reached a historical high in 2020, mainly due to the sudden rise in health expenditures, reversing the material reduction in deficits in the period 2011-18.

**Figure 2. Social expenditures per components**
% of GDP




Source: OECD, Scope Ratings GmbH

**Figure 3. Social expenditures versus OECD average**
OECD average = 100




Source: OECD, Scope Ratings GmbH

**Limited age-related fiscal pressures**

The European Commission[1] estimates that, under a no-policy-change scenario, the total cost of ageing, related to pensions, health care, long term care and education, would amount to 30.2% of GDP by 2050 (**Figure 4**). Still, this represents only a modest 0.7pps increase from 2019, well below that for the EU average (+2.5pps) and most peers, including Spain (+2.2pps), Germany (+3pps), and Belgium (+4.6pps). More benign age-relate long-term fiscal pressures constitute an important credit strength for France relative to peers. This reflects less adverse demographics, as well as previous reforms aimed at alleviating age-related costs (e.g., indexation of pensions to inflation).

However, France’s age-related expenditures are already elevated and expected to remain among the highest in the EU (about 3.7pps above the EU average). Given the political difficulty of lowering social expenditure in France, this will continue to be a source of budget rigidity in the long run. It also requires elevated taxation and social contributions to finance France’s social systems, which can weigh on economic performance through labour costs and hampered productivity. Finally, high social spending increases the sensitivity of the French budget to economic shocks given that some social expenditures are among the most cyclical.

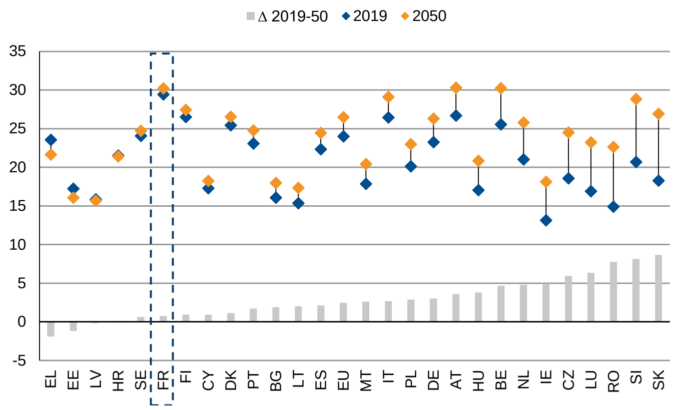
**Large social security deficits post Covid-19**

The generosity of the French welfare state in comparison with other advanced economies, coupled with the Covid-19 crisis and the structural, albeit modest, increase in age-related spending put pressure on the social security’s systems accounts. In 2020, most of the deficit resulted from the ‘illness’ account, expected to remain in deficit until 2025 (**Figure 5**). However, the government plans a gradual reduction in social security deficits according

[1] European Commission, 2021 Ageing Report

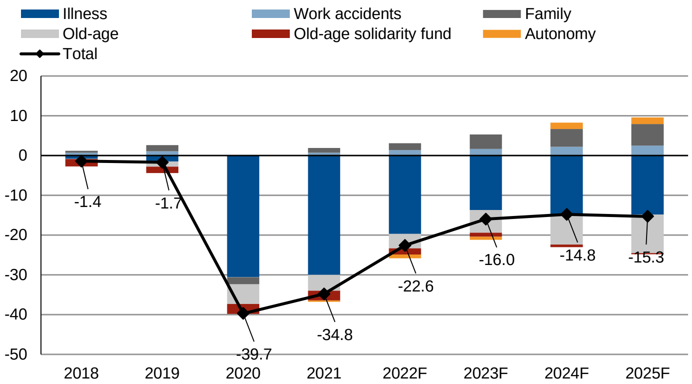
to the 2022 budget due to the strong economic recovery, as initially anticipated. Still, the deficit of the old-age account is expected to increase, from EUR 4bn to almost EUR 10bn.

