STABILITY PROGRAMME: 2006-2008

After the severe, unexpected slowdown in activity in 2003 and in view of the increase in the public deficit triggered by this slowdown, the government has reaffirmed the direction of its economic policy.

In budgetary terms, the priority is to reduce the public deficit by controlling spending. The objectives for 2004 and 2005, namely to reduce the public deficit to less than 3 GDP points in 2005 and decrease the weight of public debt in France's GDP starting in 2006, have remained the same.

This firm commitment to fiscal consolidation is not inconsistent with a growth policy. In the short term, the government has implemented a number of measures to promote consumption and investment, all designed to avoid a further increase in the deficit. In addition to short-term economic action, the government's steps to reduce the deficit and preserve the social services (retirement, health insurance) that are so important to the French people are also helping to boost public confidence and thereby promote long-term growth.

More generally, given the combined impact of an ageing population, globalisation and the development of new technologies, inaction and fatalism would increase the risk of our country "falling behind". That is why the government is taking action and implementing reforms. The measures included in the 2005 budget bill to promote research and centres of competitiveness, the change in status of large public enterprises and provisions to ensure greater access to their capital, and the reforms now being prepared in the mass-retailing sector attest to this commitment.

1. The policies implemented by the government support a return to growth and will help reduce the public deficit to less than 3 GDP points in 2005.

In 2004, the initial results of this strategy were achieved.

GDP is expected to show an annual average increase of approximately **2.5% in 2004**, after taking into account the higher number of days worked this year – a rate that exceeds that of the euro zone as a whole (slightly less than 2%). Although our foreign trade is hampered by the appreciation of the euro and sluggish domestic demand among our main European partners, this return to growth is based on renewed demand among households and businesses.

As in the rest of Europe, domestic demand is benefiting from lower interest rates. In France, the government has taken **a number of measures to promote consumption** (including steps to encourage donations, release wage savings funds, and lower prices in the mass-retailing sector) and investment (such as the exemption from local business tax on new 2004-2005 investments) **which do not adversely affect public finances** in the short term. After several years of uncertainty and inaction, the positive effects of confidence in the reforms aimed at strengthening our social insurance system and the strict implementation of measures to stabilise public finances are also contributing to this recovery.

The public deficit will be reduced to less than 3% in 2005.

The 2005 budget bill currently being reviewed in Parliament confirms the objective of reducing the public deficit to **3.6 GDP points in 2004.** The return to growth and rigorous control of spending have resulted in a marked improvement in the State's accounts. While gross tax revenues show a gain of € 5 billion over estimated figures in the initial budget act for 2004, strict control of spending based on extensive reallocation measures, setting aside and cancellation of appropriations will enable us to **adhere, for the second year in a row, to the ceiling approved by Parliament, resulting in a freeze on State spending in real terms.** The State's budget deficit will fall to € 49.3 billion in 2004, compared with a projected € 55.1 billion in the initial budget act.

Despite this **improvement in the State's accounts** compared to the estimates in the initial budget act and last spring's updated forecast (a deficit of 3.2 GDP points instead of the 3.7 points originally predicted), the targeted public deficit for 2004 has not been revised downward, because of negative changes in other general government accounts. A weaker slowdown than expected in health insurance spending (up 5.2% in value, versus a projected 4.0%), the negative impact on the UNEDIC (national employment agency) accounts that resulted from the reintegration of unemployed persons, following a recent jurisdictional decision, and a more gradual rebound than anticipated in the wage bill and social contributions are **weakening the accounts of social** funds compared to the most recent projections, while steady growth in public investment **is adversely affecting investment by local authorities**. Thus, the goal of reducing the public deficit to 3.6 GDP points has remained unchanged, despite stronger growth in 2004.

The 2005 budget bill is centred on two key objectives: (i) **reducing the public deficit to less than 3 GDP points** in order to fulfil France's commitment to its European partners and finally begin to reduce public debt; (ii) **supporting growth, innovation and employment** at a time when Europe's economic recovery remains fragile and unemployment is still high.

The budget bill is based on maintaining a growth rate of **2.5% in 2005.** This estimate is premised on a gradual improvement in growth in Europe and an increase in domestic demand to offset the effects of the slowdown in the worldwide economy within a context of stable exchange rates and a drop in oil prices. The budget bill relies on the conventional assumptions of a stabilisation of the dollar/euro exchange rates at its August level, i.e. 1 euro = US$ 1.22, and of a decline in the average price per barrel of Brent crude oil to US$ 36.50 in 2005. **The risk of a downward trend, however, has increased since the budget bill was presented.** The slowdown in the third quarter bears witness to the fragility of Europe's economic recovery. Even though the situation is somewhat calmer of late, recent tensions could raise concerns about continued high oil prices in 2005. Lastly, as evidenced by exchange rate fluctuations over the last few weeks, persistent imbalances in the US economy continue to pose the risk of a severe weakening of the dollar, which would surely hinder short-term growth in Europe. If these risks materialise, the euro zone countries would be uniformly affected and the responsiveness of European macroeconomic policies would again be put to the test, although average annual growth in this zone was barely 1.3% between 2001 and 2004 and inflationary pressures remain moderate.

