Liberté • Égalité • Fraternité
RÉPUBLIQUE FRANÇAISE

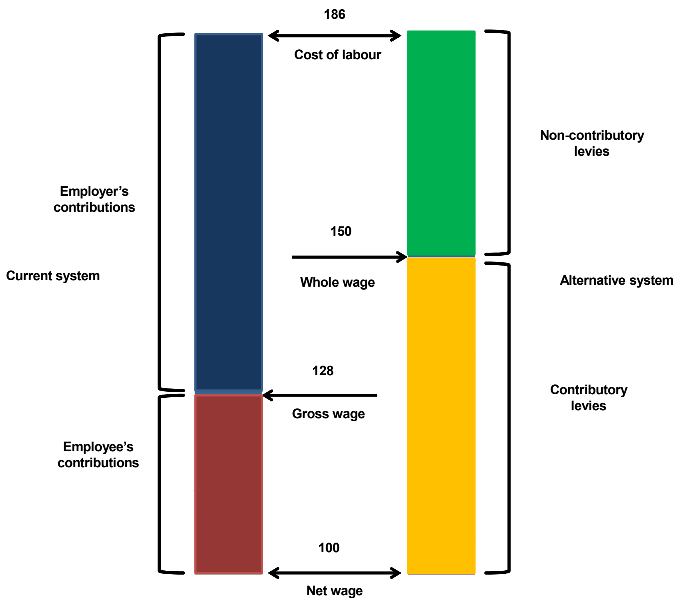
No. 200
June 2017

TRÉSOR-ECONOMICS

Clarifying the contributory component of social protection

- In France, much of the high level of government expenditure (57.3% of GDP in 2014) can be explained by the size of government social protection systems. The benefits paid by these schemes account for half of government expenditure (€630bn in 2014, or 29.4% of GDP). Most of this expenditure takes the form of retirement pensions and healthcare insurance payments.
- Most of these schemes are contributory (57% of the amounts paid, or 16.7 percentage points of GDP). This means that benefit amounts depend on the contributions previously paid by the recipient. The main contributory plans are the retirement pension schemes and the unemployment insurance, whereas healthcare insurance and family benefits are mainlygranted to every citizen regardless of their contributions.
- A high level of government expenditure automatically leads to a high level of taxes and social security levies, but there is reason to think that the levies allocated to financing contributory schemes could be less adverse for growth and jobs. Contributory schemes use contributions to finance benefits that are ascribed directly to the contributor. Therefore, they could be seen as deferred income or mandatory insurance rather than as taxes. In contrast, levies that finance non-contributory plans (healthcare insurance and family benefits) are no different from taxes on wages, economically speaking.
- Unfortunately, the complexity of payslips and the lack of transparency about financing for social protection mean that it is difficult today for wage earners to make the distinction between the contributory and non-contributory social levies deducted from their paycheques.
- Consequently, a reform of payslips would have the dual advantage of clarifying the roles of the different plans paying benefits, as well as providing better economic incentives, which could help to boost the labour supply. Such a reform could also replace the usual legal distinction between employers' and employee's contributions on payslips with a more economically-based distinction between contributory and non-contributory levies and would clarify which social levies are used to finance contributory benefits.
- This would ultimately promote a change in wage bargaining, which would no longer focus on gross wages (including employees' contributions and excluding employers' contributions, or some 130% of net wages). Instead talks would focus on the "whole wage" (net wage plus contributory levies, or some 150% of the net wage), which is more representative of the wage earner's true compensation.

Proposal for an alternative system to finance social protection



Source: DG Trésor, for a company with more than 20 employees in Paris.

MINISTÈRE DE L'ÉCONOMIE ET DES FINANCES

1. France's social protection system is mostly contributory

1.1 Different degrees of contributory intensity can be identified within the social protection system

A contributory social protection system is defined by the positive link between contributions paid and benefits received. A social insurance plan is typically a contributory plan, where the contributions are seen as an insurance premium that entitles contributors to benefits when the risk materialises. In most cases, the benefit paid depends on the amount of the contributions paid, even though this principle does not always apply (see below). This insurance-based system is different from a solidarity-based social protection system in which benefits are paid to all or to specific beneficiaries, subject to residence requirements, but no requirement regarding prior contributions.

