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Public Finance System Overview:

French Departments And Departmental Syndicates

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Institutional Framework Assessment:

Extremely predictable and supportive
Very predictable and well-balanced
Evolving but balanced
Evolving and unbalanced
Volatile and unbalanced
Very volatile and underfunded

Trend:

Improving
Stable
Weakening

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Major Factors: Strengths And Weaknesses Of The Institutional Framework For French Departments And Departmental Syndicates

Strengths:

- Mature and stable intergovernmental system.
- Track record of systemic support from the central government in extraordinary circumstances.
- Prudent fiscal policy framework, enhanced by contractual budgetary targets.

Weaknesses:

- Weak budgetary flexibility and high exposure to socioeconomic and real estate cycles, resulting in structural revenue and expenditure imbalances.
- Limited transparency of off-budget operations with lack of consolidation requirements in the treatment of financial data from related entities and ancillary budgets, including social housing

entities.

- Local tax reform has highlighted this government tier's weak institutional and political power, with limited capacity to block or influence unwanted changes.

Recent Developments

After ending the housing tax, the central government decided to transfer the share of the property tax levied by French departments to cities. In our view, this local tax reform the French parliament approved in December 2019 put an end to the improving trend we were seeing for the institutional framework for French departments. This reform testifies to the weak institutional and political powers of French departments, with limited capacity to block or influence unwanted changes mandated by the central government. It will also increase French departments' structural revenue and expenditure imbalances.

In 2021, departments will lose their only source of revenue that they could modify the rate of. The property tax will be compensated by a share of the national value-added tax (VAT), over which they have no tax leeway and which will account for 23% of operating revenue. Therefore, we see budgetary pressure on French departments from 2021 owing to this tax switch. In an economic downturn social allowances would increase while the proceeds from VAT and of property transfer fees (17% of their operating revenue) would drop, as happened in 2009, leading to a decrease in operating margins. In a recession, we also believe the offsetting mechanisms would be limited. Departments will be allotted an extra €250 million share of VAT (or a very low 0.4% of their operating revenue, seeing as €115 million are already to be taken from an existing support mechanism), and the dynamic of this share will be saved in case of an economic downturn. That means, if VAT increases by 10%, €25 million will be saved for extraordinary support in case of financial distress.

We believe this reform offsets the positive effects of the stabilization of the main state transfer ("dotation globale de fonctionnement", DGF) to French local and regional governments (LRGs) since 2018 (after years of cuts), and by the new contractual framework the central government has set up, which limits operating expenditure growth for the largest French LRGs.

Predictability

Frequency and extent of reforms

In our view, the overall predictability of the institutional framework for French LRGs is quite strong. Major institutional system reforms in France are infrequent and limited in scope. For instance, a decade passed between the last two major reforms in 2004 and 2015, with relatively modest changes in the institutional landscape for French LRGs. The 2004 reform, by far the most important in the past 30 years, enacted the transfer of new responsibilities to various layers of local governments from the central government. These responsibilities accounted for only about 7% of LRG's total budget at that time.

However, in our view, the local tax reform will negatively affect departments and amplify the structural imbalances between their expenditure and revenue structures. We consider it has weakened the predictability of their institutional framework; French departments were not able to influence this reform, unlike other layers of governments were able to.

Departmental syndicates (single-purpose interdepartmental entities) are subject to the French

LRGs law ("Code Général des Collectivités Territoriales") and, as for traditional LRGs, systemic reforms are rare and do not trigger an overhaul of the system. Furthermore, owing to the large extent of their operating autonomy, we view syndicates as less sensitive to central government decisions. Their operating revenue relies largely on the taxes or quasi taxes they levy and subsidies from their member governments. Consequently, there is little room for the central government to pass on its financial stress to syndicates, unless in an indirect way through their member governments.

Hampered ability to influence or oppose damaging reforms

Within the French institutional system, French departments' have some political weight. Indeed, as with other LRGs, departments' representatives elect members of the Senate, the upper chamber of the French parliament. As a result, we consider that they have the ability to soften unwanted changes through their representation in the Senate. For a proposal to become law, it has to be approved by the two chambers (the Senate and the National Assembly). However, the National Assembly has the last word if there is a disagreement between the two chambers. In our view, this limits departments' ability to amend unwanted reforms.

