COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.11.2009
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Recommendation for a

COUNCIL RECOMMENDATION TO FRANCE

with a view to bringing an end to the situation of an excessive government deficit

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[1], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”[2], which is part of the Stability and Growth Pact.

On the basis of the data reported by the French authorities on 6 February 2009 in a letter from the Minister of the Economy, Industry and Employment addressed to the Commissioner of Economic and Monetary Affairs and taking into account the Commission services’ January

[1] See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No 103/209.

[2] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the “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, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

2009 interim forecast, the Commission adopted a report under Article 104(3) for France on 18 February 2009[3].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 February 2009.

On 24 March 2009, the Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), addressed to the Council, in accordance with Article 104(5), its opinion that an excessive deficit existed in France.

Subsequently, acting upon a recommendation by the Commission, the Council decided on 27 April 2009 that an excessive deficit existed in France in accordance with Article 104(6), and, also on a recommendation by the Commission, it addressed recommendations to France in accordance with Article 104(7) with a view to bringing an end to the situation of an excessive government deficit by 2012. In its recommendations, the Council established a deadline of 27 October 2009 for effective action to be taken.

Regulation (EC) No 1467/97[4], Article 3(5), states that if effective action has been taken in compliance with a recommendation under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 104(7). To this end, the Commission has assessed recent macro-economic and budgetary developments as well as effective action taken by France.

3. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

According to Article 3(5) of Council regulation (EC) No 1467/97, the occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009.

The Commission services' January 2009 interim forecast, on which the Council recommendation of 27 April was based, expected a contraction of real GDP of 1.8% in 2009, following estimated growth of 0.7% in 2008. After several years of relatively robust growth, economic activity had lost momentum in the course of 2008 and further deteriorated towards the end of the year in the wake of the global downturn. The Commission services' January 2009 interim forecast anticipated the general government deficit to reach 5.4% of GDP in 2009, after 3.2% in 2008. The excess over the 3% of GDP threshold in 2008 (the deficit was revised upward to 3.4% of GDP in the spring 2009 EDP notification) mainly reflected the fact that there was a lack of fiscal consolidation following the abrogation of the previous excessive deficit procedure in January 2007 and when France was in good/neutral economic times[5]. The projected budgetary deterioration in 2009 reflected the expected working of automatic stabilisers in response to the economic downturn, as well as the impact of the December 2008

[3] All EDP-related documents for France can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

[4] OJ L 209, 2.8.1997, p. 6.

[5] As also note by the Council in its opinion of 10 March 2009 on the updated stability programme (OJ C 64, 19.03.2009, p. 1).

fiscal stimulus package estimated at the time at 0.8% of GDP and of discretionary measures of around 0.1% of GDP stemming from previous draft budget laws.

The Commission services' autumn 2009 forecast projects economic activity in 2009 to contract by 2.2%, which is 0.4 pps. deeper than what was anticipated in the January 2009 forecast. This is linked to a worse outcome in 2008 and a sharper drop in GDP growth in the first quarter of 2009 than anticipated at the beginning of the year, notably as a result of a very strong destocking phase. Since there were no major revisions in inflation projections, the revision of nominal GDP were similar to that of real GDP. Overall, the revision of the growth outlook compared to what was expected at the time of the Council recommendation is rather limited and applying standard budgetary elasticities would only raise the deficit by ¼% of GDP.

However, according to the autumn 2009 forecast, the general government deficit in 2009 will reach 8.3% of GDP, fully in line with the official projection in the 2010 draft budget law unveiled on 30 September. This is nearly 3 pps. higher than projected in the Commission' services January 2009 interim forecast (-5.4%) and 2¾ pps. higher than the target in the Council recommendation (5.6%) which included new stimulus measures of around ¼% of GDP[6]. The increase by 2¾% is first of all linked to the fact that the economic downturn had a larger budgetary impact than an application of standard budgetary elasticities would have implied (around 2% of GDP). This was notably due to the significant downward revision of corporate tax receipts (by around 1¼% of GDP), and to a lesser extent to VAT, which also suffered somehow from an unexpected decrease of its tax base linked to composition effects. In addition, the impact of previously adopted measures in the framework of the recovery plan (notably those aimed at alleviating firms' liquidity constraints) was higher than expected by ¼% of GDP. Only 0.1% of GDP of the higher deficit outcome can be attributed to a new discretionary measure after the Council recommendation was adopted, which was the decision to decrease VAT for the catering sector as of 1 July 2009. Concerning the expenditure side, the implementation of the budget can be considered broadly on track. Expenditure overruns are associated to higher social transfers.

