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FUNDING THE MODERN STATE:

THE INTRODUCTION OF VALUE ADDED TAX IN FRANCE[*]

The period of the 'great boom' was characterized in France as elsewhere in western Europe by a greatly increased role for the State in the national economy. Government expenditure as a proportion of GDP rose steadily, the pattern of expenditure changed with increasing amounts being spent on new areas of activity such as health, economic services, housing and pensions, and the sources of revenue also changed, with greater reliance being placed on taxation to fund public expenditure.[1] Indeed, it is claimed that higher taxes were implicit in Europe's postwar settlements and, contrary to growth theory, were actually conducive to economic growth.[2]

While considerable scholarly attention has been focused on the nature of government expenditure there has been much less interest in the sources of government revenue. With taxation generally seen as a "dry topic, second only to death in certainty and dreariness"[3], the question of which taxes governments raised and what impact those taxes had on the economy, is not explored.[4]

In 1954-55 the French government reformed its fiscal system with the introduction of

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*. I would like to thank both the British Academy and the Nuffield Foundation for their assistance in funding the research on which this paper is based.

1. Angus Maddison, *Dynamic Forces in Capitalist Development*, Oxford 1991.

2. Centre for Economic Policy Research, "Golden Years", in *European Economic Perspectives* No. 12, February 1997.

3. Cathie Jo Martin, "American business and the taxing State: Alliances for growth in the postwar period", in W. Elliot Brownlee (ed.), *Funding the Modern American State, 1941-1995*, Cambridge 1996.

4. This is no longer true of the United States, where interesting research into the history of taxation is being undertaken. See Brownlee (ed.), op. cit.

a new tax on value added to replace the existing taxes on production and sales. This change in the tax system, which was to increase its elasticity, was ultimately what permitted public expenditure to grow. In fact VAT was soon to become the mainstay of the entire fiscal system in France. It was subsequently adopted by the European Community as the common form of indirect taxation in all member states and by many other countries throughout the world. Indeed it has been claimed that in the history of taxation no other tax has swept the world as VAT has done over a thirty-year period.[5] This makes the history of fiscal reform in France of international as well as national importance. Why should France have been the first country to introduce a tax which had been under discussion in Germany since the 1920s, and had been proposed by the American occupation authorities in postwar Japan only to be rejected by the Japanese parliament?

The most common explanation, and the one espoused by tax experts, is that VAT evolved through a process of continual refinement of the fiscal system.[6] Having once in recent times overturned the entire structure of their regime's taxes, the French were more predisposed than most to question their fiscal system and to modify it, according to Carl Shoup, a leading American tax expert and the author of the Japanese reform proposal. Why the French should have accepted a system which relied considerably more on socially-regressive indirect taxes than on direct taxes has been attributed to cultural factors such as the

[5]. A. Tait, *Value Added Tax. International Practice and Problems*, IMF, Washington D.C. 1988.

[6]. Jean-Yves Nizet, *Fiscalité, économie et politique. L'Impôt en France 1945-1990*, Paris 1991; and Carl S. Shoup, "Some distinguishing characteristics of the British, French and United States public finance systems", in *The American Economic Review*, Vol. XLVII, May 1957, No. 2.

low degree of civic consciousness of French people.[7]

Neither of these explanations is satisfactory. The fact that it took almost fifty years and two hundred parliamentary bills before the system of direct taxation inherited from the Revolution could be reformed, does not fit with Shoup's analysis. Indeed, it was the reluctance of the French people to accept changes in the system of taxation in the period between the French Revolution and the Second World War which most impressed French economic historians. Bouvier and Wolff explained this inertia in terms of the slow rate of change of the French social structures.[8] Similarly, the theory that Latin people do not pay their taxes has been disproved, not least by the experience of the post Second World War period in France.

Research based on detailed documentary evidence in France reveals a much more complicated picture. French fiscal reform stemmed from four separate but inter-related factors. The first was the rapid growth in government expenditure after the Second World War and a decline in the willingness of French people to lend money to the government. The second was that the tax system was seen to be profoundly inequitable, with reforms being a constant preoccupation of postwar governments. Thirdly, the tax system was considered to be inefficient and open to wide-scale fraud. And finally, the tax system was seen to favour and protect archaic and inefficient methods of production. However, not all these factors were of equal importance, as will now be explained.

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[7]. C. Webster and A. Wildarsky, *A History of Taxation and Expenditure in the Western World*, New York 1986.

[8]. J. Bouvier and J. Wolff (eds.), *Deux Siècles de fiscalité française, XIXe - XXe siècles* (Paris, 1973).

AN OVERVIEW OF FRENCH FISCAL HISTORY

In 1945 the fiscal burden (taxation as a proportion of national income) was light in France compared with Britain or the United States.

Table 1. Taxation as a Proportion of National Income

	1938	1945
France	20.9	21.0
United States	25.6	34.1
Great Britain	24.1	40.1

Source: Ministère des Finances, *Inventaire de la situation financière* (Paris 1951).

The structure of taxation was also quite different. The French collected anything from a quarter to a third of their revenue from direct taxes, compared with over a half in Britain and three-quarters in the United States. And whereas the system of direct taxation had changed very little since its introduction by Joseph Caillaux during the First World War the system of indirect taxation had been modified constantly.

The system of direct taxation was based on a general income tax introduced in July 1914 and on a number of scheduled taxes levied on distinct categories of income which in 1917 replaced the four direct taxes inherited from the French Revolution.[9] These schedules

[9]. The *Quatre Vieilles* introduced between 1790 and 1799 were:

- the land tax (*contribution foncière*), a tax of 16 per cent on income from lands and buildings;
-the personal income tax (*contribution personnelle mobilière*), a tax of 5 per cent on individual incomes;
-the so-called "patente" tax (*patente*), a proportional tax based on the rental value of business premises;
-the windows and doors tax (*impôt des portes et fenêtres*).

United States Treasury, "Income Tax Laws of France", prepared in the office of the General Counsel for the Department of the U.S. Treasury, 1938.

included for the first time income from salaries and wages. Six different schedules were created: 1) income from property, 2) income from land, 3) agricultural profits, 4) industrial and commercial profits, 5) wages, salaries, pensions, annuities, and 6) profits of non-commercial professions.