This contrast between the two types of systems above can be found in the traditional contrast between the Bismarck social protection model, meaning a contributory system financed by social levies, and the Beveridge model, where benefits are paid to all and financed through general taxation. In practice, however, contributory and solidarity components coexist in our government social protection system: there is no example of a "pure" contributory system, where benefits are strictly proportionate to contributions paid. Mandatory retirement savings schemes come the closest but still have a solidarity component. Our contributory plans are always combined with redistribution mechanisms to some extent. For example, contributory benefits paid for a risk that materialises for only a few contributors, such as accidents at work, also include a solidarity component.

The degree to which each social benefit paid by general government in 2014 is contributory can be assessed using the following typology, from the most redistributive to the most contributory:

- **Degree 1: means-tested non-contributory benefits.**

These benefits are accessible only for individuals and households with incomes below an eligibility threshold. They express national solidarity with those most in need and are intended to correct certain inequalities and fight poverty.

This category includes income support benefits (social inclusion benefit or "RSA", minimum old age benefits, adult disability allowances), means-tested family benefits (back-to-school benefits, family supplements, birth grants and early childhood benefits), payments from supplementary universal healthcare insurance and housing benefits.

- **Degree 2: Universal non-contributory benefits.**

This category primarily covers mandatory healthcare insurance payments and healthcare provided by hospitals. Basic healthcare insurance has only been truly universal since 2016, with the introduction of Universal Healthcare Protection (PUMA), but, prior to that, there were many mechanisms that already enabled non-contributors to obtain healthcare coverage. Since its introduction in 1999, Universal Healthcare Coverage has made it possible to cover anyone residing in France in a stable and lawful manner for more than three months, including the homeless, but, before that, personal insurance and *département*-level or central government medical benefits ensured virtually universal coverage for healthcare.

The vast majority of family benefits make up the other main component in this category. Only the means-tested benefits included in the previous category, and sick pay and civil service family allowance (see below) are not included. The figures given are based on the 2014 data. Consequently, they include family allowance benefits in this category, even though they have been adjusted for income since 1 July 2015. For figures based on 2015 data, a sixth category for income-adjusted universal non-contributory benefits could be considered. This category would include family allowance benefits, along with other benefits, such as the childcare supplement of early childhood benefits and the attendance allowance.

- **Degree 3: Contributory benefits paid when a risk materialises**

The benefits in this hybrid category are based on a contributory insurance model, but with a major solidarity component in favour of contributors who are affected by the insured risk. These benefits include those paid to contributors who are affected by the materialisation of a risk, where the amount of the benefits received depends directly on the contributions paid in most cases. This is currently the case for unemployment benefits, disability benefits, benefits for accidents at work, sick pay and maternity pay. In some cases, the indemnity may be a lump sum (sick pay for farmers, death benefit since 2015, minimum unemployment benefit).

Retirement pension credit for childrearing and survivor's pensions are included in this category. Survivor's pensions are basically contributory, since the amount depends directly on the contributions paid, however, they have a major solidarity component in favour of the surviving spouse, who would otherwise suffer a decrease in resources after the death of their spouse. This solidarity component can also be seen in the means-testing of such pensions by most pension schemes (general pension scheme, pension scheme for the self-employed and farmers' pension scheme). Similarly, pension credits for childrearing are proportionate to the pension amount, which means they are directly linked to contributions, but they include a pension solidarity component in favour of pensioners with three or more children.

- **Degree 4: Defined-benefit retirement pension schemes.**

In France, the bulk of retirement pension schemes operate as defined-benefit schemes (general scheme and aligned schemes, basic civil service pension scheme). This means that the pension benefit amount paid depends on the years worked and a reference wage based on a formula such as:

Pension = accrual rate x reference wage x (years of service)/(years of service required for full pension)

These schemes are highly contributory since the pension amount depends directly on past wages and the number of years of service, which determine contributions paid. However, many computation rules and solidarity arrangements attenuate the contributory nature of these schemes.

