EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 7 January 2003
ECFIN/6/03–EN

2002 UPDATE

OF THE CONVERGENCE PROGRAMME OF FRANCE

(2003-2006)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS

The 2002 update of the stability programme of France, which covers the period from 2003 to 2006, is the first programme prepared by the new government which took office in June 2002. According to the French authorities, the programme provides a multi-annual budgetary strategy designed to support a strong and lasting improvement in economic and employment growth. This is to be achieved through alleviation in the tax burden, reduction in the general government deficit and the implementation of structural reforms. The budgetary strategy is based on norms for general government expenditure increases in real terms; the budgetary margins arising from lower-than-GDP growth in expenditures are split between deficit reduction and tax relief. The programme is rich in information and broadly complies with the requirements of the code of conduct on the content and format of the programmes, even if some aggregates, in particular employment figures, are provided in a definition not fully compatible with the code of conduct.

On 19 November 2002, the Commission, considering that budgetary developments observed in 2002 and planned for 2003 constitute a significant divergence from the projections of the 2001 update, recommended to the Council to send an early warning to France in order to prevent the occurrence of an excessive deficit.

In 2002, the French public finances deteriorated markedly. The 2002 update of the stability programme estimates the 2002 general government deficit at 2.8% of GDP, a level higher than that estimated by the French authorities when the early warning was launched. It is recalled that the deficit projected in the 2001 update was 1.4% of GDP. Monthly budgetary indicators until November suggest that the 2002 general government deficit could even come out closer to the 3% of GDP Treaty reference value. According to Commission services calculations, the larger part of the total slippage in public finances in 2002 is due to a deterioration in the cyclically-adjusted balance, which mainly reflects an overrun in expenditures. The remaining part can be attributed to cyclical factors: economic activity decelerated in 2002, real GDP growth being estimated at 1.2% in the current updated stability programme, as against 2.5% in the 2002 Budget.

The budget for 2003 projects the general government deficit at 2.6% of GDP, after 2.8% in 2002. It is recalled that the Broad Economic Policy Guidelines for 2002 recommended that France should “aim at a sufficient decline of the 2003 deficit to ensure that a close to balance position in 2004 can be achieved”. The figures of the programme are consistent with a decrease in the cyclically-adjusted deficit by 0.2 percentage point in 2003, to 2.6% of GDP[1]. In Commission’s view, the risk for the government deficit to be worse than projected, and that the deficit becomes excessive in 2003, i.e. the starting year of the current update of the stability programme, is large if new measures are not implemented. Indeed, the macroeconomic assumption underlying the budget of an increase in real GDP by 2.5% is to be considered as optimistic; for that year, the Commission projects real GDP growth at 2.0%[2] and an increase in the general government deficit by 0.2 percentage point between 2002 and 2003. Moreover, a further deterioration in the 2002 position, which appears possible in view of recent budgetary indicators, or an eventual slippage in government expenditures could also contribute to an increase in the general government deficit above 3% of GDP in 2003.

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1 These calculations are based on the production function method approved by the Council.

2 Attaining in 2003 a rate of growth of 2.5% would imply a marked acceleration in real GDP growth as from the end of 2002 which is not heralded by monthly indicators. It is recalled that the November 2002 OECD forecast projected real GDP growth at 1.9% in 2003 in France.

The general government debt is projected to increase from 57.3% of GDP in 2001 to 59.1% of GDP in 2003. This forecast does not take into account the impact on general government accounts of recently decided financial operations[3]. These decisions could bring the debt ratio to level close to 60% of GDP in 2003, and, in the event of higher than projected deficit or lower nominal growth, this threshold may even be breached.

For the period 2004-2006, the macroeconomic projections of the 2002 updated stability programme are based on the same two scenarios as in previous updates: a "cautious" scenario, real GDP growth averaging 2.5% a year over the period, and a "favourable" scenario where real GDP growth reaches 3% per year. The "cautious" scenario appears the more plausible one. Indeed, the favourable scenario makes the assumption of a strong increase in total investment and in the employment rate which, in the absence of bolder than already announced reforms, appears uncertain. In the cautious scenario, real GDP follows the same path as its potential level as calculated by Commission services on the basis of the national authorities figures or on the basis of the Autumn Commission forecast. This scenario, consistent with a potential output growth averaging 2.5%, the central value of the range provided by the French authorities, is then considered in this assessment as the reference scenario for assessing budgetary developments.

