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FRANCE: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE DECEMBER 2008 UPDATE OF THE STABILITY PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term budgetary programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 18 February 2009. Comments should be sent to Suzanne Casaux, Pierre Ecochard and Samuel de Lemos Peixoto (suzanne.casaux@ec.europa.eu, pierre.ecochard@ec.europa.eu and samuel.de-lemos-Peixoto@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services' January 2009 interim forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying methodological paper prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 18 February 2009. The ECOFIN Council is expected to adopt its opinion on the programme on 10th March 2009.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

1. INTRODUCTION

This document assesses the December 2008 update of the French stability programme, taking into account all currently available information, notably the Commission services' January 2009 interim forecast. The programme, which was submitted on 23 December 2008, covers the period 2008-2012 and builds on the 2009 budget proposal. The programme includes explicitly a description of the French recovery package and its impact on public finances. Still, the amendments to the 2009 budget were not included in the programme. The programme details the measures adopted by the French authorities in response to the economic downturn and contains budgetary projections reflecting the impact of the stimulus measures.

2. MAIN CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

In the course of 2008, economic activity decelerated rapidly, as the weakening of domestic demand was combined with a sharp global downturn. Contrary to the previous years, domestic demand provided only limited support to growth. Households' consumption was restricted by the deceleration of real disposable income, which was hit by high inflation and the on-going deterioration of the labour market. At the same time, investment suffered from the downturn in the investment cycle and the housing market, as well as from the impact of the financial crisis on confidence and credit conditions. After a deceleration in the first half of 2008, GDP collapsed in the fourth quarter, leading to an annual GDP growth of 0.7%. Taking into account the still gloomy prospects for the coming quarters and the positive impact on economic activity of the recovery package, GDP is expected to contract by 1.8% in 2009 in the Commission services' January 2009 interim forecast. Accordingly, the output gap was positive in 2008 and is expected to enter negative territory in 2009 and to further deteriorate in 2010 when growth will still be below potential. This output gap profile reflects the sharp economic downturn and is based on a potential growth of 1½% as estimated in the Commission services' January 2009 interim forecast (on average for the period 2007-2010) [1]. After declining strongly for two years, and in the wake of the contracting economic activity, the unemployment rate has increased since mid-2008 and is projected to go on rising in 2009 and 2010, remaining above the euro area average. France is thus expected to be in economic bad times both in 2009 and 2010, after neutral times in 2008 and good times in 2007. In view of the falling growth and the deteriorated situation of public finances, France's main challenge in the medium term will be to continue improving the overall competition framework and to further modernise the labour market, while sticking to the expenditure targets, and strengthening the pace of budgetary consolidation as soon as the economic situation has gained momentum.

The global economic and financial crisis has affected economic activity via the trade and confidence channel. Even though France is not a particularly export-oriented economy, it is exposed to the global downturn given the magnitude of the slump in world trade, and in

[1] The potential growth is calculated on the basis of the Commission services' January 2009 interim forecast with the common agreed methodology. According to the Commission services' latest forecast, potential growth is estimated at 1.6%, 1.4%, 0.9% and 1.0% respectively in the period 2007 – 2010. These estimates can be considered to be on the low side as structural reforms under implementation could somewhat enhance potential growth in the coming years.

particular in its neighbouring countries[2]. This is expected to have negative repercussions also on investment, while contracting employment and wage growth in the near term may dampen private consumption. The confidence crisis in the banking sector and the associated drying-out of the interbank market has entailed a tightening of liquidity and lending conditions, albeit to a more limited extent than in other countries. The direct effect of the crisis on the French banking system have been so far limited on the back of several factors, including the predominance of a universal banking system and relatively sound balance sheets in the corporate and the financial sector. On top of that, banking system support measures should also sustain the supply of lending. So far, the impact of the financial crisis on credit growth has been surprisingly limited in the corporate sector. On the other hand, loans to households, particularly mortgages, have decreased more sharply, also due to a falling demand. The financial crisis has implied an increasing cost of funding and the need for banks to match assets with liabilities. Thus, the tightening of financing conditions has amplified the already existing downturn in the housing market. The rise in interest rates from 2006, the peak reached by loan maturities and the increasing pessimism of French households concerning their future disposable income were the main reasons for the freezing of the French housing market which started at the beginning of 2007. Even if housing prices have started to fall, the effect on consumption should be small, since the practice of equity withdrawal by banks is extremely limited. All in all, after having supported economic activity for a few years, the construction sector and in particular household investment should fall sharply in 2009.

According to the Commission services' calculations, from 2004 to 2006 France's general government structural balance improved by 0.7 pp of GDP. Starting from 2007, this trend reversed, with the structural balance deteriorating by 0.3 pp of GDP. Due to worse-than-expected economic conditions in 2008 but also to other factors including the tax cuts adopted in 2007, France will thus enter into recession in 2009 with a very limited fiscal space. Against the background of already fragile public finances (the deficit is expected to have breached the 3% of GDP threshold already in 2008) the downturn and the related stimulus measures will have a significant impact on the deficit which is expected to exceed 5% of GDP in 2009.

On 4 December, President Sarkozy announced a €26 billion (1.3% of GDP) stimulus package to tackle the economic downturn, following the 26 November Communication from the Commission to the Council on a European Economic Recovery Plan (EERP). The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy. The French package can be described as a balanced mix of revenue and expenditure instruments and is in line with the EERP. The announced measures are concentrated in public investment (0.6% of GDP) and support to enterprises (0.6% of GDP). According to the French government, the new measures would raise the deficit by 0.9% of GDP and foster growth by +0.6% over the next two years, with the main impact in 2009. The Government is also implementing a number of structural reforms, which are expected to have a positive impact on the potential growth of the economy, and, therefore, on public finances in the long run. As far as the goods and services markets are concerned, the above-mentioned law on the modernisation of the economy aims at raising potential growth, notably by promoting individual entrepreneurship and reducing existing barriers to competition, including in the retail sector. On the labour market front also new laws have been adopted, notably as regards flexicurity. The law on the modernisation of the labour market, which was adopted in June 2008 and represents the transposition of the social partners' first inter-professional agreement, aims to develop both more secure and more

[2] 65% of French exports were directed to the EU in 2007.

flexible contracts. An important reform of social dialogue procedures has also been brought in to facilitate majority agreements. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

Box: Measures to help stabilise the financial system

In response to the financial crisis, the French Government undertook a number of measures addressed to ensure the stability of the financial sector. In order to dampen its consequences on solvency ratios of French banks, the Government decided, thanks to a €40bn[3] fund, to purchase subordinated bank debt without acquiring voting rights. In exchange, banks are notably supposed to commit to increase loans to the economy in order to guarantee a degree of financing in line with the needs of economic agents. Furthermore, a €320bn[4] fund will guarantee bank debts. This guarantee scheme is aimed at improving the access to finance of banks, in the context of the severe pressure the market for interbank loans has had to face since the beginning of the financial crisis. Banks will pay a premium for the Government guarantee for their loans.

3. MACROECONOMIC SCENARIO

According to the December 2008 Stability Programme, GDP growth will be positive throughout the programme period (2008-2012). After 2.2% in 2007, it is projected to slow to 1.0% in 2008 and further to a range of 0.2%-0.5% in 2009, before it would increase again in 2010 (2.0%), and then come out at +2.5%, above potential (estimated in the programme at close to 2% for the entire period) from 2011 onwards. In comparison, the Commission services' January 2009 interim forecast is much less optimistic, also taking into account the latest information available up to mid January including the sharp contraction of industrial output in October and November. Given the scope of the drop in industrial production, GDP contracted sharply at the end of 2008, leading to a carry-over for 2009 of around -1%. It is thus expected that GDP will grow more slowly than envisaged in the programme in 2008, decline sharply in 2009 by 1.8% and that economic expansion will remain subdued in 2010 at +0.4%. Summing up, the programme's growth projections appear favourable for 2008 and markedly favourable for the years 2009 and 2010. They can be considered as markedly favourable also for 2011 and 2012, when comparing the growth rates in the programme with the potential output estimates (both according to the programme as recalculated by the Commission services' and according to the Commission services' January 2009 interim forecast).

[3] Of which, the Commission has authorised €21 billion.

[4] Of which, the Commission has authorised €265 billion.

Table I: Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011	2012
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	0.7	1.0	-1.8	0.2-0.5	0.4	2.0	2.5	2.5
Private consumption (% change)	1.1	1.1	0.1	1.3	0.3	2.4	2.8	2.8
Gross fixed capital formation (% change)	-0.2	0.2	-5.3	-3.6	-0.6	2.4	3.2	3.2
Exports of goods and services (% change)	1.5	1.6	-3.5	1.3	1.3	5.0	6.5	6.5
Imports of goods and services (% change)	2.3	1.5	-1.4	0.3	0.7	4.6	6.1	6.1
Contributions to real GDP growth:								
- Final domestic demand	1.0	1.0	-0.7	0.2	0.3	2.0	2.4	2.4
- Change in inventories	-0.1	0.0	-0.5	0.0	0.0	0.1	0.1	0.1
- Net exports	-0.2	0.0	-0.5	0.3	0.1	0.0	0.0	0.0
Output gap[1]	1.0	-0.6	-1.7	-1.8	-2.3	-1.6	-1.1	-0.4
Employment (% change)	0.8	0.8	-1.9	0.1	-0.7	0.3	0.8	0.8
Unemployment rate (%)	7.8	n.a.	9.8	n.a.	10.6	n.a.	n.a.	n.a.
Labour productivity (% change)	-0.1	0.3	0.1	0.4	1.1	1.7	1.7	1.7
HICP inflation (%)	3.2	3.3	0.8	1.5	1.5	1¾	1¾	1¾
GDP deflator (% change)	2.4	2.2	2.0	1.8	1.6	1¾	1¾	1¾
Comp. of employees (per head, % change)	2.6	2.9	2.1	2.7	2.0	3.4	3.4	3.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-3.8	-3.4	-4.0	-2.6	-3.9	-2.5	-2.4	-2.4

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source :

Commission services' January 2009 Interim forecasts (COM); Stability programme (SP)

Divergences in the forecasts of developments of economic activity are also reflected in the composition of growth. According to the programme, both internal demand and net export will support GDP growth in 2009, respectively by 0.2 and 0.3 pp. In contrast, in the Commission services' January 2009 interim forecast, the projected contraction in 2009 is driven by a sharp slump both in internal demand and net exports. The 2.3 pp GDP growth difference is explained by a much lower contribution from net trade in the interim forecast (by 0.8 pp), and a lower domestic demand (by 0.9 pp) coupled with a negative contribution from the change in inventories (0.5 pp, whereas in the stability programme the contribution is assumed to be zero). According to the Commission services' projections, the materialisation of the steep and rapid deterioration of the external environment, signs of which have been looming more clearly since October in the trade data and business order books, will cause French exports markets to decline by around 2% in 2009 leading to a considerable fall of French exports (by 3.5%). Conversely, in the programme, exports are expected to grow, in line with a still positive rise of French exports markets (+1.3%). Concerning domestic demand, almost two thirds of the difference comes from private consumption, most notably from disposable income. According to the Commission services' forecast, household disposable income would slow due to a sharp deceleration of the compensation of employees (0.6% against 2.8% in the programme), a drop in employment (by 1.9%) and modest wage increases in the context of low inflation whereas employment would grow slightly (by 0.1%) and wages would only moderately decelerate in the programme. In addition, households are set to behave more cautiously and convert a bigger part of their revenue into additional saving. In the Commission services' forecast, gross capital formation would be limited by a weaker demand and by the persisting tightening of financial conditions. Finally, the negative contribution from a decline in inventories in the interim forecast reflects the fact that they are recorded at high levels in the manufacturing business surveys and can be expected to be scaled back as production adjusts to weaker levels of demand. For example, in the automotive industry, faced with excess stock levels in the wake of declining sales, the manufacturers have had to close down plants for extended period in the fourth quarter of 2008. The programme's macro-economic scenario includes the impact on growth of the recovery package, adopted early December by the French authorities. The effects of the stimulus assumed in the programme are plausible and similar to the Commission services' estimate of 0.6%. However, in the Commission services' forecast, the impact would be spread over two years (+0.4 pp in 2009 and +0.2 pp in 2010) while the programme update suggests that the impact would be concentrated in 2009. In the Commission services' forecast, the initiatives put in place by the government in the frame of the "recovery plan" are forecasted to lead to a slow recovery only in the second part of 2009 with economic activity expanding by 0.4% in 2010.

