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Trends in French public spending: a retrospective survey

This study was prepared under the authority of the Treasury and Economic Policy General Directorate and does not necessarily reflect the position of the Ministry of the Economy, Finance and Employment.

- The share of public spending in GDP has risen sharply in France over the past fifty years, rising from 35 % at the beginning of the 1960s to over 50 % since the 1990s.

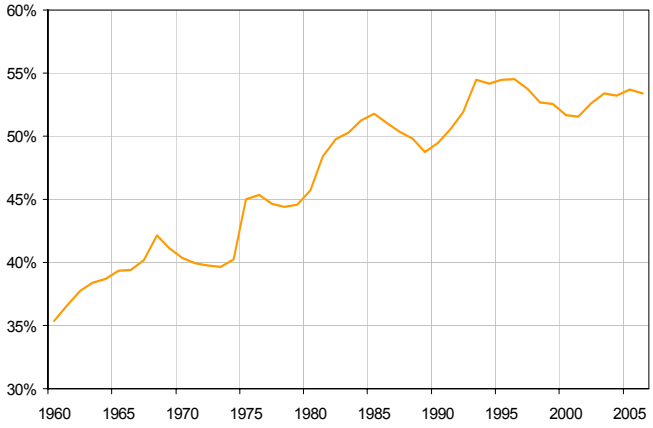
- The rise has not been a steady one, being especially pronounced when fiscal policy was called upon to stimulate the economy (after the fiscal stimuli of 1974 and 1981). Over the long run, the main driver has been the rapid growth in social security spending due to structural factors, especially population ageing: this latter trend is expected to continue, looking to 2050.

- Among OECD countries, the share of public spending in GDP ranges from 30 % for South Korea to 55.5 % for Sweden, a difference of more than 20 percentage points of GDP. France ranks among those countries where the ratio is highest. The differences chiefly reflect national collective preferences as to how the provision of needs and public goods should be financed-privately or by society. Nevertheless, the trend in French public expenditures in the recent period looks worrying by comparison with those of our neighbours: spending has continued to rise as a percentage of GDP, whereas in Germany the trend has been reversed.

- According to estimates by the DGTPE, over half of the rise can be attributed to social security funds, even though their share in overall spending growth edged down slightly starting in 2005, then more distinctly in 2006 as a result of the abatement of the national healthcare expenditure target (ONDAM) and falling unemployment. Moreover, the contribution from local governments has risen, partly as a result of the transfer to them of new areas of competence voted since 2002.

- Spending needs to be brought under control in order to cope with the heavy pressure on social security expenditure foreseeable in the medium term, mainly due to population ageing, and in order to bring the ratio of spending to GDP back down to the European average. The French authorities have set a target of halving the rate of growth in public spending over the lifetime of the current parliament.

Public spending as a % of GDP in France



Source: INSEE.

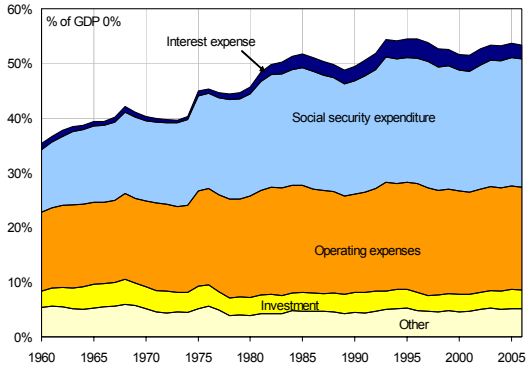
DGTPE
DIRECTION GÉNÉRALE DU TRÉSOR
ET DE LA POLITIQUE ÉCONOMIQUE

1. Over the long period, the determinants of trends in French public spending reflect a combination of economic factors and social choices

1.1 Public spending has risen continuously as a share of GDP since 1959

Over the long period, the share of public spending (as defined in the national accounts, see box 1) in GDP has risen significantly. It represented around 35 % of GDP at the beginning of the 1960s (see chart 1). By the early-1990s, public spending had grown to represent almost half of the national wealth produced in a year.