Nevertheless, constitutional changes or organic laws that affect the LRGs' institutional landscape need both chambers to agree on the exact same bill. As a result, the Senate, like the National Assembly, holds veto power on constitutional changes that affect LRGs.

French LRGs benefit from constitutional guarantees that allow them to challenge decisions that may hobble their self-governance and national autonomy at the national constitutional court. Although this supports some consensus-building between the central government and LRGs on decentralization matters, we consider that it does not entirely prevent conflicts related to this topic and the central government usually has the last word. Furthermore, the recent law limiting the number of mandates locally elected has hampered departments' influence on the political system.

In our view, the influence of departments through their main lobby association ("Assemblée des départements de France") has reduced. French departments earlier were able to use their political influence to amend unwanted changes, and had a track-record of doing so. For instance, in 2014, strong campaigning against the central government's proposition to disband this layer of government succeeded. Similarly, they were able to raise state grants to compensate for the increase of spending related to unaccompanied foreign minors. However, they have not reached an agreement about the full compensation of other social allowances.

French departments were not able to use their former influence to oppose the local tax reform that will constrain their flexibility. Despite their strong opposition to transferring their share of the property tax, the central government managed to get its reform through the parliament. In our view, other layers of local government have stronger influence than French departments. For instance, French cities' revenue and expenditure balances have been left almost untouched, and French regions were granted a dynamic share of VAT instead of stable state transfers.

Though departmental syndicates do not exert any direct influence on the central government's policymaking process, they do have some political leverage through their LRG members and their representatives in the national parliament.

Revenue And Expenditure Balance

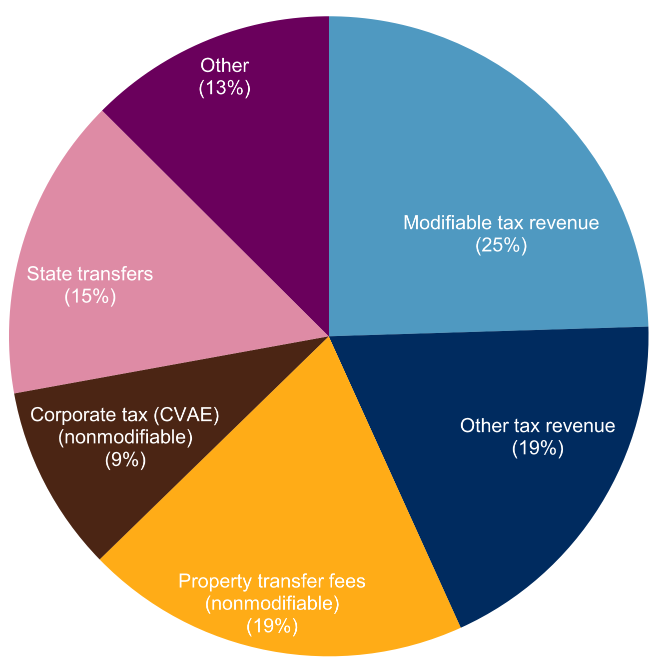
Barely adequate balance between revenue and expenditure needs exacerbated by the local tax reform

French departments are already exposed to structural revenue and expenditure imbalances, mainly owing to weak budgetary flexibility and high exposure to socioeconomic real estate cycles. The local tax reform will further increase their dependency on the macroeconomic cycle and reduce flexibility.

Departments can currently adjust the property tax rate, which accounted for 23% of their combined operating revenue in 2018. From 2021, departments will lose this tax leeway, and their revenue flexibility will consequently diminish. High dependence on economic activity-related taxes and property transfer fees exposes departments to any downturn in the economic or real estate cycles.