On the basis of the "cautious" macroeconomic scenario, the government deficit is projected to decline by 0.5 percentage point of GDP per year as from 2004 to reach 1.0% of GDP in 2006. The budgetary adjustment in actual terms would be faster should the "favourable" scenario materialise, the government deficit declining on average by 0.7 percentage point of GDP per year to reach 0.5% of GDP in 2006. To reach this outcome, real expenditures are planned to increase by a cumulated 3.9% in real terms over the period 2004-2006, a rate lower than real GDP growth. The margins thus created are partly allocated to tax relief: in the cautious scenario, the tax cuts average 0.2 percentage point of GDP per year; in the favourable scenario, they average 0.3 percentage point of GDP per year. The general government debt is projected to decline from 59.1% of GDP in 2003 to 57.0/55.4% of GDP in 2006, depending on the macroeconomic scenario.

The 2002 update lacks ambition concerning the time profile and the size of the budgetary consolidation. First, the budgetary adjustment is back-loaded, as the effort (measured as the change in the cyclically-adjusted balance) planned for 2003 reaches barely 0.2 percentage point of GDP. Second, between 2002 and 2006, the underlying budgetary position improves on average by hardly 0.5 percentage point a year. These plans are not in conformity with the understanding of the October Eurogroup that, as from 2003, countries "which have not yet reached a close to balance position need to pursue continuous adjustment of the underlying balance by at least 0.5 percentage point of GDP per year", neither with the subsequent Commission Communication[4], which stated that countries with high deficits should seek an improvement in the underlying budget position "higher than 0.5 percentage point of GDP each year".

Moreover, a close to balance underlying budgetary position is not reached in the end-year of the programme in the cautious scenario while in the favourable scenario such a position is reached in 2006 only thanks to a projected sudden improvement in potential output as from 2004, which reflects optimistic projections for capital accumulation and labour market developments. A consequence of these projections is that, according to Commission calculations, a budgetary position providing a sufficient safety margin to

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[3] These financial operations include, in particular, the capital injection by the State in the company France Télécom and the sale of the state owned assets of the company Crédit Lyonnais.

[4] COM (2002) 668 final of 27.11.2002

avoid breaching the 3% of GDP Treaty reference value under normal cyclical conditions (i.e. the so-called minimal benchmark) would not be attained before 2005.

Finally, it is to be remarked, in particular, that the reduction in the actual deficit planned between 2002 and 2005 is lower than that planned in the 2001 update under similar macroeconomic assumptions. After the large slippage of 2002, and given that the budgetary position is currently at a level which could lead to the occurrence of an excessive deficit, a higher priority should have been attached to deficit reduction in the early years of the period covered by the programme.

The slow budgetary adjustment path projected in the 2002 update is partly due to the implementation of tax cuts from 2003. The previous update conditioned the implementation of tax cuts after 2003 on the attainment of a close to balance budgetary position. Such a relevant condition was welcomed by the Council in its opinion on the 2001 update. Moreover, in the context of the favourable scenario, a part of the margins created by favourable growth conditions are used to implement larger tax cuts, and the budgetary effort is comparable to that of the cautious scenario. These plans are not considered sufficient by the Commission in view of its Communication of 27 November stating that countries should seek a more ambitious annual improvement in the underlying budgetary position if growth conditions are favourable.

On the expenditure side, the target for the increase in real general government expenditures is the same as in the previous update. However, some concerns exist about the achievability of this objective if ambitious reforms are not rapidly implemented. First, recent budgetary developments have brought further evidence of the difficulties in meeting the multi-annual targets set for real expenditures in the previous updates; indeed, the expenditure increments targeted for the periods 2000-2002 and 2001-2003 in the 1998 initial stability programme and its first update will be missed by a large margin due to slippages in the health sector, and, more recently, in the State sector and in the unemployment insurance. Second, the constraints arising from the ageing of population and the debt burden will increase during the period covered by the current update, making the environment less favourable for expenditure restraint. Finally, while the ceiling remains the same as in the previous update, new priorities have emerged on the expenditure side since the general elections of 2002; financing these priorities will require tight expenditure restraint in other areas.