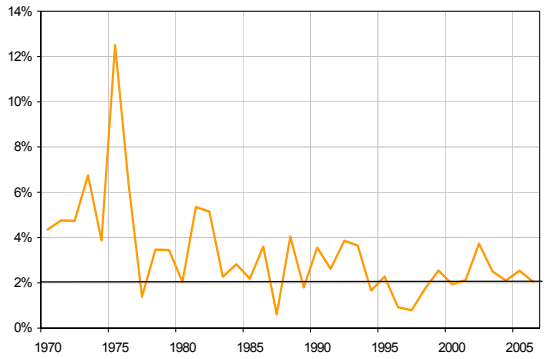
Chart 1: trends in public spending as a share of GDP



Source: INSEE.

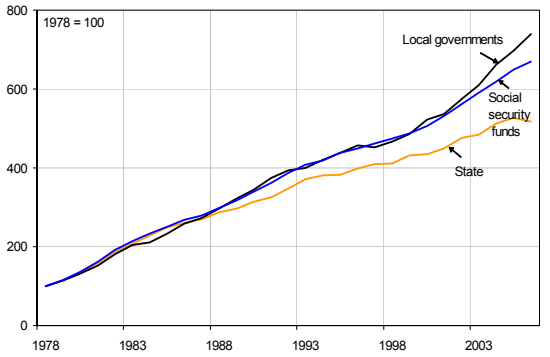
This trend is due in the first place to the rapid growth in social security expenditure. The debt service charge has also increased in line with the rise in public debt. Operating expenses have remained stable as a percentage of GDP.

Chart 2: growth in public spending in real terms since 1970



Source: INSEE.

Chart 3: trends in spending by sub-sector



Source: INSEE.

Box 1: **The concept of expenditure in the French national accounting system**

The national accounts seek to determine what, by nature, is an expenditure, regardless of the name given to it, and regardless of whether or not it gives rise to a cash movement. The key criterion is that an expenditure is a movement that "impoverishes" the general government entity concerned in the sense that its net financial assets are diminished (either by a decline in its assets or by an increase in its liabilities). This definition is adopted by convention inasmuch as only financial assets are considered, to the exclusion, for example, of long-lived assets such as buildings, roads, ports, etc. In practical terms this definition leads to exclude from the scope of public expenditure some transactions that are treated as expenditure in the budgetary sense of the term, for example:

- purchases of securities are not deemed to be public expenditures as defined in the national accounts. This is because they do not entail any diminution in the net financial assets of general government entities, merely a reallocation of assets between cash and securities within the entity's total assets;

- capital endowments may also be excluded from public expenditure if they lead to an increase in the value of the firm of which the Government is a shareholder, and hence, ultimately, of the State's assets. On the other hand, if these endowments are non-repayable, they will be treated as expenditure.

Conversely, transactions with no impact on the budget, such as the waiver of a financial claim (for example following a debt cancellation by the Club of Paris creditors), are recorded as public expenditure in the national accounts. This is because the waiver of a financial claim by a general government entity entails a corresponding decline in its net financial assets. When a government guarantee is exercised, the guaranteed debt becomes a State debt, thereby increasing the State's liabilities. Consequently this is an expenditure within the meaning of the national accounts.

The use of this criterion in the national accounts can lead to the recording of expenditures that have never had any counter-entry under the cash heading. The absence of cash flows does not mean no expenditure has taken place if a sum of money for which a debt legally exists adds to the liabilities of a general government entity. This applies, among others, when a benefit has been paid on the State's account but has not given rise to an expenditure in the State budget for lack of sufficient credits available (for example, for certain social security benefits paid on the State's account).

National accounting also leads to other corrections that treat the concept of expenditure differently from cash basis or general accounting, with the application of accrual accounting. Under this type of accounting, public expenditure in the national accounts is attached to the year in which the legal obligation constituting a debt; i.e. the "chargeable event", actually arose, the inclusion of social security contributions treated as a charge (this mainly concerns contributions that the State pays to itself in order to balance the accounts of the civil and military pensions schemes), or again levies on revenue intended for local authorities or the European Union (since these levies replace budgetary allocations, they are treated as expenditure in the national accounts).

The share of public investment has tended to decline since the 1980s. The relative share of the different sub-sectors has changed, with the size of local budgets growing steeply partly due to decentralisation, and the rapid rise in social security expenditure. Consequently, the relative share of the State has declined (see chart 2).

