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Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the excessive government deficit in France

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof,

Having regard to the recommendation from the European Commission,

Whereas:

(1) According to Article 126 of the Treaty on the Functioning of the European Union (TFEU), 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) On 27 April 2009, the Council decided, in accordance with Article 104(6) of the Treaty establishing the European Community (TEC), that an excessive deficit existed in France and issued recommendations to correct the excessive deficit by 2012 at the latest[1], in accordance with Article 104(7) TEC 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[2].

(4) On 2 December 2009, the Council decided, in accordance with Article 126(7) TFEU, that although effective action had been taken by the French authorities, unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the Council recommendation of 27 April 2009. As a consequence, the Council recommended that France correct its excessive deficit by 2013 at the latest.

(5) On 21 June 2013, the Council decided, in accordance with Article 126(7) TFEU, that although effective action had been taken by the French authorities, unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the Council recommendation of 2 December 2009. As a consequence, the Council recommended that France correct its excessive deficit by 2015 at the latest. In order to bring the general government deficit below 3% of GDP in a credible and sustainable manner, France was recommended to (a) reach a headline deficit of 3.9% of GDP in 2013, 3.6% in 2014 and 2.8% in 2015, which was considered to be consistent with delivering an improvement in the structural balance of

[1] All documents related to the excessive deficit procedure of France can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/france_en.htm.

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

1.3% of GDP in 2013, 0.8% in 2014 and 0.8% in 2015, based on the extended Commission 2013 spring forecast; (b) fully implement the already adopted measures for 2013 (1½% of GDP) and specify, adopt and implement rapidly the necessary consolidation measures for 2014 and 2015 to achieve the recommended improvement in the structural balance, while proceeding as currently planned with a thorough review of spending categories across all sub-sectors of general government, including at social security and local government level; (c) use all windfall gains for deficit reduction. It was further recommended that budgetary consolidation measures secure a lasting improvement in the general government structural balance in a growth-friendly manner. In its recommendations, the Council established the deadline of 1 October 2013 for France to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No 1467/97, to report in detail on the consolidation strategy envisaged to achieve the targets.

(6) On 15 November 2013, the Commission concluded that based on the Commission 2013 autumn forecast, France had taken effective action in compliance with the Council recommendation of 21 June 2013 to bring its general government deficit below the 3% of GDP reference value and considered that no additional step in the excessive deficit procedure was therefore necessary.

(7) In accordance with Articles 9(1) and 17(2) of Regulation (EU) No 473/2013, France presented an Economic Partnership Programme to the Commission and to the Council on 1 October 2013. The Council considered in its opinion adopted on 10 December that the Economic Partnership Programme of France included a set of fiscal-structural reforms that were partly adequate to support an effective and lasting correction of the excessive deficit.

(8) On 5 March 2014, the Commission issued a recommendation regarding measures to be taken by France in order to ensure a timely correction of its excessive deficit. In its recommendation, the Commission considered that France had to make further efforts to ensure full compliance with the Council recommendation of 21 June 2013. In its stability programme submitted on 7 May 2014, France outlined a number of additional measures for 2014. Also taking into account the fact that the fiscal effort achieved in 2013 was higher than expected at the time of the Commission recommendation, it was considered that the stability programme broadly responded to the Commission recommendation.

(9) On 13 January 2015, the Commission presented a Communication on "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact" (COM(2015) 12). The Communication clarifies that the Commission will take into account the existence of a dedicated structural reform plan, providing detailed and verifiable information, as well as credible timelines for adoption and delivery, when recommending a deadline for the correction of the excessive deficit or the length of any extension to that deadline. The Commission will closely monitor the implementation of the reforms. In case of failure to implement, the Commission will consider it an aggravating factor when assessing effective action in response to the Excessive Deficit Procedure recommendation and when setting a new deadline for the correction of the excessive deficit. Lack of effective action will lead to a stepping up of the procedure and the possible suspension of European Structural and Investment Funds. For euro area Member States, this means that the Commission will recommend to the Council the imposition of a fine.

(10) According to Article 3(5) of Regulation (EC) No 1467/97, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU, 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 occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the Council recommendation.

(11) In accordance with Article 126(7) TFEU and Article 3 of Council Regulation (EC) No 1467/97, the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of an excessive deficit to an end within a given period. The recommendation has to establish a maximum deadline of six months for effective action to be taken by the Member State concerned to correct the excessive deficit which can be reduced to three months. Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(12) In the Commission staff working document of 29 May 2013, the Commission services projected that the French economy would contract by 0.1% in 2013 and would then expand by 0.6 % and 1.1 % in 2014 and 2015, respectively. In addition, the Commission 2013 spring forecast, which underpinned the scenario laid down in the staff working document of 29 May 2013, expected the harmonised index of consumer prices (HICP) to increase by 1.2 % in 2013 and 1.7 % in 2014. These growth and inflation forecasts were used as a basis for the Council recommendation under Article 126(7) TFEU of 21 June 2013. In 2013, GDP growth actually turned out to be slightly higher than expected by the Commission as GDP grew by 0.3 %. On the other hand, the HICP increased by only 1.0 %.