**Figure 4. Total cost of ageing projections for EU countries**
% of GDP




Source: European Commission, Scope Ratings GmbH

**Figure 5. Balance of France's social security accounts**
EUR bn



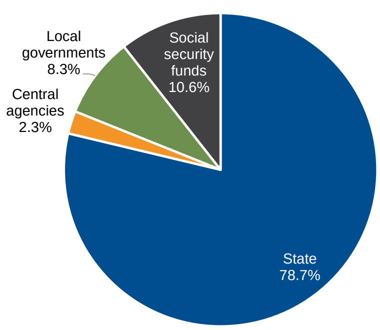

Note: projections based on the 2022 social security budget.
Source: Ministry of Finance, Scope Ratings GmbH

## Rising social debt calling for reforms

Large deficits of the social security accounts have led to a significant increase in France's social debt, which represents EUR 300.1bn or 10.6% of total public debt and mostly relates to the debt of CADES, Unédic, Acoss, and French hospitals, (**Figures 6 and 7**). The mission of CADES, founded in 1996, is to wind down France's debt related to accumulated social-security deficits using newly created financial resources protected by law[2].

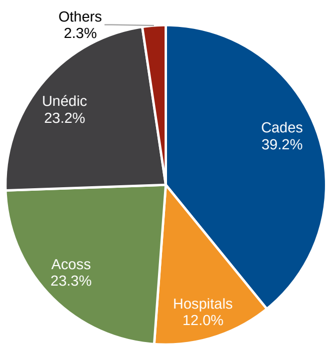
Originally, CADES was expected to complete its mission by 2024, after which the entity would be dissolved and the associated taxes would be eliminated, thus reducing the fiscal burden, or used to finance other expenditure, thus increasing France's fiscal space. Given widening social security deficits in response to the Covid-19 crisis, the French government transferred EUR 136bn of additional debt to Cades in 2020. The government also decided to postpone the end-date for the repayment of the social debt to 2033. From a credit perspective, the rise in social debt, aggravated by the Covid-19 crisis, deserves close attention, and highlights the need to reform the main pillars of the French welfare state, including the pension and healthcare systems and the unemployment scheme.

**Figure 6. French public debt by administration**
% of total public debt, as of Q3 2021




Source: Cour des Comptes, Scope Ratings GmbH

**Figure 7. French social security debt by funds**
% of social debt, as of end 2020




Cades (social debt), Acoss (cash management of the general social security system), Unédic (unemployment scheme)
Source: Cour des Comptes, Scope Ratings GmbH

[2] These resources include the "social debt redemption" tax (CRDS), which comes on top of a fraction of the "general social contribution" tax (CSG), charged on all income and investments.

## Pension system: complex and costly but limited additional pressures from ageing

**Large pension expenditures produce strong social outcomes for the elderly…**

The French public 'pay-as-you-go' pension system ensures that pensions paid are financed by contributions paid in the same year by workers. Workers obtain the right to a pension after retirement by paying these contributions through their career.

The current system fosters strong social outcomes for the elderly and results in one of the lowest old-age income poverty rates among peer countries at 4.4% in 2018, lower than Belgium (8.5%), Germany (9.1%) and the United Kingdom (15.5%). French retirees also benefit from a higher equivalised disposable income than the overall population[3], on average. France is the only major western economy in this situation according to the French Pensions Advisory Council[4].

**…but represents a significant fiscal burden compared to peers**

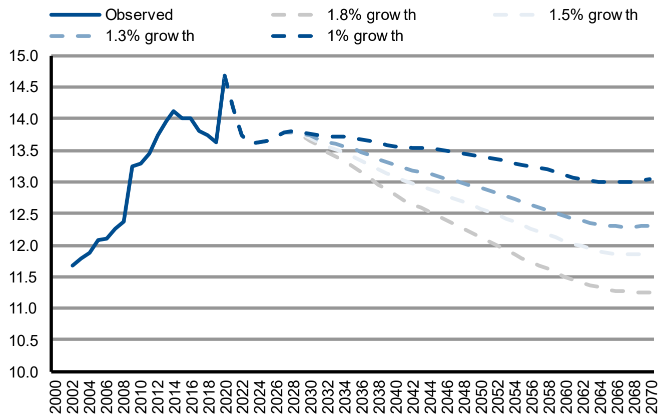
At 13.9% of GDP in 2020, French public pension expenditures are among the highest in the OECD. This reflects both the generosity of the system but also relatively low retirement ages. The legal retirement age is currently set at 62, while the effective age of labour market participants stands at about 60.5 years, with both figures being among the lowest in OECD countries. The public pension system has generated continuous deficits since 2008, jumping to EUR 18bn in 2020 (0.8% of GDP) from near balance in 2019, in part due to the adverse revenue effects of the Covid-19 crisis.