Beyond the direct consequences on deficit targets, the non respect of expenditure ceilings could, if repeated, damage the overall credibility of the budgetary strategy, given the relevance of these norms as an anchor. A positive first step towards improving expenditure control was made recently with the introduction of structural measures designed to curb ex ante expenditures, in particular in the health sector. In the same vein, the actions designed to improve the control of budgetary execution in the State sector are also welcome. A second positive step is the commitment to implement corrective infra-annual measures in the social security sector in the event of an evidence of overspending. These measures constitute clear progresses. However, they should be complemented by the introduction of a mechanism ensuring automatic compensation across years of eventual overspending in the general government sector.

All in all, the current update of the stability programme does not comply with essential requirements of the stability and growth pact, in particular with that of reaching a close to balance budgetary position in the medium term. The budgetary adjustment planned in the programme lacks of ambition, in particular in the first years of the period covered by the programme. A larger improvement in the underlying budgetary position in 2003 and 2004 would contribute to reduce the risk for the general government deficit to breach the 3% of

GDP threshold and allow the attainment of an underlying budgetary position close to balance by the end of the period covered by the programme.

The Commission considers that on the basis of current policies, the risk of persistent budget imbalances cannot be excluded. The planned move to a deficit of 1% by 2006 of GDP is inadequate in light of the projected budgetary impact of ageing populations. A greater degree of budgetary ambition is required, and France should complete the transition to a position of budget balance before 2006. Moreover, achieving sustainability will require maintaining a balanced budget position in underlying terms over the very long run: this implies running large primary surpluses for many years so that a large reduction in the debt ratio is recorded prior to the budgetary impact of ageing populations taking hold. The Commission welcomes the intentions of the French authorities to reform pension and health care systems in light of ageing populations. These reforms need to proceed according to the time frame indicated in the programme, as they have been subject to repeated delays in recent years.

1. INTRODUCTION

The 2002 update of the stability programme of France was submitted to the Commission on 13 December 2002[5] and covers the period from 2003 to 2006. This programme, which is the first programme prepared by the new government which took office in June 2002, provides a multi-annual budgetary strategy designed to support a strong and lasting improvement in economic and employment growth. This is to be achieved through alleviation in the tax burden, reduction in the general government deficit and the implementation of structural reforms.

The overall budgetary strategy of the 2002 updated stability programme is based on defining norms for the increase in general government expenditure in real terms. The budgetary margins arising from lower-than-real-GDP growth in real expenditures are planned to be split between deficit reduction and tax relief. The budgetary strategy has not changed since the original stability programme was presented in 1998, and this strategy was commended by the Council, which considered that a clear binding norm for expenditures growth supports a transparent budgetary adjustment.

The programme is rich in information and broadly complies with the requirements of the Code of conduct on the content and format of stability programmes. However, some aggregates - employment growth for instance - are provided in the programme in a definition not compatible with the requirement of the code of conduct. The need to comply fully with the code of conduct is reinforced by the implementation of the new production function method to compute potential output using the figures provided by the Member States. To the same end, it would have been suitable that the programme provides wages per head for the total economy and unemployment rate figures in the harmonised definition, even if these series are not compulsorily required in the code of conduct. Moreover, the presence in the programme of explicit projections for revenues and spending categories for the general government sector in national accounting would have allowed a deeper analysis of the quality of the projected budgetary adjustment. Finally, external macroeconomic assumptions differ slightly from the Commission Autumn forecasts, but a detailed sensitivity analysis is included.

[5] This is 13 days after the expiration of the deadline agreed by the Council in the code of conduct on the format and content of stability and convergence programmes.

The assessment of the 2002 update of the stability programme of France is made one month after the adoption by the Commission of a Recommendation to the Council to send an early warning to France in order to prevent the occurrence of an excessive deficit.