Currently, however, the positive trend of economic surveys in the manufacturing, services and construction sectors, coupled with the success of the support measures adopted last summer (the addition of € 3 billion to the economy between June and October for households with a higher propensity to consume, thanks to measures that encourage donations, along with the release of € 1.1 billion held in wage savings funds in September) and continued low interest rates in Europe, **lead us to maintain a growth projection in France of approximately 2.5% in 2005.** The latest estimates from the European Commission, which are based on less favourable assumptions in terms of oil prices and exchange rates, point to slightly lower growth (2.4% in 2004 and 2.2% in 2005).

In this context, **the budget bill firmly maintains discipline at the State level**, **with stabilisation of spending in real terms for the third straight year,** despite rising debt service charges and retirement benefit costs (up € 1.3 billion and € 2.0 billion respectively in 2005, the equivalent of a 1.2% increase in value of the general budget expenditures), the financing priorities of the current legislature (defence, internal security and justice), and a stronger effort to boost social cohesion, research and development assistance. This stabilisation of spending is the result of a significant redeployment effort. Reduction of the civil service staff has also been stepped up (10,200 positions eliminated, i.e. 7,200 fewer jobs given the creation of 3,000 positions in priority sectors). The stabilisation of State spending alone will result in an improvement of 0.4 GDP points in the public administrations' structural balance in 2005.

In addition, **the implementation of health insurance reform should lead to a deceleration in social spending in 2005.** The social security budget bill is based on a 3.2% increase in health insurance spending in 2005, versus a 5.2% increase in 2004. Social benefits should also level off as a result of the drop in unemployment, while spending by local authorities is expected to slow down after several years of high growth. This would bring public spending to a level of 53.6 percent of GDP, down from 54.7 percent in 2003 and 54.0 percent in 2004; however, this is still far higher than the European average (48.0 percent of GDP in 2005 according to the European Commission's latest projections for the euro zone).

At the same time, the budget bill contains **a set of highly targeted tax cuts** totalling € 2.0 billion in 2005. The aim of these tax reductions is to enhance our country's attractiveness in light of business relocations abroad (by eliminating the corporate income surtax over two years, creating centres of competitiveness, establishing local business tax credits for vulnerable companies in hard-pressed employment pools), to support employment and labour income (by creating a tax credit for apprenticeships, boosting tax reductions for home businesses, increasing the earned-income tax credit, and further reducing charges on social benefits associated with the sharp increase in the *SMIC* (minimum wage)), and to promote social justice (by raising exemption ceilings for inheritances and establishing new tax credits for home ownership as an alternative to the "zero-rate loan" programme). Moreover, in view of the **projected supplemental revenues as part of health insurance reform** (an increase of € 3 billion starting in 2005), the pension reform initiative for civil servants, and the solidarity plan for dependent persons (up € 1 billion in 2005), **the rate of compulsory levies would be virtually stabilised in 2005.**

The reduction of the public deficit to 2.9 GDP points in 2005 based on the budget bill projections is boosted by a one-off lump sum payment for the admission of EDF-GDF's pension scheme to the general scheme following the company's change in status approved last summer by Parliament. The amount of this payment, which was valued at € 6.9 billion (0.4 GDP points) in the budget bill, was recently revised upward to € 7.7 billion following negotiations between the companies and the social partners involved, which should reduce the public deficit in 2005 accordingly. Since negotiations have also begun in this regard, this payment could be supplemented by a one-off payment for admission to supplementary schemes (Agirc-Arco)[1].

The cyclically-adjusted public deficit would therefore decrease by 0.6 GDP points in 2005 and 0.5 GDP points in 2004. This improvement in 2005 would stem from the implementation of discretionary measures representing 0.8 GDP points, half of which is the result of a structural consolidation effort that excludes the EDF-GDF one-off payment.

Deficit reduction, the allocation of proceeds from sales of publicly-owned companies to the government debt relief, and the return to growth would also halt the increase in the ratio of public debt to GDP. After an increase of nearly 7 GDP points in 2002-2003, this ratio would continue to grow by slightly more than 1 GDP point in 2004 and by only ¼ GDP point in 2005. It would then level off at 65.0 percent of GDP in 2005, a figure that would still far exceed the European threshold of 60 percent, further demonstrating the need to pursue efforts aimed at medium-term stabilisation.