**High funding costs and complexity of the pension system**

The share of national wealth dedicated to pensions will remain one of the highest among rich countries. In 2020, the OECD estimated the effective rate on average earnings for mandatory pension contributions in France at 27.8%. This is the third highest level among OECD countries behind Italy (33%) and the Czech Republic (28%) and is well above Germany (18.6%) and the United Kingdom (20.4%). Additionally, the fragmentation of the current system, with 42 schemes for specific professional categories, greatly hinders labour mobility, given the lack of transparency of the system and the fact that the same contribution does not grant the same pension rights depending on the worker's profession.

**Figure 8. Projected pension expenditure, per productivity growth assumptions**

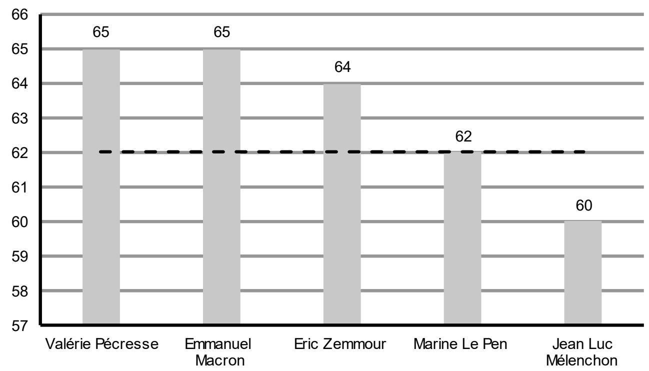
% of GDP




Source: COR, Scope Ratings GmbH

**Figure 9. Retirement age proposals for main presidential candidates**

Years




Note: The dotted line represents the current legal retirement age.
Source: Scope Ratings GmbH

[3] The equivalised disposable income is the total income of a household, after tax and other deductions, that is available for spending or saving, divided by the number of household members converted into equalised adults (Eurostat)
[4] Conseil d'orientation des retraites (2020), Panorama des systèmes de retraite en France et à l'étranger

Relatively low pressure for extra spending from ageing populace

Looking ahead, France faces limited additional pension spending pressures from population ageing. The French Pensions Advisory Council expects public spending on pensions to decline as a percentage of GDP under various policy scenarios assuming a gradual increase of the retirement age up to 64 years given past reforms and the increasingly delayed entry of French citizens in the work force (**Figure 8**). Nonetheless, pensions will continue to weigh on fiscal fundamentals, as pension systems are projected to post deficits through 2030 of 0.3%%-0.7% of GDP per year. In addition, the decline in pension spending under current policies poses social challenges given that the old age dependency ratio is expected to rise, meaning that the purchasing power of retirees is due to decline. These factors underscore the need for reform.

Multiple parametric reforms passed since 1990's…

Structural imbalances of the pension system have led governments to pass reforms in 1993, 2003, 2010, and 2013. Successive reforms focused on the modification of parameters used to establish the benefits attached to social contributions from workers, with the objective to restore long term sustainability. Yet, no comprehensive reform of the entire pension system has been introduced to date, including through simplification of the system, since the issue has proven highly socially and politically sensitive.

… but systemic reform delayed by Covid crisis, protests

In 2019, president Macron put forward an extensive reform of the pension system, aimed at ensuring its financial sustainability and unifying its schemes. It proposed to transition to a universal, point-based system, which would leave a larger room for capitalization for high earners. It also aimed to gradually lift the statutory retirement age from 62 to 64 years, by indexing it to life expectancy gains. Nonetheless, the proposed reform was met with large protests. This, combined with the Covid-19 crisis, led to the government to postpone the reform.