2. IMPLEMENTATION OF THE PREVIOUS UPDATES OF THE STABILITY PROGRAMME

2.1. Implementation of the budget for 2002

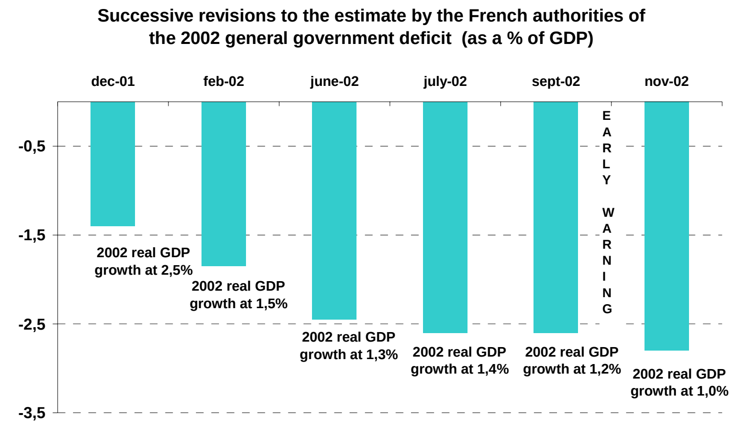
French public finances deteriorated markedly in 2002, the general government deficit being estimated by the French authorities at 2.8% of GDP in the 2002 update of the stability programme. he worsening in the general government deficit compared to 2001 amounts to 1.4 percentage point of GDP, the largest deterioration observed since the recession of 1993. This deterioration represents also a large deviation from the plans of the previous stability programme update, which projected a stabilisation in the general government deficit at 1.4% of GDP in 2002, under the assumption of an increase in real GDP by 2.5%. Since the beginning of 2002, several revisions to the government finances targets were made by the French authorities:

– In February, the French authorities revised downwards their real GDP growth forecast for 2002 from 2.5% to 1.5% and, consequently, adjusted the objective for the 2002 general government deficit upwards from 1.4% of GDP to 1.8% of GDP. This revision reflected the cyclical impact of the new forecast for real GDP growth.

– In May, after the presidential elections, the government launched an audit on public finances, the results of which estimated the general government deficit in 2002 to be within the range 2.3-2.6% of GDP. The audit was based on two main assumptions: (1) 1.3% real GDP growth in 2002 and (2) no-policy-change .

– In July, the French authorities presented a corrective budget bill for 2002 aimed at implementing a cut in the income tax by 5%. In this corrective budget bill, the French authorities decided to target a general government deficit of 2.6% of GDP in 2002, which is the highest value of the range provided by the auditors one month earlier, thus not correcting the observed slippage in the budgetary situation.

– Finally, in November, after the Commission recommended to the Council to send an early warning to France, the French authorities presented a further corrective bill, which revised upwards the general government deficit estimate for 2002 from 2.6% of GDP to 2.8% of GDP. This level is higher than that estimated by the French authorities when the early warning procedure was launched by the Commission (2.6% of GDP). Moreover, recent economic and budgetary indicators suggest that the 2002 general government deficit could come out even closer to the 3% of GDP reference value.



Events corresponding with the dates mentioned in the table beside:

December 2001: presentation of the 2001 update of the stability programme;

February 2002: presentation of the winter macroeconomic forecasts;

June 2002: audit on public finances (a range 2.3-2.6% of GDP was provided);

July 2002: corrective budget for 2002;

September 2002 : draft 2003 budget;

November 2002 : second corrective budget for 02;

According to the calculations made by the Commission on the basis of the method endorsed by the Council applied to the figures of the 2002 update of the stability programme, the larger part of the total slippage in public finances in 2002 from initial plans is due a deterioration in the cyclically-adjusted balance. As it was identified by the auditors already in June, the deterioration in the underlying budgetary position mainly reflects an overrun in expenditures in the State sector (worth ½ percentage point of GDP) and in the health sector (worth ¼ percentage point of GDP); the part which can be attributed to cyclical factors amounts to about 0.5 percentage point of GDP.

2.2. Implementation of the previous updates and revisions to the general government deficit objectives

Four years after the publication of the initial stability programme, an overview of the implementation of the 1998 stability programme and its successive updates allows to better assess the budgetary strategy and how objectives have evolved in the recent years. In particular, it is today possible to assess completely the implementation of the original stability programme, which covered the period 2000-2002.

The original programme, presented in January 1999, projected a decline in the general government deficit by 1.1 percentage point of GDP between 1999 and 2002, from 2.3% of GDP to 1.2% of GDP, under the assumption of an increase in real GDP by 2.5% a year on average. The projections of the 2002 update suggest that the objectives set in 1998 will be missed by a large margin, despite an average real GDP growth only slightly lower than planned[6]. Over the period under review, the general government deficit will have increased by 1.2 percentage point of GDP between 1999 and 2002 (from 1.6% of GDP in 1999 to 2.8% of GDP in 2002).

The main reason for this result is that expenditures norms were not adhered to, as shown in the table below. Ceteris paribus, it can be argued that, if the spending norm set in the 1998 stability programme for the period 2000-2002 had been respected, the level of the 2002 general government deficit would be 1.7 percentage point of GDP lower than currently planned, and the objective for the 2002 deficit set in the 1998 programme – i.e. a general government deficit at 1.2% of GDP - would have been attained. The room for manoeuvre in the current juncture would then have been much larger.

