French Multiyear Public Finance Programme Up to 2004

Introduction

For three years now the French economy has been growing robustly at a rate of about 3%. 1.6 million jobs have been created; the number of jobless has fallen by more than 900,000, i.e. over a quarter of total unemployment.

The objective of the multiyear public finance programme is to maintain this trajectory through the year 2004. French economic policy is aiming for full employment, going beyond merely reducing unemployment to mobilise all of the country's human resources, raising the employment rate of the population. This objective is in conformity with those set by the extraordinary European Council in Lisbon in spring 2000.

To achieve this goal, it was necessary first to absorb the demand deficit built up by the French economy during the 1990s due to inappropriate economic policies that were inadequately co-ordinated at the European level. This goal is in the process of being achieved. Demand is now vigorous, and household consumption and business investment are on track for sustained growth.

To continue to advance towards full employment, it will be increasingly necessary to raise the growth potential of the French economy by bringing those who have been excluded back onto the labour market and by stimulating investment, particularly in new technologies. Production capacity is in the process of being expanded, thanks to a higher investment rate, which soon should be back to the level of the late 1980s; this would allow France to catch up part of its investment lag. The productivity of the economy as a whole is rising due to growth in innovation and the introduction of new technologies. The economy has the potential for long-term non-inflationary growth of 3%. Core rate inflation is low, with the inflation rate in France falling significantly below that of the euro zone as a whole.

Maintaining a balanced economic approach is the key instrument in this strategy. Thanks to the reduction in public deficits, France and the euro zone have benefited from favourable monetary conditions. Low interest rates have been the condition for sustained expansion of domestic demand in the euro zone countries. The French authorities have reaffirmed their commitment to a balanced economic approach by continuing to improve the public accounts. In 2001, the French general government borrowing requirement will be close to the average of the euro zone countries. With 3% annual growth, the goal of balanced public accounts will be reached in 2004.

Another tool for promoting sustained growth is the mobilisation of all the growth factors in the French economy, including capital and labour resources, new technology and economic efficiency.

Businesses operating in France today are generally enjoying high profitability, and the overall outlook is satisfactory. The resources needed for sustained capital investment have been freed up by renewed growth and business tax reductions. While the level of capital investment is lagging behind that of the faster growing economies, particularly in the field of new technology, it should rise in the coming years. This should lead to a reduction in the currently high level of pressure on production capacity.

In the medium and long terms, France will benefit as the number of people of working age increases faster than in many of its European partners. The result of this factor is that the growth potential of the French economy will rise more rapidly – subject to the condition, however, that labour resources be mobilised effectively. The main ways to achieve this include increasing the labour force participation rate of older people, improving the conditions for youth to enter the labour market, continuing efforts to bring women into the workforce, improving training and fighting the exclusion of the least skilled from the job market.

There are three ways France is seeking to stimulate greater innovation: encouraging new entrepreneurs, promoting new technologies and freeing up new capital to promote growth.

Another factor raising the growth potential of the French economy is greater efficiency on the markets for goods and services. The liberalisation of major network sectors like telecommunications, transport and energy in accordance with European directives, without sacrificing equal access to public services, should help to lower relative prices in these areas, thus raising purchasing power and competitiveness. In this respect, the position of large French corporations on the main European markets augurs well.

The multiyear plan of tax cuts and fiscal reform is a factor of sustainable growth, especially because it encourages better remuneration of labour. This plan forms part of an effort to harmonise European tax systems.

These factors taken together indicate that the potential growth rate of the French economy, previously estimated at between 2% and 2.5%, is already higher than this and should be close to 3% per year. In this situation, given suitable macroeconomic policies France should experience sustained growth from now until 2004, with favourable consequences for employment and public finances.

1. The Economic Assumptions

a) Recent developments and the short-term outlook

The forecasts developed in drawing up the previous programme for the years 2001-2003 banked on growth of at least 3% in 2000 and 2.5% or 3% in 2001. The data available on developments since then indicate the need to revise these growth forecasts upward. Growth should be equal to or higher than 3.2% in 2000 and 3% next year.