In the light of the latest developments in oil prices and the intensity of the global downturn, the programme’s projections for inflation appear to be on the high side for 2009, and can be considered realistic thereafter.

4. BUDGETARY STRATEGY

4.1. Budgetary implementation in 2008

The Commission services' January 2009 interim forecast projects a deficit of 3.2% of GDP, which is 0.9 pp worse than in the previous update and also 0.3 pp higher than the figure contained in the most recent programme update. As indicated by the French Minister of the Economy, Industry and Employment, in a letter addressed to the Commissioner of Economic and Financial Affairs on 6 February 2009 the general government deficit for 2008 might have reached 3.2% of GDP[5], fully in line with the interim forecast estimate. The 0.9% of GDP difference with the target from the previous update can be largely explained by (i) a worse-than-anticipated outcome in 2007 mainly due to lower-than-expected revenue (0.3 pp), (ii) markedly weaker growth in 2008 (0.7% in the interim forecast) than expected in the previous update (2-2.5%) lowering tax revenue compared to plan (0.3 pp), and (iii) higher interest payments, reflecting an upsurge in inflation in 2008 (0.2 pp).

4.2. Near-term budgetary strategy

The programme sets a budgetary target of 3.9% for 2009. This target takes into account the implementation of the recovery package announced on 4 December and is consistent with the November budgetary targets set in the update of the Draft Budget Law. Indeed, the Draft Budget Law unveiled on 26 September initially forecasted public deficit for 2009 at 2.7%. It was amended following the new growth and deficit projections announced by the Government on 6 November in the context of the financial crisis. Economic growth was revised downwards (to [0.2% - 0.5%] in 2009, compared to [1.0% - 1.5%] initially); as a consequence, the forecasted public deficit for 2009 was increased to 3.1%. The draft was

[5] This number is not yet final since data on local authorities public finances are still missing.

finally adopted by the Parliament on 28 December 2008 but modified again in January 2009, in order to take into account the budgetary impact of the recovery package of 0.8% of GDP in 2009. The new budget target contained in the stability programme update is thus 3.9% of GDP. However, according to the previously mentioned letter, the general government deficit would reach 4.4% of GDP in 2009 (and 3.1% of GDP in 2010) based on an unchanged macroeconomic scenario.

In the new update of the stability programme, the revenue-to-GDP ratio is expected to decrease slightly, from 49.8% of GDP in 2008 to 49.6% of GDP in 2009, notably on account of the measures decided in the stimulus package.

The budgetary projections in the new update of the stability programme take into account the new measures announced in the 2009 Draft Budget Law, as well as the impact of tax cuts decided before the new budget. The Government introduced a new tax on capital gains, designed to offset the cost of the new incentive scheme aimed at making work pay (*Revenu de Solidarité Active*). Moreover, in the Social Security Budget Law for 2009, the Government increased the tax on the turnover of complementary insurance and on pharmaceutical companies (which would raise 0.1% of GDP), in order to limit the deficit of social security in 2009. Based on the measures the Government decided upon before the new budget, tax revenue would decrease by 0.2% of GDP (0.1% of GDP on account of the fiscal package, mainly involving tax cuts, and 0.1% of GDP from the change in the tax collection of benefits).

The expenditure ratio would increase, from 52.7% of GDP in 2008 to 53.5% of GDP in 2009, taking also into account the measures decided in the December 2008 recovery package, particularly additional public investment.

The programme presents the French recovery plan, as announced by the Government in December 2008. The French recovery plan can be described as a balanced mix of revenue and expenditure instruments and seems to be broadly in line with the EERP. Its measures encompass public investment (mainly in public enterprises, infrastructures, research and defence), the labour market (such as a total exemption from social security contributions by employers of small companies), support to firms (such as sectoral aids for the housing and automobile industry, as well as an acceleration of government payments to enterprises, especially SMEs) and support to household purchasing power (mainly € 200 grants in April 2009 to lower income households). The package can be considered as targeted and timely. The announced measures are temporary since they notably consist in anticipating reimbursement of tax credits and frontloading public investment, with a 0.8% of GDP impact on the deficit in 2009 and 0.05% in 2010. They bear no costs for public finances beyond 2010. The French stimulus package appears to be an appropriate response to the sharp downturn, given that when the sharp economic downturn arose, France's fiscal space was limited, as public deficit was already around the 3% of GDP threshold and the debt ratio was also above 60%. Moreover, in the context of the financial crisis and help to the bank system, the government established two funds: the first one is endowed with a maximum amount of around 2% of GDP to subordinate bank debt issues, without acquiring voting rights, and about 16% of GDP maximum have been allocated to the second one in view of guaranteeing bank debts.

Table II. Main budgetary measures for 2009

Revenue measures[1]	Expenditure measures[2]
Measures in response to the downturn	
• Acceleration of Government payment to corporations (-0.3% of GDP)	• Additional public investment (0.3% of GDP) • Sectoral aid for housing and automobile industry (0.1% of GDP) • Social measure in favour of the low income households (0.1% of GDP)
Other measures	
• New tax on capital gains (0.1% of GDP) • Increase of the tax on the turnover of complementary insurance and on pharmaceutical companies (0.1% of GDP) • Fiscal package (-0.1% of GDP) • Change in the dividend taxation (-0.1% of GDP)	• Making work pay measure (*Revenu de Solidarité Active*) (0.1% of GDP)

Note:

[1] Estimated impact on general government revenue

[2] Estimated impact on general government expenditure

Source: Commission services and Budget Law

Table III: Composition of the budgetary adjustment

(% of GDP)	2007	2008		2009		2010		2011	2012	Change: 2008-2012
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP	SP
Revenue	**49.7**	**49.6**	**49.8**	**49.4**	**49.6**	**49.9**	**50.0**	**50.0**	**50.2**	**0.4**
of which:										
- Taxes on production and imports	15.1	14.9	14.9	14.9	15.0	15.0	15.0	15.0	15.0	0.1
- Current taxes on income, wealth, etc.	11.5	11.4	11.6	11.1	11.1	11.4	11.3	11.3	11.4	-0.2
- Social contributions	18.0	18.0	18.0	18.2	18.2	18.1	18.3	18.4	18.4	0.4
- Other (residual)	5.2	5.2	5.3	5.3	5.3	5.3	5.4	5.3	5.4	0.1
Expenditure	**52.4**	**52.7**	**52.7**	**54.9**	**53.5**	**54.9**	**52.7**	**52.0**	**51.3**	**-1.4**
of which:										
- Primary expenditure	49.6	49.9	49.8	52.0	50.7	52.0	49.9	49.2	48.5	-1.3
of which:										
Compensation of employees	12.9	12.9	12.8	13.2	12.9	13.2	12.8	12.5	12.4	-0.4
Intermediate consumption	5.1	5.1	5.1	5.2	5.1	5.2	5.0	4.9	4.7	-0.4
Social payments	23.1	23.3	23.2	24.5	23.7	24.7	23.7	23.5	23.4	0.2
Subsidies	1.4	1.4	1.3	1.4	1.4	1.4	1.3	1.3	1.2	-0.1
Gross fixed capital formation	3.3	3.3	3.3	3.6	3.5	3.4	3.2	3.0	2.9	-0.4
Other (residual)	4.0	4.0	4.1	4.1	4.1	4.0	4.0	4.0	3.9	-0.2
- Interest expenditure	2.7	2.9	2.9	2.9	2.8	2.9	2.8	2.8	2.8	-0.1
General government balance (GGB)	**-2.7**	**-3.2**	**-2.9**	**-5.4**	**-3.9**	**-5.0**	**-2.7**	**-1.9**	**-1.1**	**1.8**
Primary balance	**0.1**	**-0.3**	**0.0**	**-2.6**	**-1.1**	**-2.1**	**0.1**	**0.9**	**1.7**	**1.7**
One-off and other temporary measures	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.8**	**-3.3**	**-2.9**	**-5.4**	**-3.9**	**-5.0**	**-2.7**	**-1.9**	**-1.1**	**1.8**
Output gap[2]	1.8	1.0	-0.6	-1.7	-1.8	-2.3	-1.6	-1.1	-0.4	0.2
Cyclically-adjusted balance[2]	-3.5	-3.7	-2.6	-4.6	-3.0	-3.8	-1.9	-1.4	-0.9	1.7
Structural balance[3]	**-3.6**	**-3.8**	**-2.6**	**-4.6**	**-3.0**	**-3.8**	**-1.9**	**-1.4**	**-0.9**	**1.7**
Change in structural balance		*-0.1*	*1.0*	*-0.8*	*-0.4*	*0.8*	*1.1*	*0.5*	*0.5*	
Structural primary balance[3]	-0.9	-0.9	0.3	-1.7	-0.2	-1.0	0.9	1.4	1.9	1.6
Change in structural primary balance		*0.0*	*1.2*	*-0.8*	*-0.5*	*0.7*	*1.1*	*0.5*	*0.5*	

Notes*:*

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations

4.3. Medium-term budgetary strategy

The medium-term budgetary strategy of the programme is to reduce the structural deficit from its current level towards the medium term objective (MTO) of a balanced budget by 2012, by lastingly restraining public expenditure and stabilizing the tax burden as a share of GDP.

The structural balance, as recalculated by the Commission services on the basis of the information in the programme, is projected to improve from 2010 onwards, starting with a substantial adjustment of around 1% of GDP followed by adjustments of 0.5% of GDP in the two subsequent years. However, the recalculated structural balance would still show a deficit of 0.9% in 2012.

According to the projections of the programme, after peaking at 3.9% of GDP in 2009 the headline general government deficit is projected to fall rapidly to reach 1.1% of GDP in 2012.

From 2009 onwards, as interest expenditure as a share of GDP would be stable, the primary balance would follow a profile similar to the headline, implying an improvement, from -1.1% of GDP in 2009 to 1.7% in 2012.

In spite of the programme's objective to stabilise the tax burden, programme figures show an increase in revenue as a share of GDP by around ½ pp, which is notably explained by the evolution of social contributions.

The programme projects that the expenditure ratio (which is the highest in the euro area) will decrease from its peak of 53.5% in 2009 towards 51.3% in 2012. This objective is notably backed by cuts in public employment, thanks to the implementation of the General Review of Public Finances (or *Revue Générale des Politiques Publiques*), which entails annual assessments of the efficiency of public policies, ministerial strategies, and audits for modernising the State. As regards social security transfers, the growth of healthcare spending is framed by the national objective (or ONDAM), set at 3.3% in value in 2009, and at the same rate, on average, for the period 2010 – 2012. This norm is, however, non-binding.