Real public expenditure has risen at an average rate of slightly over 2% a year. Certain "spikes" are easily identifiable, particularly at the time of the major fiscal stimuli of 1974 and 1981 (see charts 2 and 3).

1.2 An increase partly attributable to the economic determinants of public spending…

The impact on spending of economic or structural determinants is estimated assuming no change in legislation or policy. Consequently, even if growth in an expenditure item is mechanical (for example, spending linked to population ageing, see below), how it is allocated between public and private spending is a matter of collective choice as to what proportion of spending ought to be financed by society.

1.2.1 Spontaneous factors of growth in public spending in the short and medium term

In the short term the economic cycle has a significantly greater influence on tax revenue than on public spending. This is because the bases on which tax revenue depends are tightly bound up with the state of economic activity. Spending, on the other hand, depends mainly on the amounts voted by Parliament.

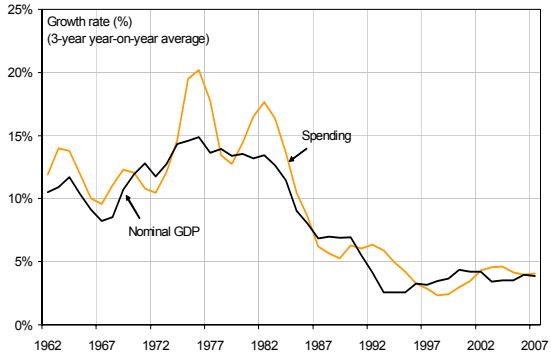
Some expenditures are nevertheless sensitive to cyclical factors. Spending on unemployment benefits, for instance, rises when activity deteriorates and the number of jobless increases. Spending on the minimum integration income (revenu minimum d'insertion-RMI) follows this phenomenon with a time lag: at the end of a slack period, there are more jobless people reaching the end of their entitlements and spending on the RMI is higher. When the economy picks up, spending on the RMI falls more slowly than spending on unemployment benefits.

There is also a time lag (around 1 year) in the impact on other means-tested spending such as housing benefits, for instance, since they depend on income received in the year preceding their payment.

The state of the economy also affects spending *via* price trends. This is because the Budget Act sets spending in current euros. If inflation finally turns out higher than was expected in the Act, and if the level of spending voted is complied with, then real expenditure will automatically be lower than planned. In general, if prices rise faster than expected, consumption spending by the general government will be more costly (and *vice versa*). Spending on pensions and family allowances are a significant exception to this, their purchasing power being safeguarded by an automatic inflation-indexing mechanism[1].

In the medium term, public spending tends to follow economic and price trends, and hence trends in nominal GDP (see chart 4 below for France). The rate of growth in public spending can of course diverge from that of nominal GDP over specific periods connected with important policy choices.

Chart 4: spending growth and GDP growth



Source: INSEE.

The change in the share of public spending in GDP over time did not take place gradually in France: it corresponds rather to shocks to spending in the years 1974-76 and 1981-82; the resulting imbalances have never been righted ever since.

The linkage between GDP growth and the supply of public services can be interpreted in several ways. In a fast-growing economy, it is natural that investment too should rise at a comparable pace, insofar as a growing economy needs more public infrastructures such as roads, ports and airports, etc. It is difficult, too, not to index the value of certain operating expenditures on inflation[2].

1.2.2 Long-term factors

In the longer term, public spending is also influenced by structural factors. The changing structure of the economy and society modifies the type of public spending and its level. Among these structural factors, population ageing is most likely to affect public spending in the coming years. Demographic projections by INSEE published in July 2006 point to a sharp rise in the share of over-60s in the total population between now and 2050, rising from a fifth of the population in 2005 to nearly a third.

(1) The indexation rule used is designed to offset observed differences (positive or negative) between the amount of the benefit paid on the basis of forecast inflation and the amount that ought to have been paid in the light of actual inflation. The adjustment is made with a one-year time-lag.

(2) The linkage is a loose one nonetheless and may conceal contrary movements. Healthcare spending tends to rise faster than national income, demand for it rising more than proportionally to income.

Population ageing affects public spending *via* a number of channels, including pensions and healthcare spending. Pensions spending will rise automatically due to the increase in the number of retirees. At the same time, an older population means greater demand for healthcare, which is becoming costlier as a result of technological progress. The third channel concerns spending relating to the cost of dependency, which is expected to increase with greater life expectancy.