- A fraction of old age pension contributions is "uncapped", which means that the contributions are calculated on wages, including the fraction in excess of the social security ceiling. Meanwhile, the reference wage for benefits is capped, which means that pension benefits are calculated with regard to the fraction of wages below the social security ceiling.
- Various exemptions from contributions, such as across-the-board abatements for low wages, may apply to old age pension contributions without diminishing pension entitlements.
- The reference wage for benefits is computed on only a fraction of the years of service (25 best years for the general pension scheme or the final pay grade for the last six months or more for the civil service pension scheme). Therefore the reference wage used to calculate benefits does not reflect all of the contributions paid.
- Free contribution credits for periods of unemployment, sick leave, military service, etc., increase pension entitlements without payment of contributions.
- People who continue to work and pay contributions after they start collecting their pension no longer obtain additional entitlements.

Furthermore, the retirement pension system naturally produces redistribution of income in favour of contributors who live until retirement age and, among pensioners, in favour of those who live the longest.

- **Degree 5: Defined-contribution retirement pension schemes.**

This category covers certain pension schemes operating on a points-based system, such as the supplementary pension schemes for private-sector wage earners (AGIRC-ARRCO) and civil servants (RAFP), as well as the basic pension scheme forliberal professions (CNAVPL). The contributions paid in each year are converted into points at the purchase value of a point in force for that year. When the pension is calculated, a point is translated into a benefit value, which is multiplied by the number of points acquired to determine the amount of the pension benefit paid.

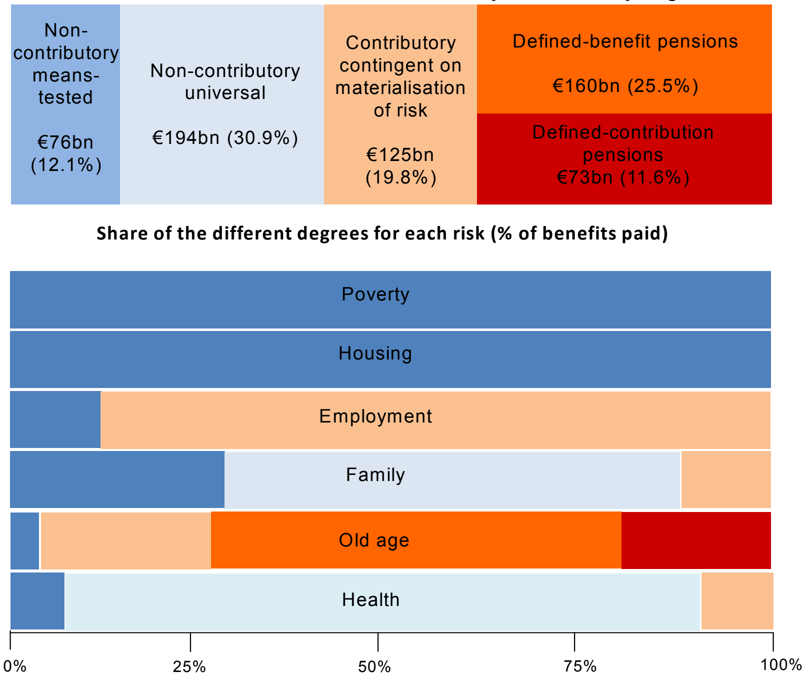
These schemes are more contributory than defined-benefit systems, because they are calculated on the basis of all of the contributions made over the course of a career. However, they also include various solidarity mechanisms, such as supplementary contributions that do not generate entitlements[1], free pension points for periods of unemployment, sick leave and maternity leave and supplements for dependent children.

1.2 Evaluating the contributory and non-contributory shares of benefits paid in 2014

According to the typology we have defined, France's government social protection system is mainly contributory. In 2014, contributory benefits (Degrees 3 to 5) accounted for 16.7 percentage points of GDP, or 57% of the social benefits paid by general government. Non-contributory benefits (Degrees 1 and 2) accounted for 12.6 percentage points of GDP, or 43% of total benefits.