The achievement of the expenditure restraint strongly relies on the implementation of the "zero volume growth" rule. According to this rule, central government spending, including transfers to local authorities and the European Union, should stay stable in volume terms. However, the rule will not be fully respected in 2009, even without taking into account the impact on central government expenditure of the recovery plan. This is due to the planned transfers to local authorities[6]. Without taking into account the impact of the recovery plan, central government spending would grow by 0.1% in volume. According to the programme, the rule would be respected from 2010 to 2012 and the implementation of the zero volume rule throughout the programme period would be compatible with a no-policy change assumption. As discussed in the next section, the rule means however that there will be very little room for manoeuvre for central government expenditure.

4.4. Risks to the budgetary targets

The budgetary outcomes are subject to downside risks throughout the programme period. According to the Commission services' January 2009 interim forecast, the deficit will be 3.2% of GDP in 2008, 5.4% in 2009 and 5.0% in 2010, against respectively 2.9%, 3.9% and 2.7% in the programme. According to the new forecast announced in the above-mentioned letter sent by Minister Lagarde, the 2008 deficit is now expected to have reached 3.2% of GDP, and is projected at 4.4% and 3.1% of GDP in 2009 and 2010, respectively. Additional risks to the budgetary targets in the programme can be summarized as follows.

The macroeconomic outlook will most probably be worse than envisaged by the scenario of the programme, which appears markedly favourable over the entire programme period, as concluded in Section 3. This is especially the case for 2009, when the growth difference with the Commission services' interim forecast attains 2.3 pp. Even the higher deficit target of

[6] In order to maintain a "zero volume growth" target, planned nominal spending has to be adapted following an update of inflation forecast. On 6 November, the government unveiled a new lower inflation projection of 1.5% and central government spending (without the recovery plan) was adapted accordingly in order to maintain a zero growth in volume. However, the government decided, in breach to the rule, to stick to the initial forecast for the contributions to local authorities. Therefore, central government expenditure, including transfers to local authorities and the EU, will increase by 0.1% in volume terms in 2009.

4.4% of GDP recently announced by the government is still based on the macroeconomic scenario that was released at the beginning of November. Budgetary outcomes are thus likely to be significantly worse than targeted in 2009 and 2010 due to the normal functioning of automatic stabilisers, both on the revenue and expenditure sides (lower tax collection and higher unemployment benefits, respectively). As for the outer years, the growth outlook in the programme (2.5% for both 2011 and 2012) is substantially higher than the potential growth as estimated by the Commission services on the basis of the January 2009 interim forecast (around 1½% on average for 2007-2010), which creates again a negative risk for public finances.

Possible expenditure slippages constitute an additional downward risk. France has a rather poor track record when it comes to respecting its budgetary targets, as illustrated in Figure 2 in annex 2.

First, as far as the central government is concerned and according to the new update of the stability programme, expenditure would be stable in volume on average during the period 2008 – 2012, after having posted an average increase of 1% between 1998 and 2007. Given France's past track record (see section 6 below), expenditure overruns cannot be ruled out. Civil servants' pensions and interest payments will exert strong pressure on the budget as they will account for 70% of the planned increase of the central government expenditure between 2008 and 2011 (compared to roughly 30% of the nominal increase from 2003 to 2007). This, and other obligatory increases in expenses, will leave almost no room for manoeuvre for expenditure increases in value.

Second, social security spending would, according to the programme, increase by 1.75% on average each year from 2008 to 2012, after 2.75% from 1998 to 2007. Healthcare expenditure and pensions account for roughly 4/5 of social security spending but since the evolution of pensions is largely determined by demography, the uncertainty in the evolution of social security spending lies mainly in healthcare expenditure. Measures to contain healthcare spending rely on the implementation of the latest social security finance act (*Loi de Financement de la Sécurité Sociale*), and on the national health insurance spending objective (*Objectif National des Dépenses d'Assurance Maladie*), set at 3.3% for 2008–2012. According to the programme, this objective will be reached thanks notably to a series of reforms aimed at increasing the efficiency of the healthcare system. However, many of these measures are nonbinding or of limited impact. As a consequence, healthcare expenditure could turn out to be higher than projected by the programme, as it has often been the case in the past.

Finally, the growth rate of local authorities' spending is projected to decrease, from 2.75% on average from 1998 to 2007, to 1.75% from 2008 to 2012. Again, given past track record on local authorities' spending, there is a risk that this projected growth rate will not be achieved.

5. DEBT DEVELOPMENTS AND LONG-TERM SUSTAINABILITY

5.1. Debt developments

Starting from 63.9% in 2007, the programme expects the debt-to-GDP ratio to have increased to 66.7% in 2008, to rise further to 69.1% in 2009 taking into account the recovery plan, and to reach 69.4 in 2010. The debt ratio is projected by the programme to decrease in the two following years, standing at 66.8% in 2012. These figures are noticeably lower than those in the Commission services' forecast, according to which the debt-to-GDP ratio would reach

72.4% in 2009 and 76.0% in 2010 mostly due to significant differences to both the macroeconomic scenario and the deficit forecasts.

Over the last six years, the debt targets of the successive stability programmes have always been revised upwards and often missed (see Figure 3 in annex). For instance, in the 2007 update of the stability programme, the 2012 target was 57.9%, as opposed to 66.8% in the current update, well above the 60% debt threshold.

Risks to the debt scenario are clearly on the upside, due to the above mentioned risks to the deficit targets.

In the context of the financial crisis and as already mentioned, the government established two funds: the first one of around 2% of GDP to subordinate bank debt issues, without acquiring voting rights, and the second of up to 16% of GDP to guarantee bank debts, not necessarily impacting public debt. Additional capital injection in the banking sector, either as a consequence of the existing recapitalisation and guarantee mechanisms, or because of possible additional measures, cannot be excluded and could have a significant impact on debt. As most of the debt is denominated in euro and as the average maturity of the negotiable debt is almost seven years (which can be considered sufficient), there are no significant risks related to currency denomination and debt maturity.

Table IV: Debt dynamics

(% of GDP)	average 2002-06	2007	2008		2009		2010		2011	2012
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**63.2**	**63.9**	**67.1**	**66.7**	**72.4**	**69.1**	**76.0**	**69.4**	**68.5**	**66.8**
Change in the ratio	1.5	0.3	3.1	2.8	5.4	2.4	3.6	0.3	-0.9	-1.7
Contributions [2] *:*										
1. Primary balance	**0.5**	**-0.1**	**0.3**	**0.0**	**2.6**	**1.1**	**2.1**	**-0.1**	**-0.9**	**-1.7**
2. "Snow-ball" effect	**0.4**	**-0.1**	**1.0**	**0.9**	**2.8**	**1.3**	**1.5**	**0.3**	**0.0**	**0.0**
Of which:										
Interest expenditure	2.7	2.7	2.9	2.9	2.9	2.8	2.9	2.8	2.8	2.8
Growth effect	-1.0	-1.3	-0.4	-0.6	1.2	-0.3	-0.3	-1.3	-1.7	-1.6
Inflation effect	-1.2	-1.5	-1.5	-1.3	-1.3	-1.2	-1.1	-1.2	-1.2	-1.2
3. Stock-flow adjustment	**0.6**	**0.5**	**1.9**	**1.9**	**0.0**	**0.0**	**0.0**	**0.1**	**0.1**	**0.0**
Of which:										
Cash/accruals diff.	0.0	0.2		0.2		n.a.		n.a.	n.a.	n.a.
Acc. financial assets	0.4	0.3		1.7		n.a.		n.a.	n.a.	n.a.
Privatisation	-0.4	-0.4		n.a.		n.a.		n.a.	n.a.	n.a.
Val. effect & residual	0.0	0.0		0.0		n.a.		n.a.	n.a.	n.a.

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations

5.2. Long-term sustainability

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2006 according to an agreed methodology.[7]

Table 3 in the Annex 2 shows that the projected increase in age-related spending is rising by 3.1% of GDP between 2010 and 2050, slightly below the EU average. Sustainability indicators for two scenarios are presented in Table 4 in the Annex. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2008 level, the sustainability gap (S2)[8] would amount to 3.4% of GDP, about 0.4% pp more than in last year's assessment, which is due to a lower estimated structural primary balance in the starting year. The starting budgetary position is not sufficient to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing. If the 2009 budgetary position of the Commission services' January 2009 forecast was taken as the starting point, the sustainability gap would widen by 2% of GDP.

In contrast to the "2008 scenario", which reflects the weakening of the budgetary position in response to the current economic crisis, the "programme scenario", which is based on the end-of-programme structural primary balance, shows a smaller gap. If the budgetary consolidation planned in the programme was achieved, risks to long-term sustainability of public finances would be somewhat mitigated.

Based on the assumptions used for the calculation of the sustainability indicators, Figure 4in the Annex 2 displays the projected debt/GDP ratio over the long-term.

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account. They are summarized in Table 5 in the Annex 2.

The long-term budgetary impact of ageing is slightly lower than the EU average, with pension expenditure showing a somewhat more limited increase, as a result of the pension reforms already enacted, among which the reform of the so-called *régimes spéciaux* (special pension regimes), aimed at aligning the required contribution period with the rules of other regimes. The budgetary position in 2008, as estimated in the programme, which is worse than the starting position of the previous programme, compounds the budgetary impact of population ageing on the sustainability gap. If the 2009 budgetary position of the Commission services' interim forecast was taken as the starting point, the sustainability gap would worsen substantially. Moreover, the current level of gross debt is above the Treaty reference value. Indeed, risks to the debt scenario are on the upside, reflecting the risks to the budget balance

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7 Economic Policy Committee and the European Commission (2006), 'The impact of aging on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-50)', *European Economy − Special Report* No. 1/2006. European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006. European Commission (2008), *Public finances in EMU – 2008, European Economy* No. 4/2008.

8 The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

as well as the possible need to undertake further bank rescue measures and the contingent liabilities stemming from the fund aimed at guarantying bank debts. The above-mentioned risks from the financial sector stabilisation schemes (e.g. recapitalisation, guarantees) put in place by France could have a potential negative impact on the long-term sustainability of public finances, primarily via their impact on government debt, although some of the costs of the government support could be recouped in the future. Ensuring higher primary surpluses over the medium term, as already foreseen in the programme, would contribute to reducing the medium risks to the sustainability of public finances.

6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

France's track record shows that general government expenditure overruns have not been exceptional over the past decade, indicating weaknesses in the existing budgetary framework.

On 23 July 2008, the Congress adopted a reform of the Constitution that introduced a balanced budget objective for public administrations. This objective is, however, non-binding. The reform also established a pluriannual budget to be adopted by Parliament. The first pluriannual budget will be adopted in 2009 and will cover the period 2009–2012, i.e. the same period as the stability programme. The reform should contribute to a better management of public finances and help budgetary discipline, to the extent that it will promote a long-term strategy both on the revenue and expenditure side. The Parliament, indeed, can control the adjustment path of public finances and oversee the implementation of the reforms adopted. Additionally, following the launch of the General Review of Public Policies in mid-2007, a number of measures were taken to rationalise public expenditure, including the non-replacement of one out of three retiring civil servants in 2008 and one out of two in 2009.

The control of central government spending relies notably on the "zero volume growth rule", recently extended to broader categories of expenditure including transfers by the central government to local authorities and to the EU. Given the implementation of the French recovery plan, expenditure is set to increase by 3.0% in volume terms in 2009, hence breaching the expenditure rule with a large margin. Even if the impact of the recovery plan would be excluded, the rule would be violated in 2009, although by a smaller margin.

