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# International relocation and deindustrialisation: some French perspectives

Catherine Mathieu and Henri Sterdyniak, OFCE

## 1. Introduction

General public debates on international relocation in the EU-15 generally focus on the process in its narrow sense: a company closing a plant in one of EU-15 countries while simultaneously opening a plant in a low-wage emerging country where it will produce goods at lower costs to be offered on the same market as previously. We will consider here relocation processes in a broader sense: production relocation from ‘Northern’ countries to low-wage economies, initiated by a ‘Northern’ company choosing to locate or to outsource part of or all its production in a Southern area; a ‘Northern’ company leaving its ‘Northern’ supplier of intermediate consumption purchases for a supplier in a southern country; a ‘Northern’ company of the trade sector leaving a supplier in a ‘Northern country’ for a supplier in a southern country; a ‘Southern’ company winning market shares over ‘Northern’ companies, first in its domestic market, then in third countries and finally in ‘Northern’ countries themselves. International relocation processes are difficult both to measure and to stop.

International relocation or in other words ‘delocalisation’ will be addressed in this paper from a French policy perspective. The issue was already very topical 12 years ago and focused on how to tackle relocation of traditional production industries, mainly textile (as well as shoe and leather) industries, from France to Asian newly emerging economies. At that time a number of politicians raised the issue of introducing fiscal measures to stop delocalisation (see Arthuis, 1993, Lauré, 1993). Among the ideas were: lowering taxation on low-skilled labour, introducing a social VAT, i.e. compensatory duties (*droits compensateurs*) on imports from developing countries (see Lauré, 1993, and, for a critical view, Mathieu and Sterdyniak, 1994).

International relocation and the domestic job losses involved became again highly topical in 2004, as elsewhere in Europe, with several reports being released: Fontagné and Lorenzi (2004), Grignon (2004) and Roustan (2004). The 2005 budget contains several measures aiming at promoting the attractiveness of specific French areas. It is worth noting that over the last 10 years, the policy debate has moved from supporting low-skilled employment in traditional industries to supporting high-tech industries and possibly employment in ‘sheltered’ services (see Letournel, 2004). Some French economists, like Messerlin (2004), think French labour, goods and services markets are too regulated and should simply be deregulated, with no other measures needed. But a majority of French economists think measures should be introduced either to support endangered industries or to favour the emergence of well-positioned industries.

Section 2 discusses the potential impacts of relocation from Northern to Southern countries and policy answers. Section 3 addresses global strategies aiming at promoting growth and competitiveness in line with the Lisbon Strategy based on research and innovation. Section 4 addresses proposals aiming at the promotion of top-priority sectors. Section 5 considers measures in favour of unskilled workers. Section 6 describes and discusses specific measures taken by the French government to stop relocation. Section 7 concludes.

## 2. Potential impacts of international relocation and policy answers

The emergence of low-wage countries in international trade has seven main impacts on Northern countries:

- 1) Imports from the 'South' rapidly increase their market share in Northern domestic markets, especially for goods requiring a high proportion of unskilled labour.
- 2) Southern countries rapidly increase their market share in Northern foreign markets, especially for goods requiring a high proportion of unskilled labour.
- 3) Southern countries increase their imports of capital intensive or skilled-labour intensive products made in Northern countries.
- 4) The low prices of Southern produced goods reduce price levels in Northern countries and thereby increase consumers' purchasing power in these countries.
- 5) The weakening of labour demand for unskilled workers and the threats of delocalisation exert a downward pressure on unskilled workers' wages. Depending on the country, these wages will either drop (which will raise inequalities and dampen consumption) or be maintained (which will contribute to raise unemployment). Depending on the country, taxation or social measures will be introduced, or not, to reduce the rise in inequalities.
- 6) Northern companies will try to sell on rapidly growing Southern markets and will invest less in the North. This explains part of the observed stagnation of company investments in some European countries.
- 7) Capital flows towards Southern countries and their exports' income lead to an appreciation of their exchange rate, except if there is a significant rise in Southern imports of capital goods produced in the North. This exchange rate appreciation limits the size of delocalisation. However Southern countries can avoid this to occur through accumulating foreign currency reserves, like China does.