A very contentious issue ahead of the presidential election

Pension reform is one of the main themes in this year's presidential elections. A clear divide appeared between the top candidates regarding the legal retirement age. Valérie Pécresse, Emmanuel Macron and Eric Zémmour had pledged to increase the retirement age up to 65, Marine Le Pen intended to leave it unchanged, while Jean Luc Mélenchon wanted to bring it down to 60 (**Figure 9**). While only Emmanuel Macron and Marine Le Pen remain on the second-round ballot, the parameters of the reform will be subjected to negotiations depending on the result of the June 2022 legislative elections, given divergence of views surrounding the appropriate retirement age among political forces. The growing fragmentation and polarisation of French politics[5], which the first round of the presidential election entrenched, will make it even more challenging for the next president to finding political consensus on this socially sensitive issue.

## Healthcare system: Legacy of Covid-19 crisis and ageing population will result in additional pressures

Elevated expenditures funded by compulsory contributions

The French healthcare system aims to provide universal health coverage, with most expenditure geared towards funding hospitals. Health expenditures represented about 11.2% of GDP in 2019, the highest level in the EU after Germany (11.7%), but well below the United States (17.0%). About 77% of health expenditure is covered by public sources, while private compulsory insurance schemes cover another 5%.

Strong results but lower efficiency compared to peers

France obtains overall strong results in terms of health outcomes, with one of the highest life expectancies, at 82.5 years in 2019 according to the World Health Organization. It lags peers in several aspects, however, especially with regards to preventable causes of mortality, reflecting low investment in preventive care. France ranked 11th over 35 in the

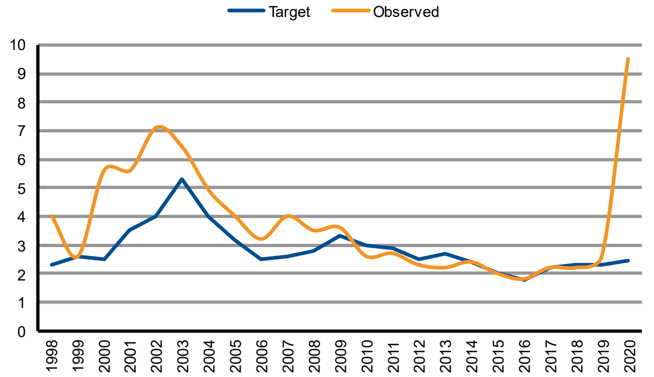
[5] See Scope (2022), Political fragmentation and polarisation in France could frustrate pursuit of economic reforms

2018 Euro Health Consumer Index comparing the efficiency of European health care systems, with weak scores on prevention and access to care. It also tends to underperform peers in terms of healthy life expectancy at birth (64.2 years on average) and at age 65 (11.0), especially compared with Germany (66.3 and 12.2 respectively).

**Covid crisis tests limit of the fiscal framework for healthcare**

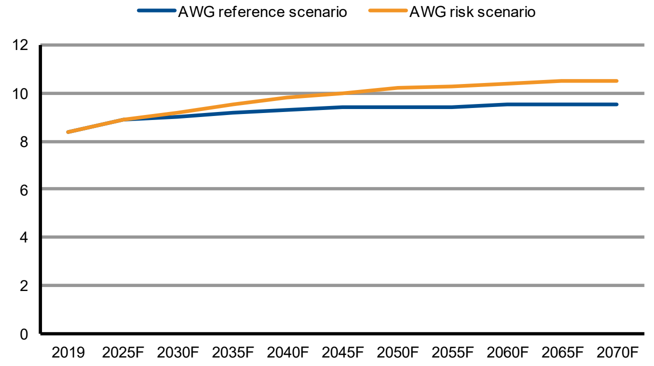
Given structurally elevated expenditure, the government has set a yearly growth objective for national health expenditure (Ondam[6]) in the 1990's with the aim to control spending. After a decade of above target increases, the rate of growth of health expenditures remained below or very close to the objective between 2010 and 2019 (**Figure 10**). Yet, following this period of gradual improvements, the outbreak of the Covid-19 crisis caused the deficit of the health insurance system to shoot up to around EUR 30bn in 2020 and 2021, down from EUR 1.9bn in 2019. Going forward, the government expects this deficit to gradually decrease to EUR 14bn in 2025.