[6]Real GDP growth was 3.8% in 2000, 1.8% in 2001 and is estimated by the French authorities at 1.2% in 2002. This gives an average growth rate of 2.3%.

Table 1	
From the deficit reduction planned in the 1998 programme to the outcome	
Deficit reduction planned in the 1998 SP between 1999 and 2002	**-1.1**
Impact of:	
Lower than projected real GDP growth [(1)]	+0.3
Overrun in real expenditures [(2)]	+1.8
Others	+0.2
Deficit increase observed between 1999 and 2002	**+1.2**

[(1)] Real GDP growth was projected in the original SP to average 2.5% over the period 2000-2002. It will in fact average 2.3%. The cumulated differential over the three years, i.e. 0.6 percentage point of GDP, explains 0.3 percentage point of increase in the general government deficit.

[(2)] The original SP targeted an increase in real expenditures by 3.5% between 1999 and 2002 (the original figure in ESA 79 accounting system was 3.0%). The increase will in fact reach 7.0%.

2.3. Lessons to be drawn from recent budgetary developments

In general, the evolution of public finance objectives in the successive updates of the stability programme shows that the attainment of a close to balance or in surplus budgetary position, as requested by the Stability and Growth Pact, has been systematically postponed. From the comparison between the 2002 and the previous updated stability programmes, two major features emerge:

- First, the reduction in the actual deficit planned between 2002 (i.e. the year of the slippage in public finances) and 2005 in the current update of the stability programme, that is 1.2 percentage point of GDP, is slightly lower than that planned for the same period in the previous update, i.e. 1.4 percentage point of GDP, under identical macroeconomic assumptions. Given that the current budgetary position is at a level which could lead to the occurrence of an excessive deficit, a higher priority should have been attached to deficit reduction in the early years of the period covered by the 2002 programme, particularly in 2003.

- Second, strong similarities exist between the original stability programme, presented in 1998, which forecasted a decrease in the general government deficit from 2.9% in 1998 to 1.2% four years later, and the 2002 update, which, based on comparable macroeconomic assumptions and the same strategy, projects a decrease in the general government deficit from 2.8% in 2002 to 1.0% four years later. This comparison highlights the central importance of the respect of expenditure norms in the context of the French strategy.

Table 2

General government deficit objectives in the successive updates of the stability programmes (2.5% real GDP growth scenario)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Original programme (1998)	2.9	2.3	2.0	1.6	1.2	-	-	-	-
Updated programme (1999)	2.7	2.1	1.7	1.3	0.9	0.5	-	-	-
Updated programme (2000)	2.7	1.8	1.4	1.0	n.a.	n.a.	0.5	-	-
Updated programme (2001)	2.7	1.6	1.4	1.4	1.4	1.3	0.5	0.0	-
Updated programme (2002)	2.7	1.6	1.3	1.4	2.8	2.6	2.1	1.6	1.0

3. THE MACROECONOMIC ASSUMPTIONS

3.1. The macroeconomic projections of the stability programme

The 2002 update of the stability programme forecasts real GDP growth at 1.2% in 2002 and 2.5% in 2003. For the years from 2004 to 2006, the projections of the 2002 update are based on the same scenarios adopted in the previous updates: a "cautious" scenario, with real GDP growth averaging 2.5% a year, and a "favourable" scenario, where real GDP growth reaches 3% per year.

According to the programme, these two scenarios are underpinned by two assumptions for potential real GDP growth : a "cautious" assumption, in which potential real GDP growth is at 2¼% a year, and a "favourable" assumption of an increase in the potential growth rate of the French economy to 2¾%. In the "favourable" scenario, the increase in potential real GDP growth is due to structural improvements in the labour market and to a more rapid capital accumulation. In both cases, inflation remains stable between 2004 and 2006 at 1.5% a year, the acceleration in real GDP to an above potential growth rate remaining insufficient to close the output gap (see table below).

Table 3

Real GDP growth, potential real GDP growth and output gap
projected by the French authorities in the 2002 update of the stability programme

	2001	2002	2003	2004	2005	2006
"Cautious" scenario						
Real GDP growth	1.8	1.2	2.5	2.5	2.5	2.5
Potential real GDP growth	2.25	2.25	2.25	2.25	2.25	2.25
Output gap	-0.2	-1.25	-1.00	-0.75	-0.50	-0.25
"Favourable" scenario						
Real GDP growth	1.8	1.2	2.5	3.0	3.0	3.0
Potential real GDP growth	2.25	2.25	2.25	2.75	2.75	2.75
Output gap	-0.2	-1.25	-1.00	-0.75	-0.50	-0.25

Source: 2002 update of the stability programme.