Chart 1

French Departments: 2018 Operating Revenue Breakdown

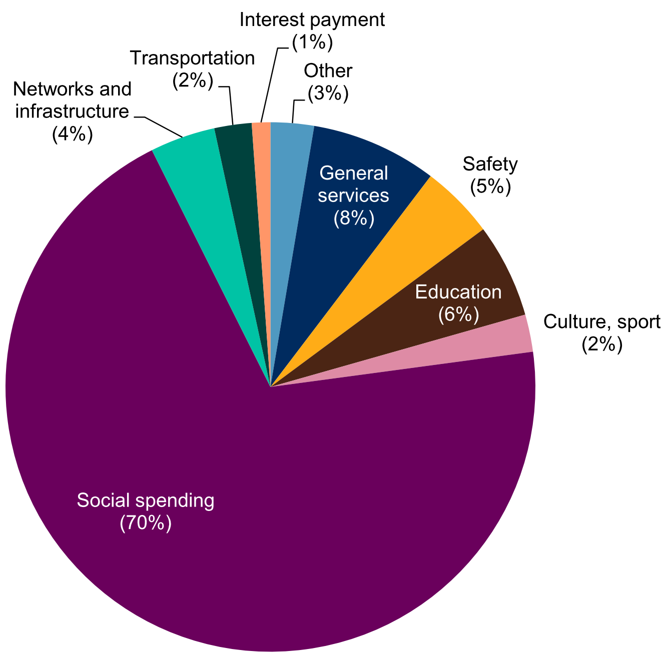


Source: Observatoire des finances et de la gestion publique locales, 2019.

Their expenditure flexibility is also weak. The share of hard-to-reduce social spending has constantly increased in the past few years, and accounted for nearly 70% of operating expenditure in 2018. These social allowances are increasing rapidly; for example, the minimum social allowance (revenu de solidarité active; RSA) expanded by 3.5% in 2019, representing 20% of combined operating expenditure for French departments. Even though we expect the growth of the RSA to decelerate in the next few years, the recent reform of the unemployment system could push up the number of beneficiaries.

Chart 2

French Departments: 2018 Operating Expenditure Breakdown



Source: Observatoire des finances et de la gestion publique locales, 2019

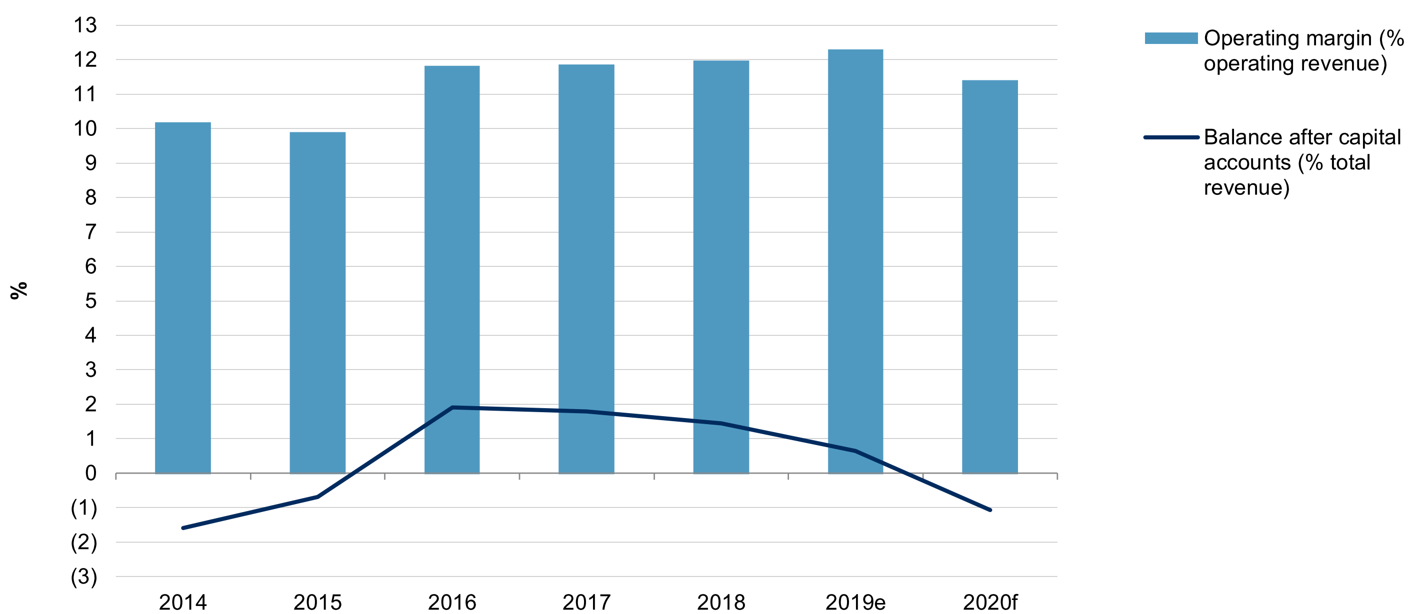
Recent developments have supported departments' budgetary performance. The central government decided from 2018 to stabilize the main state transfer to LRGs, (dotation globale de fonctionnement; DGF), which made up 12% of departments' operating revenue in 2018. It alleviated pressure on operating revenue, which had been cut €1.2 billion annually in 2015-2017 (2% of their annual operating revenue). Furthermore, the central government has set individual operating expenditure growth limits for the 322 largest LRGs, which includes all departments, whereby their operating expenditure growth cannot exceed 1.2% per year in 2018-2020. The rate can be adjusted by up to 15 basis points according to demographic and wealth data, or according to past budgetary efforts. The central government penalizes LRGs that do not meet the budgetary target by deducting part of their tax revenue.