Conversely, population ageing can lead to lower spending *via* two channels. A less youthful population ought to entail lower educational spending, assuming no change in teacher-pupil ratios. Spending relating to employment could fall too, even if there is no automatic correlation between employment and ageing.

The margin of uncertainty around these different effects in the long run is considerable, of course, but it is nevertheless important to realise the scale of the challenge. For healthcare spending, based on a set of assumptions regarding cost trends, the OECD estimates the additional spending at between 1.7 and 3.6 percentage points of GDP looking to 2050. It estimates additional dependency-related spending at between 1.0 and 1.7 percentage points of GDP.

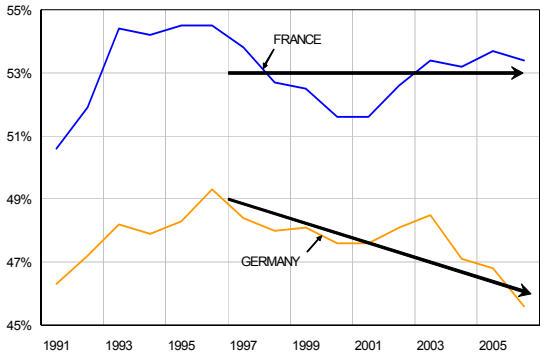
1.3 ... but this rise also reflects a collective preference

For a given level of per capita wealth, differences in the level of public spending reflect political trade-offs between society-financed and privately-financed spending more than anything else. Within the OECD, public spending as a percentage of GDP ranges from 30 % for South Korea to 55.5 % for Sweden, a difference of more than 20 percentage points of GDP[3].

These differences chiefly reflect national collective preferences as to how the provision of needs and public goods should be financed-privately or by society. Healthcare spending in the United States is higher than in the major European Union countries (15 % of GDP versus around 10 % in France, 11 % in Germany, 8.5 % in Italy, and 7.7 % in the United Kingdom[4]), but the proportion of this spending financed out of taxes and social security contributions is lower in the United States (4 4%, versus 76 % in France, 78 % in Germany, 75 % in Italy and 83 % in the United Kingdom). The difference in the share of public spending *vis-à-vis* the United States mainly reflects wide differences in approaches to social protection financing. The European system depends mainly on institutions financed out of taxes and social security contributions. America's social protection is mainly a matter for private initiative.

Within the euro zone, the differences are less pronounced. There are nevertheless significant disparities, and recent trends are divergent: in particular, spending ratios have been relatively stable in France, on average, over the past 15 years, whereas the ratio is trending downwards in Germany (see Chart 5).

Chart 5: general government's spending as % of GDP



Source: INSEE and Destatis (national accounts).

There has consistently been a gap of at least 4 percentage points of GDP since 1990 (rising to 8 percentage points of GDP in 2006). It notably stems from:

- defence spending, which represents 1 percentage point of GDP more in France than in Germany (2 percentage points of GDP in France in 2005 versus 1 percentage point in Germany);
- investment by the general government-housing notably-which is around 1 percentage point higher in France;
- personnel costs (13.3 percentage points of GDP in France in 2005, versus 7.5 percentage points in Germany)[5].

2. How to analyse the recent trend in public spending?

Recent trends in public spending in France may appear to give cause for concern when compared with those of our neighbours. For instance, Germany has sharply cut the share of public spending in GDP since 2003, while Sweden has reduced its public spending almost consistently since 1995, with an accumulated fall in share of GDP of more than 10 percentage points, over the period.

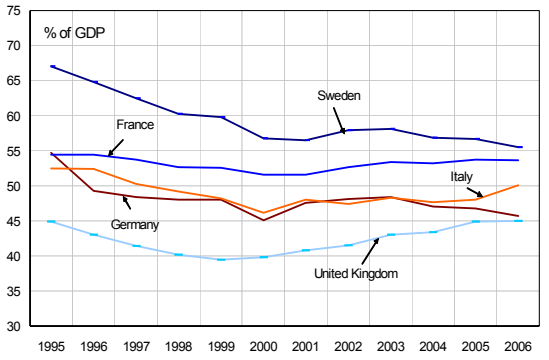
(3) Source: OECD data, Economic Outlook no. 81, 2007.