The impact of the emergence of Southern countries on employment in the North must not only be considered from a global point of view in a long run perspective, but also in a medium term perspective (what are the adjustment costs for the productive system?) and in terms of employment structure: the cuts in unskilled jobs add to those resulting from technical progress. Even if they are smaller in numbers, they are more sudden and more concentrated in some specific sectors. Trading-off unskilled for high-skilled jobs is not necessarily good news for employment in the countries where unskilled unemployment is already high.

Should European countries implement policy measures to fight deindustrialisation, *i.e.* the decline of production industries both as a share of total output and in terms of employment levels? Three views are opposed. The free-market view states that deindustrialisation is a natural phenomenon for European economies. Production has already moved from agriculture to industry in modern economies. These countries should now rely on the one hand on high skilled jobs in research and development, innovation and management and on the other hand on employment in services. This is a *sine qua non* condition for raising productivity. No public policy should be implemented to stop the international relocation process. On the contrary, relocation should be encouraged through opening frontiers and allowing for free competition. The world market will set the level of wages of high skilled workers. Services sectors will remain widely sheltered from international competition, and hence the wage level of 'sheltered' workers in services will be set at a domestic level and will rise in line with high skilled workers employment. Wages should be set both in services sectors and for high skilled workers through a market process. There is no guarantee that the market equilibrium will be

socially acceptable and that income inequalities will not be excessive. But there is no alternative (TINA, as Margaret Thatcher said).

'Reformists' think that there is a significant risk for Europe to be badly positioned in world competition. First, research and development as well as education spending are too low. Second, there are a number of rigidities in terms of labour legislation, wage bargaining institutions and laws restricting dismissal. Second, the welfare state weighs strongly on sectors facing fierce competition from abroad. The European social model needs to be reformed in order to become more competitive. Risk taking firms and workers must be supported. This implies supporting well-performing and innovating industries. The growth of these sectors will compensate for the employment losses in unskilled industries. How should this support take place? Two views can be found. In one view, the general environment of companies needs to be improved, taxes need to be reduced, labour legislation must be reformed, incentives need to be introduced (through research tax credits for instance). In another view, support should be given to specific companies – helping the emergence of and supporting European champions – and to specific innovative sectors, like biotechnologies. To a certain extent this view is similar with the free-market one: more jobs in technology industries will increase the number of jobs available for 'medium' skilled workers, which in turn will make more jobs available for unskilled workers. Here also, the final degree of income inequalities is unknown.

Last, the 'archaic' view asks for specific support to be implemented in favour of unskilled labour as the functioning of economies *per se* raises social inequalities and makes unskilled workers unemployed, which cannot be accepted. Here also two views can be found. In one view, industrial sectors and national companies being in difficulty should be supported, a certain level of protectionism should be maintained, unfair competition should be fought, areas where employment is strongly affected should be subsidised. In another view, unskilled workers only should be subsidised, without interfering with production choices. These transfers may be found counterproductive because they benefit the losers and must be paid by the winners. Moreover, globalisation makes it difficult to raise taxes on high income people and healthy companies with a view to help people on lowest incomes and companies in difficulty. Individuals and companies subject to taxation may decide to leave for a country where taxation is lower.

### **3. Promoting growth and competitiveness**

The Lisbon Strategy and the Sapir Report (2003) claim for a successful 'way out' for Europe: making the European economy the most innovative of the world. The aim is to compete with the US but not with China; to export to rapidly growing markets rather than in slowly growing (or not growing at all) European markets and to specialise in high value added sectors.

More European and national resources should be devoted to higher research and development spending and to higher education, by creating 'excellence poles' in Europe. Structural reforms should take place to increase mobility and risk-taking incentives.

Specific taxation rules should be introduced for companies operating at a European level, in order to allow them to take advantage of economies of scale; markets should be more rapidly deregulated and open.

This strategy raises six issues:

- 1) The State should create a business-friendly environment rather than help specific companies. DG Competition prevents Member States from implementing industrial policies.