Overall, it can be concluded that, assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009, unexpected adverse economic events with major unfavourable budgetary effects have occurred in France.

[6] Notably tax breaks for low income households.

		2008	2009	2010	2011
Real GDP (% change)	COM Jan 2009 interim forecast	0.7	-1.8	0.4	n.a.
	COM Autumn 2009 forecast	0.4	-2.2	1.2	1.5
Nominal GDP (% change)	COM Jan 2009 interim forecast	3.1	0.1	2.0	n.a.
	COM Autumn 2009 forecast	2.9	-0.3	2.5	3.3
General government balance (% of GDP)	COM Jan 2009 interim forecast	-3.2	-5.4	-5.0	n.a.
	COM Autumn 2009 forecast	-3.4	-8.3	-8.2	-7.7

4. ASSESSMENT OF EFFECTIVE ACTION TAKEN

According to Regulation (EC) No 1467/97 and the revised Code of Conduct[7] a Member State should be considered to have taken effective action if it has acted in compliance with the 104(7) recommendation. The Code of Conduct states that the assessment of effective action should in particular take into account whether the Member State concerned has achieved the annual improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall should be made. In case of a multi-annual adjustment, the Code of Conduct specifies that the assessment should mainly focus on the measures taken in order to ensure an adequate fiscal adjustment in the year following the identification of the excessive deficit.

In its recommendations under Article 104(7) of 27 April 2009, the Council notably recommended to France, after having implemented the fiscal measures in 2009 as planned in the budget, to implement the necessary efforts to bring the deficit below the reference value by 2012 and, to this end, strengthen the foreseen annual average fiscal effort to at least 1% of GDP starting in 2010. Moreover, the recommendation asked that, in order to limit risks to the adjustment, France should effectively enforce existing expenditure rules and take further steps in order to guarantee the respect of the multiannual expenditure reduction target of the general government by all subsectors and continue to implement measures in the context of the general review of public policies. Finally, the French authorities were recommended to ensure that the government debt ratio is put on a declining path and approaches the reference value at a satisfactory pace. The Council established the deadline of 27 October 2009 for the French government to take effective action to achieve the 2009 deficit target of 5.6% of GDP and to

[7] "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.

specify the measures that will be necessary to progress towards the correction of the excessive deficit.

As regards 2009, the French government has implemented the fiscal measures as planned in the budget. There was one minor revision to the budget after the Council recommendation was adopted in order to include the VAT decrease for the catering sector increasing the deficit by 0.1% of GDP. As mentioned above, the higher-than-expected deficit outcome of 8¼% of GDP (compared to the target of 5.6% of GDP at the time of the recommendation) can be essentially attributed to unexpected adverse economic events with major unfavourable budgetary effects which occurred on the revenue side. This negative revenue surprise and the slightly stronger-than-expected impact of the fiscal stimulus measures adopted by France (around ¼pp of GDP) almost fully explain the stronger deterioration in the structural balance by 3% of GDP (instead of 0.8% of GDP expected in the Commission services' January 2009 interim forecast).

As for 2010, based on the Commission services autumn 2009 forecast, the general government deficit is expected to decrease from 8.3% of GDP in 2009 to 8.2% of GDP in 2010. This projection takes into account the partial phasing out of the recovery measures in line with the EERP (from +1.2% of GDP in 2009 to +0.4% of GDP in 2010), which is however partially compensated by new expansionary measures in the 2010 draft budget law (with an estimated impact of ½% of GDP). Specifically, this includes the reform of the local business tax (*taxe professionnelle*) that would increase the nominal deficit by around 0.6% of GDP, of which 0.4% is related to anticipated reimbursements, therefore a one-off measure that only affects 2010. It also includes consolidation measures (introduction of an environmental tax, as well as an increase in taxes included in the draft social security budget law) which would improve the budgetary position by less than 0.2% of GDP. All in all, the discretionary measures for 2010 reduce the deficit by around ¼ % of GDP.