3.2. Evaluation by the Commission

The projections for real GDP growth for the years 2002 and 2003 appear on the high side of expectations. Indeed, attaining a rate of growth of 1.2% in 2002 and 2.5% in 2003 would imply a significant acceleration in real GDP growth as from the fourth quarter of 2002 which is currently not heralded by monthly indicators. An increase in real GDP by 1.0% in 2002, and around 2.0% in 2003, as forecast by the Commission in Autumn, and which implies an acceleration in economic activity from the first quarter of 2003 appears more likely. The OECD, in its November forecast, projects real GDP growth at 1.9% in France for 2003. The Consensus forecast of December is a real GDP growth of 1.0% in 2002 and 1.7% in 2003.

For the years from 2004 to 2006, the "cautious" scenario, projecting real GDP growth at 2.5% a year, appears the more plausible one. Indeed, the favourable scenario, which projects real GDP at 3% per year, makes the assumption of a strong increase in total investment and in the employment rate which, at this stage, appears uncertain:

- In the favourable scenario, employment in the private sector is projected to increase by 1.8% per year on average over the years 2004 to 2006. In the same period, Eurostat projects an increase in the working age population by 0.4-0.5 percentage point per year. This means that the employment rate is projected to increase by more than 1 percentage point per year after 2004. In the absence of bolder reforms than those already announced, assuming that such an increase could occur without generating inflationary pressures appears too optimistic an assumption, in light of the tensions appeared on the labour market in the course of 2000. Moreover, it is recalled that employment growth has been virtually nil since Spring 2002, following three years of very strong labour deepening.

- In this scenario, total investment is projected to increase by 4.7% per year in real terms over the period 2004-2006, with private investment increasing by 7.2% per year on average. Such a rate for total investment was reached during the period 1998-2001, but this followed an average growth of 1% in the ten preceding years. Moreover, the rate of capacity utilisation is currently lower than its historical average. It is recalled that over the last twenty years total investment increased in line with real GDP growth, i.e. at a 2.2-2.3% annual rate.

Table 4

Real GDP growth, potential real GDP growth and output gap

<u>PF method applied to the projections of the 2002 update of the stability programme</u>

	2001	2002	2003	2004	2005	2006
"Cautious" scenario						
Real GDP growth	1.8	1.2	2.5	2.5	2.5	2.5
Potential real GDP growth	2.5	2.3	2.4	2.5	2.6	2.6
Output gap	1.0	0.0	0.1	0.1	0.0	-0.1
"Favourable" scenario						
Real GDP growth	1.8	1.2	2.5	3.0	3.0	3.0
Potential real GDP growth	2.7	2.4	2.5	2.8	2.9	3.0
Output gap	0.9	-0.3	-0.3	-0.1	0.0	0.1

<u>Note:</u> the 2002 update of the stability programme omits some indicators necessary to the calculation of the potential output through the production function method. In particular, while total employment is necessary for this calculation, the programme provides only the number wage earners in the private sector. We assumed that the evolution of the public employment and of non dependant workers was the same as forecast for 2003 by the French government. For the computation of the Nairu, we assumed that the change in wage inflation for the whole economy is the same as that provided for the private sector. Finally, Commission services computed an unemployment rate consistent with the assumptions of the programme: a growth in labour force equal to that projected by Insee between 2001 and 2006, and an increase in total employment as already specified.

Source: Commission calculations applying the production function method endorsed by the Council to the inputs provided by the French authorities in the 2002 update of the stability programme.

The analysis of potential growth confirms that it is reasonable to consider the cautious scenario[7] as the reference scenario for assessing budgetary developments. When applying the agreed production function method to the inputs of the "cautious" scenario provided by the French authorities, potential real GDP averages 2.5% between 2003 and 2006. This level corresponds to the central value of the range provided by the French authorities (2¼-2¾%). The estimates made by the Commission using the same method on the basis of its Autumn forecasts were very similar.

[7] When applying the HP filter method to the figures of the 2002 update of the stability programme to compute the potential output, the results are very close to those of the production function method. Indeed, in the case of the cautious scenario, potential real GDP growth is estimated at 2.4-2.5% between 2001 and 2006. The output gap remains close to zero between 2002 and 2006.