In addition there was a seventh category, which was not strictly speaking a schedule: that of income from certain types of securities and investments (*impôt sur le revenu des valeurs mobilières*). This tax had been introduced in 1872 and although it was clearly a tax on income it was collected by the Administration of Indirect Taxes. It was withheld at source by the bank or corporation.

The general income tax introduced in 1914 was superimposed on the scheduled taxes as well as on income from securities and investments. While the scheduled taxes were levied at a flat rate in excess of a minimum the rate of the general income tax was graduated and increased from one per cent on the first 10,000 francs of taxable income to forty per cent on taxable income exceeding 1,320,000 francs.

While some of the scheduled taxes were based on actual income, others were assessed somewhat arbitrarily on the basis of estimated income according to what was known as the "*forfait*" system. Under this system, the taxpayer submitted a number of crude indicators such as volume of sales, size of stocks, or number of employees, to the tax authorities, who then used a formula to estimate the income. At the outset in 1917 the tax on industrial and commercial profits was based on the *forfait* system. In 1920 this was replaced by assessment on the basis of actual net profits, but then changed again in 1934 to allow small firms which could not afford accurate book-keeping to choose either method.[10]

The tax on farmers' incomes was based throughout the war and interwar period on a

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[10]. Min. Fin. Z 809, "Assiette forfaitaire de l'impôt".

variant of the *forfait* system. Curiously there was no definition in French law of "agriculture", which gave the tax administration greater freedom in determining the type of activity subject to this tax, than was the case for industrial or commercial profits. The most common practice was for assessment of agricultural profits to be made on the basis of the rental value of the land (cadastral revenue), which was itself an estimated value for the purpose of the land register. The reason for assessing tax on the basis of estimated profits was because farmers were not required by law to keep books and accounts.[11] At a time when the contribution to the war effort in terms of human lives of this section of the population was disproportionately high, there was little enthusiasm for adopting a punitive tax regime for farmers.[12]

However, the consequences of this policy were that minimal revenue was raised from the agricultural sector. In 1941, the year that the system was reformed, the taxes paid by the agricultural sector were 0.5 per cent of those paid by wage and salary earners.[13] The central feature of the 1941 reform was that the tax on agricultural profits was to be determined by applying different coefficients in each *département*. These coefficients were calculated by comparing average profits per hectare with average rental value of the land. In homogeneous *départements* only one coefficient was applied, whereas in *départements* with distinct agricultural regions, several coefficients were used. This reform did increase the tax paid by the agricultural sector, although by 1945 it was still only about 6.6 per cent of that paid by

[11]. Ibid.

[12]. Jacques Wolff, "Fiscalité et développement en France entre 1919 et 1939", in J. Bouvier et J. Wolff (eds.), *Deux siècles de fiscalité française, XIXe-XXe siècles*, Paris 1973.

[13]. Ministère des Finances, *Inventaire de la situation financière* (Paris, 1951), p. 460.

wage and salary earners.[14]

Altogether, the burden of direct taxation was very unevenly and inequitably distributed across different groups, as can be seen from Table 2.

Table 2. Distribution of Direct Taxes

	1935	1938	1946
		(% of total)	
Wages and salaries:	9.6	10.4	43.0
Industrial and commercial profits:	27.8	26.5	32.6
Profits from non-commercial professions:	2.8	2.1	3.0
Agricultural profits:	0.2	0.3	3.0
Income from land:	17.8	11.2	4.4
Income from securities & investments:	41.8	49.5	14.0
Total	100	100	100

Source: Ministère des Finances, *Inventaire de la situation financière* (Paris, 1951).

In 1946 the share of total direct taxes paid by those on fixed incomes had more than quadrupled compared with pre-war, while that of securities and investments had declined by almost the same amount. Since the tax on income from securities and investment was also withheld at source[15] the decline must have been due to a decline in distributed profits. However, there was no correspondingly large increase in the revenue from profits tax. Since tax rates were roughly comparable across schedules, the uneven returns indicated either a high level of fraud, or a greater ability to avoid paying taxes legally.

In comparison with the system of direct taxes, the system of indirect taxes had been changed many times since the First World War. In 1917 the French government, following the German example, had wanted to introduce a tax which would have a high yield and

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14. ibid.

15. Since 1939 the tax on wages and salaries had been withheld at source.

follow the movement of prices. For this reason, it introduced a stamp duty on all payments. All retail trade was included. But the yield fell far short of expectations. In 1918 160 million francs was raised, whereas 1150 million francs was predicted. The experiment was abandoned and the tax was replaced in 1920 by a turnover tax (*taxe sur le chiffre d'affaires*) at a rate of 2 per cent for all goods except luxuries, where the rate was higher, and for essentials, mainly foodstuffs, which were exempt.

The tax produced a high yield, but quickly came under attack for a number of different reasons. It was criticized for pushing up prices, and for giving the Ministry of Finance access for the first time to the accounts of industrialists and traders. More serious, perhaps, was the charge that the cascade tax pushed up the price of exports, since only the last stage of tax could be reclaimed when a product was exported. The export price therefore included all previous taxes. It was also seen to distort the structure of production by favouring large integrated concerns. The government composed of Radicals and Socialists which was elected in 1924 promised to abolish the tax, although it succeeded only in modifying it. In 1925 it created a single *ad valorem* tax collected at one or more stages of production on specified goods. Each year until 1934 the list was extended, but since the turnover tax was not abolished, the system became increasingly complex and entirely defeated the reforms of 1925.

In 1936 the Popular Front government did manage to abolish turnover taxes, replacing them with a single tax on production. The underlying principle of this tax was that manufacturing could be divided into two processes: production and distribution. The production tax of 6 per cent was imposed as a good passed from one sector to the other. When it was introduced in 1936 it was based on an annual statement made by the producer to his supplier, checked by the tax authorities and according to which the producer assumed responsibility for paying the tax or delivering the product to another producer, in which case tax was suspended. Although in theory the new tax greatly simplified the system of indirect tax, in practice it introduced a number of new complications. Firstly, the definition of production was often contested. Secondly, depending on the number of producers involved in the production process and thus the number of times that tax was suspended, the system could be open to abuse.[16]

By exempting small artisans from the tax it gave them a great advantage over larger firms and encouraged the splitting of businesses into segments in order to take advantage of the exemption.[17] As a result the production tax was soon to prove insufficiently elastic to meet the needs of rearmament, and in 1939 the cascade tax had to be re-imposed, initially under the name of an armaments tax, and later a transactions tax. The rate of the production tax was raised to 15.35 per cent in 1940. A local tax was introduced on retail trade in 1942 at a rate of 0.25 per cent and finally a luxury tax was levied in 1943.[18]

PUBLIC EXPENDITURE IN FRANCE AFTER 1945

At first it seemed as if public expenditure excluding social security would follow a similar pattern after the Second World War to that after the First World War. In other words, after a period of expansion due to the needs of reconstruction, it would fall, but then stabilize at a level higher than the prewar level.