Breaches of the rule are not common: it has been formally adhered to in recent years. However, the respect of the rule has only been achieved by frequently changing the "perimeter" of the rule, i.e. changing/reducing the expenditure lines covered. Indeed, some fast growing expenses have been excluded or shifted. For instance, the *revenue minimum d'insertion* (RMI, soon to be replaced by the *revenue de solidarité active*) is now paid by local authorities, and is therefore outside the perimeter of the rule. Moreover, certain expenditure have been recorded as tax deduction, hence as lower revenue rather than expenditure which is equivalent in deficit terms but not neutral for the rule. It should also be noted that the rule is applied using 2002 as a base year, a year when the level of expenditure was particularly high.

7. ASSESSMENT

This section assesses the budgetary strategy, taking into account risks, in the light of (i) the adequacy of the fiscal stimulus package in response to the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP) as endorsed by the European Council conclusions on the European Economic Recovery Plan (EERP) on 16 December 2008 and the overall fiscal stance (ii) the criteria for short-term action laid down the above mentioned Commission Communication, and (iii) the objectives of the Stability and

Growth Pact. The adequacy of the stimulus package has to be assessed taking into account France's specific circumstances, notably as regards the fiscal space. Considering all relevant indicators, the French fiscal space can be characterised as limited. When the downturn occurred, France's deficit was around the 3% threshold and debt was above the 60% threshold, even though the economic situation was rather favourable for several years. This fragility of public finances is accompanied by a weak competitiveness, notably due to the deterioration of cost-competitiveness compared to France's main trading partners, adding to a medium-high technology positioning that does not protect France against competition from emerging economies. In this context and given the situation of public finances and the issues with competitiveness, the French stimulus package appears to be a globally appropriate response to the downturn.

The French recovery plan can be described as a balanced mix of revenue and expenditure instruments in line with the EERP. The effect of the package should be timely, in particular as far as the social measures in favour of lower-income households or the frontloading of payments to enterprises are concerned, while other measures will take more time to bear fruit: public investments will take time to be implemented and their effect will be spread across a longer time-period. The announced measures are temporary, with very limited costs for public finances in 2010 and none thereafter. As the bulk of the package consists of frontloading investments and government payments to enterprises, the effect on the deficit in 2011 and 2012 might even turn out to be positive. In addition to the reversibility of deficit-increasing measures, the EERP stressed the need for improving budgetary policy-making in the medium-term, by strengthening the national budgetary rules and frameworks. In the case of France, as mentioned in section 6, there has been some progress recently in this area; however, there is still a lot of room for improvement.

The budgetary outcomes are subject to downside risks throughout the programme period. First, the targets of the programme do not yet reflect the worse outcome in 2008 (by 0.3% of GDP) recently confirmed by a letter sent by the French Minister of the Economy, Industry and Employment, addressed to the Commissioner of Economic and Financial Affairs on 6 February 2009. This outcome also reflects the fact that there has been a lack of fiscal consolidation in good/neutral economic times[9] and it explains part of the upward revision of the 2009 deficit target to 4.4% of GDP (which also takes into account a downward revision of corporate taxes). More importantly, the macroeconomic outlook in the programme does not show the recession expected for 2009, implying substantial budgetary risks, even to the latest deficit targets announced by the Government. Moreover, on top of the impact of automatic stabilisers, there are risks of expenditure overruns in healthcare spending since measures contained in the social security law are non-binding or have a limited impact. Finally, given the past track record of local authorities, there is a risk that the planned expenditure targets will not be met. Risks to the debt scenario are also on the upside, reflecting the risks to the budget balance as well as the possible need to undertake further bank rescue measures and the contingent liabilities stemming from the fund aimed at guarantying bank debts.

[9] The assessment of whether the economy is experiencing good or bad economic times relies on the analysis of the output gap, positive in 2007 and in 2008 (which could indicate good economic times), but also draws on an overall economic assessment, such as employment, private consumption, investment or external imbalances, which can modify the initial conclusions. On this basis, France would have been in good economic times in 2007 and in neutral in 2008. Still, the structural balance deteriorated by 0.3pp and 0.2pp of GDP in 2007 and 2008, respectively, according to Commission services' interim forecast.

Annex 1. Special topic: Taxation and the minimum wage in France: impact on unemployment

1. Introduction

Tackling unemployment has been high on the agenda of EU policy makers for several decades, and France has been no exception. Yet, at the beginning of a severe economic downturn, the French unemployment level remains high and is expected to increase. In spite of numerous employment policies adopted over the previous decades by all governments, the labour market still underperforms compared to most of France's peers, with relatively high unemployment and a weak participation rate. Moreover, the employment policies that have been adopted seriously weigh on public finances.

The key weaknesses of the French labour market are well documented, the most significant of which are linked to (i) a dual market with several different and complex contracts, (ii) excessive protection of insiders compared to outsiders, (iii) inefficiencies in the functioning of job agencies, (iv) malfunctioning incentives stemming from employment benefit mechanisms, (v) complex and lengthy litigation processes following layoffs, and (vi) a high minimum wage[10]. Recent policies have been trying to improve the functioning of the labour market and some progress has been achieved as regards labour contracts, social dialogue and job agencies.

The most significant long-term efforts, however, have focused on policies that aim at offsetting the negative effects that the high minimum wage has on efficiency. While acknowledging the numerous systemic effects of the minimum wage and its interactions with the employment protection legislation, this chapter will concentrate on social contribution reductions lowering the cost of hiring at or near the minimum wage as they are, by far, the most important of such policies in terms of cost and, presumably, impact on unemployment. The high minimum wage (the *SMIC*: *Salaire Minimum Interprofessionnel de Croissance,* defined as a minimum salary per hour worked) is established by law and there is little room for adjusting wages to lower productive workers; thus it might not be profitable for firms to hire certain low-skilled workers. Tackling this issue with tax cuts in social contributions has proved a rather successful policy. However, tax cuts are costly – especially in the context of a high public deficit – and have reached a limit, as social contributions at SMIC level are now very low. Therefore, the policy of lowering labour cost at or near the minimum wage now needs to be pursued through other policy avenues.

This chapter will analyse the impact on unemployment and public finances of the above-mentioned tax cuts in social contributions for low wages and will discuss the possibilities to address the undesirable effects of such tax cuts. Part 1 will be devoted to the description of stylised facts regarding the labour market in France and the level and impact of the SMIC; part 2 will analyse the impact on public finances and on employment of the tax cuts in social contributions for wages close to the SMIC; finally, part 3 will conclude.

[10] See for instance the Camdessus report, 2004, *Vers une nouvelle croissance pour la France.*

2. UNEMPLOYMENT AND THE MINIMUM WAGE

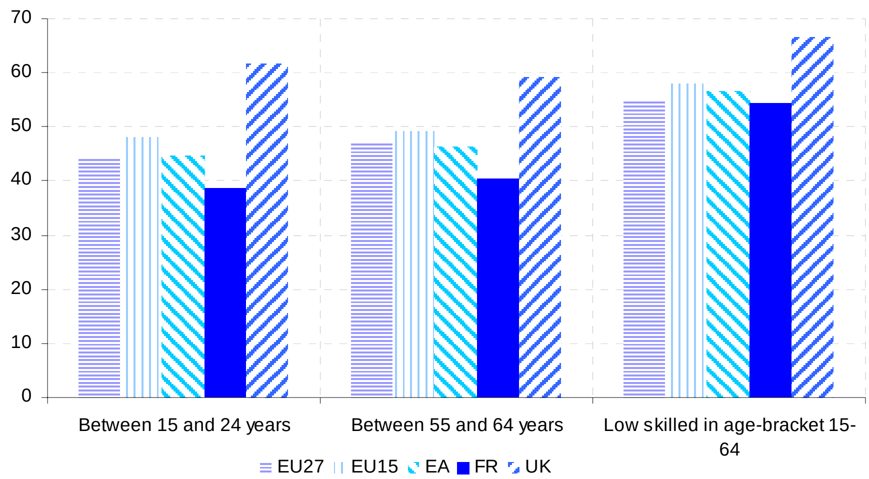
2.1. The insufficient utilisation of labour: a French weakness

Over the last ten years, real GDP grew in France at an annual average rate of 2.3%, matching the euro area average very closely. Still, the unemployment rate averaged 8.9% and thus exceeded the euro area average by 0.5 pp. Moreover, France is among the worst performers as far as the employment rate is concerned with only 64.6% of people of working age in employment in 2007 against 65.7% for the euro area as whole. This is due both to the relatively low participation rate (70.2% in 2007) and the persistently high unemployment rate (8.3% in 2007).

Insufficient utilisation of labour is one of the major issues of the French economy. It dampens the level of GDP per capita, which is only equal to the EU15 average while the hourly labour productivity is 18 pp above the EU15 level. The decomposition of growth reveals that the net contribution from labour was weaker than in the euro area through most of the period 1996-2008. While favourable demographic developments sustained GDP growth, a sluggish rise of the participation ratio in addition to the decrease in the average number of hours worked held it back.

There are significant differences between age groups, with clear problems at both ends of the age distribution. Despite improvements since 1999, employment rates of young and older workers as well as low-skilled workers are still lower than the euro area averages.

Figure 1: Activity rate of low skilled people and by age groups (2007)

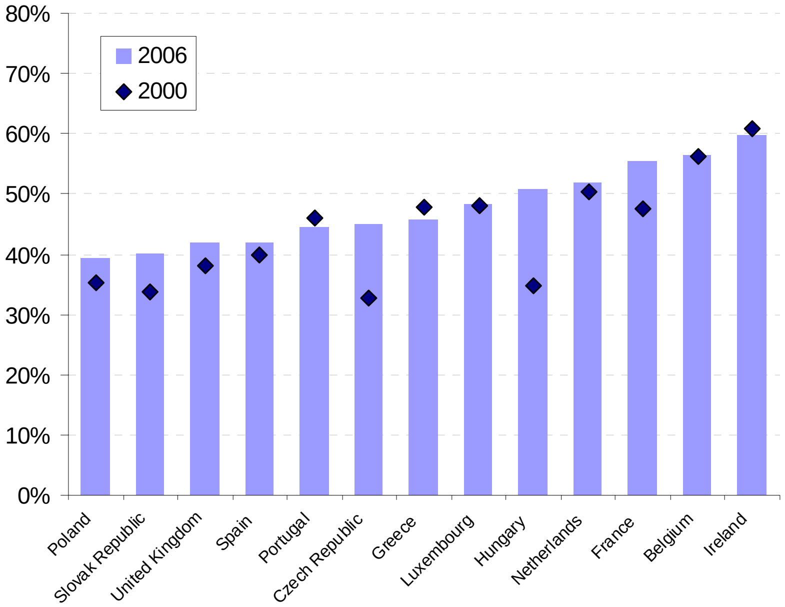


Source: *Commission services, Eurostat.*

2.2. The minimum wage: high and rising over the previous years

The minimum wage is set at a relatively high level: on 1 July 2008, the net monthly SMIC was €1037.53. As can be seen on Figure 2, France is one of the countries with the minimum wage closest to the average salary, implying that a relatively high proportion of workers are paid at the minimum wage or slightly above it. Specifically, 13% of employees were paid at the SMIC level in 2007, and, according to a recent study by Cahuc *et al.*, the salaries of around 35% of workers are impacted somehow by the SMIC level[11].