2. The stability programme supports the objectives of fiscal consolidation for the 2006-2008 period.

The programme is based on realistic economic assumptions.

The stability programme, like that of last year, is based on a growth scenario of 2.5% per year during the period 2006-2008. This scenario is founded on an estimated potential growth rate of 2.25% per year, in accordance with the latest demographic projections and reasonable assumptions with respect to the reforms undertaken to boost employment and productivity. While the economic downturn in 2002-2003 helped widen our output gap, estimated at 2 GDP points in 2003, the growth scenario we have adopted should allow the accumulated gap to be bridged very gradually. However, it should not be completely closed at the end of this period, which demonstrates the prudence of the growth scenario used.

The fulfilment of this scenario implies the existence of monetary and financial conditions favourable to business in Europe in order to withstand external crises and increase demand throughout the euro area. With interest rates held in check, however, growth in France could

[1] Pending the conclusion of the negotiations on admission to the supplementary schemes, the stability programme conventionally maintains public deficit projections that are based on the provisional estimate of the one-off payment made to the general scheme, as it was calculated when the budget bill was being prepared (€ 6.9 billion). Neither the payment by EDF-GDF of a € 750 million entry fee payable to the supplementary schemes nor a possible one-off payment to these schemes was taken into account.

prove even stronger – approximately 3% by the end of this decade, thanks to a far-reaching policy of economic reform and modernisation.

Efforts to control spending will continue in 2006-2008.

The government plans to pursue its objective of stabilising State spending in real terms during the period 2006-2008. Achieving this objective will require extensive cost-cutting measures, given the increase in debt service charges (up 4.2% per year in real terms in 2006-2008) and retirement benefit costs (up 3.3% per year), further reductions in employer's contributions to finance the upward convergence of the various minimum wages, and the financing of multi-year sectorial estimates acts in priority areas. In this regard, the government must take full advantage of the opportunities offered by the application of the constitutional bylaw on budget acts (LOLF) starting in 2006 to continue to increase the productivity of State services, target its actions more effectively, and expand the recently created cross-disciplinary structural savings projects (modernisation of the State's property management and public purchasing procedures, development of public-private partnership agreements, etc.).

The aim of health insurance reform is to make insured individuals and professionals more accountable in order to improve the efficiency of our health-care system and prevent further deterioration in its accounts (the health insurance deficit is estimated at € 13.2 billion for 2004). This reform seeks to achieve € 11 billion in savings on expenditures during the 2004-2007 period. Given an increase in receipts of more than € 4 billion, this would enable the social security funds to balance their accounts in 2007. In this context, the increase in health insurance spending would be reduced to an average of only 2.1% in volume per year in 2006-2008. This reduction, coupled with a decrease in unemployment benefits, would make it possible to reduce growth in social spending to 1.7% on average per year over the period versus an annual average of 3.0% during the period 2002-2005, despite an increase in retirement expenditures (which should rise an average of 2.8% per year during the period).

With the expected reduction in spending by local authorities, this tighter control of State spending and social expenditures would limit the growth in public spending to 1.2% per year over the period. This growth in spending, which is less than potential economic growth by one-half, would result in structural margins equivalent to 0.5 GDP points per year. Moreover, public spending would be reduced from 53.6 percent of GDP in 2005 to 51.7 percent in 2008.