But, in many cases, supporting specific companies or research areas could prove more efficient to raise growth in Europe.

2) Is it possible to promote scientific education and research in a context where financial profitability is a major objective?

3) Should European economies accept the death of traditional industries that are the more labour-intensive, to concentrate on highly profitable activities involving a very limited number of very high skilled jobs?

4) Should European countries encourage their companies to develop mainly on external markets, at the risk of having the companies relocating their production abroad?

5) This policy leaves aside traditional sectors in difficulty. It gives an incentive to firms for leaving these sectors. Will the development of high-technology sectors be sufficient to bring back a satisfactory level of employment?

6) What kind of jobs can we offer to the manual-oriented young men, if no workers job are available in Europe ?

Some aspects of the Lisbon strategy can be found in French reports, suggesting for instance to support R&D and innovation through taxation measures (Grignon, 2004).

According to Fontagné and Lorenzi (2004), the importance of scientific and technical issues should be restored in the European culture and education. The European enterprise should be promoted. Funding innovation should be made easier. The Report lists 10 priorities. 7 of them are part of this strategy: developing technology universities (*Universités de technologie*); adopting a small business act; unifying the European innovation equity stock exchanges; increasing the role of the European Science Foundation; introducing a surveillance of the relocation of headquarters; introducing rules applying to 'European companies'; promoting mergers between European Member States companies.

Other suggested measures aim at increasing European attractiveness (Grignon, 2004):

- Improving the legislation of productive activities.

- Making easier new company launch and company ownership transfers (by inheritance or sale).

- Strengthening competitive advantages (quality of infrastructure, low energy prices)

- Promoting employability (higher education, professional training); deregulating labour markets; increasing flexibility and mobility

- Harmonising company taxation, public aid and social legislation in Europe.

- Promoting norms, patents and European labels.

- Promoting the harmonisation of social and environmental standards at world level and rewarding the fulfilment of these norms at an international level with the help of the consumers.

#### **4. Promoting high-priority sectors, implementing industrial policies again**

Among recent reports, Fontagné and Lorenzi (2004) suggest that competition policies and industrial policies in Europe should be rebalanced. Specific (*i.e.* restricted to a small group of European companies), industrial co-operation should be promoted, 'European champions' should be promoted albeit increasing the SMEs' capacity to adapt.

An aggressive strategy would consist in helping firms to produce higher-technology products for rapidly growing markets. Industry and innovation should become national priorities. Large programmes in top-priority sectors should be favoured.

Three priorities are listed: giving a 'brand name' to competitiveness poles; defining priority sectors at the European Council's level; setting a group of 3 European industrial managers to suggest initiatives supporting these sectors.

The Roustan Report (2004) suggests that State implements again a strategy to increase research funding and piloting innovations. The report recommends the issue to be tackled at the European level: less competition versus more industrial policies, research subsidies, tax harmonisation and rebuilding local area attractiveness through local public action. The Report also underlines that European enlargement may provide higher growth.

The Grignon report (2004) calls for a 'new-colbertism', in other words for a European industrial policy: implementing a sector approach by launching large innovative projects in rapidly growing sectors; defining the sectors to be promoted; improving parallel conducts of competition and industrial policies. It suggests using the EU trade policy to help the industry. It also recommends that the State supervises production processes (*filières de production*).

Beffa (2005) suggests the implementation of industrial policies again. The strategy would consist in launching programmes promoting industrial innovation ('PMII': *programmes mobilisateurs pour l'innovation industrielle*). Companies, experts and public servants would define innovative industrial sectors (like hydrogen production chain, biofuels, high-definition secured networks); big companies would receive subsidies if they develop research in these fields (50% of research expenses being covered by public funding) and would have to develop their network with small or medium size companies. So France would have 'national champions' in high-tech sectors (France currently has a too strong specialisation in nuclear, space and military sectors). The report leaves a question open: at what level should this policy be settled? Should it be at the French level (with a notification to European institutions) at the European level or within restricted cooperation between a small number of countries (like France with Germany)?