(1) One-off and temporary contribution to the Agirc pension scheme and the contribution to the Association for the management of the financing for the Agirc and Arrco pension schemes.

Chart 1: social benefits in 2014, ranked by contributory degree



Sources: DREES, Social Protection Accounts for 2014 and DG Trésor estimates.

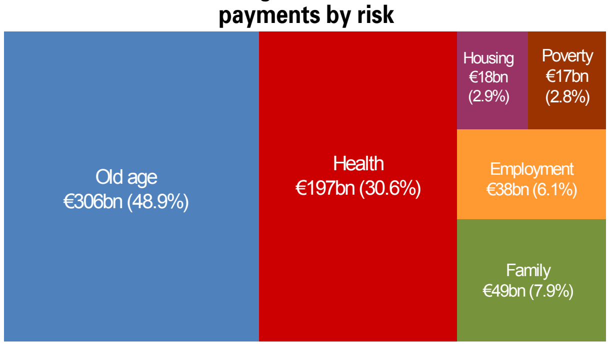
Box 1: Government social protection benefits account for half of government expenditure and cover various risks

Social protection refers to all of the national collective insurance and solidarity mechanisms that protect individuals and households against certain social risks. The materialisation of these risks triggers the payment of social benefits that compensate for some or all of the loss of resources or added expenses associated with the materialisation of the risk. Traditionally, there are six main categories of social risks:

- **Health:** The deterioration of an individual's health can trigger coverage of healthcare costs (healthcare insurance payments) or compensation for loss of income (sick pay). This risk also includes benefits paid for accidents at work, occupational diseases and disability[a].
- **Old age**: The end of one's working life at a certain age entitles individuals to replacement income, paid either directly to pensioners (individual retirement pensions) or to their heirs (survivor's pensions). Attendance benefits[b] are also included in this category. .
- **Family**: Family benefits may take the form of general benefits for children (family allowance), childcare subsidies, maternity pay or supplementary income for parents (e.g. civil service family allowance).
- **Employment:** This risk is mainly covered by unemployment benefits, skills training and employability benefits.
- **Housing:** The benefits covering this risk are mainly means-tested benefits for renters[c], as well as subsidies for first-time homebuyers.
- **Poverty:** This risk is covered by social welfare benefits for those most in need. The main benefits are the social inclusion benefit, the in-work income supplement and the employment incentive bonus[d], along with housing benefits for persons in distress.

This survey covers social benefits paid by general government (Social Security, central government, local government) in 2014, based on the social protection accounts published by the Directorate of Research, Studies, Assessment and Statistics (DREES). Based on this survey field, social benefits came to 627bn, or 29.4 percentage points of GDP in 2014. Old age and healthcare risks accounted for two-thirds of the benefits (48.9% and 30.6% respectively, see Chart 1).

Chart 2: General government social benefit payments by risk



Source: DREES, Social Protection Accounts for 2014.

a. Including disability pensions, the adult disability allowance, and the disabled child allowance. In the case of the disability compensation benefit, the amount paid to beneficiaries under 60 years of age is included in healthcare risks and the remainder is included in old age risk.
b. Mainly the attendance allowance, the disability compensation benefit paid to beneficiaries over the age of 60 and housing benefits for elderly beneficiaries requiring attendance.
c. Individual housing benefit, the social housing allowance and the family housing allowance.
d. Situation as it was in 2014, the year of the data used for this survey. The in-work benefit replaced the employment incentive bonus and the in-work income supplement on 1 January 2016. Since the introduction of the European System of Accounts (ESA) 2010, refundable tax credits are recognised as expenditure and no longer as a decrease in revenue.

Healthcare benefits are mainly non-contributory (88% of healthcare benefits). Mandatory healthcare insurance payments and non-market[2] hospital healthcare services account for the bulk of health risk benefits and are universal non-contributory benefits (Degree 2). Some non-contributory benefits are means-tested (Degree 1), such as supplementary universal healthcare insurance payments and free health care, along with the adult disability allowance[3]. Contributory healthcare benefits are the benefits paid when the risk materialises (Degree 3, mainly sick pay, disability pensions, accident-at-work and occupational disease benefits).