The structural balance, according to the Commission services Autumn 2009 forecast, would improve by ½ % of GDP in 2010 as the above-mentioned one-off revenue loss linked to the reform of the local business tax is to be excluded from the calculation of the structural balance in 2010[8]. Thus, France will start consolidating its public finances in 2010 essentially through the partial phasing out of the recovery measures. While this consolidation falls short of the minimum average annual structural effort of at least 1% of GDP over the period from 2010 to 2012 as foreseen in the recommendations, this has to be seen in the context of the still fragile economy in 2010.

Regarding the fiscal framework, in order to limit the risks to the adjustment, France was also recommended to effectively enforce existing expenditure rules and to take further steps in order to guarantee the respect of the multi-annual expenditure reduction target of the general government by all sub-sectors and to continue to implement measures in the context of the general review of public policies. The reform of the Constitution adopted on 23 July 2008 introduced a general objective of balanced budgets for general government[9], which for the time being is non-enforceable. Following the launch of the General Review of Public Policies (*Revue Générale des Politiques Publiques*, RGPP) in mid-2007 aimed at increasing the efficiency of spending of the central State, the Government announced in the draft budget law

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8 In the draft budget law for 2010, the French authorities project an improvement of the structural balance by 0.3% of GDP, which does not take into account one off measures.

9 Article 34, 4th paragraph, of the newly adopted Constitution : "*Des lois de programmation déterminent les objectifs de l'action de l'État. Les orientations pluriannuelles des finances publiques sont définies*

for 2010 that it would extend the RGPP to other central bodies. It was also announced in October that the Government intends to implement from 2010 a reform of local authorities, aiming at simplifying the structure at the local level with potential expenditure savings.

Overall, taking into account economic developments compared to the outlook in the Commission services' January 2009 interim forecast, it can be concluded that France has taken effective action as required by the Council recommendation of 27 April 2009.

5. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

The recommendation adopted on 27 April 2009 set the target date of 2012 to bring the general government deficit below the reference value. Since the French authorities are considered to have taken effective action in compliance with the Council recommendations of 27 April 2009 under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in France, a revised recommendation for France extending the deadline by one year is justified.

In order to achieve the correction of the excessive deficit by 2013 in the context of a medium-term framework, the French Government would have to make an average annual structural budgetary adjustment of 1¼% of GDP over the period 2010-2013, which would be helped by the complete phasing out of the recovery measures and possibly some better-than-expected growth or revenue surprises partially mirroring the negative surprises of previous years. Judging from the draft 2010 budget, and correcting for the one off in 2010, the French authorities have announced an improvement in the structural balance of around ¾ pp[10] over the period 2011 - 2013, which according to their calculations (and based on a growth assumption of 2.5% from 2011 to 2013) would bring the headline deficit to 5% of GDP in 2013 and not lead to a halt of the debt increase. Thus, starting from 2011 there is a need for a more ambitious average annual structural budgetary adjustment than the one envisaged by the authorities, in order to bring the deficit below the reference value by 2013.

To this end, the consolidation efforts should be strengthened from 2011 compared to that projected by the French authorities and an average annual structural budgetary adjustment of 1¼ % of GDP over the period 2010-2013 should be ensured[11]. Moreover, the French

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10 It is not clear to what extent these calculations follow the commonly agreed method.

11 In line with the initial recommendations under Article 104(7) issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In particular, in the case of France due

authorities should specify the measures that are necessary to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting, and accelerate the reduction of the deficit in case economic or budgetary conditions turn out better than currently expected. Given that France has one of the highest tax burdens and expenditure ratios in the European Union, focus should be put on containing public expenditure in the coming years, particularly in the areas of healthcare and local authorities.