Indeed, expressed in terms of GDP, public expenditure was no higher after 1945 than

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16. Nizet, *op. cit.*, p.35.

17. John F. Due, "Sales Taxation in Western Europe, Part II", *National Tax Journal* vol. VIII no. 3, September 1955.

18. Min. Fin. Z 815 "Evolution historique des taxes sur le chiffre d'affaires".

after 1918. However, after falling in 1949 it rose again in 1950 and continued to rise until 1958. This was partly due to the American pressure on its NATO partners to increase their defence spending after the outbreak of the Korean War and partly due to the cost of France's own colonial wars.

Table 3. Public Expenditure as a Proportion of GDP at Constant 1938 Prices

Year	State	Local Authorities	Social Security	Total
1872	8.2	2.8	0	11.0
1912	8.8	3.8	0	12.6
1920	27.8	5.0	0	32.8
1929	13.6	5.1	0.1	18.8
1938	20.1	5.5	0.9	26.5
1947	29.0	3.7	8.1	40.8
1948	30.4	4.1	6.5	41.0
1949	27.0	4.7	6.6	38.3
1950	28.9	5.3	6.9	41.1
1951	27.0	5.2	6.8	41.0
1952	31.9	5.3	7.0	44.2
1953	34.8	5.9	7.9	48.6
1954	34.8	6.2	8.6	49.6
1960	29.1	6.8	10.5	46.4

Source: Ch. André & R. Delorme, *L'Etat et l'économie*, Paris 1983, p.728.

Table 4 Defence Expenditure as a Proportion of Total Public Expenditure in France 1872-1980

Year	
1872	26.4
1912	41.1
1921	30.4
1929	28.0
1938	40.7
1947	32.4
1948	20.6
1949	21.8
1950	20.9
1951	30.1
1952	36.2
1953	36.3
1954	32.7
1955	27.5
1960	27.9

Source: André and Delorme, *op. cit.*, p.727.

However, this increase in defence expenditure, while not high by historical standards in France, did nonetheless raise problems for the French Treasury, since much of the new public expenditure after the war in civil investment and welfare had been financed by reducing the proportion of defence spending in the budget. It had also been financed by using the counterpart of Marshall Aid - a source which was due to expire in 1952. Whereas French governments had relied in the past and particularly in the nineteenth century on covering a large part of their expenditure through private loans[19], after 1945 this was no longer an option. The problem was that it took several years for the French State to accept that it could no longer try to secure its legitimacy by raising money internally. The attempt

[19]. On the eve of the First World War, the French State, it is claimed, was the most indebted in the world. D. E. Schremmer, "Taxation and public finance: Britain, France and Germany", in Peter Mathias and Sidney Pollard (eds.), *The Cambridge Economic History of Europe*, vol. VIII (Cambridge, 1989) p. 399.

by Prime Minister Antoine Pinay to solve the budgetary problems caused by re-armament by issuing a loan in 1952 was to mark the end of this illusion.

PROPOSALS FOR FISCAL REFORM

It is somewhat surprising that taxation scarcely featured on the reform agenda for postwar France of the French Resistance. Even though the reforms demanded by it and written into the Charter of the *Conseil National de la Résistance* (CNR) called for a greatly enlarged role for the State in French economic life, no provision was made for ensuring that the State would be able to finance its activity in a non-inflationary way. Given the social diversity of the resistance groups, all that could be agreed was that those who had profited from collaboration should have their assets confiscated.[20] Thus the laws of 18 October 1944 and 6 January 1945 were designed solely to confiscate "illicit" profits and left intact the wealth made since 1940 and the structure of taxation. Some attempt to remedy this was made with the introduction of a national solidarity tax on 15 August 1945. This took the form of a levy on wealth as assessed on 4 June 1945 as well as a contribution from profits made between 1 January 1940 and 4 June 1945, calculated on a progressive scale from 3 to 20 per cent.[21] The returns fell well below expectations and were even considered to have contributed to inflation, since firms were able to pass them on through higher prices to the consumer.[22] As a result tax revenue covered only 45 per cent of government expenditure in 1945.

Of course, this deficit was due in part to the low level of economic activity and could

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20. Nizet, op. cit.

21. Min. Fin. 1A 394. "L'évolution de la législation fiscale de juin 1940 à l'époque actuelle."

22. INSEE, *Le Mouvement économique 1944-1957*, (Paris, 1958).

be expected to shrink as the economy recovered from the war. Apart from the socialists who insisted that all normal public expenditure should be financed from taxation,[23] the expectation was that some, particularly the "exceptional" expenditure arising from the need to modernize the economy, could be raised through voluntary loans.[24] However, given the increasingly inequitable distribution of the burden of direct taxation, as is clear from Table 2, no government could resist for long the pressure to reform the fiscal system.

In 1946 the government responded to this pressure by setting up a special committee on tax reform, composed of representatives of the government, the trade unions, civil servants, tax officials, technicians and different categories of taxpayers. While it stimulated several proposals for fiscal reform due to the fact that almost everyone had a grievance, it was unable to produce a majority report.[25]

One of the earliest proposals for tax reform, and by far the most comprehensive, came from the Communist-dominated trade union, the *Confédération Générale de Travail* (CGT). Motivated by both the injustice and the inefficiency of the fiscal system, it called for a number of changes in both direct and indirect taxes and in the administration of the fiscal system itself. These included the replacement of the various income taxes by a single, uniform income tax, based on actual income rather than the '*forfait*', an annual tax on wealth, the introduction of a tax on business in the form of a tax on value added to replace the existing multiplicity of taxes on sales or turnover, and the merging of the tax administrations

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[23]. *Journal Officiel*, 1945, "Budget des services civils pour l'exercice 1945", intervention by Jules Moch, 7/2/45.