Old-age pensions, as expected, are the most contributory schemes (96% of the benefits paid), under defined-benefit and defined-contribution pension schemes (Degree 4 and Degree 5) and survivor's pensions and pension supplements (Degree 3). Only the minimum old-age benefit and attendance benefits are non-contributory.

Family benefits are largely non-contributory (87% of family benefits). Most of the benefits paid by the National Family Allowance Office are universal (Degree 2), such as the family allowance, the childcare supplement and the early childhood benefit and the supplement for free choice of working time[4]. Early childhood benefits paid by municipalities or tax credits for childcare expense for children under the age of 6 years[5] are also included in this category. Other benefits are means-tested, such as the birth grant and the early childhood benefit, the back-to-school benefit or the family income supplement. Contributory family benefits are mainly maternity pay, the civil service family allowance paid to government employees. These benefits are not subject to prior contributions, but eligibility is based on employment, which means that they are not universal.

Unemployment benefits are mainly contributory (87% of the benefits paid), the bulk of the benefits paid out by the Unemployment Insurance Scheme are directly linked to the contributions paid in. Benefits paid by the Solidarity Fund, such as the specific solidarity allowance, the pension equivalent benefit and the aid to unemployed starting up or rescuing companies, are non-contributory.

Poverty and housing benefits are all means-tested and exclusively non-contributory

2. A major reform of the financing of social protection and payslips would have the dual advantage of clarifying the roles of the different systems paying benefits, as well as enhancing economic incentives

2.1 The financing of social protection is not always appropriate for the type of benefits paid

When France's Social Security was set up in 1945, the model for the healthcare and family branches was based on workers' contributions, which justified the introduction of social security contributions. Today, the continuing role of these contributions in financing these branches causes confusion. Contributions to finance the family and healthcare branches[6] are no longer related to the benefits paid out. In economic terms they are no different from taxes on wages to finance specific public policies, in this case social policies.

On the contrary, contributory levies are based on a different economic model, since the amounts contributed have a direct impact on the contributors' entitlements. This means that a contributory levy is a form of compulsory insurance, which is government insurance in this case, and it corresponds to deferred wages. This makes it different from taxes to finance social policies.

Clarifying the sources of financing for contributory and non-contributory benefits is, therefore, a key issue for the transparency of our social protection system. Several reforms have already helped to clarify this matter, such as the creation of the General Social Security Contribution in 1991, which replaced the contributions used to finance family benefits. This contribution was increased in exchange for cuts to healthcare insurance contributions in 1997 and 1998. More recently, the Responsibility and Solidarity Pact cut the contributions financing family benefits for employees earning up to 3.5 times the minimum wage.

However, this clarification has yet to be completed. In 2014, social levies paid to general government stood at €408bn[7], or 19.2 percentage points of GDP. This is more than all of the contributory benefits combined (€357bn, or 16.7 percentage points of GDP). Healthcare and family benefits are mainly universal, but they account for some €75bn and €35bn of social security contributions respectively. In contrast, the general pension scheme is mainly financed by contributions, but it receives funding from other sources, such as €22bn in transfers from the old-age solidarity fund. In other pension schemes, such as supplementary pension schemes and the scheme for the self-employed, social levies are more in line with the amount of contributory benefits to be financed.

(2) Services provided for free or for a token price.
(3) The adult disability benefit is included in the "disability" sub-category of "health" risk in social protection accounting.
(4) This benefit was replaced on 1 January 2015 by the joint childrearing benefit.
(5) Since the introduction of the European System of Accounts (ESA) 2010, refundable tax credits are recognised as expenditure and no longer as a decrease in revenue.
(6) For the share financing benefits in kind.
(7) Including imputed social levies (€42.5 billion), primarily as part of the payment of central government pensions.

