French taxes

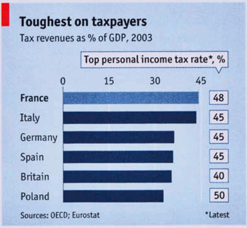
When cuts aren't kind enough

PARIS

Less to this than meets the eye

FRANCE'S president, Jacques Chirac, took power in 2002 on a pledge to cut income taxes by a third; so far, he's trimmed them by just 10%. So a move by Dominique de Villepin, his prime minister, to simplify France's tax bands and chop the top rate from 48% to 40% sounds impressive. The reality may be less so.

The decision to lower the top tax band was part of a broader overhaul announced last week by Thierry Breton, the finance minister. This will slash the number of income tax bands from six to four, with the lowest rate of 5.5% kicking in on income of €5,515 ($6,700), and a top rate of 40% on earnings of €65,559 or more. By capping the top rate at 40%, the change will make France level with Britain and milder than Germany. While these cuts will not be included in next week's 2006 budget, they will apply on earnings in 2006, taxable in 2007, a presidential election year. "This reform," says Jean-François Copé, the budget minister, "will profoundly shake up the French fiscal landscape."



Certainly, the tax plans are an improvement. For one thing, they clarify the structure. Not only will the tax bands be compressed, but a long list of over 400 tax-deductible expenses is also to be trimmed, with a per-household cap on the total paid. For another, the chief beneficiaries should be low-to-middle earners. More than 70% of the tax reductions, says the government, will go to households with income between €10,000 and €40,000. This reflects Mr de Villepin's plan to "make work pay" and discourage spongers.

Yet the plan fails in its other goals: to woo more investors and discourage tax exiles. For sure, cutting the top rate has symbolic value in a country where as recently as 2000, it was 54%. Yet, under France's arcane system, there is a tax exemption for 20% of earnings, so the effective top rate was never as high as the "48%" figure implies. This exemption will now end, so the net change may be marginal. "The aim is for nobody to be worse off," says one official. "At worst, the effect for top earners should be neutral."

Given the fiendish complexity of the French tax system, any effort to make it user-friendly should be welcome. But two problems remain. The first is that this reform touches only income tax, not the other host of contributions that choke the tax-payer. According to a study by the Cercle d'Outre-Manche, a French business association in Britain, the average French pay-slip lists more than 40 deductions, compared with just two (tax and national insurance) in Britain. The government says it wants nobody's overall tax bill to exceed 60% of household income; but there is no plan to deal with this fragmentation, or to touch France's anomalous wealth tax.

The other question is the financing of the new tax cuts, which will cost €3.5 billion. Mr Breton says that they will be covered by the €4.5 billion of savings that he will secure by freezing the 2007 budget in volume terms. But public finances are already strained. This week Mr Breton admitted that the government's budget deficit for 2006 would be "in the order of 3%", compared with a previous forecast of 2.7%. This year, the deficit will be kept to 3% only thanks to a windfall payment from EDF, the state energy company.

In short, amid all the talk of fiscal reform there is a big missing element: spending cuts, above all on the heavy state bureaucracy. For years, the government has vowed to take advantage of demographic change by replacing only one in two retiring civil servants. Yet this has never quite happened. The number replaced in 2004 and 2005? Roughly nine in ten. ■