[24]. See Frances Lynch, *France and the International Economy: from Vichy to the Treaty of Rome* (London, 1997), Chapter 4.

[25]. W. Baum, *The French Economy and the State* (Princeton, 1958), p.164.

into a single one with greater powers of control.[26]

It was the administrative reform which was in fact the least contentious. Under two decrees in March and April 1948 a single Tax Authority replaced the four separate divisions which had jealously guarded their independence since the French Revolution. These were: the bureau of direct taxes, the bureau on indirect taxes, the customs bureau and the bureau of registration and stamp taxes.[27] This was to mean that taxation could be considered from a single perspective, thereby reducing some of the rigid distinctions between direct and indirect taxes. It was also designed to simplify the collection of taxes and thereby reduce the level of fraud.

However, the CGT's proposal to replace the production tax and the transactions tax by a new tax on value added did provoke considerable criticism. The CGT argued that from the perspective of pure economic theory a tax on final consumption would have been preferable to a multi-stage tax on value added. In practice, though, the collection of a tax at a single stage called for a high rate which then encouraged the black market, as the luxury tax introduced in France in 1943 had demonstrated. On the other hand a multi-stage tax which was also cumulative, such as the transactions tax, was seen to discriminate unfairly against small specialist firms in favour of large firms which were vertically-integrated. One merit of the value-added tax was seen to be that it would expose fraud since declaration of the value of sales and purchases would have to be made by firms at different stages of production and distribution. Another was that it would furnish the State with a more accurate picture of what was happening in the economy. The CGT proposed a

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[26]. Min. Fin. B28370, "CGT Projet de Réforme Fiscale", 25.4.47.
Min. Fin. B51739, "Exposé du projet de réforme de la CGT", 10.1.47.

[27]. Carl Shoup, "Taxation in France", *National Tax Journal*, vol. VIII no. 4, December 1955.

rate for VAT of 10 per cent across the board. The only exception envisaged was on exports if it proved necessary. Even then, only the exporter of the final product was to be reimbursed. It was estimated that the final price to the consumer would not be affected by the introduction of VAT although the structure of intermediate prices clearly would be.[28]

Many of these arguments won support within the fiscal reform committee. Maurice Lauré, an '*inspecteur des finances*', criticized the complexity of the existing system which allowed different exemptions to apply to the transactions tax, the production tax and the local tax, and which often turned the production tax into a cumulative tax. Pierre Uri, from the *Commissariat au Plan*, positively welcomed the introduction of VAT if it were to be applied to the agricultural sector as well as to the products consumed by it. Not only would this increase public revenue, he argued, but it could promote the modernisation of agriculture by reducing the extent of home consumption.[29] However, the majority of the Committee on Tax Reform criticized the CGT's proposal on a number of grounds. It was felt that it would not be practical to apply VAT to small firms which in most cases lacked proper accounting procedures, nor to abolish all exemptions. It was also argued that if only the final exporter were to be eligible for a tax rebate this would encourage the exportation of semi-finished goods, which would be harmful to the French economy as a whole. The defenders of the production tax argued that it had been set up precisely to reduce the number of firms liable to pay it, as well as to encourage exports. But by far the most serious criticism was levelled against the CGT's definition of value-added. Since this included not only the difference in value between sales and purchases but also changes in the value of stocks, it was argued that

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[28]. Min. Fin. B 28370. Projet de réforme fiscale, CGT 25.4.47

[29]. Min. Fin. B 28334. Meeting 16 July 1948.

this would effectively mean that profits were being taxed twice.[30] As far as the CGT was concerned this was fully justified, since firms were able to reduce their liability to pay profits tax in the short term by accumulating stocks. In a period of rapidly rising prices, stockpiling served as a hedge against inflation whilst at the same time contributing to inflation. This expansion of stocks could also have explained the low tax returns on income from interest and securities, seen in Table 2.

Despite the failure to reach agreement on tax reform, the trend was for taxes to cover a larger proportion of government expenditure in 1946 and 1947. However, in 1948, despite the exceptional taxes levied by Finance Minister René Mayer in January 1948, this trend was reversed. Furthermore, while the government was counting on being able to use the counterpart of Marshall Aid to cover some of the deficit, the American Economic Cooperation Administration in France was to make the release of counterpart conditional on a reform of the French fiscal system.[31] This condition enabled the government to win a derogation from the 1946 Constitution and introduce such a reform by decree.

THE 1948 FISCAL REFORM: AN ATTACK ON FRAUD

The underlying assumption of those who drafted the reform bill introduced by Finance Minister Maurice Petsche on 8 December 1948 was that the basic structure of the French fiscal system was sound, obviating the need for a radical reform.

[30]. B 28343. 20th meeting of the Committee on Tax Reform, 28 July 1947.

[31]. N.A.V.S. RG 286 memo from D. Bruce, December 1948.

Table 5 French budgets, 1945 - 1957 (in thousand million francs)

Year	Total Expenditure	Fiscal Receipts	Tax Revenue as a proportion of expenditure
1945	523	238	45
1946	681	462	68
1947	914	685	75
1948	1591	1050	66
1949	2047	1487	73
1950	2380	1770	74
1951	2905	2203	76
1952	3623	2579	71
1953	3751	2814	75
1954	3840	2965	77
1955	4092	3102	76
1956	4767	3479	73

Source: INSEE, *Le Mouvement Economique en France de 1944 à 1957* (Paris, 1958).

In September 1948 the Ministry of Finance had made some changes to the way in which the production tax was collected, simply in order to increase its immediate yield. This entailed replacing the 'suspension of tax' provision (whereby the tax was paid only by the final producer) by a system of fractional payments. This meant that each manufacturer all along the line from raw material to finished commodity would pay a part of the tax.[32] As a result of this change in indirect taxes, the focus of the fiscal reform proper of December 1948 was on direct taxes. As Maurice Petsche explained to the National Assembly, the objective of the fiscal reform was two-fold: to equalize the fiscal burden, and to simplify the legislation. The intended result was to reduce fraud and increase tax revenue. For the first time ever, a distinction was to be made between the income of private individuals and that of companies. In each case it was the total income from all sources which was to be taxed together rather than separately under the different schedules.