Figure 2: Hourly minimum wage for full-time workers (after-tax value) as a percentage of the net average wage, 2000 and 2006



Source: *OECD*

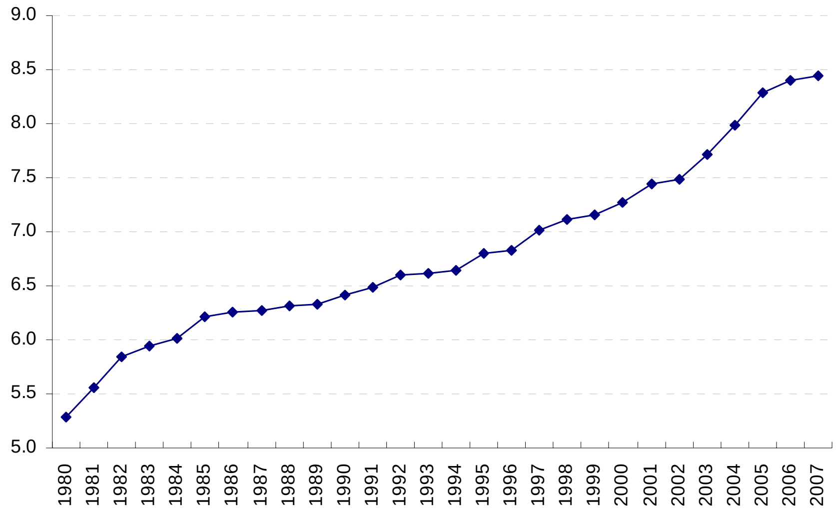
Figure 3 shows that the gross hourly SMIC in constant euros has significantly increased in the last 25 years, from €5.28 in 1980 (in 2007 euros) to €8.44 in 2007. Until a reform was adopted in November 2008, the yearly rise of the SMIC was at least equal to inflation plus an index linked to the real increase of the average wage paid to workers in the industrial sector – SMBO or *salaire moyen de base ouvrier* – in order to reflect productivity gains. The government had the possibility to add on top a discretionary element ("*coup de pouce*"). In the last few years, the SMIC increased more rapidly than previously and than the median wage. This was mainly a result of the generous "*coups de pouce*" as well as of the *Loi Fillon* of 2003, which notably merged upwards the different levels of SMIC resulting from the 35 hours law[12]. From 1992 to 2002, the SMIC increased on average by 3.0% per year, while during the years 2003-2005, it rose by 5.5% each year as a consequence of the merger of the different

[11] See "Salaire minimum et bas revenues: comment concilier justice sociale et efficacité économique?", Cahuc, Cette, Zylberberg, 2008, report of the *Conseil d'Analyses Economiques*

[12] The reduction in working time to 35 hours was implemented gradually in France between 1998 and 2002. To avoid a drop in revenue as the number of hours worked diminished, *monthly* wages were kept constant for minimum wage earners, through the *Garantie Mensuelle de Rémuneration* (monthly revenue guarantee – GMR). As firms switched from the 39-hour week to the 35-hour week at different times, different GMRs appeared. The minimum wage being indexed on inflation, there were 5 different GMRs – that is to say five different minimum wages – when the law was finally fully implemented in 2002. The merger between these minimum wages was done by gradually increasing GMRs up to the level of the highest one, which prompted a narrowing of the gap with average wages[12].

levels of SMIC. From 2006, the average annual SMIC increase diminished to 2.4% also due to the absence of "*coup de pouce*".

Figure 3: Gross hourly SMIC in 2007 Euros



Source: *INSEE; data treatment: Commission services*

A specificity of the French minimum wage is that it applies to the whole economy, independently of the geographic situation, the economic sector, or the age of the person involved[13]. Thus, groups whose productivity is lower than average, as the young taking a first job or low-qualified workers, are faced with the same minimum wage as more productive workers[14].

It has been usually been said that a high level of SMIC is a way to fight poverty and inequality. However, Cahuc *et al.* argue convincingly that the SMIC does not prevent the existence of low income workers, a situation which occurs notably in the case of part time jobs. Furthermore, when it comes to fighting inequalities and as highlighted by the Camdessus report, a broad consensus has now emerged on the fact that the specificities of the French minimum wage, its relatively high level and the fact that it does not depend on the category and therefore productivity of workers, are a burden for the employment of workers with a low productivity.

2.3. The impact of the minimum wage on unemployment

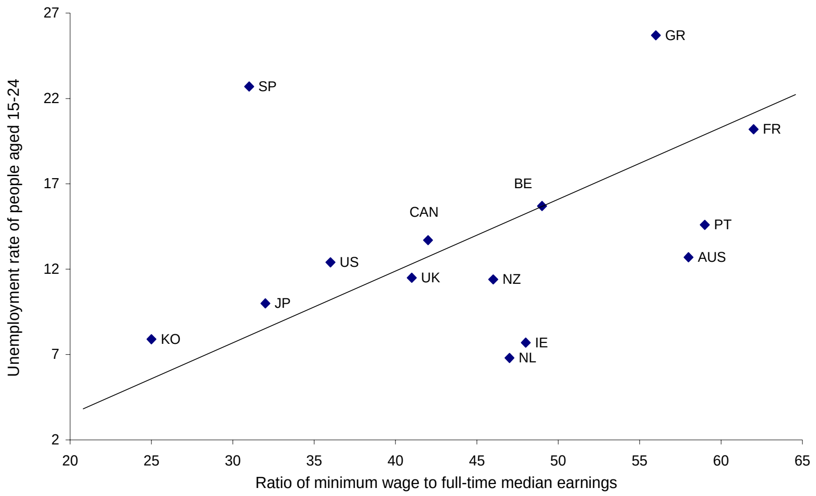
Overall, a minimum wage is generally considered to have a detrimental effect on employment. Abowd *et al.*, for instance, estimate that, in the case of France, a 1% increase in the minimum wage decreases the future employment probability of a man (woman) currently

[13] The tentative introduction in 1993 of a weaker minimum wage for youngest workers by the Balladur government (*CIP* or *Contrat d'Insertion professionnelle*) was eventually abandoned after massive demonstrations.

[14] It should be mentioned however that the SMIC does not fully apply to workers under 18.

employed at the minimum wage by 1.3% (1.0%)[15]. Since the elasticity of employment to labour cost is higher in absolute terms for less productive workers, a high minimum wage is particularly detrimental to the employment of lower-qualified workers. Neumark and Wascher concluded from a broad review of the literature that "the studies that focus on the least-skilled groups provide relatively overwhelming evidence of stronger disemployment effects [of the minimum wage] for these groups"[16]. The positive relationship between the minimum wage across OECD countries and the youth unemployment rate presented in the Figure 4 illustrates this link.

Figure 4: Minimum wage and youth unemployment



Source: *Commission services, OECD.*

Additionally, high labour costs for low-skilled workers, stimulated notably by SMIC increases, can lead to undeclared work. In its 2007 report, the *Conseil des prélèvements obligatoires* (National Council on Taxes) estimates frauds to social contributions due to undeclared work at between €6.2 and €12.4 billion in 2004 (or 0.3% to 0.6% of GDP). The frauds are concentrated in the construction sector (28.5% of the frauds in 2005 according to the latest available figures) and in the retail sector (21.2% of the frauds in 2005), namely sectors where low-skilled workers are over-represented.

3. Policy responses to the negative effects of the minimum wage

The relatively high level of the minimum wage has contributed to exclude the less productive workers from the labour market. To counteract this undesirable effect, the French authorities have been implementing labour tax cuts at or near the minimum wage for the last 15 years.

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[15] J. Abowd, F. Kramarz, D. Margolis, "Minimum wages and employment in France and the United States", Working Paper, NBER, 1999.

[16] D. Neumark and W. Wascher, "Minimum Wages and Employment: A Review of Evidence from the New Minimum Wage Research", Working Paper, NBER, 2006, revised 2007.

3.1. Policy response: fiscal incentives for the employment of low productivity workers

The French authorities have used tax cuts in social contributions since 1993 in order to keep a high and rising minimum wage, which corresponds to a well established social compromise, while tackling unemployment[17]. The mechanism limits the cost for employers of hiring at the minimum wage, while preserving the purchasing power of workers. These measures have been undertaken by both left-wing and right-wing governments. The first cuts were introduced by the government of Edouard Balladur in 1993, followed by those of Alain Juppé and Lionel Jospin (Prime Ministers between 1995 and 1997, and 1997 and 2002, respectively). Contributions are virtually non-existent at SMIC level and progressively increase until the salary reaches 160% of the SMIC.

Figure 5: The net SMIC and the labour cost at SMIC level, as a proportion of median wage

Source: *Insee; data treatment: DARES-DGTPE*

Comment: The vertical line indicates the year in which cuts in social contributions begin. Thereafter, the evolution of net wage (received by the employee) and that of labour cost (paid by employers) differ: the labour cost as a share of the median wage diminishes and then remains rather stable, while the net wage as a share of the median wage increases.

The overall impact on unemployment appears significant, even if there are divergences between the different estimates available[18]. Most of them rely on a simplified model of the economy where the effects of the tax cuts in social contributions on the goods market are not taken into account; they just have an impact on the labour market. In those models, capital is supposed to be substitutable, to a certain extent, to unskilled labour only. For an elasticity of around 2.5 of unskilled labour with capital, the available estimates point to the creation of 390,000 to 440,000 stemming from the successive exoneration schemes between 1993 and 1997; but with an elasticity of around 0.7, the number of jobs created falls to a range between 100,000 to 120,000. Taking into account the changes since 1997, a recent study estimates that

[17] In this paper, only general tax cuts in social contribution are covered (*allègements généraux de cotisations sociales*). There exist other tax cuts in social contribution, most focused on specific employee categories.

[18] See "Un essai de bilan économique des mesures prises depuis quinze ans pour stimuler l'emploi en France", 2003, Direction de la Prévision du Ministère de l'Economie, des Finances et de l'Industrie.

if the tax cuts in social contributions were to be suppressed 800,000 jobs would be destroyed within a few years[19].

Tax cuts in contributions in the TEPA package and in the recovery plan

The tax cuts on social contributions for low wages appear as a constant feature of labour taxation policies over the previous years.

A fiscal package, including tax cuts on social contributions on all wages, and not only on low wages, was adopted in August 2007 in line with the commitments taken during the presidential campaign by the incumbent President. The so-called TEPA package (*Loi en faveur du Travail, de l'Emploi et du Pouvoir d'Achat*) was adopted on 22 August 2007. It notably cuts tax on overtime, in view of fostering hours worked in France, as well as increasing households' purchasing power, in the framework of a more global policy of "making work pay". Contrary to most other measures in the employment field, this scheme is not targeted to specific households. Any worker doing overtime, whatever the salary level, can take advantage of it, contrary to previous social contributions cuts which were usually focused on salaries at or slightly above the minimum wage.

The French recovery plan includes additional temporary tax cuts for 2009. This new scheme will benefit enterprises with less than 10 employees and will cover new recruitments only. For employees paid the SMIC (€1321, gross), this represents a €185 cut. The cut decreases gradually until the salary reaches 1.6 times the SMIC. Unlike the existing general tax cuts in social contributions, these are cuts in other contributions, most notably pension and unemployment insurance contributions.