Two factors underpin the improved outlook for growth in the short term: the expansion of international trade, resulting from greater synchronisation of the cycle among the main regions in the global economy, and the renewed buoyancy of domestic demand.
For the first nine months of 2000, exports are up by more than 11%, in particular those to the euro zone; moreover, France's market share of imports in the OECD zone seems to be rising, due to the solid competitive level of the French economy.

The buoyant growth of consumption was fuelled by the creation of 500,000 jobs in the private sector and the initial impact of tax cuts on household income. In the past year the rise in oil prices has held back the increase in purchasing power, and it accounted for about 1% of the rise in consumer prices over the past twelve months. However, the impact of the deterioration in the terms of trade on household income was offset by the cuts in taxes affecting households, which amounted to 0.7 GDP point this year.

Recent business surveys indicate that 2001 will see steady growth of 3% or more. The outlook for manufacturing is bright, and solid domestic demand will spur growth in the services sector. After the exceptional growth of the last two years, the construction sector should stabilise. Employment should expand by close to 2.5% next year, leading to a further fall in the numbers of jobless.

b) The outlook up to the year 2004

Two sets of macroeconomic assumptions have been adopted:

- In the first scenario, our growth potential amounts to an annual rate of 2.5%, with business investment rising at the same pace as in the 1999-2000 period, while structural unemployment falls slightly.

- In the second scenario, which represents the objective of French economic policy, the growth potential is pushed up to an annual rate of about 3% due to increased levels of investment and job creation. The strength of investment will reflect in particular rapid growth in new technologies. The sharp expansion in employment will lead to a significant fall in the level of unemployment, with no increase in the inflation rate. This development would be the result of reductions in social charges on labour and greater openness to competition on goods markets. Tax cuts, particularly those aimed at encouraging people to return to work, will help bring into play labour resources greater than those arising from demographic forces alone.

Growth will continue to be driven by the buoyancy of domestic demand and employment, and inflation will remain moderate.

As pressure on the oil market eases, the recent acceleration in prices following the rise in the cost of energy goods will decrease, leading to more moderate inflation in 2001. After falling to 1.2% in 2001 and 2002, the annual inflation rate should stabilise at about 1.5% during the 2003-2004 period, with demand generally in line with supply. In both scenarios the dynamics of growth is based on the state of domestic demand, with no significant positive contribution from abroad.

The prospects for employment are good, despite the attenuation of the factors which increase the job content of growth and the completion of the process of work time reduction.

Salaried employment in the market sector will experience exceptionally strong growth in 2001-2000 (projected at 3.2% and 2.5%). This should taper off in the 2002-2004 period, while remaining positive (1.5% and 1% per year in the two scenarios, respectively). This is due to the slowing pace of certain factors that promote job-rich growth (the impact of the reduction of charges targeted at low-skilled workers, the increase in part-time work, etc.) as well as to the near completion of the transition to the 35-hour working week.

The process of work time reduction will be close to an end in 2004. About 80% of private sector employees will be covered by a company agreement. Starting in 2002, the transition to the 35-hour week will mainly involve small enterprises. Net job creation generated by work time reduction will be proportionally lower than what was expected for 1999-2001.

Overall, the reduction in the working week will shift the distribution of added value slightly in favour of employees up to 2004. The creation of additional jobs will lead to the total wage bill rising at a faster pace than GDP. The rate of unemployment, as defined by the ILO, will be close to 7% in 2004.

2. The Public Finance Strategy for Long-term Growth

a) Continuity in spending strategy

As in the two previous financial years, the public finance programme in France is based on a target for growth in public spending.

The importance of a multiyear plan for public spending goals continues to be based on two economic policy objectives:

b) to make better use of public finances in the regulation of economic life. By setting rules on the medium-term growth of public spending, the government is letting the automatic stabilisers play smoothly on the volume of spending;

c) to modernise the budget process by setting government action in a multiyear framework. Determining the amount of resources available to each government department makes it easier to define structural policies and enables the government authorities to carry on dialogue with the rest of society in a planned way.