Increase in public spending in 2006-2008
in volume, annual average

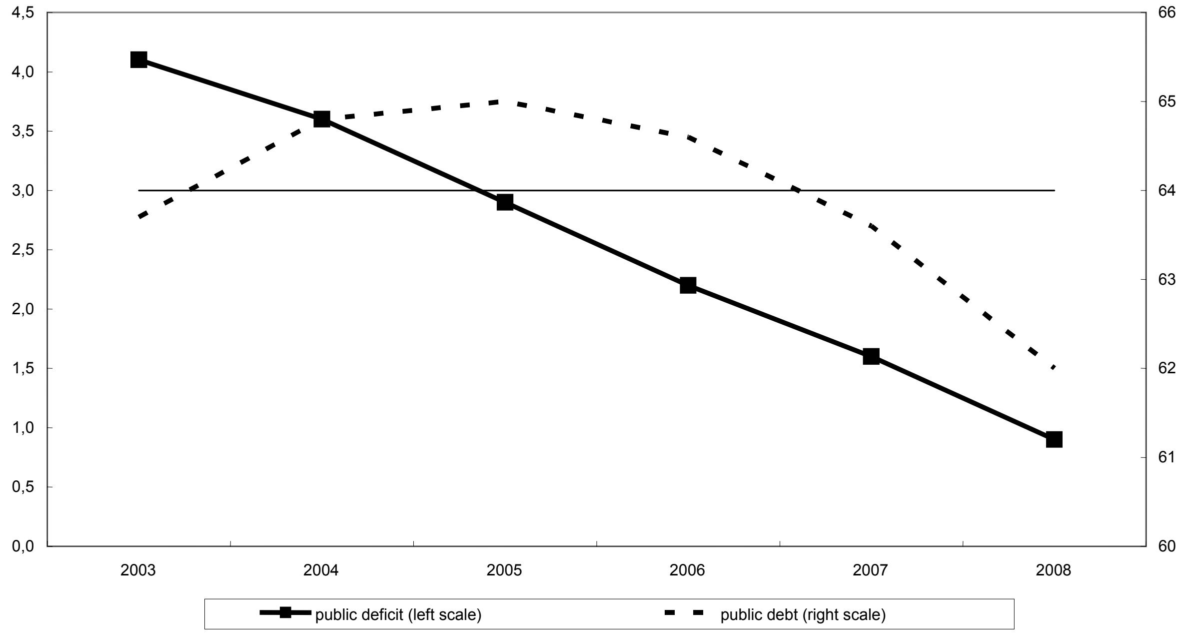
Public spending, *including:*	1.2%
State (budgetary accounting)	0.0%
State (national accounting)	0.2%
Social security funds *including:*	1.7%
Health insurance spending	*2.1%*
Retirement expenditure	*2.8%*
Local authorities	1.8%

The structural deficit will be reduced by 0.5 points each year.

The programme also relies on stabilising the tax burden ratio at 43.7 points of GDP in 2006-2008, given the increases and decreases expected to result from measures already approved or proposed (such as the continued increase in exemptions from social contributions, business tax relief for new investments, and tax measures included in the 2005 budget bill). With a significant increase in non-tax public revenues and payment of the EDF-GDF one-off contribution in 2005, the ratio of public revenue to GDP would also remain stable during the 2006-2008 period.

Under these conditions, the public deficit would gradually decrease to just under 1 GDP point in 2008. The cyclically-adjusted reduction would be 0.5 GDP points each year and the underlying status of public finances would be a near balance by the end of the period. At the same time, the ratio of public debt to GDP would begin to decrease beginning in 2006, falling to 62.0 GDP points in 2008. This reduction could be accelerated by debt relief operations in the form of the sale of State assets.

PUBLIC DEFICIT AND GENERAL GOVERNMENT DEBT, 2003-2008
(in GDP points)



Thanks to pension reform and the projected impact of health insurance reform, public finances would be in a good position to deal with the effects of the ageing crisis, which are expected to increase during the next decade.

The improved budgetary framework boosts the credibility of the consolidation objectives

To ensure that these consolidation objectives become a reality, the government has also begun to update the budgetary framework in order to protect itself from past mistakes and poor habits:

- The recent periods of economic growth in France and abroad show that significant slippages can occur in the event of tax revenue windfalls. This is why the government recommended that Parliament amend the LOLF to require that, in the future, the government stipulate in advance, upon presentation of the budget bill, how it would use any tax revenue surpluses with respect to the budget bill assessments. While the government has undertaken to allocate the full amount of these potential surpluses to reducing the public deficit so long as this deficit is not less than 3 GDP points, this new measure introduces a new and important requirement of transparency in managing the public finances;

- Health insurance spending represented a source of ongoing slippage in the accounts of social security institutions, given that the national spending target for health insurance was established merely for informational purposes. In addition to cost-cutting and revenue-generating measures to correct this problem, the recently enacted insurance reform calls for a complete reorganisation of health insurance management, which will give considerable autonomy and financial management authority to health insurance funds. The reform also calls for the creation of an early alert committee responsible for recommending corrective measures whenever it perceives a risk that spending targets will be significantly exceeded.

The government also plans to amend the constitutional bylaw on social security financing with a view to setting multi-year spending targets in an effort to improve the financial management of the system;

- Lastly, to ensure that local authorities are more closely aligned with the national objectives of improvement of public finances, the government plans to organise an annual conference, prior to the preparation of the budget bill, attended by representatives of the State, the social security funds and local governments to discuss financial strategies for the coming year.

These measures, along with the emphasis placed on the retirement and health care reform packages to ensure the long-term viability of public finances, are consistent with the discussions underway regarding reform of the stability and growth pact.

The government does not intend to repeat the errors made during previous periods of economic growth. It will take full advantage of the growth momentum that began in 2004 in order to permanently reduce the public deficit through rigorous control of spending. Under these conditions and by reducing the number of pointless regulations, we will enjoy greater freedom to promote economic policy and reduce unemployment.