32. Carl Shoup, "Taxation in France", *op. cit.*

The personal income tax consisted of a proportional income tax and a progressive surtax. The proportional income tax was a flat tax levied at 18 per cent on income from all sources with no deductions at the base and calculated on the basis of a direct evaluation by the taxpayer. It was not applied to income from wages and salaries, while artisans, small businessmen and professionals continued to have the option of substituting the 'forfait' system for a personal assessment. The progressive surtax was then levied on top of the proportional income tax at nominal tax rates rising steeply from 10 to 60 per cent. Although the scale of the new surtax above the first 10 per cent was exactly the same as that of the general income tax which it replaced, in practice it favoured those on higher incomes, although the rise in prices disguised this bias.

The tax on corporate profits was levied on all business firms organized in the legal form of corporations, at a uniform rate of 24 per cent. Where the profits were distributed they were taxed again at 18 per cent under the proportional tax and possibly again under the progressive surtax.[33] The new corporation tax attracted particular criticism from the Left when the fiscal reform decree was debated in the National Assembly later that month. It was pointed out that whereas undistributed profits were to be taxed at 24 per cent, they would previously have been taxed under the '*bénéfices industriels et commerciaux*', often at 28 per cent. Distributed profits which were not put into reserves would be taxed at 18 per cent under the *taxe proportionelle* instead of at 30 per cent under the tax on income from securities and investment.[34]

The tax reform was therefore not seen to have created a fairer system but simply to

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[33]. Baum, op. cit., pp. 132-138.

[34]. Journal Officiel, 1948. 2e séance du 21 décembre 1948. "Maxima des dépenses et voies et moyens pour 1949", intervention by M. Gaston Auguet.

have favoured large companies and shareholders. However, judged by the two objectives of reducing fraud and increasing tax revenue, the fiscal reforms of December 1948 were considered to have been a success. It was calculated that between 1949 and 1951 receipts rose by 590,000 million francs, of which 340,000 million francs were due to an increase in prices and production and 250,000 million francs were due to an increase in tax rates and the reduction of fraud. Indeed, over the whole period between 1944 and 1951 the increase in fiscal receipts due to increased rates and reductions in fraud was greater than the contribution from the counterpart of Marshall Aid.[35]

Because the reforms introduced in January 1949 were designed to simplify administrative procedures rather than to correct any underlying inequity in the system, criticism of the system continued, and proposals for more fundamental reform were put forward. One proposal came from the *Confédération française de travail chrétien* (CFTC), the small Christian trade union. Arguing that while in principle direct tax on income was a more equitable form of taxation, in practice many direct taxes became indirect taxes because in a sellers' market they were passed on in the form of higher prices. For this reason the CFTC advocated replacing almost all direct taxes, apart from those on the highest incomes, by a production tax levied on all consumer goods but at differential rates. The resulting revenue could then be redistributed to families and those on low incomes.[36]

In 1950 revenue from income tax as a proportion of total tax revenue was a mere 28 per cent in France, compared with 65 per cent in Britain and 85 per cent in the United States. This was not due to significantly lower rates of income tax in France, since in fact the rates

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35. Min. Fin. B 28357. Memo from P. Allix, 27 March 1951.

36. Min. Fin. B 28343, "Proposition de loi sur la réforme fiscale présentée par la CFTC en 1949".

were comparable across all three countries. What it was due to was a much narrower tax base in France on account of the large number of evasions or exemptions.

For many people the most shocking exemptions were those granted to the agricultural sector. In 1949, out of a theoretical tax revenue of 750,000 million francs agriculture paid a mere 70,000 million francs. The 1948 reforms had failed to alter the way in which the tax on agriculture was calculated. It was recognized that to base the tax on the actual income of farmers would not work, since the tax authorities simply did not have the resources to check the accuracy of the declarations. To get around this problem the CFTC proposed that '*forfaits*' should be calculated on an individual basis but this proved less popular than the alternative proposal that mixed farms should be taxed according to whether they were small, medium or large.[37]

[37]. Min. Fin. B28371, "Les Revenues de l'exploitation agricole", 15.5.52.

Table 6 Main Categories of Government Revenue (in percentage)

	1938	1945	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955
Direct Taxes	15.1	23.4	14.2	22.4	24.4	23.8	28.3	26.6	27.3	29.0	27.0	26.2
Taxes on Investment & Securities	9.5	2.2	2.2	2.4	2.1	1.4	1.4	1.2	1.2	1.3	1.3	1.4
Stamp duty	14.8	9.8	8.0	7.1	6.0	6.8	5.5	5.2	5.1	4.9	4.7	4.5
Customs duty	14.4	1.6	3.9	5.4	5.1	6.9	10.4	10.7	10.2	10.6	11.5	12.6
Indirect contributions	11.4	5.1	3.7	4.2	4.7	3.7						
Turnover taxes	16.1	27.8	33.2	33.5	37.6	42.1	37.9	41.3	41.7	37.5	37.1	35.7
Tobacco	6.7	4.4	6.6	7.8	8.3	6.6	5.9	4.7	4.4	4.8	4.4	4.0
Exceptional taxes:												
Illicit profits		2.3	2.6	1.4	0.7	0.3						
National solidarity			10.6	6.0	1.6	0.6						
Others	12.0	23.4	15.0	9.8	9.5	7.8	10.4	9.6	9.2	10.8	13.5	15.1
Total	100	100	100	100	100	100	100	100	100	100	100	100

Source: INSEE, Le Mouvement Economique 1944 - 1957 (Paris, 1958).