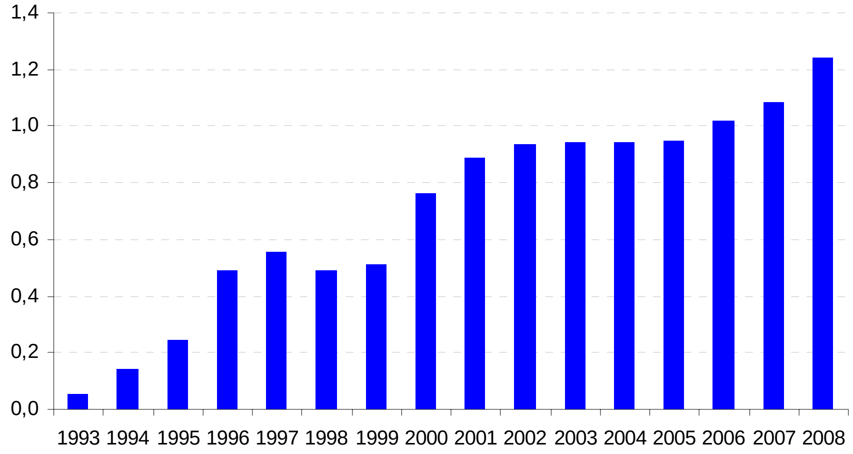
3.2. Potential weaknesses of the policy response

Tax cuts in social contributions can engender two main detrimental consequences for the French economy.

First, their cost for public finance has risen almost every year since they were first introduced in 1993, reaching €20.5 billion in 2007, and exceeding €24 billion in 2008. This cost increases with every SMIC raise, as the exonerations are calculated as a proportion of it. However, these figures are expressed in gross terms: they do not take into account the savings associated with, notably, the higher unemployment that would prevail in the absence of the cuts.

[19] See J. Boissinot, J. Deroyon, B. Heitz, V. Rémy, "Les allègements de cotisations sociales patronales sur les bas salaries en France de 1993 à 2007", Complément du Rapport du CAE *Salaire minimum et bas revenus*, 2008.

Figure 6: Global cost of general tax cuts in social contribution as a share of GDP



Source: *ACOSS; data treatment: Commission services*

Note: data for 2008 partially rely on forecasts.

Second, in addition to the cost for public finances, the measure could also entail a negative side effect through a low-wage trap mechanism. Indeed, at a wage level slightly above the SMIC, the cost for the employer of a wage increase is impacted by the rapidly rising marginal social contribution rate as it converges toward the standard rate with no exonerations. A recent study, which relies on 1984-2003 panel data, found a limited but significant negative effect of tax cuts in social contribution on the growth of salaries close to the SMIC[20]. Other studies found no such effect, without being able to rule it out however.

4. CONCLUSION: FINE-TUNING POLICIES TACKLING THE UNEMPLOYMENT OF LESS PRODUCTIVE WORKERS

Looking for employment is not an easy task in France, particularly for workers with a relatively low productivity. As the minimum wage is set at a very high level compared to the average wage, it makes it difficult for workers with a relatively low productivity to find a job. At the same time, there is a strong social consensus in favour of a high minimum wage as a means to support purchasing power, and any reduction appears particularly difficult. Consequently, since 1993, following notably recommendations from the General Planning Commission (*Commissariat Général du Plan*), policy makers centred their efforts on reducing the social contributions that employers pay for workers employed at or near the minimum wage. These measures have significantly helped tackling unemployment and offsetting the effect of the increases in the SMIC level.

However successful, cuts in social contributions for low wages have now reached a limit: social security contributions paid by employers when hiring at the minimum wage are residual (4.4%; 2.3% for firms with less than 20 employees) and there is little room for further reductions. Additionally, the cuts weigh heavily on the already fragile public finances: their cost now exceed 1.2% of GDP.

[20] B. Lhommeau, V. Rémy, "Les politiques d'allègements ont-elles un effet sur la mobilité salariale des travailleurs à bas salaires ?", *Document d'études de la DARES*, 2008.

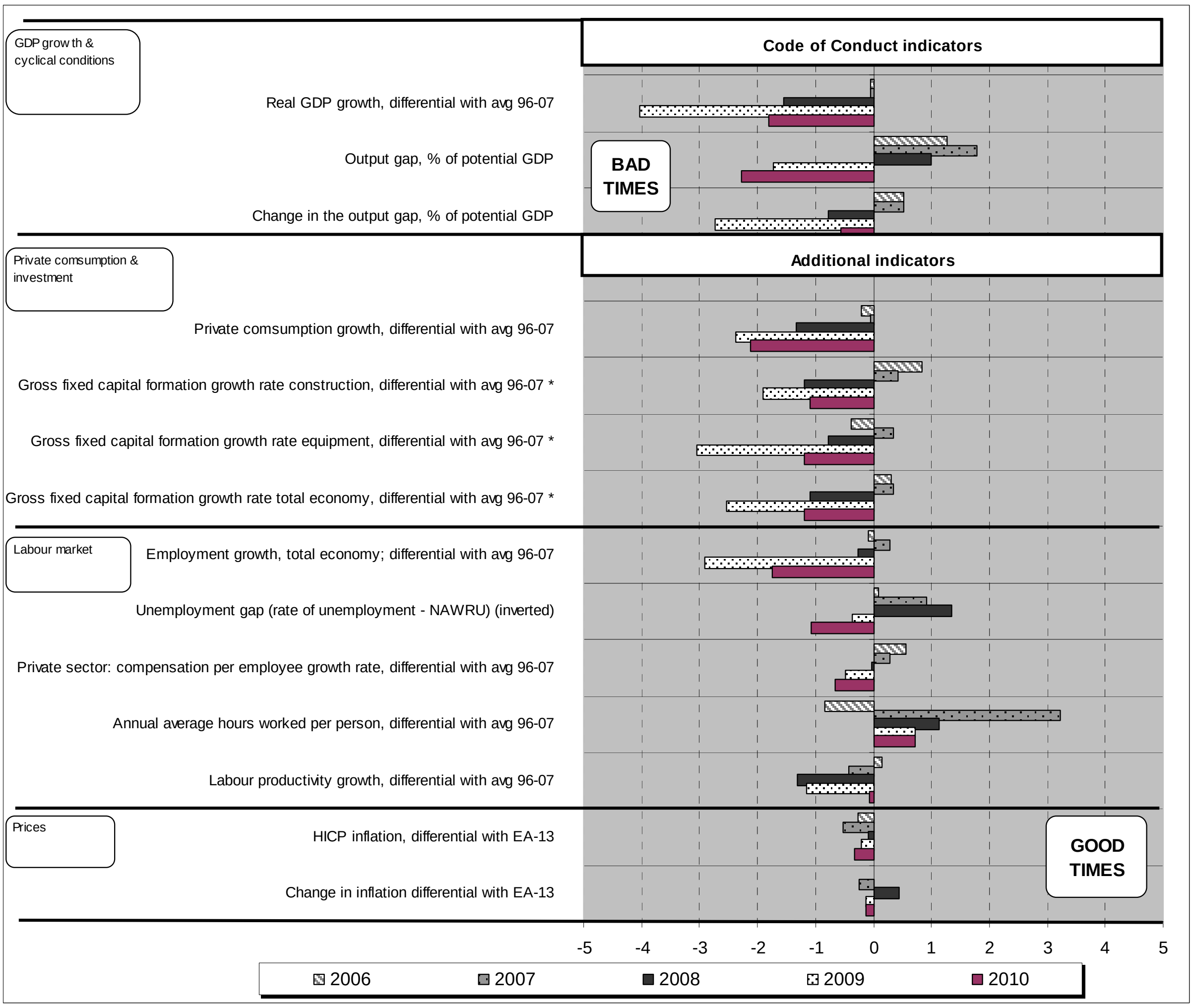
Efforts to reduce the cost of hiring workers with a relatively low productivity now can be pursued by keeping annual increases moderate[21], and by applying the SMIC in a less uniform way, differentiating notably according to seniority and level of qualification. In addition, the current framework for tax cuts in social contributions can be improved by addressing the existing tax loopholes. Namely, the tax cuts in social contributions could be dependent on yearly rather than monthly wages. This would prevent tax optimisation without harming employment, while reducing the cost by 0.1% of GDP, according to a recent report by the National Assembly[22].

[21] The recent reform of the indexation method (which includes the creation of a consultative commission to advise the government on minimum wage increases) might work in that direction, although it is too early to draw firm conclusions in this respect.

[22] Rapport d'information déposé par la mission d'information commune sur les exonérations de cotisations sociales, Assemblée nationale, juin 2008.

ANNEX 2. ADDITIONAL TABLES AND FIGURES

Figure 1: Good and bad economic times



Source: Commission services' January 2009 interim forecast

Table 1: Budgetary implementation in 2008

	2007		2008	
	Planned **SP Nov 2007**	**Outcome** **COM**	**Planned** **SP Nov 2007**	**Outcome** **COM**
Government balance (% of GDP)	-2.4	-2.7	-2.3	-3.2
Difference compared to target	**-0.3**		**-0.9**	
Of which : due to a different starting position end 2007			-0.2	
due to different revenue / expenditure growth in 2008			-0.7	
p.m. Denominator effect and residual [2,3]			-0.1	
p.m. Nominal GDP growth (planned and outcome)			4.1	3.1
Revenue (% of GDP)	50.7	49.7	50.4	49.6
Revenue surprise compared to target [1]	**-1.0**		**-0.8**	
Of which : due to a different starting position end 2007			-1.0	
due to different revenue growth in 2008			-0.3	
p.m. Denominator effect [2]			0.5	
p.m. Residual [3]			0.0	
p.m. Revenue growth rate (planned and outcome)			3.5	2.9
Expenditure (% of GDP)	53.2	52.4	52.6	52.7
Expenditure surprise compared to target [1]	**0.8**		**-0.1**	
Of which : due to different starting position end 2007			0.8	
due to different expenditure growth rate in 2008			-0.5	
p.m. Denominator effect [2]			-0.5	
p.m. Residual [3]			0.0	
p.m. Expenditure growth rate (planned and outcome)			2.9	3.9

Notes:

[1] A positive number implies that the outcome was better (in terms of government balance) than planned.

[2] The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue

[3] The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.