(4) Source: OECD data, 2003

(5) This gap stems notably from the fact that German hospital personnel are not included in the public sector. On the other hand, spending on health benefits is higher in Germany than in France (the difference was 2.6 percentage points of GDP in 2005). In addition, France has more teachers due to its lower school admission age (age 3 in France, compared with 6 in most German Länder). Overall, these differences account for a gap in personnel costs between France and Germany representing 3.5 percentage points of GDP.

This calls for a more detailed understanding of the recent trend in public spending over the period

Chart 6: share of public spending in GDP



Source: Eurostat.

2.1 All sub-sectors have contributed to the rise in public spending in current euros in past years

The trend for growth in public spending to outpace economic growth has continued in recent years (real public expenditure rose by 2¼ % a year over the period 1996-2006). The share of spending in GDP rose by 0.8 percentage point between 2002 and 2006. The steepest nominal increase in spending over the period has occurred in local governments, with a rise of 29 %, partly due to the transfer of areas of competence to them. Spending by social security funds also increased significantly (up 24 % in nominal terms[6]). State expenditure rose by only 9 % over the same period.

Care is needed in interpreting these figures by category of general government entity, since the data published in the national accounts are compiled on a current perimeter basis. Yet the perimeter of general government has altered significantly in recent years. For instance:

- The 18 December 2003 Act transferred the task of managing the "RMI" minimum income scheme to the local authorities. This transfer of powers, compensated for by a transfer of part of the proceeds of the French domestic tax on petroleum products (TIPP), helped account for the surge in local authority spending in 2004;
- The direct compensation by the State of lower social security contributions on low wages in 2004, with the winding up of the FOREC (Fund to finance the reform of employers' social security contributions) and the transfer in 2006 of tax revenue to the social security administration to compensate for exemptions from social security contributions, had a direct impact on State expenditure as reflected in the national accounts[7].

Finally, it is not easy to work our way back from spending by sub-sectors to aggregate public spending overall. The reason is that the **simple addition of spending recorded for each general government entity does not equal total public spending, since spending by sub-sectors comprises any transfers from one general government entity to another**. It is therefore necessary to "consolidate" these transfers in order to reconstitute the respective share of each sector in total public spending.

2.2 An attempt to break down public spending in order to isolate each sub-sector's contribution to spending trends

Owing to cross-flows between government departments, the change in total spending is not the sum of spending by the different sub-sectors. It is therefore necessary to subtract these flows in order to understand the role of each sub-sector in the change (see Box 2).

This yields a "breakdown" of public spending that reflects the relative share of each sub-sector in total spending, where the sum of contributions is indeed equal to the aggregate change. This breakdown shows that social security funds account for a little under half of public spending, the State for nearly 30 %, local governments for 20 %, and central government agencies 6 %. Moreover, the level of State expenditure has declined significantly, since it is the chief source of transfers to the other government entities (see table 1).

Table 1: share of the different sub-sectors in public spending

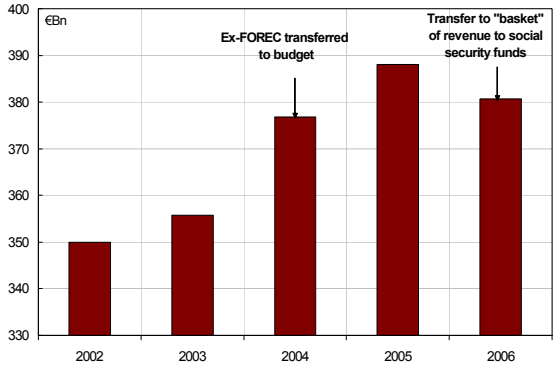
	National accounts		"Breakdown"	
	€Bn	%	€Bn	%
General government	956.7		956,7	
State	380.4	40 %	278.1	29 %
Central government agencies	62.2	6 %	57.0	6 %
Local governments	199.3	21 %	194.0	20 %
Social security funds	437.0	46 %	427.7	45 %
Total sub-sectors	1078.9	113 %	956.7	100 %

Source: INSEE, DGTPE calculations.

(6) It also registered the steepest increase in absolute terms, with a rise of €70 billion.