We anticipate high operating balances over 2020-2021 at about 11% of operating revenue. In 2018 and 2019, French departments' operating balance averaged 12% of operating revenue. This strong budgetary performance was mainly driven by the buoyant housing market, leading to an average increase in property transfer fees of 6.5%, and by tight monitoring of operating expenditure (-0.1% on average). Despite the upturn in capital expenditure, which increased by 6% on average in 2018-2019 (after a 1.2% decrease in 2017), departments posted surpluses after capital accounts, representing 1.3% of total revenue on average.

We expect departments will maintain their strong budgetary performance in the next few years. We expect revenue to stay flat in 2020-2021 because of the reduced property transfer fees and the local tax reform, which will freeze revenue from the property tax. In our view, growth of the RSA will decelerate to 1.5% on average in 2020-2021, but departments remain under pressure from social allowances as spending related to foreign unaccompanied minors continuing to trend up. With the step-up in capital expenditure, we anticipate that departments will post minor deficits after capital accounts--after four years of surpluses.

Chart 3

French Departments: Budgetary Performance

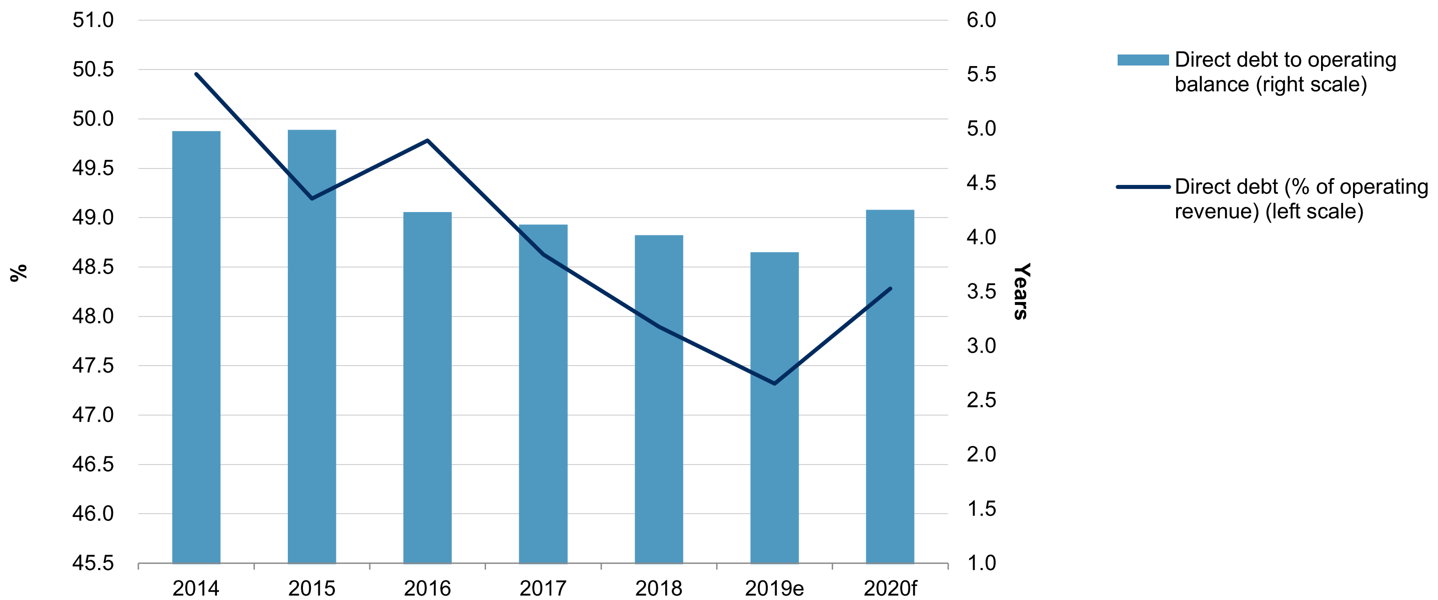


e--Estimate. F-- Forecasts. Sources: Observatoire des finances et de la gestion publique locales for 2014-2018 ; S&P Global Ratings estimates for 2019 and forecasts for 2020.