THE ROAD TO VAT

The one event which was to have the most dramatic impact on the fiscal system and which was ultimately to be responsible for the adoption of VAT was the outbreak of the Korean War. Arguments about the inequity of the fiscal system paled into insignificance beside the American demands on France to increase its military spending. Had this been seen as a short-term problem, it would not have provoked the sort of fundamental debate which was to take place in France in the early 1950s. Had the American demands not come at a time when France was already heavily engaged in fighting a war in Indochina, the problem might not have appeared so serious. But as it was, the move to perhaps a permanently higher level of military expenditure combined with the termination of Marshall Aid forced the French government to explore new ways of raising revenue. Taxation was thus to be a major issue in the run-up to the legislative elections of 1951. So much so that the Director of the Budget, Roger Goetze, criticized the prominence given to it by most of the political parties. In Goetze's view taxes could not be raised any further, while constant talk of fiscal reform simply encouraged fraud. As he saw it, the only way to face up to the budget deficit was to address those areas of expenditure where action was most urgent. This meant bringing the defence of Indochina into the international arena, and asking the United States to supply France, free of cost, the military hardware which was being produced in France as a result of the Korean War.[38]

The chief inspector of taxes, Pierre Allix, was equally negative about the possibility of raising the extra revenue required out of taxes. Were he to have increased direct taxes on both individuals and corporations, this would have been socially unjust, given the low standard of living of French workers, and would have jeopardized the attempt at that time to

[38]. Min. Fin. B 28361, Memo from R. Goetze, 12 July 1951.

introduce collective bargaining in wages. Were he to have raised the tax on corporations alone, this would not have raised sufficient revenue. Were he to have adopted what might have seemed the most equitable solution, namely to levy the same percentage increase on both direct and indirect taxes, it would in fact have fallen more heavily on indirect taxes and resulted in higher prices. The other option was to levy a new tax on capital, but he considered that this would be more appropriate in dealing with a crisis of over-production rather than one caused by the needs of rearmament.[39] In fact it was the economic as opposed to the financial pressures arising from rearmament which were to prove decisive in the debate about tax reform.

At first sight it had seemed that French industry would be able to meet the increased demands arising from rearmament, without cutting back supply to the market. But the scope for expanding national production, judged to be 12 per cent given the existing capacity, was in fact limited to between six and seven per cent due to a number of bottlenecks. These included an inflexible labour supply; a shortage of housing, which prevented industrial regrouping or relocation which might have increased productivity; an underlying shortage of energy, particularly of coal; as well as supply bottlenecks of other raw materials and intermediate goods.

Even supposing that production could have been increased to meet the demands of rearmament, it was not certain that it would not have unfavourable repercussions on domestic prices and stability. Any increase in wages would raise the demand for consumer goods and, given the low standard of living of French workers, wages would have been spent in the most vulnerable and most heavily squeezed sectors of the economy, namely the textile and consumer goods industries. Such an increase in demand would have led those industries to

[39]. Min. Fin. B 28357. Note for Minister from Allix, 17 October 1950.

invest and to increase the demand for capital goods. The final result would have been an increase in prices and wages and a fall in the exchange rate.

The conclusion drawn by the Ministry of Finance was that, given the labour shortage, a policy based on deficit financing would not work. What was needed was a policy designed to improve labour productivity.[40] Not only would this lead to an increase in output but it would also produce higher fiscal returns with which to cover the additional expenditure on rearmament. This discovery of labour productivity by officials in France fitted well with the new emphasis on labour productivity of the American Economic Cooperation Administration (ECA). But whereas initially ECA's exhortations had found most appeal among French employers, after the Korean War even the planners were shifting their focus away from improving the productivity of capital to improving that of labour.[41]

In April 1952 an official report was published which for the first time argued strongly in favour of the adoption of VAT. This report was the work of a special commission on productivity and taxation which had been set up in January 1952. Its principal author, Maurice Lauré, had been one of the few to argue the case for VAT in 1948. Since then he had been on a productivity mission to the United States to find out why the fiscal burden was so much lighter in the United States than in France. The answer lay, he claimed, in the higher levels of labour productivity in the United States. If labour productivity in France could be raised then tax receipts would rise and the overall fiscal burden would fall, he argued.[42]

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[40]. Min. Fin. B 28357, Projet d'exposé des motifs d'ensemble aux éléments composant la loi de finances.

[41]. Anthony Carew, *Labour under the Marshall Plan* (Manchester, 1987), p. 161.

[42]. Min. Fin. 1A 394 French Tax Mission to USA, 22/11/1950.

Table 7 National Income and Tax Levy (in thousand million dollars)

	National Income	Levy of Taxes and Social Security	Taxes as proportion of national income
USA 1948	214	54.5	25.4
France 1949	81	5.8	32.2

Source: Min. Fin. IA 394.

Thus, in addition to all the other criticisms of the production tax which had been voiced in 1948 a new one was heard - namely, that it impeded the investment necessary to raise labour productivity. This was because under the production tax the only expenditure which could be set against tax was what was incorporated physically into production. This meant that investment in all those factors which were seen to improve productivity such as research and development, energy, advertising, or capital equipment, were taxed twice. A further advantage was that if the fiscal system could be used to promote investment throughout the economy this would enable the government to cut its own spending on investment.

Publication of the report from the Commission on Productivity and Taxation coincided with the formation of the third government of the second legislature, this time led by Antoine Pinay. Pinay's policy was based neither on trying to increase taxes nor on cutting public expenditure, but on encouraging hoarders of wealth to lend to the government under very favourable terms. His reaction to the report on taxation was to set up another commission on fiscal reform, named after its vice-chairman, Louis Loriot, President of the Finance Division of the *Conseil d'Etat*. Its remit was to report to the government on the ways in which the fiscal system could be simplified while at the same time improving the distribution of taxes and reducing their burden. The commission was composed of 20 people drawn from among politicians, planners, trade unions, chambers of commerce, the general confederation of the Middle Classes, the association of mayors and three independent experts. The general director of taxes, the general director of customs and indirect taxes and the director of public accounts, all participated, but in a consultative role.

The planners immediately widened the scope of the Commission to include as objectives of fiscal reform, in addition to financial stability and an equitable distribution of income, the growth of national income and of productivity and the expansion of trade. They argued that unlike the situation in Britain, where the government was able to use fiscal policy to fine-tune the economy, in France the government had so little control over taxes that it was constantly trying to raise revenue without being in a position to consider its economic impact. This resulted in a particularly inequitable distribution of income in France. According to studies undertaken by the planners, wage-earners who constituted over 60 per cent of the active population accounted for less than 45 per cent of the national income. The average income of a wage-earner, as a proportion of the average national income, was lower in France than in any European country studied by the United Nations Economic Commission for Europe. Furthermore, the purchasing power of a wage-earner in France, in terms of the prices of certain essential goods, was lower than in other countries. Of course, as the planners pointed out, the UN studies took no account of social welfare benefits. Nonetheless the pressure to increase wages was seen to be one of the main factors in the high rate of inflation in France since 1945.

