The Pitfalls of the French Economic Model

France’s economy has produced stagnant growth and high unemployment.

In January, French President François Hollande warned that his country is facing an “economic and social emergency.” Earlier, Hollande declared that the country’s struggle with unemployment, which stands at over 10.5 percent, is as serious as its problems with terrorism. France has struggled to recover economically in the years following the 2008 financial crisis. Growth has been sluggish, with GDP rising by merely 0.2 percent in 2014 and 1.1 percent in 2015. For Hollande, who faces an election in 2017, unemployment and low growth are indeed a primary concern. These challenges, however, are a byproduct of the weaknesses of France’s economic model. Without further reforms, this model will limit France’s economic growth prospects. It will also contribute to the further erosion of Paris’ relationship with the German government and European Union. As Geopolitical Futures outlined last week, the French-German alliance is cracking as the countries’ economic models diverge.

With each new crisis in the EU, the bloc’s cohesion is eroding further. Disagreements over how to address the eurozone’s financial woes are one of the sharpest divides, causing not only friction but the adoption of ad hoc policies and, increasingly, leading countries to dispute and ignore some EU rules.

France is a country between the Atlantic and Mediterranean, between northern and southern Europe. Its economy is similarly divided. At its core, the French model combines the highly diversified and advanced features of German, British and the U.S. economies with some of the rigidities and inefficiencies found in many southern European economies. As a result, France is a wealthy yet highly
centralized and bureaucratic country.

**Barriers for Business**

France has consistently performed far worse than peers like Germany, the U.K. and the U.S. in competitiveness surveys over the years. A study by the American Chamber of Commerce in France and Bain & Company in 2014 found that only 12 percent of American companies operating in France rate it positively.

One reason for this discrepancy is the French economy’s focus on high public spending and high tax rates. Following World War II, France – like most European states – developed a welfare state model, a social contract with its citizens whereby the state became responsible for providing stability and protecting citizens’ welfare through a web of social services and employment regulations. According to data from the International Monetary Fund (IMF), public social spending in France reached 32 percent of GDP in 2014, constituting the highest ratio among all countries in the Organisation for Economic Co-operation and Development (OECD.) Similarly, pensions expenditures are the highest in the OECD, and the country’s public sector wage bill is one of the highest in Europe.

This high level of social spending has led to some of the highest tax rates in Europe, impacting business prospects. High tax rates are common in Europe, but the French tax system is particularly burdensome for employers. In France and Germany, the tax wedge — the difference between total labor costs to the employer and net take-home pay — is nearly the same, but the amount employers are expected to pay towards employee benefits is different. According to the OECD, in France, employer social security contributions stood at 27.7 percent of total labor costs in 2014, but only 16.2 percent in Germany. For comparison, the employer contribution was 9.7 percent in the U.K.
At the same time, red tape and barriers to competition also pose a significant challenge for French businesses. Last summer, under the leadership of Economy Minister Emmanuel Macron, new legislation was introduced to try to ease barriers for businesses and boost employment. The so-called Macron Law extended the number of Sundays shops may be open and made it easier to hire and lay off employees, among other changes. Nevertheless, these reforms are only a small shift: cumbersome regulations and barriers to competition, especially in the services sector, continue to hinder significant economic growth and job creation. France’s economic woes often emanate from abroad, but the domestic barriers for business are the main factors slowing recovery. The 2008 financial crisis and its aftermath were an external economic shock for France: export levels initially plunged as France’s trade partners reeled from the crisis, and foreign direct investment levels fell, reaching a 27-year low in 2013. But while some of its peers have somewhat recovered and are now enjoying higher growth rates, France’s rigid domestic policies are leaving the country with low growth rates and high unemployment.

**Impact of Eurozone Membership**

France boasts the second largest economy in the eurozone, with the service sector representing almost 80 percent of GDP, similar to the U.S. and U.K. French citizens enjoy a high standard of living, although not quite as high as their German neighbors: GDP per capita in 2014, at $42,732, was about $5,000 less than in Germany, according to World Bank data.

France is highly integrated with the eurozone and, on the whole, membership in the bloc benefits France. According to U.N. Comtrade data, over 40 percent of French exports went to eurozone countries in 2014. France’s banking and financial sectors are intimately linked with the rest of the eurozone. In the 1980s, the French franc underwent several rounds of devaluation and since joining the eurozone,
France has enjoyed the benefits of having a stable currency. However, its membership in the currency union has also led to a loss of control over monetary policy, and thus of the ability to devalue its currency to make French products more competitive or address imbalances in the economy. Moreover, membership in the eurozone means France is legally bound to comply with European Union fiscal policies. However, especially when it comes to spending and public debt levels, the French model is often incompatible with the goals and interests of EU institutions. Most important, Germany sees the French model as unsustainable and problematic for the future of the eurozone.

Conclusion

The French economy is not, as Hollande claims, in crisis. Just as France is caught between north and south, its economic outlook is mixed. France is not facing the kind of significant economic disruptions we see in Greece, or even challenges similar to the banking woes of Italy. But France has failed to boost growth to the level of its north European neighbors. Significant reforms remain far off, especially with an election coming up next year and the ruling Socialist party attempting to stay in office. Ad hoc stimulus measures may improve France’s performance, but without deep structural reforms the country’s growth prospects will remain limited, and Paris will continue clashing with Berlin and Brussels over economic policy.