### **Competitiveness Poles**

The development of 'competitiveness poles' (*pôles de compétitivité*) designed to help activity in given geographical areas is also a key measure of Datar's strategies, as is the support for the building of firms networks (clusters). Competitiveness poles should be given a 'brand name'; they should be advertised and benefit from lower taxation. Dedicated risk-capital should be developed, transport and telecommunication infrastructure should be provided. The link between national and European policies remains difficult to tackle.

Both Grignon and Roustan Reports suggest a strengthening of the role of local administrations in supporting local firms and employment.

## **5. Supporting unskilled employment**

Two strategies are often suggested to compensate for the negative effect of foreign relocation on employment. The first one would be to increase the level of employment in sheltered services, like construction, tourism, hotels and restaurants sectors (see Letournel, 2004 or Grignon, 2004) or to increase the size of the services to households' sector (see Debonneuil and Cahuc, 2004). This would be done through tax incentives (allowing individual employers to benefit from lower social contributions as is already the case for companies), and through restructuring measures (making the services sectors more industrial and professional). The

French government has introduced such measures in February 2005. But this strategy may be difficult to implement due to social habits (getting used to hiring employees is something that needs to be learnt by households) and because of the reluctance of young people to apply for such jobs. This strategy implies a rise in income inequalities.

The second strategy consists in cutting unskilled labour costs. Since 1985, companies get a rebate on their contributions on low wages, up to a maximum of 26 percentage points of employers' social contributions (in 2005, on a total of 40 percentage points) for workers at minimum wage levels. This reduces by 18.6 % the cost of the minimum wage for firms. Besides, low-wage workers benefit from a refundable tax credit of 4.6 % of their wage earnings in order to increase the gap between the minimum wage and the minimum income entitled to adults unemployed and not entitled to unemployment benefits (*RMI: revenu minimum d'insertion*). This is a 'making work pay' measure. The social contributions' rebate measure gives companies an incentive to hire unskilled workers (especially in services sectors) and can also help keep companies hiring a high level of low skilled labour stay in France. These measures cost 17.5 billions of euros by year in the French budget (1% of GDP). The social contribution's rebate is estimated to have increased the number of jobs by 400,000. These rebates have the advantage of breaking the link between unskilled labour costs and the living standard of unskilled people. But they are costly for the Social Security budget on which they are funded and they lead to the creation of specific low-wage jobs with no career prospects.

The Grignon Report (2004) recommends a measure often suggested in France in past years, which would consist in abolishing (or significantly cutting) employers' social contributions and simultaneously increasing VAT. This reform aims at making the social security system being funded by consumption expenditures (and especially by imports) rather than by wages. The reform would entail competitiveness gains and cut wage costs in labour intensive sectors hence raising employment. In our opinion, the reform would be totally ineffective because the VAT weighs on wages (like employers' social contributions) and not on capital goods (see Sterdyniak and Villa, 1998). Competitiveness gains would arise only if the rise in the prices of imported consumer goods resulting from higher VAT had no impact on wages, meaning that consumers would see their purchasing power reduced.

## **6. The French fiscal measures**

The French government has introduced a significant number of measures, more or less successful, to prevent foreign relocation. These measures aim at providing an incentive for companies settling or to staying in France. They compensate partly for the high level of taxation in France. At the same time, they add to tax competition.

Since 2003, bonuses paid to foreign 'high skilled' foreign employees working in France have been exempted from income tax. This measure aims at attracting headquarters and research departments of big companies in France. The risk is that all countries introduce similar measures and raise tax competition at the expense of the distributional goals of income taxation. 'High skilled employees' will be less taxed if they work abroad than if they work in their country. These measures will be increased in 2005. In that field, European harmonisation would be useful.

A research tax credit has been introduced in 2004 allowing companies to benefit from a subsidy equal to 45% of the annual increase in their research and development expenses plus 5% of the amount spent. But, due to the European legislation, the tax credit has a relatively low ceiling. It would be useful to allow States to subsidize more significantly private research.