Source : Commission services

Table 2: Evolution of budgetary targets in successive programmes

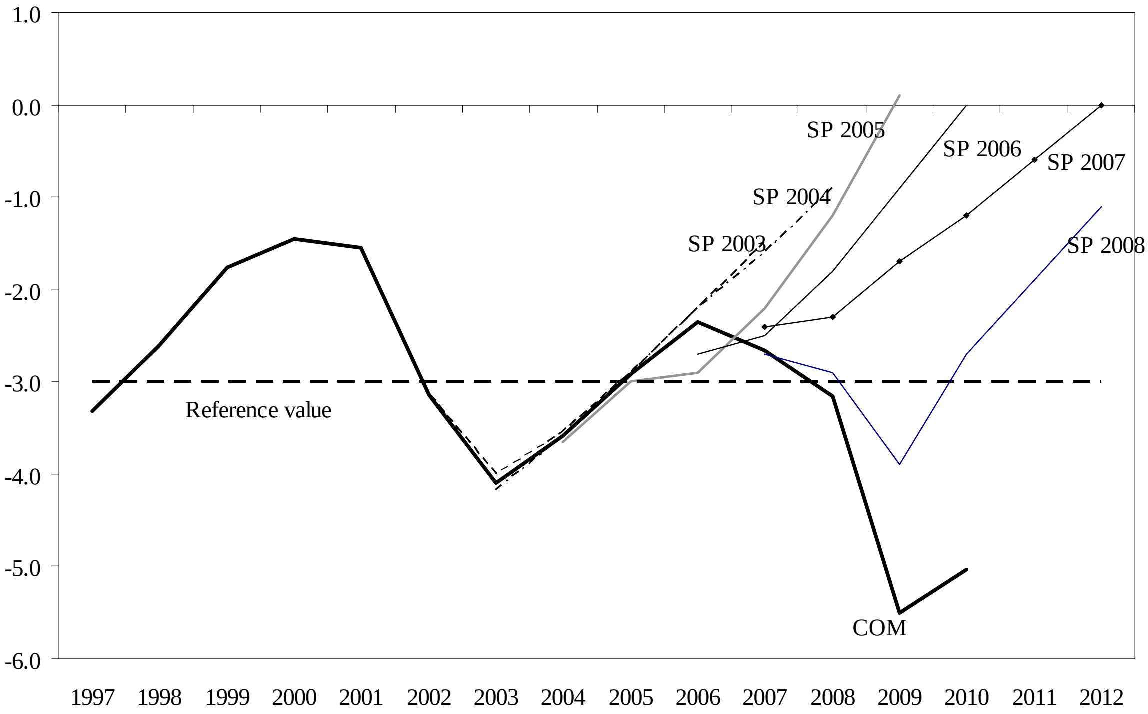
		2007	2008	2009	2010	2011	2012
General government balance (% of GDP)	**SP Dec 2008**	**-2.7**	**-2.9**	**-3.9**	**-2.7**	**-1.9**	**-1.1**
	SP Nov 2007	*-2.4*	*-2.3*	*-1.7*	*-1.2*	*-0.6*	*0.0*
	COM Jan 2009	-2.7	-3.2	-5.4	-5.0	n.a.	n.a.
General government expenditure (% of GDP)	**SP Dec 2008**	**52.4**	**52.7**	**53.5**	**52.7**	**52.0**	**51.3**
	SP Nov 2007	*53.2*	*52.6*	*51.9*	*51.2*	*50.6*	*49.9*
	COM Jan 2009	52.4	52.7	54.9	54.9	n.a.	n.a.
General government revenue (% of GDP)	**SP Dec 2008**	**49.7**	**49.8**	**49.6**	**50.0**	**50.0**	**50.2**
	SP Nov 2007	*50.7*	*50.4*	*50.1*	*50.0*	*50.0*	*50.0*
	COM Jan 2009	49.7	49.6	49.4	49.9	n.a.	n.a.
Structural balance[1] (% of GDP)	**SP Dec 2008**	**-2.9**	**-2.6**	**-3.0**	**-1.9**	**-1.4**	**-0.9**
	SP Nov 2007	*-2.0*	*-1.9*	*-1.4*	*-1.0*	*-0.4*	*0.0*
	COM Jan 2009	-3.6	-3.8	-4.6	-3.8	n.a.	n.a.
Real GDP (% change)	**SP Dec 2008**	**2.2**	**1.0**	**0.2-0.5**	**2.0**	**2.5**	**2.5**
	SP Nov 2007	*2-2.5*	*2-2.5*	*2.5*	*2.5*	*2.5*	*2.5*
	COM Jan 2009	2.2	0.7	-1.8	0.4	n.a.	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0 all over the period covered (2007-2012) according to the most recent programme and are 0.1% of GDP in 2007, 0.1% in 2008, all deficit-reducing and 0 in 2009 and 2010 according to the Commission services' January 2009 interim forecast.

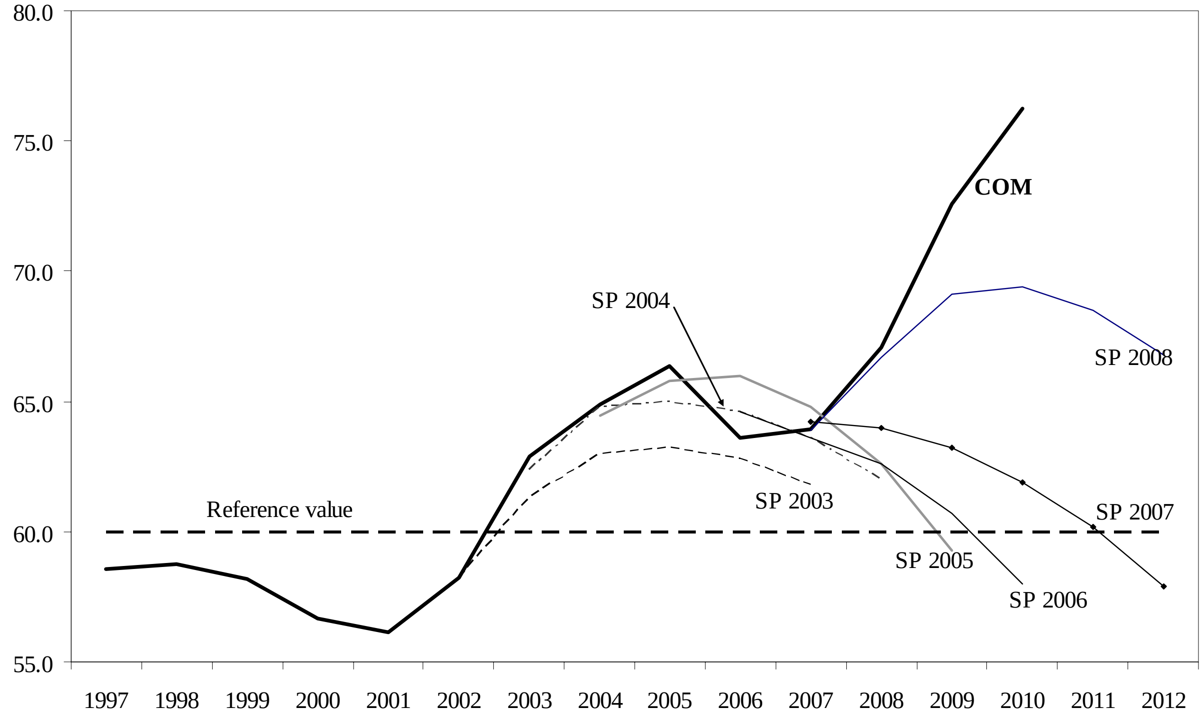
Source :
Stability programmes (SP); Commission services' January 2009 Interim forecasts (COM)

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Figure 3: Debt projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Table 3: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2010- 50
Total age-related spending	**26.9**	**27.0**	**27.9**	**29.0**	**30.1**	**30.1**	**3.1**
- Pensions	12.8	12.9	13.7	14.3	15.0	14.8	1.9
- Healthcare	7.7	8.0	8.4	8.9	9.3	9.5	1.5
- Long-term care	0.3	0.3	0.3	0.4	0.5	0.5	0.2
- Education	5.0	4.7	4.6	4.5	4.5	4.5	-0.2
- Unemployment benefits	1.2	1.1	0.9	0.9	0.9	0.9	-0.2
Property income received	**0.6**	**0.6**	**0.6**	**0.6**	**0.5**	**0.5**	**-0.1**

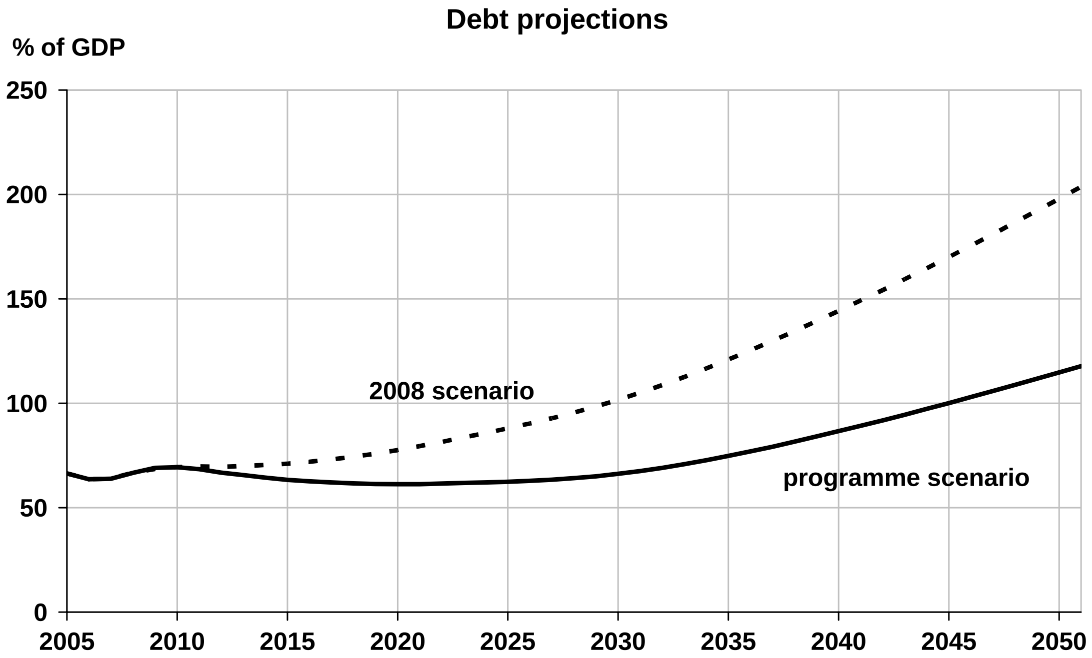
Source: Economic Policy Committee and Commission services.

Table 4: Sustainability indicators and the required primary balance

	2008 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	2.7	3.4	3.5	1.0	1.8	3.4
of which:						
Initial budgetary position (IBP)	0.7	0.8	-	-0.9	-0.9	-
Debt requirement in 2050 (DR)	0.1	-	-	0.0	-	-
Long-term change in the primary balance (LTC)	1.9	2.6	-	1.9	2.6	-

Source: Commission services.

Figure 4: Long-term projections for the government debt ratio



Note: Being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.
Source: Commission services.

Table 5: Additional factors

	Impact on risk
Debt and pension assets	-
Decline in structural balance until 2010 in COM January 2009 interim forecast	na
Significant revenues from pension taxation	na
Alternative projection of cost of ageing	na
Strong decline in benefit ratio	-
High tax burden	na
Non-age related budgetary measures with intertemporal effect	na

Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability. 'na': not applicable.
Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".
An explanation on these factors can be found in chapter IV of: European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006.
Source: Commission services.

ANNEX 3. COMPLIANCE WITH THE CODE OF CONDUCT AND TABLES FROM THE PROGRAMME

The update broadly adheres to the code of conduct as far as data requirements are concerned. The missing data did not impede the assessment. Most compulsory data have been provided except assumptions on short- and long-term interest rates (Table 8).

Part of the optional data is missing. Tables on general government expenditure by function and on long-term sustainability are partly filled (Table 3: all data are missing for 2010; Table 7: total expenditure, social security pension, old-age and early pensions, other and occupational pensions, interest expenditure, total revenue composition and all assumptions are missing). Employment-hours worked and labour productivity-hours worked are missing (Table 1.c labour market development); net lending/borrowing of the private sector and statistical discrepancy (table 1.d sectoral balances); government consumption (nominal) (Table 2 general government budgetary prospects); stock-flow adjustment composition (for 2009-2012) and privatisation proceeds (for 2008-2012), liquid financial assets and net financial debt (Table 4 general government debt developments) are missing as well. In addition, figures for 2007 are not provided for real GDP and change in inventories (Table 1a) and labour productivity persons (Table 1c).

The tables on the following pages show the data presented in the December 2008 update of stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading. The programme broadly follows the code of conduct as far as its table of contents is concerned.