2.2 Clearer identification of contributory levies and non-contributory levies could have beneficial effects for the labour market

Contributory and non-contributory social security levies could give rise to different economic incentives if the contributors are truly aware of the link between the contributions paid and their entitlements or benefits. In such a case, if the contributory levies were perceived as deferred income, even though it could be contingent on the materialisation of risk, there is reason to think that employees would bargain in terms of current income net of non-contributory levies and income tax[8], while considering contributory levies as part of their net income. Based on this assumption, contributory social levies would not be fully included in the tax wedge (see Box 2), which could lead to an increase in labour supply, compared to the situation where no partial recuperation of these levies is perceived. A clearer perception of contributory levies could therefore lead to a decrease in structural unemployment.

Box 2: Should contributory levies be included in the tax wedge?

Whether or not contributory social levies should be included in the tax wedge is a delicate question. There is reason to think that existence of a direct consideration, in the form of entitlements or benefits, could give these levies the appearance of supplementary compensation. Employees might no longer bargain in terms of wages net of all social levies, and reason in terms of "whole wages" incorporating net wages and contributory levies.

However, this would assume that employees have a clear understanding of social protection mechanisms, that they are aware of the amount of contributory levies paid into the system and that they are able to anticipate the future benefits associated with the levies. Cotis and Loufir[a] put forward the idea that the labour supply is less sensitive to contributory levies than to non-contributory levies, but empirical research generally concludes that there is a link between unemployment and the size of the tax wedge, including contributory social levies, when no attempt is made to distinguish between contributory and non-contributory levies[b]. When the distinction is made Disney (2004)[c] found positive correlation, using panel data on the OECD countries, between the female labour force participation rate and the level of contributory levies financing retirement pension schemes. However, the same correlation was not found for males.

a. Cotis, J.P. and A. Loufir (1990), "Formation des salaires, chômage d'équilibre et incidence des cotisations sur le coût du travail".
b. See for example, based on OECD panel data: Andrea Bassanini and Romain Duval, *Unemployment, institutions, and reform complementarities: re-assessing the aggregate evidence for OECD countries* (2009).
c. Disney, R., T. Boeri and T. Jappelli (2004), "Are Contributions to Public Pension Programmes a Tax on Employment?", *Economic Policy*, Vol. 19, No. 39, pp. 267-311.

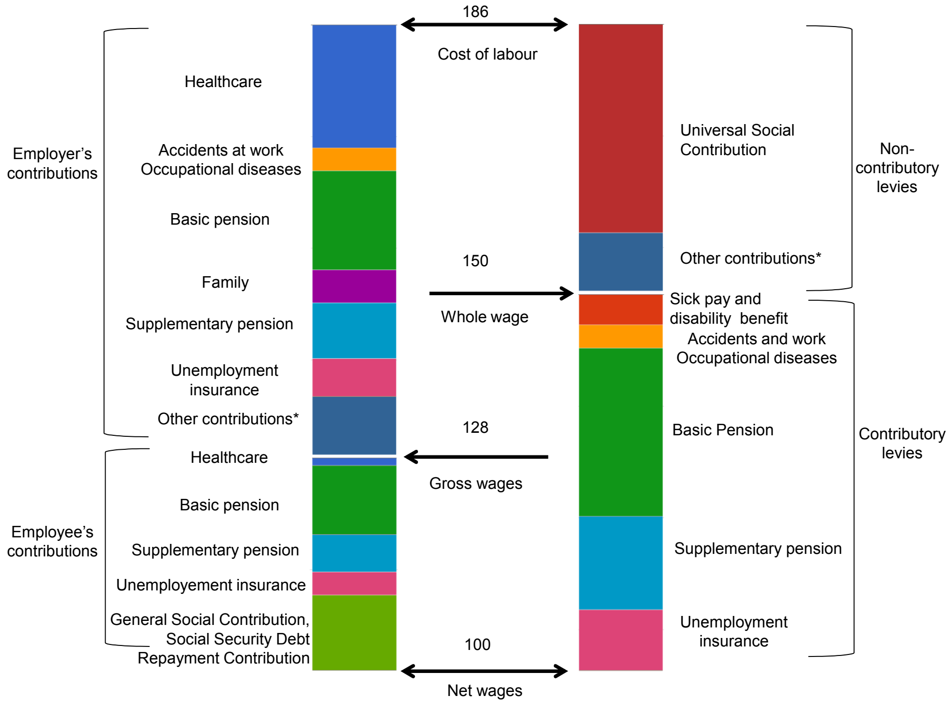
Today, it seems highly unlikely that a large number of contributors have a clear perception of the amount of contributory levies paid into the social security system. Payslips show a large number of contributions and deductions, with no clear separation of the contributory share. A clarification of the financing for social protection on payslips could take the following form:

- All non-contributory deductions (non-contributory levies, the General Social Security Contribution, the Social Security Debt Repayment Contribution, and the Solidarity Contribution for Autonomy) could be combined into a "universal social security contribution". This levy, like the General Social Security Contribution, would be a tax to finance social policies.
- The remaining social levies could be combined into a contributory block that could be treated as deferred income, specifying the amounts dedicated to each risk: old age, unemployment, accidents at work, as well as contributory healthcare benefits (sick pay, accidents at work, occupational diseases, disability benefits and death benefits) along with maternity pay. The new mechanism would have to divide the current levy rate for healthcare insurance between the different benefits (non-contributory healthcare benefits, disability benefits, sick pay, death benefits). This would enhance the transparency of financing for the healthcare branch, thereby increasing acceptance of the levy.

Under the new arrangement, cuts to social levies should prioritise universal non-contributory levies (family and healthcare) that are more like actual taxes on wages, to increase the impact of these cuts on boosting employment.

(8) Especially after withholding at source takes effect.

Chart 3: Proposal for payslip reform



Source: DG Trésor.

* Including transportation subsidy, solidarity contribution for autonomy, contribution to national housing fund, apprenticeship tax and vocational training expenditure (for a company with more than 20 employees in Paris).

At the same time, highlighting the notion of "whole wages" (net wages and contributory levies) should lead to employees having a clearer perception of their real earnings from work. In the long term, this notion could also take the place of gross wages (net wages plus employee's contributions) in wage bargaining and contracts of employment. This would be the same as eliminating the distinction between employee's contributions and employer's contributions in favour of a new more economically valid distinction between contributory and non-contributory social levies.

The distinction between employee's contributions and employer's contributions is not economically relevant in the medium term. In the short term, an increase in employee's contributions reduces net wages, whereas an increase in employer's contributions increases the cost of labour. But, in the medium term, the tax impact considered in wage bargaining, meaning the amounts of the levies actually borne by employees and employers, will be determined by the elasticity of labour supply to net wages and the elasticity of labour demand to the cost for employers, and no longer depend on the legal definition of the levies. This means, with the exception of the lowest wages set by the statutory minimum wage, none of the economic decision-making will be guided by gross wage levels: employers will seek the lowest cost of labour and employees will seek the highest net wage. Combined with the clarification of the contributory share of social levies, the elimination of the distinction between employee's and employer's contributions would strongly increase the transparency of social levies.

This change in the format of payslips does not seem to raise any special technical problems, other than agreeing on the contributory or non-contributory nature of each levy. Should wage bargaining shift from focussing on gross wages to whole wages, we would need to examine the legal and technical implications of such a shift (defining the statutory minimum wage, transition from current contracts, governance of social security schemes, etc.)

2.3 Clarifying the contributory share of social benefits would facilitate international comparisons

Greater awareness of the share of taxes and social security contributions used to finance contributory benefits should enhance the attractiveness of France's social security and tax system. In international comparisons by the OECD, France has one of the highest aggregate tax and social security contribution rates, at 45.5% of GDP in 2014, compared to the OECD average of 34.2%. If we exclude contributory benefits, assessed at 16.7% of GDP in this survey, France's aggregate tax and social security contribution rate would be more in line with that of countries without extensive contributory government schemes, such as the United Kingdom (32.1%) or the United States (25.9%).

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Publisher:
Ministère de l'Économie
et des Finances

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English translation:
Centre de traduction des
ministères économique
et financier

Layout:
Maryse Dos Santos

ISSN 1962-400X
eISSN 2417-9698

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This study was prepared under the authority of the Directorate General of the Treasury (DG Trésor) and does not necessarily reflect the position of the Ministry of Economy and Finance.