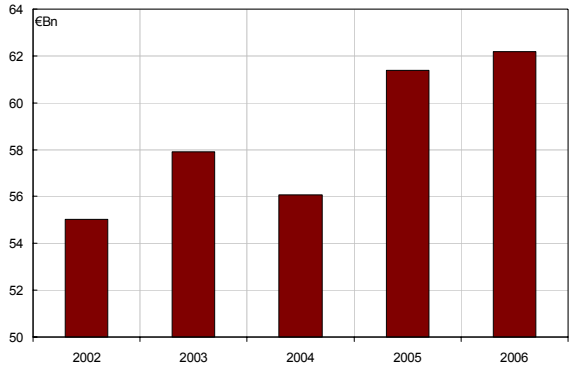
(7) This impact is naturally cancelled out when considering consolidated public spending (all government departments combined), in which case there is no impact on spending, since the reductions in social security contributions affect only the level of taxes and social security contributions.

Chart 7: State expenditure



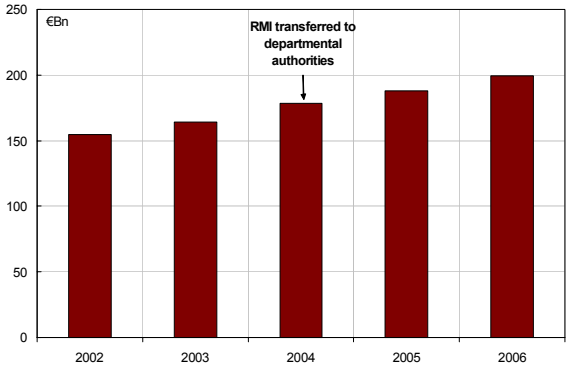
Source: INSEE

Chart 8: expenditure of central government agencies



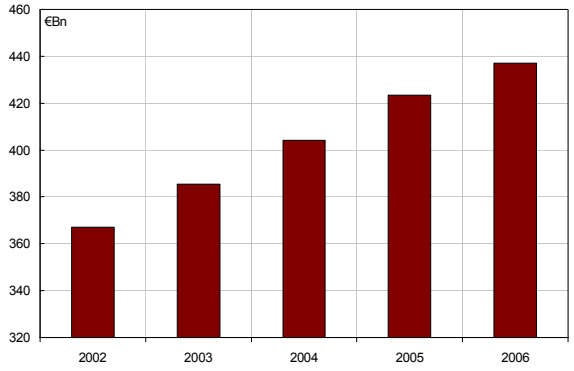
Source: INSEE

Chart 9: local government expenditure



Source: INSEE.

Chart 10: expenditure of the social security funds



Source: INSEE.

Public spending trends in real terms can be broken down such as to isolate each sub-sector's contribution (see table 2). Over the recent period, the social security funds remain the prime contributor to the growth in public spending. The share attributable to them dipped slightly after 2005, then more distinctly so in 2006, as a result of the abatement of the national healthcare expenditure target (ONDAM) and the fall in unemployment. The period also witnessed vigorous growth in local spending (see table 2).

Trends in the different sub-sectors' contributions to public spending can be accounted for as follows.

Table 2: contributions of the different sub-sectors to growth in public spending

	2002	2003	2004	2005	2006
Growth in public spending (in real terms, in %)	3.8	2.5	2.0	2.6	2.1
Contribution of the State	0.9	0.4	0.4	0.5	0.2
Contribution of central government agencies	0.0	0.2	−0.3	0.2	0.1
Contribution of local governments	1.0	0.8	0.7	0.6	0.9
Contribution of social security funds	1.9	1.3	1.3	1.2	0.9

Source: DGTPE calculations.

2.2.1 The contribution of the State and central government agencies

After peaking in 2002, the level of State expenditure voted in the initial Budget Act has systematically been respected since 2003. Overall, budget spending has moved in line with prices. The contribution of State expenditure to the change in public spending ought therefore to be close to zero. In fact, though, it turns out to have been slightly positive between 2003 and 2006, on the order of a half percentage point, for a number of reasons:

- France's contribution to the European budget (the '4th resource') is not a budgetary expenditure but a diminution of revenue; it is nevertheless treated as an expenditure in the national accounts. The vigour of this item accounts for nearly 0.2 percentage point each year in the State's contribution to higher public spending, with the exception of 2006, when it declined slightly, thereby accounting for the fall in the contribution;
- The growth in "fictitious" social security contributions[8], mainly due to trends in pensions spending, is another explanatory factor. This is a bookkeeping convention that has its counterpart on the revenue