The provision of high quality public services will continue as resources are freed up in two ways:

- taking advantage of renewed growth to reduce mechanisms set up in periods of high unemployment, while reaping the benefits of the reduction in the numbers of those covered by income guarantee schemes for the jobless (guaranteed minimum income, means-tested social benefits). The resulting room for manoeuvre will make it possible to meet new social requirements, such as that of dependent elderly people;

- making public services more efficient. Increasing the productivity of services makes it possible simultaneously to improve services and control spending. The reform process aimed at modernising the state sector will enable increases in the productivity and quality of government services.

d) A renewed commitment to government spending targets up to 2004

Carrying forward the decisions made during the previous programming procedures, the government has decided on a 1% increase in the volume of spending in the central government budget for the entire 2002-2004 period. This increase corresponds to the average rise recorded since 1997.

The overall strategy concerning the increase in central government spending can be broken down into 7 objectives:

<u>1. Better ensure the state's sovereign functions.</u> In line with the decisions reached while drafting the 2001 budget bill, the resources of the Ministry of Justice will continue to be augmented. A multiyear programme to improve prison conditions has been adopted. The public safety services will be given the resources they need to be effective.

<u>2. Invest in education.</u> To develop the qualifications needed by society and strengthen the public education system, a multiyear hiring plan has been drawn up.

<u>3. Keep the state's commitments to other areas of government.</u> Levies on revenue that go to local government and the European Union, which are recorded as government spending for purposes of the national accounts, will probably grow at a faster pace than general budget spending. This is due to three factors: the solidarity and growth pact, which channels the fruits of growth into local government; the increasing impact of the reform of the business tax, which will raise the volume

of central government transfers to local government; and the impact of the Berlin agreement on the national contribution to the EU budget.

4. Increase spending on the civil service in line with the policy choices of the last few years, i.e. a real increase of just over 1% per year.

5. Adjust spending on employment to the new situation of the job market. Unemployment has fallen significantly over the last three years, resulting in the resizing of a number of schemes. This trend will continue in accordance with trends on the labour market, especially where subsidised jobs in the non-market sector are concerned. Only a third as many people are entering early retirement schemes, making it possible to continue to downsize these through more selective requirements. As for youth employment programmes, the creation of "new services" has met with such success that it is possible to foresee ongoing financing capable of replacing most of the central government financing schemes in this area. In addition, management and labour have decided to make a commitment to finance an individualised return-to-work programme, reflecting their desire to activate spending on employment.

6. Maintain defence capabilities. While carrying forward the programme to professionalise the armed forces, France will continue to adjust its defence spending in accordance with an international environment marked by peace, ten years after the end of the cold war.

7. Rein in the growth in debt. Given the stability in long-term interest rates, reducing the government deficit by an average of FRF 20 billion per year will make it possible to contain the increase in the debt burden to just under 2% per year in real terms. This contained rate of increase is also due to the allocation of part of the proceeds from the sale of UMTS licenses to reducing the government debt. The future privatisation of public assets has not been included in the programme.

e) Social welfare spending and employment

f) Activate spending on unemployment

Employer-employee organisations that manage unemployment insurance schemes have decided to implement a programme, in line with the initiatives already taken, establishing more than FRF 20 billion in spending commitments in order that the unemployed will have individualised follow-up from the ANPE (French national employment agency) to help them return to work.

g) Make spending on health care more effective

In the area of health care, the target of total growth of 5.5% in real terms between 2002 and 2004 means that the expenditure projected in 2001 must continue to be slowed down. This policy of keeping health insurance spending in check is compatible with a high-quality health care service as well as with continuing to make health care more effective. This slower rate of growth of health spending reflects the impact of both those measures to improve control of health spending which have already been implemented, and those which will be considered for inclusion in the next social security budget bill.

h) Maintain support for families

The purchasing power of family benefits will be maintained, especially for benefits that are not means-tested. Other family benefits are distributed to families in accordance with their income.

The significant job creation effort and advances in income should gradually reduce the number of people who need this kind of social welfare net. Overall, the country's expenditure on the family is among the highest in Europe and this will be maintained.

i) Carry through the gradual reform of pensions to consolidate unfunded schemes

The proportion of the population over the age of 60 should continue to rise in coming years. Several approaches are being adopted to deal with this situation. They are the subject of in-depth consultation within the Conseil d'Orientation pour les Retraites (Advisory council for retirement pensions) set up by the Prime Minister.