According to the French authorities, the debt-to-GDP ratio is projected to increase from 67½% in 2008 to 91¼% in 2013, driven by the high primary deficits. Those figures take into account the impact of interventions in the financial and automobile sectors, for a total of around ¾% of GDP[12]. By starting the consolidation efforts in 2010, the government has made a first step towards curbing the rise in the debt-to-GDP ratio and eventually put it on a declining path. However, according to the Commission services autumn 2009 forecast the debt ratio is still increasing in 2010 by 6% of GDP. Rapid budgetary consolidation is therefore necessary with a view to bringing the government gross debt ratio on a declining path that approaches the 60% of GDP reference value at a satisfactory pace. Furthermore, the French authorities should seize any opportunity beyond the structural budgetary adjustment, to accelerate the reduction of the gross debt ratio back towards the reference value.

Enhanced surveillance under the EDP, which seems necessary in view also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the French stability programme which will be prepared between 2009 and 2013 could usefully be devoted to this issue.

consideration was given to the substantial economic downturn, the size of the required budgetary correction, and the high level of the debt. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

12 This number does not include about 4% of GDP of borrowing by the SFEF (with Government guarantee) since Eurostat clarified on 15 July 2009 that debt issued by "other central state bodies" in support of the financial sector would not be included in the general government debt.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011	2012
Real GDP (% change)	COM Autumn 2009	2.3	0.4	-2.2	1.2	1.5	n.a.
	SP Dec 2008	2.2	1.0	0.2-0.5	2.0	2.5	2.5
Output gap[1] (% of potential GDP)	COM Autumn 2009[2]	1.9	0.8	-2.5	-2.5	-2.4	n.a.
	SP Dec 2008[3]	0.4	-0.6	-1.8	-1.6	-1.1	-0.4
General government balance (% of GDP)	COM Autumn 2009	-2.7	-3.4	-8.3	-8.2	-7.7	n.a.
	SP Dec 2008	-2.7	-2.9	-3.9	-2.7	-1.9	-1.1
Primary balance (% of GDP)	COM Autumn 2009	0.0	-0.6	-5.5	-5.4	-4.7	n.a.
	SP Dec 2008	0.1	0.0	-1.1	0.1	0.9	1.7
Cyclically-adjusted balance[1] (% of GDP)	COM Autumn 2009	-3.6	-3.8	-7.0	-7.0	-6.5	n.a.
	SP Dec 2008	-2.9	-2.6	-3.0	-1.9	-1.4	-0.9
Structural balance[4] (% of GDP)	COM Autumn 2009	-3.7	-3.9	-7.0	-6.6	-6.5	n.a.
	SP Dec 2008	-2.9	-2.6	-3.0	-1.9	-1.4	-0.9
Government gross debt (% of GDP)	COM Autumn 2009	63.8	67.4	76.1	82.5	87.6	n.a.
	SP Dec 2008	63.9	66.7	69.1	69.4	68.5	66.8

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.
[2] Based on estimated potential growth of 1.8%, 1.5%, 1.2%, 1.2% and 1.4% respectively in the period 2007-2011.
[3] Based on estimated potential growth of 2.1%, 2.0%, 1.7%, 1.8%, 2.0% and 1.8% respectively in the period 2007-2012.
[4] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are *0 all over the period covered (2007-2012)* according to the most recent programme and *0.1% of GDP in 2007, 0.1% of GDP in 2008, all deficit reducing,* 0.4% of GDP in 2010 deficit increasing and 0 in 2009 and 2011according to the Commission services' autumn 2009 forecast.

Source:
Stability programme (SP); Commission services' Autumn 2009 forecasts (COM); Commission services' calculations.

Recommendation for a

COUNCIL RECOMMENDATION TO FRANCE

with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof;

Having regard to the recommendation from the Commission;

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(4) On 27 April 2009 the Council decided, in accordance with Article 104(6), that an excessive deficit exists in France and issued recommendations to correct the excessive deficit by 2012 at the latest, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[13]. This would have implied an average annual fiscal effort of at least 1% of GDP over the period 2010-2012. The Council also established a deadline of 27 October 2009 for effective action to be taken

(5) According to Article 3(5) of Council Regulation (EC) No 1467/97, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission and before taking into account the relevant factors mentioned in Article 2(3) of

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[13] OJ L 209, 2.8.1997, p. 6.

Regulation (EC) No 1467/97, to adopt a revised recommendation under Article 104(7).