(8) These are the counterpart of the social security benefits provided directly by employers to their employees, former employees and other claimants, less-where applicable-the social security contributions payable by employees. The State pays a number of benefits to civil servants (present or retired) coming under the social insurance heading (employers' schemes) for which no prior contribution is levied. The main benefits concerned are old age and disability benefits for tenured personnel, sick leave for tenured personnel and the family income supplement paid on top of family allowances from the second child onwards.

side of the State accounts, but it automatically increases public spending in the national accounts;

- A third series of factors also plays a role, notably cancellation of foreign governments' debt.

With the exception of 2004, the contribution of central government agencies to public spending trends has been fairly flat. On the other hand, there was a sharp drop in grants paid in 2004 by the *Centre National pour l'Aménagement des Structures des Exploitations Agricoles* (CNASEA-national centre for the development of farm structures) in respect of subsidised employment contracts, "solidarity employment contracts" and "consolidated employment contracts". These were replaced in 2005 by the "employment assistance contracts" and "contracts for the future" instituted by the Social Cohesion Act. The consequent saving accounts almost in its entirety for the negative contribution of central government agencies to the change in public spending in 2004. The return to a positive contribution by these central government agencies in 2005 stemmed primarily from the growing role of the ANRU and the AFITF[9], together with trends in housing benefits paid by the FNAL[10].

2.2.2 The contribution of local governments

Trends in the contribution of local governments between 2002 and 2006 reflect three factors. First, they reflect the phasing-in of new policies entrusted to them by law. Spending related to the nationwide devolution of rail transport infrastructures to the regions in 2002 accounts for 0.2 percentage point of the local governments' contribution to the growth in public spending. The introduction of the long-term care allowance (APA-" allocation personnalisée pour l'autonomie") has had a more lasting effect, since its phasing-in contributed 0.3 percentage point to the rise in public spending in 2002 and 0.2 percentage point in 2003. Although not negligible, its subsequent influence is less significant.

The local electoral cycle is another factor helping to explain the rise in the contribution of local governments. After a degree of slack in local investment spending in the year following the municipal elections, local councils start implementing the projects for which they were elected. Spending rises to a peak in the year preceding the following election, which partly accounts for the exceptionally large rise in local investment in 2006[11]. The other explanatory factor concerns the boost given to the 2000-2006 management plans (signed between the State and local governments) by the privatisation revenue transferred to the AFITF in 2005. Overall, the increase in investment spending contributed 0.4 percentage point to the growth in public spending in 2006.

Finally, the rise in personnel spending was a major contributor to the overall growth in local spending. Its influence was particularly significant in 2002 and 2006. This was because 2002 witnessed an increase in local governments' labour forces, reflecting the impact of the law on the reduction of working hours. Pay increases contributed around 0.3 percentage point to the growth in public spending. In 2006, the increase in local governments' employees' pay contributed nearly 0.3 percentage point to the growth in overall spending. Over and beyond the various general and special pay review mechanisms, departmental and regional authorities appear to have been seeking to strengthen their managerial staffs preparatory to assuming responsibility for trunk roads and secondary-school technical, blue-collar and service personnel.

2.2.3 The contribution of social security funds

The high contribution of social security funds between 2002 and 2005 was sustained by fast rising healthcare spending. Their contribution came to around 0.7 percentage point in 2002 and 0.6 percentage point in 2003, notably due to a series of increases in healthcare prices and fees, before dipping to 0.5 and 0.4 percentage point in 2004 and 2005.

The contribution of old-age insurance spending over the period was more uneven, owing to the impact of increases in old-age allowances, but it was significant nevertheless. The decline recorded between 2002 and 2003 (from 0.7 to 0.5 percentage point) was subsequently offset by the implementation of new early retirement measures.

Moreover, deteriorating economic conditions account for the particularly high contribution-given the total amount of benefits paid-made by higher spending on unemployment benefits at the start of the period. This came to around 0.3 percentage point in 2002 and 0.2 percentage point in 2003. The effects on hospitals of the reduction in working hours and implementation of the "Hôpital 2007" plan are residual explanatory factors for the rise in social security expenditure over the period in question.