Creating the Pension reserve fund will make it possible to build up reserves in the various unfunded schemes so as to smooth out the impact of the increasing cost of pensions. At the end of 2002, this fund will have total savings of about FRF 100 billion, which should rise to at least FRF 1,000 billion in constant French francs by 2020, or approximately 10% of GDP.

In order to guarantee public service retirement pensions, the government has offered to make a pact with government employees on the pension issue, which would include, first, the gradual alignment of the period during which civil servants make contributions with that of private sector employees, and second, measures to improve the system, particularly with respect to taking account of the most arduous tasks and the inclusion of some bonuses in pension calculations.

Ensure greater choice of retirement age. It is essential to raise the employment rates of senior citizens. In this regard, the priority placed on returning to work means putting an end to undesired early retirement and increasing the pension incomes of those who want to extend their working lives.

j) Keeping up local government spending

Spending by local government should continue to grow at a pace just below 2% as total national wages continues its long-term rise. The debt burden should fall due to the funding resources generated.

k) Controlling growth in spending by all areas of government

Overall, taking into account all areas of government, the total volume of growth in public spending should increase by 4.5% over the years 2002-2004. The rise in spending by the unemployment insurance system decided on by the managerial organisations goes a long way towards explaining the increase with respect to the objective set in the previous multiyear programme (4%). This increase breaks down as follows:

Total growth in real expenditure between 2002 and 2004 (3 years)

General government	4.5%
Central government (budget accounting)	1.0%
Social security administrations	4.8%
- Health care	5.5%
- Pensions	5.8%

Local government	5.2%

This increase will lead to reducing public spending as a share of GDP by about 0.8 GDP point per year. This development should make it possible to bring the public spending/GDP ratio down to below 50% in 2004, i.e. the level of the early 1980s. **About half the resources freed up in this way will be allocated to cutting the public deficit, and the rest to reducing taxes.**

3. An Effective Strategy for Reducing and Reforming Taxes

In 2000 and 2001, the burden of compulsory levies, which is structurally heavy in France, should fall by a total of one GDP point due to the decision to cut taxes by about 2 GDP points, which will be offset in part by strong spontaneous growth in tax and social welfare revenue. **A decrease of nearly one point will take place between 2002 and 2004.** In 2002-2003, the three-year plan to reduce and reform taxes and to reduce employer's contributions will be continued as part of the work-time reduction programme.

a) Reducing taxes on business

In order to promote dynamic, competitive enterprises, three major reforms will cut taxes paid by business.

The elimination of wages from the business tax base will be complete in 2003. The mechanical impact of this will be a reduction of FRF 6 billion (0.6 GDP point) on the business tax owed by companies. This measure lowers the cost of labour by approximately 2 percentage points on average.

To help business implement the reduction in the working week, companies are being exempted from almost all employer social security contributions on minimum wage jobs. Overall, in 2004, the cuts in employer social security contributions will total more than FRF 70 billion (3/4 GDP point).

In 2003, the corporate income tax, which reached a level of almost 40% in 1997, will be brought down to 33%. For the smallest enterprises, the rate will fall as low as 15% in 2002 for the first FRF 250,000 in profits.

The organisations that manage unemployment insurance have decided to reduce employer contributions by about FRF 14 billion between now and summer 2002.

b) Remunerating labour well

The three-year tax reduction plan provides for cutting income tax by FRF 45 billion, which comes on top of the FRF 11 billion reduction already decided in 2000. For all those who live essentially from their labour, this reduction, which comes to over ½ GDP point, will leave them with a greater part of the fruit of their efforts. This measure will encourage social and career mobility. It will ensure that the talents of the workforce are better compensated and more properly reflect their contribution to the creation of wealth.

The reduction in income tax rates is greatest for those in the middle and lower income brackets, lightening by 10% the tax burden on virtually all taxpayers.