(6) The January 2009 interim forecast had projected a contraction in real GDP by 1.8% in 2009 and an increase in the general government deficit to 5.4% of GDP. Against the background of a 0.2% of GDP base effect stemming from a higher-than-expected deficit in 2008 and additional fiscal stimulus measures of 0.2% of GDP adopted in February, the Council recommended a deficit target of 5.6% of GDP for 2009 in line with the Government's new target. The Commission services' autumn 2009 forecast projects the contraction of economic activity to be higher and to reach 2.2%, while the general government deficit would increase to 8.3% of GDP. The impact of this deeper-than-expected contraction will be significantly higher (by around 2 percentage points) than what would be suggested by using standard budgetary elasticities and what was expected in the interim forecast, specifically due to the sharp deterioration of tax receipts, notably from corporations. Concerning the expenditure side, the implementation of the budget can be considered broadly on track. Expenditure overruns are associated to higher social transfers. In addition, the impact of previously adopted measures in the framework of the recovery plan was higher than planned by ¼% of GDP. Only 0.1% of GDP of the higher budget outcome can be attributed to a new discretionary measure (decrease of VAT for the catering sector) after the Council recommendation was adopted. In view of the above, unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred after adoption of the recommendation under Article 104(7).

(7) In response to the Council's recommendations under Art. 104(7) of 27 April 2009, the French government has implemented the fiscal measures as planned in the 2009 budget with the exception of the above-mentioned minor revision to the budget adopted after the Council recommendation in order to include the VAT decrease for the catering sector (increasing the deficit by 0.1% of GDP). As also mentioned above, the higher-than-targeted expected deficit outcome of 8¼% of GDP (compared to the 5.6% of GDP recommended deficit) can be essentially attributed to unexpected adverse economic events with major unfavourable budgetary effects which occurred on the revenue side. This negative revenue surprise and the somewhat stronger-than-expected impact of the fiscal stimulus measures adopted by France almost fully explain the stronger deterioration in the structural balance by 3% of GDP (instead of 0.8% of GDP expected in the Commission services' January 2009 interim forecast). As for 2010, based on the Commission services' autumn 2009 forecast, the general government deficit is expected to decrease from 8.3% of GDP in 2009 to 8.2% of GDP in 2010. This projection takes into account the partial phasing out of the recovery measures in line with the EERP (from +1.2% of GDP in 2009 to +0.4% of GDP in 2010), which is however partially compensated by new deficit increasing measures in the 2010 draft budget law (with an estimated impact of ½% of GDP, including 0.4% of GDP one offs). In structural terms, the balance is expected to improve by ½ % of GDP in 2010[14]. Thus, France plans to start to consolidate its public finances in 2010 essentially through the partial phasing out of the recovery measures. While this consolidation falls short of the minimum average annual structural effort of at least 1%

[14] In the draft budget law for 2010, the French authorities project an improvement of the structural balance by 0.3% of GDP, which does not take into account one off measures.

of GDP over the period from 2010 to 2012, this has to be seen in the context of the still somewhat fragile economy in 2010. Overall, taking into account the particular circumstances of the economic crisis and the European Economic Recovery Plan, the French authorities can be considered to have taken effective action.

(8) Since the French authorities are considered to have taken effective action in compliance with the Council recommendations of 27 April 2009 under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in France, revised recommendations under Article 104(7) for France extending the deadline by one year can be justified.

(9) This would imply an average annual structural budgetary adjustment of 1¼% of GDP over 2010 - 2013[15]. The recommended adjustment takes into account the higher deficit level in 2010 (8.2% of GDP) notably reflecting the significant budgetary impact of the downturn, but also has to be seen against the fact that (i) no consolidation was achieved after the abrogation of the previous excessive deficit procedure in January 2007, (ii) some deficit-increasing measures were adopted in 2009 (VAT decrease in the catering sector) and 2010 (reform of the local business tax); (iii) the debt ratio is rising rapidly; and (iv) the adjustment is expected to be supported in 2011 by the complete phasing out of the remaining recovery measures of 0.4% of GDP. It can also not be excluded that some better-than-expected growth or revenue surprises partially mirroring the negative surprises of previous years will turn out to lower the effort required, although this cannot be taken for granted at this stage. Based on the draft budget and after making a correction for the one off revenue loss in 2010, the improvement in the structural balance announced by the French authorities amounts to around ¾ pp[16], which, based on their growth assumptions of 2.5% from 2011 onwards, would bring the deficit to 5% of GDP in 2013 and therefore not lead to a halt in the debt increase. Thus, starting from 2011 there is a need for a more ambitious medium-term strategy than the one envisaged by the authorities, in order to bring the deficit below the reference value by 2013.