In line with emerging deficits, we expect larger debt intake for French departments. We forecast their direct debt burden will account for a still moderate 50% of operating revenue in 2021 versus 48% at year-end 2018. The ratio of direct debt to operating balance should remain below 5x, stronger than international peers'.

Chart 4

Direct Debt Evolution For French Departments



e--Estimate. f-- Forecasts. Sources: Observatoire des finances et de la gestion publique locales for 2014-2018 ; S&P Global Ratings estimates for 2019 and forecasts for 2020.

For most departmental syndicates, flexibility over expenditure is low. Expenditure consists mainly of contracted payments to suppliers for public services missions. However, syndicates' revenue flexibility is generally quite high because, pending member governments' approval, they can increase revenue, for example, through hikes in taxes or fees, thus preserving the adequacy of revenue to cover expenditure.

Fiscal policy framework

Similar to other French LRGs, the fiscal policy framework for French departments combines an apparent flexibility that accommodates individual choices and a set of rules to enforce budgetary balance. Unlike many other European countries, the French system does not require state pre-clearance to incur debt. Nevertheless, we consider that the central government's budgetary targets for the largest 322 French LRGs (including all departments) frame their budgetary trajectory without limiting their fiscal autonomy. They still can legally exceed official targets, but in such cases would face financial penalties.

The framework common to all French government tiers aims to help LRGs prevent stressed financial situations through indirect constraints on their budgetary balances, debt, and guarantees. LRGs are placed under the supervision of the state representative if:

- Their provisional budget is unbalanced, because French LRGs have to agree a balanced budget for both the operating and the capital sections; or

- Actual accounts show an operating deficit of more than 5%-10% of operating revenue (depending on the LRG's size).

There is no direct limit on LRG debt. However, debt can be used only to finance capital investments, not operating deficits. Moreover, annual debt repayments must be paid with the LRGs' own resources, which exclude borrowing. These rules aim to prevent LRGs from depending on debt refinancing, which we view as positive for their credit profile. In addition, these limits have a direct influence over LRGs' debt volumes and profiles. French LRGs' debt remains overall moderate, although LRGs represent a major part of public investment, and most of their debt has a smooth amortizing profile.

Furthermore, the Galland law of 1998 sets limits on debt guarantees extended by French LRGs in order to contain contingent risks. An LRG's own debt and the annual installments of debt guarantees cannot exceed 50% of its operating revenue. On top of that, the annual installment of a single guarantee cannot exceed 5% of operating revenue. In our view, although guarantees granted to social housing institutions, which make up the bulk of debt guarantees, are excluded from the calculation, the institutional and financial frameworks in which French social housing entities operate limit risks associated with the sector. We believe that recent reforms affecting the social housing sector, such as the cuts in social rents, could have an impact on French departments, which provide a large amount of guarantees to social housing operators. Indeed, their budgetary performance will be constrained by this drop in revenue.

Cash management is considerably limited by LRGs' obligation to deposit their cash each day in a non-interest-bearing account at the French Treasury. This obligation limits investment risks from a credit standpoint. Nevertheless, this constraint is partially offset by state advances on tax proceeds and transfers delivered in 12 monthly payments. It provides LRGs with a high share of predictable and safe revenue flows.

The framework is similar for departmental syndicates, except that they cannot extend debt guarantees.

Track record of systemic extraordinary and ongoing support

The French institutional framework provides a relatively high degree of systemic support. As with other layers of government, departments' direct taxes are collected by the central government, which bears the collection risk. Taxes and state transfers, which represented almost 90% of departments' operating revenue in 2018, are transferred in monthly payments and in a timely manner. Therefore, departments, like other layers of French LRGs, enjoy predictable liquidity profiles. This is a key strength of the French institutional framework. For instance, debt repayments are usually scheduled directly after the monthly installments of both taxes and grants have been cashed in. Moreover, French LRGs can benefit from an advance of monthly payments if needed.