(13) The Commission 2015 winter forecast projects GDP to have increased by 0.4 % in 2014, 0.2 pp. below what was foreseen in the baseline scenario underpinning the EDP recommendation. GDP growth is estimated to have been driven mainly by an increase in inventories, public and private consumption, while investment and net exports are expected to have decreased. By comparison, at the time of the recommendation, investment was expected to increase in 2014 on the back of improving business confidence, while external demand was projected to be much stronger. Meanwhile, falling energy prices and weak activity have offset the impact on prices of the VAT reshuffling introduced in January 2014. As a consequence, HICP inflation is set to have slowed down to 0.6 % in 2014. Inflation in 2013 and 2014 thus turned out markedly lower than projected in spring 2013. In 2015, GDP is projected to increase by 1.0 % while the HICP is expected to remain flat (0.0% inflation).

(14) In 2013, the general government deficit amounted to 4.1 % of GDP, above the 3.9 % of GDP objective set in the recommendation of 21 June 2013. In particular, public revenues were negatively impacted by the much lower-than-expected elasticity of tax revenues, in spite of discretionary measures representing EUR 27 billion (1.3 % of GDP) according to the Commission. The fiscal effort as measured by the change in the structural balance was 1.0% of GDP. Correcting for revisions in potential growth and revenue shortfalls (0.2 pp of GDP), the change in the structural balance for 2013 stood at 1.2 % of GDP. This falls short of the 1.3 % of GDP improvement recommended by the Council on 21 June 2013, albeit by a narrow margin. Based on discretionary

measures adopted on the revenue side and on developments in total expenditures compared to the scenario set forth in the Council recommendation of 21 June 2013, the bottom-up assessment of the fiscal effort stands at -0.1 % of GDP, here again slightly below the 0.0 % of GDP of additional measures deemed necessary to reach the budgetary targets set in the Council recommendation.

(15) According to the Commission 2015 winter forecast, the headline deficit is set to have increased further in 2014 despite significant efforts to rein in the increase in public expenditures. Indeed, savings are expected from the continuation of a public sector wage freeze, the impact of pension reforms, and lower expenditure at the local level. However, these are expected to have been outweighed by the ramp-up of the tax credit for competitiveness and employment (CICE), which under ESA 2010 rules is accounted for as public expenditure and whose cost is estimated to amount to EUR 11 billion (0.4 % of GDP) in 2014. On the revenue side, the reshuffling of VAT rates implemented on 1 January and the doubling of the exceptional corporate income tax paid by large companies had a positive impact on tax revenues. However, lower-than-expected real GDP growth and inflation, together with a still low elasticity of tax revenues to GDP, have weighed on fiscal revenues.

(16) The structural deficit, based on the Commission 2015 winter forecast, is estimated to decrease from 3.3 % of GDP in 2013 to 2.9 % in 2014. When taking into account the corrections for downward revisions in potential output growth (+0.0 pp of GDP) and revenue windfalls (+0.2 pp of GDP) compared with the forecast made at the time the Council recommendation was issued, the annual fiscal effort for 2014 comes in at 0.6 % of GDP. Correcting for the negative impact of the changeover to ESA 2010 on the cost of payable tax credits, a development considered outside the scope of government control, brings the top-down assessment of the fiscal effort to 0.7 % of GDP thus falling slightly short of the recommended effort of 0.8 % of GDP. Compared to the economic scenario underpinning the Council Recommendation of 21 June 2013, additional revenue measures implemented, together with developments on the expenditure side adjusted for ESA 2010, amount to 1.1 % of GDP, in line with the level deeemed necessary by the Council on 21 June 2013 ('above 1% of GDP') . The cumulated effort over 2013-2014 therefore stands at 1.9 % of GDP based on the corrected change in the structural balance, falling short of the 2.1 % of GDP recommended by the Council. Based on the bottom-up assessment, the cumulated effort stands marginally above 1.0 %, in line with the level deemed necessary by the Council.