The fiscal system was not the only factor to blame for this situation. Other reasons for inflation in France were the restrictions on competition, both internal and external, and the monopoly profits which such protection generated. Among the consequences of the poor functioning of the fiscal system was that most tax revenue came from indirect taxes and that wage-earners paid a disproportionately large amount of the direct taxes. While the planners recognized that it was technically feasible to devise a system of indirect taxation which would meet the same objectives of social justice as one based on direct taxes, they felt that it was very much more difficult. It would call for a system of multiple tax rates with some goods carrying no tax at all and some a very heavy burden, as in Britain. The French experience of having a luxury tax had been short-lived on account of the very high level of fraud. In their view, the tax system should promote the growth of national income and productivity, or at least not impede it. They criticized in this respect the production tax exemptions given to artisans and cooperatives. A further reason for reforming the tax system was to promote foreign trade. Pressure to reduce tariffs at both an international and a European level within the fixed exchange rate system set up at Bretton Woods would leave governments with no means to correct price distortions arising form their fiscal systems, they argued. In a perfectly functioning international economy or common market, goods which were exported would be exempted from domestic taxes, while imports would be subject to the same taxes as domestic products. In reality, and in particular in those countries with a cascade system of indirect taxes, imports had an unfair advantage over domestic products since they were taxed once, whereas domestic products were taxed several times. Since the French production tax was only partially cumulative, France was not the worst affected in this respect.

The specific reforms recommended by the planners were firstly the abolition of the transactions tax, since it simply added an extra layer of complication to those sectors subject to the production tax. In other sectors it provoked an intolerable degree of fraud with disastrous economic consequences. As far as external trade was concerned it had all the disadvantages of the cascade system - in terms of the inaccuracies of rebates - without any disadvantages of the cascade system - in terms of the inaccuracies of rebates - without any of the supposed advantages in the form of producing greater economic rationalization. The most effective way of reducing taxes was not by reducing costs or shortening circuits, but by eliminating a transaction. What a cumulative tax did was simply favour financial integration without promoting real economies.

With the elimination of the transactions tax reform could be concentrated on the production tax where the degree of fraud was in any case the lowest. In principle it was not a cumulative tax and had the further advantage of not promoting business regroupings to bring purchases and sales together, but in practice it was partially cumulative. This was due to the fact that only those materials which were physically incorporated in the final product or which disappeared entirely, were exempt from tax. Thus for all those supplies and services which went under the heading of general costs, the tax was in fact partially cumulative. On the other hand, tax paid on goods of rapid consumption was subsequently deductible, which gave rise to all sorts of legal cases of definition. To get around this it was proposed to tax the difference in value between purchases and sales at each stage of production and distribution so that the sum of these differences was equal to the final value of the product.

Another problem with the production tax concerned the definition of production. To avoid the legal wrangle which this produced, it was recommended that VAT be levied on all purchases of goods and services outside the firm whatever their form. This still left a number of issues to be resolved - including how to tax investment, stocks, services, trade, exports and the system of exemptions.

The treatment of investment was seen to be particularly difficult. Under the existing system expenditure on fixed investment goods and building works was not tax deductible.

This was based on GNP being equal to consumption and investment. But even this involved some double accounting in the sense that it included the value of investment goods when produced and their depreciated value when incorporated into the final selling price. Since investment was in fact taxed twice in this way, it was only viable if the returns were greater than about 18 per cent, which meant that the improvements in productivity had to be considerable for such investment to be undertaken. It was suggested that this discrimination against investment could be avoided if the basis for taxation were to become the net national product, i.e. prices net of depreciation. This then raised the delicate question of how to calculate depreciation in the taxes on dividends. It was for this reason that the CGP supported the recommendation made by the Commission on Productivity and Taxation. This was to avoid the discriminatory taxation of investment by including investment goods and building works with all the other purchases which were tax deductible - even if carried out by the firm itself. As far as the treatment of stocks was concerned, no change from the system under the production tax was envisaged. This meant that no tax was paid until the stocks were sold.

The taxation of services was to be greatly simplified. In place of the *taxe sur les prestations de services*, the transactions tax and the local tax, a single tax on value added was to be imposed. As far as exports were concerned, the planners felt that tax rebates were not always necessary, particularly for products which faced little or no competition outside France. On the other hand, for those exports which faced stiff competition and which were subject to indirect taxes in the importing country, tax rebates were to be allowed. One of the perceived advantages of VAT was that it would simplify this system. Those firms which produced almost exclusively for the export market might actually be entitled to a tax rebate if they had paid VAT on their supplies.

Apart from the *Confédération Générale de l'Agriculture* (CGA) which was opposed to any change in the fiscal system, many of the interest groups consulted by the Loriot Commission favoured the adoption of VAT. But where they disagreed was over whether VAT should apply to production alone or extend to sales. While it was recognized that most fraud occurred at the distribution stage, it was seen by the wholesale and retail trade as a wholly unacceptable burden to place on the thousands of small firms which characterized this sector. On the other hand not to apply VAT to sales would have greatly reduced the benefits. It would also have meant setting a much higher rate.

The CGT, which had favoured the adoption of VAT in 1947, was most critical of the proposal to exempt new investment from it on the grounds that this contravened the principle of fiscal neutrality. In its view, it was preferable for the government to steer the economy through the use of subsidies rather than use the fiscal system.[43]

Most industrialists, when canvassed by the employers' association, the CNPF, preferred a system of accelerated amortisation to reduce the cost of investment rather than the proposal to exempt new investment from tax.[44] What this meant in effect was that they preferred to maximise their profits through savings on tax rather than by undertaking new investment. Interestingly, the car firm Renault did not share this view and made its support for VAT and for the deductibility of investment quite clear.[45]

Similarly, the steel partnership SOLLAC, which had been formed in 1948, argued that the transactions tax, which was levied each time steel products were passed from one steel firm in the partnership to another, undermined the modernisation of steel production which

[43]. Meeting of the *Conseil Economique*, 26 March 1953.

[44]. Min. Fin. B 28370. Note, 24 April 1952.