The 2005 budget has introduced several measures against the relocation process. First, companies relocating in France their existing production in non-EU countries benefit from a tax credit. Due to the European rules, this credit has a maximum of euros 100,000 in a three-year period by company (50% of labour costs the first year, then 40%, 30%, etc.)

Second, the French budget contains a number of measures designed to improve the attractiveness of French areas ('competitiveness poles'). The idea is to give fiscal incentives to companies investing in high technology production in specific geographic areas. These poles must bring together Universities or training centres, public or private research centres, small and big firms, working together in innovating or specific production processes. These networks are expected to stop foreign relocation of these specific production activities.

Last, companies operating in areas said to be 'exposed to foreign relocation' (areas with a high level of unemployment rate and a high share of industrial employment) are entitled to a tax credit of euros 1000 per worker.

In all three cases, the measures have a limited amount. The costs expected in the 2005 Budget are respectively of 10, 50 and 330 million euros in 2005. Until now, these strategies are purely national and European rules are there to prevent their expansion. Is this a sustainable position for industrial policies in Europe?

France has suggested increased tax harmonisation in Europe, which would raise difficult issues, because Member States wish to keep domestic fiscal autonomy and also because low taxation rates are sometimes a convenient way to compensate for insufficient infrastructure, low levels of economic development or company subsidies not being allowed. Making sure that the profit tax is based on the source principle, and not on the origin principle, would avoid purely tax-motivated relocation. More, the fight against tax heavens should be strengthened at a European or world levels. Companies and financial institutions should not be allowed to have branches in or to transfer funds to these countries.

Company taxation amounted to 6.6% of GDP in France in 2002, ranking France 2<sup>nd</sup> in the EU-15, behind Luxemburg, against 6.4% in Italy, 5.2% in the UK, 3.5% in the US, 3% en Spain, 0.9% in Germany (where the figure was exceptionally low due to the tax reform). The current profit tax rate is 34.3% in France, at the level of the European average. It may be necessary to cut it down to 33.3%, but the effort to be done is limited (1.7 billion euros). The problem is not the level of profit taxation itself, but the fact that the wage tax (*taxe sur les salaires*), the tax on real estate (*taxe foncière*) and the professional tax (*taxe professionnelle*) add to profit taxation.

The professional tax is currently based on tangible assets (real estate and equipment) and particularly affects production industries. Reforming this tax has been debated for a long time. Recently it has been suggested for instance in the *Roustan Report* (2004) and the *Grignon Report* (2004). The government has promised to reform the tax in 2006, without affecting local administration funding and without increasing households' taxation. The new tax could possibly be based on value added (at the expense of trade sectors and financial institutions).

The French government refuses to undertake a global competitiveness strategy that would consist in cutting directly wages or reducing company taxation together with lower public and social expenditures. In general, the search for competitiveness gains may be worthless, since the rise in competitiveness will be cancelled between European countries while European demand will be lower. But the recent example of Germany cutting domestic labour costs to win competitiveness and hence depressing domestic demand illustrates that an isolated and non co-operative strategy can always be a temptation for a country.



## 7. Conclusion

The French government introduced several years ago cuts in employers' social contributions on unskilled work. It has recently opted for helping high-tech sectors and specific French areas, the 'competitiveness poles', rather than implementing additional measures in favour of unskilled labour in traditional industries (textile, etc). It remains to be seen how many jobs this new policy will generate. Besides, the French government is in favour of promoting the emergence of 'European champions'.

The interconnection between national and European policies remains an issue to be tackled. Three answers to deindustrialisation may be considered in Europe, mirroring different political and social issues. First, some governments could choose to implement domestic measures, but would be stopped by European authorities, in the name of free competition rules. Second, some governments could implement measures without the European authorities interfering, but this would not be optimal: is it reasonable or advisable that a Member State introduces alone domestic taxation measures strengthening tax competition in Europe? The other risk is that national measures would be limited by the fear of European reactions. The best strategy would be that European countries adopt a common strategy at the European level. European authorities could reduce the importance they give to competition policy, initiate a reflection on the future of productive activities and employment in Europe and promote a European industrial policy as part of the Lisbon strategy.

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