(17) The gap between the top-down and bottom-up assessment of the fiscal effort stems mainly from the downward revision in inflation since June 2013. In particular, for 2014, the GDP deflator growth forecast was revised down by 0.9 pp between the Council recommendation of 21 June 2013 and the Commission 2015 winter forecast. Tax revenues are strongly impacted by downward revisions in inflation. By comparison, public expenditures, which in France are often driven by norms adopted in nominal terms, are less impacted by in-year revisions in inflation. The resulting deterioration in the headline balance is not corrected for in the calculation of the structural balance, which only takes into account the output gap in volume terms. The top-down assessment of the fiscal effort is therefore sensitive to revisions in inflation. Regarding the bottom-up indicator, the yield of discretionary measures adopted in 2014 can be considered to have been only marginally impacted by the lower-than-expected inflation. To the extent that some public expenditure items under the control of the government adjusted to the lower inflation, the bottom-up indicator could have

been positively affected. However, due notably to freezes implemented on a number of public expenditures in 2014, the overall impact of the downward revision in inflation on the bottom-up is likely to have been limited.

(18) Overall, in light of the above, the available evidence does not allow to conclude on no effective action.

(19) The ratio of public debt to GDP, which represented 78.8 % in 2009 increased rapidly since then to 92.2 % in 2013. According to the Commission 2015 winter forecast, the debt ratio will continue to rise over the forecast horizon, to 95.3 % in 2014, 97.1 % in 2015 and 98.2 % in 2016 on the back of still relatively high general government deficits and subdued nominal GDP growth. Stock-flow adjustments are expected to contribute negatively to debt developments over the forecast horizon.

(20) Based on the Commission 2015 winter forecast, the headline deficit is expected to reach 4.1 % of GDP in 2015, substantially above the 2.8 % of GDP target set in the Council recommendation of 21 June 2013 and the 3 % of GDP benchmark. The considerable deterioration in the budgetary position resulting from the weaker overall position of the economy relative to the one underlying the Council recommendation of 21 June 2013 suggests that a revised recommendation under Article 126(7) TFEU for France, setting a new deadline to correct the excessive deficit is justified, in line with the rules of the Stability and Growth Pact.

(21) On 21 November 2014, the French authorities submitted a letter to the Commission in which France committed to a number of structural reforms implementing the 2014 country-specific recommendations issued by the Council on 8 July 2014. On 12 December 2014, the government published a reform agenda outlining reform priorities until 2017. This reform agenda was confirmed in a communication on the National Reform Programme made public on 18 February 2015. The authorities also provided a quantification of the expected macroeconomic impact of the main structural reforms initiated since 2012. The main reforms outlined notably include a reduction in the cost of labour through the CICE and additional reductions in employer's social security contributions through the *pacte de responsabilité et de solidarité*. These measures are expected to contribute to boosting growth and improving the sustainability of public finances and should therefore not be rolled back. However, the full impact of the reductions in the cost of labour would require complementary labour market reforms to reduce wage rigidities. Additional reforms outlined by the government include, inter alia, the 2014 pension reform, measures to reform local authorities, to improve the business environment, and to increase competition in services. In particular, the draft Law on Growth and Economic Activity addresses competition concerns for legal professions, opens up the sector of coach transport, reduces entry barriers in the retail trade and relaxes rules for Sunday work. Moreover, it also foresees a reform of the procedures for individual dismissal disputes. Altogether, structural reforms initiated since 2013 are expected to contribute to economic growth and to the long-term sustainability of public finances. However, the quantification by the authorities that these reforms will boost GDP by 3.3 pp by 2020 seems over-estimated.

(22) The information and commitments provided by the French authorities regarding structural reforms go in the right direction in the light of the requirements outlined in the Commission Communication COM(2015) 12 of 13 January 2015 on "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact" in order for France to be able to benefit from an extension of the deadline for the correction of the excessive deficit by more than one year. However, in its

communication "2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011" the Commission pointed to the limited response by France to previous recommendations in the light of the macroeconomic imbalances, and concluded that France has excessive imbalances requiring specific monitoring and decisive policy action. The Commission will consider in May, taking into account the level of ambition of the National Reform Programme and other commitments presented by that date, whether to recommend to the Council to adopt recommendations, pursuant to Article 7(2) of Regulation (EC) No 1176/2011, establishing the existence of an excessive imbalance and recommending that France take corrective action, to be set out in a Corrective Action Plan. Structural reforms are not only essential to address the excessive imbalances and strengthen potential growth but also to ensure the sustainability of public finances.

(23) Granting France one additional year, which is the rule according to Council Regulation (EC) No 1467/97, would be too demanding in the current weak economic environment as it would require an average annual improvement in the structural balance in 2015 and 2016 of more than 1.0 % of GDP, above the annual average effort recommended by the Council on 21 June 2013 for 2013-2015. On the basis of the Commission 2015 winter forecast, such an adjustment would have a very negative impact on growth both in 2015 and 2016. Therefore, and taking into account the structural reform plans announced by France and the still expected National Reform Programme, in line with the above-mentioned communication of 13 January 2015, it seems adequate to extend the deadline for France to bring an end to its excessive deficit situation by two years. The French authorities should make sure that both the adopted reforms and those planned will be fully implemented and, where needed, reinforced. In line with the above-mentioned communication of 13 January 2015, in case France fails to implement an ambitious reform agenda, the Commission will consider it an aggravating factor when assessing effective action in response to this recommendation.