**Figure 10. National health expenditures growth objective**
%




Source: Commission des comptes de la sécurité sociale, Scope Ratings GmbH

**Figure 11. Healthcare expenditures**
% of GDP




Note: Working Group on Ageing Populations and Sustainability (AWG).
Source: European Commission, Scope Ratings GmbH

**Massive support for healthcare system recently announced**

The Covid-19 pandemic highlighted shortcomings in the quality of medical services and of the working conditions of healthcare workers and thus the need to increase investment and to curb the decrease in healthcare expenditures. In 2020, the government announced a large plan (*Ségur de la Santé*) to modernise and address the decline of the health system. It includes new investments in infrastructure and equipment (EUR 19bn), system-wide wage increases (EUR 8.2bn per year on a permanent basis), and a vast recruitment plan (15,000 workers).

Over the long run, healthcare expenditures are expected to increase further and stabilise at an elevated level of around 9.5% of GDP per year according to the European Commission (**Figure 11**). In addition, the recently announced programmes and campaign promises of presidential candidates are likely to lead to additional spending pressures over the medium term.

## Unemployment: 2021 reform will have major impact on social expenditures

**Age-related expenditures should remain higher than peers**

Unemployment insurance is largely financed by social contributions from workers and corporates. In 2019, *Unedic*, the institution in charge of France's unemployment insurance, reported payments of around EUR 39bn, a deficit of close to EUR 2bn and total debt of EUR 36.8bn. On an international comparison basis, France dedicated one of the highest

[6] "Objectif national de dépenses d'assurance maladie"

shares of GDP to unemployment benefits among OECD countries, at 1.6% of GDP in 2017, alongside Spain (1.6% of GDP), but behind Belgium (1.8% of GDP) and above Germany (0.9%) and the OECD average (0.6%).

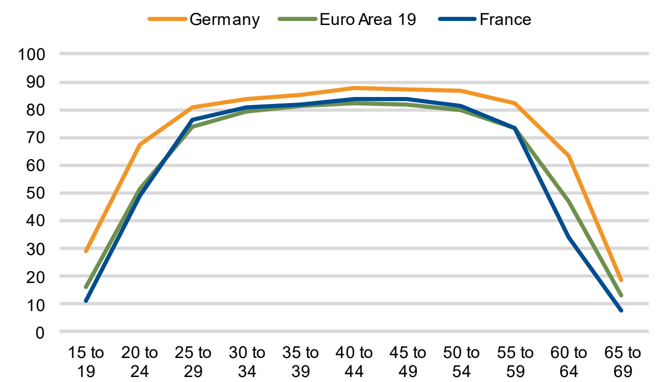
This trend is explained by France's consistently poor labour market performances in recent decades, with the unemployment rate remaining permanently above 7% since the 1980's, given its lower employment rate among the youth and senior workers compared to peers (**Figure 12**). The average duration of unemployment is also elevated, at 13.9 months in 2019, as is the long-term unemployment rate, at 38.8% of unemployed workers, about 13pps above the OECD average. Therefore, the unemployment insurance system appears to provide mixed results in facilitating the return to employment for the jobless.

**Recent financial-sustainability, employment-incentive reforms**

The government recently passed an unemployment insurance reform which became fully effective in December 2021, after delays related to the pandemic. It aims to increase work incentives by tightening eligibility conditions as well as to make the recourse to short-term, precarious contracts more costly for employers. The government expects the reform to generate around EUR 2.3bn in savings per year.