Table 1a. Macroeconomic prospects

	ESA Code	2007 Level	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change	2012 rate of change
1. Real GDP	B1*g	*n.a.*	2.2	1.0	0.2-0.5	2.0	2.5	2.5
2. Nominal GDP	B1*g	*1892244*	4.7	3.2	2.3	3.8	4.3	4.3
Components of real GDP								
3. Private consumption expenditure	P.3	*1071957*	2.4	1.1	1.3	2.4	2.8	2.8
4. Government consumption expenditure	P.3	*438012*	1.4	1.3	1.1	0.5	0.5	0.5
5. Gross fixed capital formation	P.51	*406341*	4.9	0.2	-3.6	2.4	3.2	3.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*n.a.*	0.5	0.7	0.8	0.7	0.8	0.9
7. Exports of goods and services	P.6	*501902*	3.1	1.6	1.3	5.0	6.5	6.5
8. Imports of goods and services	P.7	*538304*	5.5	1.5	0.3	4.6	6.1	6.1
Contributions to real GDP growth								
9. Final domestic demand		-	2.7	1.0	0.2	2.0	2.4	2.4
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.2	0.0	0.0	0.1	0.1	0.1
11. External balance of goods and services	B.11	-	-0.7	0.0	0.3	0.0	0.0	0.0

Table 1b. Price developments

	ESA Code	2007 Level	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change	2012 rate of change
1. GDP deflator		*n.a.*	2.5	2.2	1.8	1¾	1¾	1¾
2. Private consumption deflator		*n.a.*	2.0	2.8	1.5	1¾	1¾	1¾
3. HICP[1]		*n.a.*	1.6	3.3	1.5	1¾	1¾	1¾
4. Public consumption deflator		*n.a.*	2.2	2.2	1.5	1¾	1¾	1¾
5. Investment deflator		*n.a.*	3.0	3.1	1.2	1¾	1¾	1¾
6. Export price deflator (goods and services)		*n.a.*	0.5	1.3	0.5	1.1	1.1	1.1
7. Import price deflator (goods and services)		*n.a.*	0.6	3.8	-0.9	1.1	1.1	1.1

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2007	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*25696*	1.3	0.8	0.1	0.3	0.8	0.8
2. Employment, hours worked[2]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)[3]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Labour productivity, persons[4]		*n.a.*	1.2	0.3	0.4	1.7	1.7	1.7
5. Labour productivity, hours worked[5]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees	D.1	*984520*	4.3	3.7	2.8	3.7	4.2	4.2
7. Compensation per employee		*38.3*	3.0	2.9	2.7	3.4	3.4	3.4

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2007	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-2.8	-3.4	-2.6	-2.5	-2.4	-2.4
of which : - Balance on goods and services		-1.9	-2.6	-1.9	-1.8	-1.8	-1.7
- Balance of primary incomes and transfers		-0.9	-0.9	-0.8	-0.8	-0.7	-0.7
- Capital account		0.1	0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	B.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Net lending/borrowing of general government	EDP B.9	-2.7	-2.9	-3.9	-2.7	-1.9	-1.1
4. Statistical discrepancy		n.a.	optional	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2007	2007	2008	2009	2010	2011	2012
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	*-50.3*	-2.7	-2.9	-3.9	-2.7	-1.9	-1.1
2. Central government	S.1311	*-41.5*	-2.2	-2.5	-3.3	-2.3	-1.8	-1.2
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-7.2*	-0.4	-0.3	-0.3	-0.2	-0.1	0.0
5. Social security funds	S.1314	*-1.6*	-0.1	0.0	-0.3	-0.2	0.0	0.1
General government (S13)								
6. Total revenue	TR	*940.4*	49.7	49.8	49.6	50.0	50.0	50.2
7. Total expenditure	TE[1]	*990.7*	52.4	52.7	53.5	52.7	52.0	51.3
8. Net lending/borrowing	EDP B.9	*-50.3*	-2.7	-2.9	-3.9	-2.7	-1.9	-1.1
9. Interest expenditure	EDP D.41	*51.4*	2.7	2.9	2.8	2.8	2.8	2.8
10. Primary balance[2]		*1.1*	0.1	0.0	-1.1	0.1	0.9	1.7
11. One-off and other temporary measures[3]		*0*	0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		*510.5*	27.0	26.9	26.4	26.7	26.7	26.7
12a. Taxes on production and imports	D.2	*284.8*	15.1	14.9	15.0	15.0	15.0	15.0
12b. Current taxes on income, wealth, etc	D.5	*216.8*	11.5	11.6	11.1	11.3	11.3	11.4
12c. Capital taxes	D.91	*8.9*	0.5	0.4	0.4	0.4	0.4	0.4
13. Social contributions	D.61	*340.9*	18.0	18.0	18.2	18.3	18.4	18.4
14. Property income	D.4	*14.8*	0.8	0.9	0.9	0.9	0.9	0.9
15. Other[4]		*74.2*	3.9	4.1	4.1	4.1	4.2	4.2
16=6. Total revenue	TR	*940.4*	49.7	49.8	49.6	50.0	50.0	50.2
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		*818.9*	43.3	43.2	42.9	43.2	43.2	43.2
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	*339*	**17.9**	**17.9**	**18.0**	**17.7**	**17.4**	**17.1**
17a. Compensation of employees	D.1	*243.3*	12.9	12.8	12.9	12.8	12.5	12.4
17b. Intermediate consumption	P.2	*95.8*	5.1	5.1	5.1	5.0	4.9	4.7
18. Social payments (18=18a+18b)		*436.9*	23.1	23.2	23.7	23.7	23.5	23.4
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*106.9*	5.6	5.7	5.8	5.7	5.6	5.5
18b. Social transfers other than in kind	D.62	*330*	17.4	17.5	18.0	18.0	17.9	17.9
19=9. Interest expenditure	EDP D.41	*51.4*	2.7	2.9	2.8	2.8	2.8	2.8
20. Subsidies	D.3	*26.1*	1.4	1.3	1.4	1.3	1.3	1.2
21. Gross fixed capital formation	P.51	*61.8*	3.3	3.3	3.5	3.2	3.0	2.9
22. Other[6]		*75.4*	4.0	4.1	4.1	4.0	4.0	3.9
23=7. Total expenditure	TE[1]	*990.7*	52.4	52.7	53.5	52.7	52.0	51.3
p.m.: Government consumption (nominal)	P.3	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	**2007**	**2012**
1. General public services	1	7.0	n.a.
2. Defence	2	1.8	n.a.
3. Public order and safety	3	1.3	n.a.
4. Economic affairs	4	2.8	n.a.
5. Environmental protection	5	0.9	n.a.
6. Housing and community amenities	6	1.9	n.a.
7. Health	7	7.2	n.a.
8. Recreation, culture and religion	8	1.5	n.a.
9. Education	9	5.9	n.a.
10. Social protection	10	22.2	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	52.4	51.3

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]It should have been filled for years 2006 and 2011.

Table 4. General government debt developments

% of GDP	ESA Code	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
1. Gross debt[1]		63.9	66.7	69.1	69.4	68.5	66.8
2. Change in gross debt ratio		0.3	2.8	2.4	0.2	-0.9	-1.7
Contributions to changes in gross debt							
3. Primary balance[2]		0.1	0.0	-1.1	0.1	0.9	1.7
4. Interest expenditure[3]	EDP D.41	2.7	2.9	2.8	2.8	2.8	2.8
5. Stock-flow adjustment		0.5	1.9	0.0	0.0	0.0	0.0
of which:							
- Differences between cash and accruals[4]		0.2	0.2	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		0.2	1.7	n.a.	n.a.	n.a.	n.a.
of which:		-	-	-	-	-	-
- privatisation proceeds		-0.4	n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other[6]		0.0	0.0	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		4.5	4.7	4.3	4.3	4.3	4.3
Other relevant variables							
6. Liquid financial assets[8]		28.6	n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		35.3	n.a.	n.a.	n.a.	n.a.	n.a.

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2007	2008	2009	2010	2011	2012
1. Real GDP growth (%)		2.2	1.0	0.5	2.0	2.5	2.5
2. Net lending of general government	EDP B.9	-2.7	-2.9	-3.9	-2.7	-1.9	-1.1
3. Interest expenditure	EDP D.41	2.7	2.9	2.8	2.8	2.8	2.8
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		2.2	2.2	2.2	2.2	2.2	2.3
contributions:							
- labour		0.5	0.5	0.4	0.4	0.4	0.4
- capital		0.9	0.9	0.7	0.7	0.8	0.8
- total factor productivity		0.8	0.8	1.0	1.0	1.0	1.0
6. Output gap		0.0	-1.1	-2.7	-2.8	-2.5	-2.3
7. Cyclical budgetary component		0.0	-0.4	-1.2	-1.3	-1.2	-1.1
8. Cyclically-adjusted balance (2 - 7)		-2.7	-2.4	-2.7	-1.4	-0.7	0.0
9. Cyclically-adjusted primary balance (8 + 3)		0.0	0.5	0.1	1.5	2.1	2.8
10. Structural balance (8 - 4)		-2.7	-2.4	-2.7	-1.4	-0.7	0.0

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2007	2008	2009	2010	2011	2012
Real GDP growth (%)							
Previous update		[2; 2.5]	[2; 2.5]	2.5	2.5	2.5	2.5
Current update		2.2	1.0	[0.2;0.5]	2.0	2.5	2.5
Difference		[-0.3;0.2]	[-1.5; -1.0]	[-2.3;-2.0]	-0.5	0.0	0.0
General government net lending (% of GDP)	EDP B.9						
Previous update		-2.4	-2.3	-1.7	-1.2	-0.6	0.0
Current update		-2.7	-2.9	-3.9	-2.7	-1.9	-1.1
Difference		-0.2	-0.6	-2.2	-1.5	-1.4	-1.2
General government gross debt (% of GDP)							
Previous update		64.2	64.0	63.2	61.9	60.2	57.9
Current update		63.9	66.7	69.1	69.4	68.5	66.8
Difference		-0.3	2.7	5.9	7.5	8.3	8.9

Table 7. Long-term sustainability of public finances

% of GDP	2004	2010	2020	2030	2040	2050
Total expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: age-related expenditures	26.9	27.0	27.9	29.0	30.1	30.1
Pension expenditure	12.8	12.9	13.7	14.3	15.0	14.8
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other pensions (disability, survivors)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	7.7	8.0	8.4	8.9	9.3	9.5
Long-term care *(this was earlier included in the*	0.3	0.3	0.3	0.4	0.5	0.5
Education expenditure	5.0	4.7	4.6	4.5	4.5	4.5
Other age-related expenditures	1.2	1.1	0.9	0.9	0.9	0.9
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: property income	0.6	0.6	0.6	0.6	0.5	0.5
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions						
Labour productivity growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Real GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate males (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rates females (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total participation rates (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Population aged 65+ over total population	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Table 8. Basic assumptions

	2007	2008	2009	2010	2011	2012
Short-term interest rate[1] (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.37	1.47	1.33	1.33	1.33	1.33
Nominal effective exchange rate	110.7	113.4	111.2	111.2	111.2	111.2
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	5.8	4.7	3.9	3.7	4.2	4.2
EU GDP growth	2.9	1.2	0.4	1.9	2.4	2.4
Growth of relevant foreign markets	5.7	3.3	1.3	5.0	6.5	6.5
World import volumes, excluding EU	6.9	4.2	4.1	5.6	7.1	7.1
Oil prices (Brent, USD/barrel)	72.5	101.0	72.0	73.3	74.5	75.9

[1]If necessary, purely technical assumptions.

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