The 0.3 percentage point fall in the contribution of social security funds registered in 2006, on the other hand, stems from two factors, namely the slowdown in spending under the national healthcare expenditure target (ONDAM) (accounting for 0.1 percentage point), growth in which was limited to 3.1 % under the impact of the "Medicines Plan", and falling unemployment, leading to a saving on unemployment benefits paid out (accounting for 0.2 percentage point).

Pierre BEYNET and Hervé NAERHUYSEN

(9) (9) ANRU: *Agence Nationale de Rénovation Urbaine*-national urban renewal agency; AFITF: *Agence de Financement des Infrastructures de Transport de France*-French transport infrastructure financing agency.

(10) FNAL: *Fonds National d'Aide au Logement*-national housing assistance fund.

(11) Parliament voted to postpone the municipal elections to 2008 only in 2006.

Box 2: **The mechanism for consolidating expenditure among general government entities**

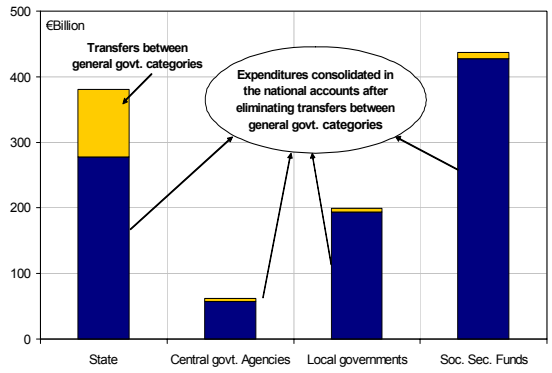
A simple example can serve to illustrate the notion of accounting consolidation. The "specific solidarity allowance" is paid by the Solidarity Fund, which is categorised as a central government agency, partly financed by a State grant. Adding together State expenditure and that of the central government agencies would result in double counting.

To consolidate public expenditure we eliminate these cross flows between general government entities. By convention, the expenditure is attributed to the sector receiving the transfer, i.e. to the one that mandates and validates the expenditure. In the foregoing example, the "specific solidarity allowance" is attributed to the Solidarity Fund and not to the State.

This convention whereby the expenditure is charged to the accounts of the receiving sector is legitimate, since the sectors generally enjoy a wide measure of autonomy in making their decisions as to the level and nature of their spending-e.g. the local authorities (in virtue of the principle of freedom to administer), or social security funds, which are partly managed by the social partners[a].

Consolidation thus provides us with a coherent picture of all sub-sectors over a given year. However, data need to be restated a second time for us to be able to compare spending trends: the spending "perimeter" needs to be homogenised by sub-sector year-on-year[b]. After restating for perimeter effects, the change in spending is calculated on the basis of a "rolling constant" scope, i.e. the growth rate for year N is calculated on the basis of the perimeter of spending in year N-1

Chart 11: consolidating public finances in 2006



Source: INSEE.

The restatements thus concern transfers of areas of competence from one sub-sector to another (e.g. decentralisation of administration of the RMI in 2004, or removal of transport investment from the budget with the formation of the French transport infrastructure financing agency-AFITF), or the reclassification of a general government entity from one sub-sector to another (for example, in 2005, the ORGANIC-the institution that manages old-age, disability and term life insurance-ceased to be a central government agency to become a social security fund)[c].

a. This convention may be open to discussion in the case of State operators. It might be conceivable in certain cases to attribute the expenditure to the sub-sector that originated the payment, which would require assessing case-by-case the greater or lesser degree of administrative autonomy enjoyed by the operators concerned. For the sake of simplicity, we have not explored this option here.
b. It is this tricky operation, mainly, that limits the reconstitution of long time-series.
c. The same holds for certain exceptional operations that durably or temporarily modify the perimeter of general government expenditure. Examples include the removal from the general government perimeter of the Direction des constructions navales (French Navy Shipyards) in 2003, or again pensions paid from 2005 onwards by the general old-age insurance scheme following the transfer to that scheme of the electrical and gas workers' pension scheme.

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Philippe Gudin de Vallerin

+33 (0)1 44 87 18 51

tresor-eco@dgtpe.fr

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Maryse Dos Santos

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