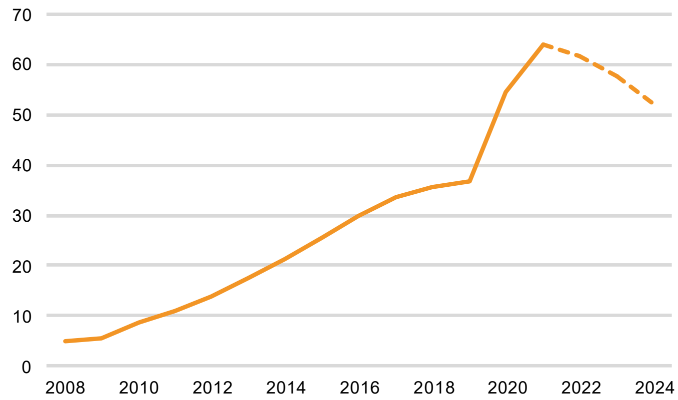
The large-scale implementation of short-term work schemes during the Covid-19 crisis, along with the fall in revenue caused by the drop-in economic activity, led the *Unedic* deficit to jump to EUR 19.2bn in 2020, before receding to EUR 9.3bn in 2021. Looking ahead, the *Unedic* expects the combined effect of the reform and of the economic rebound to allow for a sharp improvement in its budget balance. It expects to generate a surplus in 2022, for the first time since 2008, of EUR 2.2 bn, which should grow in the following years to EUR 5.4bn in 2024. Still, the unemployment insurance system remains burdened by an elevated debt stock of EUR 63.9bn in 2021, up from EUR 36.8bn in 2019 (**Figure 13**).

**Figure 12. Employment rate by working age**
% of workforce in age group




Source: Eurostat, Scope Ratings GmbH

**Figure 13. Debt of the unemployment insurance system**
EUR bn




Source: Unedic, Scope Ratings GmbH

## Concluding remarks

France's welfare state is among the most generous and protective in the world and supports strong social outcomes as well as strong resilience to external shocks such as the Covid-19 crisis. However, it comes with a fiscal cost and translates into a highly rigid and cyclical budget, that weighs on long-term fiscal outlook.

While France's demographics are favourable and the associated long-term rise in age-related costs is expected to be more contained compared to peers, the country already faces one of the highest spending burdens for pensions, healthcare and the unemployed. Targeted reforms to enhance the efficiency and effectiveness of this system are politically costly, but critical for France's fiscal and economic growth outlook. Given the country's already very high tax-burden, these reforms are arguably more important for France than for other advanced economies, which may have greater space still to raise taxes as fiscal pressures result in structurally higher deficits going forward.

## Appendix. Public debt projections – Scenarios and assumptions

The public debt projections presented in **Figure 1** are taken from the OECD 2021 Economic Survey for France. The different scenarios and assumptions that were adopted to make the projections are detailed in the following table:

**Overview of projection scenarios and assumptions:**

| Scenario | Description |
|---|---|
| **Scenario A.1** | The rise in spending related to ageing (as estimated in the European Commission 2021 Ageing Report) are fully offset. The primary balance develops endogenously and stabilises public debt in the long run at 2021 levels. |
| **Scenario B.1** | This scenario assumes that the rise in ageing-related spending is not offset by structural reforms. |
| **Scenario A.2** | In addition to the assumptions of A.1, this scenario also assumes that structural reforms (as listed in the table below) are adopted, leading to stronger fiscal outcomes and an increase in potential GDP of 1.2% by 2033. |
| **Scenario B.2** | In addition to the assumptions of B.1, this scenario assumes that interest rates rise by 125 basis points and remains stable thereafter. |

**Overview of main fiscal measures recommended by the OECD and their impact:**

| Measure | Impact |
|---|---|
| Cut further distortive business taxes (*impôts de production*) | -0.50% |
| Remove tax breaks on household saving | 0.20% |
| Strengthen environmental taxation | 0.50% |
| Once the recovery is confirmed, remove the reduced VAT rate on hotels and restaurants | 0.10% |
| ***Total tax measures*** | ***0.30%*** |
| A gradual increase in the effective retirement age to 64 in 2025 | 0.90% |
| Broad-based spending review | 0.20% |
| Increase the efficiency of local public spending | 0.20% |
| Focus housing supply support on high-density areas | 0.10% |
| Increase support for the railway network and renewables (*fonds chaleur*) | -0.20% |
| ***Total spending cuts*** | ***1.20%*** |
| ***Effect on the fiscal balance*** | ***1.50%*** |

Source: OECD, Scope Ratings GmbH

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