A second plank of the three-year cut in income tax is the reduction in taxes on low wages. This action aims to ensure better compensation for work than for non-work and is part of the large-scale programme to reduce what have been called “unemployment traps”.

4. Reducing the burden of the public debt by restoring a global balanced budget in 2004

a) Reducing the debt burden

Since 1998 the spiral of increasing the burden of the public debt has been reversed. The debt will fall from about 60% of GDP in 1998 to 57% in 2001. The public finance programme up to the year 2004 intends to carry this process forward, so that in 2004 the national debt will represent no more than 53% of GDP.
This reduction will reflect an increase in the general government primary surplus of over 3% of GDP in 2004, and the allocation of the non-recurring resources from the sale of UMTS licenses to debt reduction. As a result, the expense of servicing the debt will continue to fall, from the equivalent of 3.7% of GDP in 1997 to 3% of GDP in 2004, which corresponds to a reduction of about FRF 70 billion in the debt burden.

Simply maintaining a balanced budget beyond 2004 would bring the debt/GDP ratio down to 40% in 2010, which is the level first exceeded in 1993.

b) Preparing the budget for the ageing of the population

The French authorities intend to use the reduction of public debt to prepare for the consequences of an ageing population. Under current law, the cost of pensions could rise by 4 to 5 GDP points between now and the year 2004. It will be easier to finance this through reduction of the size and expense of the national debt and through the increase in the Pension reserve fund, which contributes to the net reduction of the general government debt.

c) Developing balanced financial relations among different areas of government

Four decision-making centres influence the overall budget: the central government, the European Union, local government and the social administrations directly managed by the social partners (the unemployment insurance programme and supplementary pension plans).

The 2004 medium-term programme indicates that, despite a reduction in the overall state budget of about FRF 20 billion each year, central government borrowing requirement will amount to nearly 1% of GDP in 2004 at a time when local government should be generating an underlying surplus of about 0.4 GDP point per year. The schemes directly managed by the social partners will show a surplus of about 0.6 GDP point. As for the European Community, levies being channelled in its direction are growing rapidly. In particular, it accounts for 0.7 point of the increase in total government spending in the year 2004.

The government’s goal is to develop clearer financial relations between the central government and other general government bodies.

d) **Improving the budget process and the way it is prepared, decided and monitored**

In addition to the issues of macroeconomic and financial strategy discussed here, the government is determined to improve the budget process *per se* In this regard, the government, with the support of Parliament, wants to modify France's "financial constitution", which is based on the 1959 constitutional bylaw. This reform, scheduled for the first half of 2001, would promote compliance with public spending commitments. One of the key provisions is the implementation of overall management of resources for the various programmes and increased accountability at the level of each department. The head of each department would have fixed targets and indicators reflecting the level of success achieved. Similarly, policy concerning public procurement, which amounts to FRF 700 billion annually, would be simplified, modernised and opened up to small and medium-sized enterprises as part of the reform of the public procurement code in the first half of 2001.

e) Balanced public finances

The medium-term public finance programme adopts the goal of balancing the accounts of the government as a whole in 2004, subject to a 3% economic growth rate. This would return the state of public finances to the situation prevailing before the first oil shock. Balancing public finances will provide fresh room for manoeuvre to manage the vicissitudes of the economic cycle.

The re-balancing of the budget will make it possible to focus more on promoting economic growth and solidarity. To achieve this, half the funds generated by the reduction of public spending as a share of GDP between 2002 and 2004 will be used to reduce the borrowing requirement. The other half will be allocated to reducing the scale of compulsory levies.

Under this hypothesis, the public deficit will fall mainly as a result of a structural improvement in the budget, in particular from expenditure rising more slowly than growth potential.

Overall, then, assuming an annual growth rate of 3%, the French economy should continue to improve its structural performance up to 2004, in which year France should record an overall surplus in public finances. This result will go hand in hand with initiatives to control budget outlays and social spending and to cut mandatory levies. In line with the policies conducted by the government, it will make it possible to reduce public debt and to provide greater leeway for action in favour of employment and social solidarity. It will also constitute a useful contribution to the coordination of economic policies in the euro zone.