We have observed a positive track-record of adequate and timely support from the central government to all French LRGs in distress, including departments. During the liquidity crisis of 2013, Caisse des Dépôts et Consignations (CDC) made available a €20 billion facility over five years (over one full year of LRGs' total yearly borrowings needs) to finance the investment needs of French LRGs. Moreover, in 2015, CDC prefunded "Fonds de Compensation de la Taxe sur la Valeur Ajoutée", a VAT refunding scheme that LRGs receive one to two years after the expense. LRGs repaid this €1 billion interest-free prefunding in two years.

In addition, the central government has set up several funds to punctually support LRGs in straightened financial situations. Every year since 2015, the central government has set up emergency financing (up to €200 million) to support departments in financial distress.

Furthermore, French departments receive state transfers via a vertical equalization system. In 2019, departments received €1.5 billion with this system, or 2% of their operating revenue. The central government set up a horizontal equalization system and created several funds. However, these funds make up only 2% of departments' operating revenue, which is marginal and insufficient to smooth discrepancies among the 101 departments.

Transparency And Accountability

Transparency and institutionalization of the budgetary process

In our view, the institutional framework for French departments and syndicates is transparent and provides for significant accountability of elected officials and financial managers. Roles and responsibilities of elected official and managers are well defined. Elected officials set policies and priorities through council votes and mayoral decisions while managers implement them. Turnover of administrative staff after elections is usually limited to a few high-ranking personnel, which insures management continuity.

Disclosure and accounting standards

Accounting standards and budgetary processes are shared among all French LRGs and their syndicates, and are established by the state. Accounting standards are developing toward full accrual accounting, but amortization and provisioning requirements and practices are still lagging. Additional accounting requirements were introduced in the aftermath of the financial crisis of 2007-2008, following problems arising from complex loans and derivatives, most of which were indexed to foreign currency exchange rates and led to skyrocketing interest burdens for some LRGs. All French LRGs must now provide a clear mapping of their debt structure according to different risk levels defined by the "Charte Gissler", a charter of good conduct between French banks and associations of elected officers representing LRGs.

Furthermore, LRGs' annual accounts must match the financial accounts (or "comptes de gestion", which include LRGs' balance sheets) prepared by the "comptable public", a state employee responsible for LRGs' cash movements. In our view, this enhances the reliability of financial information. In addition, French LRGs have to publish their financial trajectory (including all of their ancillary budgets) before adopting their annual budgets.

However, there is still a systemic weakness regarding the exclusion from consolidation of some government-related entities (GREs), especially when they are not linked to their LRGs by status. In our view, this is a systemic weakness. In the past, difficulties at the GRE level led to financial distress for some French LRGs. Furthermore, French departments tend to have a high number of GREs that operate in various sectors (social housing, digital development, etc.). French departments are financial contributors to their fire brigades and may be responsible for their liabilities.

Control levels and reliability of information

Prefects (state representatives) have the authority to ensure full implementation of legal requirements on financial reports and budget disclosure. Further controls are exercised by regional courts of audit who can call for state intervention in case of budgetary discrepancies. The oversight of the prefect and the regional court of audit covers the whole budgetary process from elaboration, to adoption, to execution, and focuses on timeliness, prudential ratios, and proper accounting.

Despite this close control, there is no required annual audit for French LRGs. The reviews by the regional courts of audit are performed only at random and the reports are usually published two to three years after the accounting year, which reduces their usefulness. Nevertheless, in 2015, the central government started a pilot project aiming to certify LRGs' accounts with audits by private auditors; 25 LRGs are participating. The first certification is due by 2020, before a review planned for 2022. In our view, this will strengthen both LRGs' internal monitoring and the consistency of their accounting practices, as well as stronger reporting regarding GREs. We believe that a general application of this process could lead to the improvement of French LRGs' accounting standards.

Trend: Stable

We expect that the institutional framework for French departments' and departmental syndicates will remain stable in the medium term.

We believe that the local tax reform could put French departments under financial pressure. In our view, the removal of their share of the property tax will exacerbate the structural imbalance between their revenue and expenditure. However, we continue to expect that the central government will provide systemic support in case of need.

In our view, positive developments could come from a stronger match between revenue and expenditures. It could be achieved through a stronger compensation of social allowances.

On the contrary, negative developments in the medium term could arise if we viewed the willingness of the central government to provide systemic support in case of need as being less likely.

This report does not constitute a rating action.