(24) Granting France two additional years would imply headline deficit targets of 4.0 % of GDP in 2015, 3.4 % of GDP in 2016 and 2.8 % of GDP in 2017. The underlying annual improvement in the structural budget balance would be 0.5 % of GDP in 2015, 0.8 % of GDP in 2016 and 0.9% in 2017. For 2015, the adjustment would thus be 0.2 pp higher than the 0.3 % of GDP improvement in the structural balance expected based on the Commission 2015 winter forecast. In the baseline scenario for 2015 and 2016, based on the Commission 2015 winter forecast, measures taken into account on the revenue side are estimated to amount to 0.1 % and -0.1 % of GDP respectively. For 2017, discretionary measures included in the extended forecast amount to -0.2 % of GDP. These include the announced abolishment of the *contribution sociale de solidarité des sociétés* as well as the gradual reduction in the statutory rate of the corporate income tax.

(25) In order to achieve the budgetary targets, it is crucial that the authorities fully implement the already announced measures for 2015 and specify, adopt and implement rapidly additional measures needed to achieve the budgetary targets in 2015, 2016 and 2017. In particular, most of the measures underpinning the commitment taken by France to reduce the projected trend in public expenditures by EUR 50 billion by 2017 remain to be specified for 2016 and 2017. Overall, the situation will have to be monitored closely and the authorities should stand ready to

take corrective action in the event of expenditure slippages or lower-than-expected yield from discretionary revenue measures,

HAS ADOPTED THIS RECOMMENDATION:

(1) France should put an end to the present excessive deficit situation by 2017 at the latest.

(2) France should reach a headline deficit of 4.0 % of GDP in 2015, 3.4 % of GDP in 2016 and 2.8 % of GDP in 2017, which is consistent with delivering an improvement in the structural balance of 0.5 % of GDP in 2015, 0.8 % of GDP in 2016 and 0.9% of GDP in 2017. This would require additional measures of 0.2 % of GDP in 2015, 1.2 % of GDP in 2016 and 1.3% of GDP in 2017 based on the extended Commission 2015 winter forecast.

(3) France should fully implement the already adopted measures for 2015 and ensure, by end April 2015, an additional fiscal effort as stipulated in paragraph (2). This would require the specification, adoption and implementation of additional structural discretionary measures equivalent to 0.2% of GDP to close the gap with the recommended improvement in the structural balance of 0.5 % of GDP for 2015.

(4) France should step up efforts to identify savings opportunities across all sub-sectors of general government, including at social security and local government level and use all windfall gains for deficit reduction. Budgetary consolidation measures should secure a lasting improvement in the general government structural balance and should not be detrimental to the improvement of the competitiveness of the French economy.

(5) The Council establishes the deadline of 10 June 2015 for France to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets. France should report in detail on (i) the additional structural discretionary measures, representing 0.2% of GDP, adopted to ensure the achievement of the recommended improvement in the structural balance in 2015; and (ii) the outlined key budgetary measures for reaching the targets in 2016 and 2017. The "Loi de Programmation des Finances Publiques" should be updated to reflect the new adjustment path. Ex-ante independent evaluation of the key measures underpinning the adjustment for 2016 and 2017 should be provided by the French authorities ahead of the deadline.

(6) France should report to the Commission and the Economic and Financial Committee as required under Article 10 of Council Regulation EU No 473/2013 in accordance with the specifications laid down in Commission Delegated Regulation (EU) No 877/2013. The report should be submitted for the first time by 10 December 2015 and on a six-monthly basis thereafter. The reports submitted on 10 December should report on the updated draft budget in response to the Commission opinion on the Draft Budgetary Plan for 2016. The report by 10 June should update and further specify the detailed information on the specific budgetary measures planned or already taken to achieve the recommended improvements in the structural balance of the following year and to ensure a timely and sustainable correction of the excessive deficit by the deadline.

France shall report on the reform plan presented in the communication made public on 18 February 2015 and to be subsequently further complemented in the National Reform Programme which shall be strictly implemented so as to improve the growth outlook and contribute to the long-term sustainability of public finances.

It will be important to back the fiscal consolidation by the implementation of comprehensive and ambitious structural reforms, in line with the Council recommendations addressed to France in the context of the European Semester and in particular those related to the Macroeconomic Imbalance Procedure.

This recommendation is addressed to the Republic of France.

Done at Brussels,

For the Council
The President