[45]. Min. Fin. B 28374. 12 November 1952.

their partnership had been designed to promote. This made SOLLAC a strong supporter of the replacement of both the production tax and the transactions tax by VAT.[46]

Perhaps the most bizarre proposal for fiscal reform which was submitted to the Loriot Commission was that of the industrialist Eugène Schueller. His proposed reform consisted of abolishing all existing taxes, except for customs duties and the tax on alcohol, and replacing them with a single tax on energy fixed at different rates for different sources of energy. According to Schueller, such a tax would reduce the fiscal burden by 50 per cent because it would reduce fraud, and encourage tax dodgers to convert their hoards of gold into loans to the government. As a result of the reduction in taxes prices would fall by 20 per cent, enabling production to rise by 30 per cent and income by 50 per cent. The simplicity of the system would release people from the burden of taxation and the intrusion of tax inspectors, he claimed.

Because of the popularity of the proposal it was examined by both the Loriot Commission and the *Conseil Economique*, both of which quickly demolished Schueller's arguments. Briefly, it was argued that there was no evidence that capital was hoarded only to escape tax. In the unlikely event that it was lent to the government, an increase in government debt was considered undesirable since it would increase the need for taxes to service it. Furthermore, the suppression of fraud would not lead to a reduction of the fiscal burden but simply its redistribution. Another criticism was that the French economy did not have the capacity to enable production to rise by 30 per cent. In fact the only valid claim was considered to be the simplicity of the proposed tax reform. But even then, experience had shown that simple systems quickly became very complicated as demands for exceptional

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[46]. Min. Fin. Z 157. "Les obstacles d'ordre fiscal à la modernisation de l'industrie sidérurgique et des mines de fer." 7 May 1953.

treatment were made. It was also clear that in taxing the main forms of energy, coal, electricity, gas and oil, incentives would be given to develop alternative forms of energy from water, wood or alcohol. It would give foreign suppliers of energy considerable control over French finances, would make the tax revenue very volatile, discourage mechanisation, and favour the rich. Indeed, the list of disadvantages was considered to be very long.[47]

When it was finally submitted to the government the Loriot report recommended the adoption of VAT in both production and distribution with exemptions of 100 per cent for investment, energy and services. Pinay reduced these exemptions to 50 per cent before submitting it to the finance committee of the National Assembly. Even then the finance committee criticized the reform bill not for failing to address the central issues of promoting investment and productivity, but for promoting them too much. As a result it feared that the reforms would be inflationary, would do nothing to reduce the weight of indirect taxes and little to reform direct taxes.[48] It felt that the proposed VAT retained much of the complexity of the production tax and merely tinkered with the existing system rather than reforming it.

As a result of these criticisms Pinay's government failed to get its fiscal reform through the National Assembly in December 1952. Francis Leenhardt, a socialist, argued that one of the main reasons for the failure was because the government ignored the injustice of its proposal. In trying to raise 58 per cent of its revenue from indirect taxes and 31 per cent from direct taxes, the burden of taxation would fall disproportionately on the poor.[49]

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[47]. Min. Fin. Z 812, "Observation sur le projet de M.E. Schueller tendant à l'institution de l'impôt sur l'énergie".
Ministère des Finances, "La Taxation de l'Energie", *Statistiques et Etudes Financières*, no. 47, November 1952.

[48]. Journal Officiel, Séance du 4 décembre 1952.

[49]. B 28376. Leenhardt writing in *Le Populaire*, 8 December 1952.

Leenhardt argued that greater justice should be brought to the French fiscal system by reversing the existing weight of direct and indirect taxes. This could be done, he claimed, by excluding the retail sector from VAT. Such a restriction would have the further advantage of facilitating the control of VAT.[50]

The Mayer government which replaced that of Pinay proposed a number of tax "improvements" which were even more limited than its predecessor's, and were not surprisingly also rejected by the Finance Committee of the National Assembly.[51]

The tax reform bill which was finally to become law on 10 April 1954 was the combined effort of the Laniel government and the Finance Committee of the National Assembly. A decree of 30 September 1953 allowed provisionally the deduction of half of the production tax due on investment goods purchased by a firm.[52] The law of 10 April 1954 which finally replaced the production tax by VAT allowed the deduction of 100 per cent of VAT on investment goods. The new rate of VAT was set higher than the rate of the production tax to allow for this exemption, and the rate of corporation tax was increased from 34 to 36 per cent. The following year VAT was extended to cover the wholesale trade and the transactions tax was abolished.[53]

Conclusion

Although tax reform was a popular demand in France in the years following the

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[50]. Min. Fin. Z 807. "Projet de réponse à l'amendement de M. Leenhardt", mars 1954.

[51]. W. Baum, op. cit., p.162.

[52]. Min. Fin. B 28379. "Projet de loi portant réforme fiscale renvoyé à la Commission des Finances", 13 November 1953.

[53]. Min. Fin. Z 814. "Deux ans de retouches fiscales", November 1955.

Second World War and advocated by almost every group in society with the exception of the farmers, there was little agreement over the form which it should take. Under pressure from the American Economic Cooperation Administration to reform the fiscal system, the French government opted for administrative simplification rather than fundamental reform in the legislation introduced by decree in December 1948. It was the increase in defence spending occasioned by the wars in Indochina and Korea, combined with the ending of Marshall Aid, which led to a more fundamental review of the French fiscal structure. In the fiscal reform commission set up by the Pinay government in April 1952 it was the views of the French planners which were to prevail. The planners recommended the substitution of both the production tax and the transactions tax by a new tax on value added (VAT) with the full exemption of investment from VAT. The perceived advantages of VAT were that it would stimulate investment, while taking the cost of much investment out of the central budget, promote trade and competitiveness, and reduce fraud. The cost of these changes was to be covered by setting the rate of VAT higher than the existing production tax and increasing the rate of the corporation tax. Criticized by the socialists for increasing the weight of indirect taxes in the French fiscal system, VAT was initially restricted to the production sector. In 1955 it was extended to cover wholesale trade, but it was not until 1968 that it was finally extended to the retail sector where it had long been acknowledged that most fraud took place.

The adoption of VAT was significant in that it substituted a highly elastic tax for two taxes which, taken together, incorporated the worst features of the cascade system without offering any of its advantages. However, the adoption of VAT was not intended as a means to allow the state to grow, even if that was its result.

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