(10) According to the French authorities, the debt-to-GDP ratio is projected to increase from 67½% in 2008 to 91¼% in 2013, driven by high primary deficits. Those figures

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15 In line with the initial recommendations under Article 104(7) issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In particular, in the case of France due consideration was given to the substantial economic downturn, the size of the required budgetary correction, and the high level of the debt. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

16 It is not clear to what extent these calculations follow the commonly agreed method.

take into account the impact of interventions in the financial and automobile sectors, for a total of around ¾% of GDP[17].

(11) As regards the long term sustainability of public finances, the long-term budgetary impact of ageing in France is lower than the EU average, thanks to reforms to the social security system already enacted. The budgetary position in 2009 compounds the budgetary impact of population ageing on the sustainability gap. Moreover, the current level of gross debt is above the Treaty reference value and the ongoing large structural primary deficits may widen the sustainability gap. The French authorities plan to implement in 2010 further reforms that would ease the budgetary impact of ageing, notably through an increase in the legal retirement age, contributing to reducing the risk to the long-term sustainability of public finances as defined by the Commission Communication[18] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[19] on 10 November 2009.

(12) Enhanced surveillance under the EDP, which seems necessary also in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of France's stability programme which will be prepared between 2010 and 2013 could usefully be devoted to this issue.

(13) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. Increased enforceability of expenditure control, notably in the areas of healthcare and local authorities would improve the quality of public finances. In addition, France should improve the overall competition framework, with particular emphasis on the network industries (gas, electricity and rail freight), further reform the pension system, modernise employment protection and enhance life-long learning.

(14) In addition, in view of the importance of achieving its medium-term objective (MTO) to provide an adequate safety margin against cyclical downturns and to ensure convergence of the debt ratio towards a prudent level, also taking into account implicit liabilities related to ageing, France should also ensure that budgetary consolidation towards the MTO is sustained after the excessive deficit will have been corrected.

HEREBY RECOMMENDS:

(1) Recognising that France's budgetary position in 2009 resulted from measures amounting to 1.2% of GDP, which were an appropriate response to the European Economic Recovery Plan, and the free play of automatic stabilisers, the French authorities should put an end to the present excessive deficit situation by 2013.

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17 This does not include about 4% of GDP of borrowing by the SFEF (with Government guarantee) since Eurostat clarified on 15 July 2009 that debt issued by "other central state bodies" in support of the financial sector would not be included in the general government debt.

18 http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf

19 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf

(2) The French authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the French authorities should:

(a) implement the deficit-reducing measures in 2010 as planned in the draft budget law for 2010 while avoiding further deterioration of public finances, and implement and strengthen the structural budgetary adjustment from 2011 onwards above the consolidation measures already planned;

(b) ensure an average annual structural budgetary adjustment of 1¼% of GDP over the period 2010 – 2013, which should also contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus;

(c) specify the measures that are necessary to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

(3) In addition, the French authorities should seize any opportunity beyond the structural budgetary adjustment, to accelerate the reduction of the gross debt ratio back towards the reference value.

(4) The Council establishes the deadline of [2 June 2010] for the French government to take effective action to implement the fiscal measures in 2010 as planned in the 2010 draft budget law for 2010 and to outline the measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The French authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the stability programmes which will be prepared between 2009 and 2013.

Furthermore, the Council invites the French authorities to implement reforms with a view to enhancing the quality of public finances and raising potential GDP growth. Increased enforceability of expenditure control, notably in the areas of healthcare and local authorities, and the reduction of the multiple existing tax exemptions would improve the quality of public finances. In addition, France should improve the overall competition framework, with particular emphasis on the network industries, further reform the pension system, modernise employment protection and enhance life-long learning to enhance potential GDP growth.

This recommendation is addressed to the French Republic.

Done at Brussels,

For the Council
The President