Table 5

Real GDP growth, potential real GDP growth and output gap
PF method applied to the Autumn 2002 Commission forecasts

	2001	2002	2003	2004	2005	2006
Real GDP growth	1.8	1.0	2.0	2.7	-	-
Potential real GDP growth	2.5	2.2	2.3	2.7	2.5	2.5
Output gap	1.2	0.0	-0.3	-0.3	-	-

Source: Commission calculations applying the production function method endorsed by the Council to the Autumn 2002 Commission forecasts.

Finally, it is worth noting that a difference exists between the Commission and the French authorities in the evaluation of the 2002 output gap. While the French authorities argue that the output gap in 2002 is negative by 1¼ percentage point of GDP, the calculations made by the Commission using the figures provided in the 2002 updated stability programme (this is true for both the HP filter and production function methods when applied to the two scenarios provided by the French authorities) estimate the output gap at a level close to zero in 2002. This is in line with the evaluation made by the Commission in its Autumn 2002 forecasts. The upward trend of underlying inflation since 2000 appears consistent with view that the output gap in 2002 was not negative: indeed, underlying inflation has remained above 2% year on year all over 2002, while it averaged 1.7% in 2001 and only 1.1% in 2000.

4. PUBLIC FINANCE

4.1. Programme overview

After the large slippage observed in 2002, the general government deficit is planned to gradually decrease as from 2003. The 2003 budget targets a government deficit at 2.6% of GDP. From 2004 to 2006, the budgetary plans are based on the same strategy as that developed in the previous updates. The cornerstone of this strategy remains the binding norm set for the evolution of real government expenditures. The margins created by the implied slower-than-GDP growth in expenditures are allocated both to reducing government deficit and to tax relief. In the 2002 update of the stability programme, real expenditures are planned to increase by a cumulated 3.9% in real terms over the period 2004-2006. For the rest, the budgetary developments depend on the macroeconomic scenario:

– In the cautious scenario, the general government deficit is projected to decline continuously by 0.5 percentage point of GDP per year as from 2004 to reach 1.0% in 2006. This reduction in the deficit between 2002 and 2006, i.e. 1.8 percentage points of GDP, is reached through a decline in the expenditure to GDP ratio by 2.5 percentage point of GDP over the period. At the same time tax cuts are implemented and the tax burden is projected to decline by 0.5 percentage point of GDP to 44.1% of GDP.

– In the favourable scenario, the general government deficit is projected to reach 0.5% in 2006. This reduction is obtained through a decline in the expenditure to GDP ratio by 3.2 percentage points of GDP over the period. The tax burden is projected to decline by 0.8 percentage point of GDP to 43.8% of GDP.

Table 6 **Projections for the general government finances (as percentage of GDP)**								
			Cautious scenario (2.5% GDP growth rate)			**Favourable scenario** (3% GDP growth rate)		
	2002	**2003**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
General government balance	-2.8	-2.6	-2.1	-1.6	-1.0	-2.0	-1.4	-0.5
Expenditure	54.0	53.4	52.8	52.2	51.5	52.6	51.7	50.8
Tax burden	44.6	44.3	44.3	44.2	44.1	44.2	44.0	43.8
Interest payments	3.2	3.2	3.1	3.1	3.1	3.1	3.1	3.1
Primary balance	0.4	0.6	1.0	1.5	2.1	1.1	1.7	2.6
Debt ratio	58.7	59.1	58.9	58.3	57.0	58.5	57.3	55.4
Source: programme de stabilité, 2004-2006.								

The general government debt is projected to decline from 59.1% of GDP in 2003 to 57.0/55.4% of GDP in 2006, depending on the macroeconomic scenario.

As already stated by the Council, a budgetary strategy based on the definition of clear binding norms for expenditures growth is an appropriate way to achieve a sustainable budgetary adjustment and to improve the quality of public finances. However, in light of the past developments, strong uncertainties surround the feasibility of the expenditure rule if not underpinned by structural reforms on the expenditure side.

To this respect, some positive aspects have to be underlined. On the expenditure side, the structural reform in the health and unemployment sectors and the projected stabilisation in real terms of the wage bill in the public sector, after several years of rapid increase, are to be welcomed. The programme also states that the tax cuts will mainly aim at sustaining employment growth; this is in particular the case of the planned cuts in social security contributions which are designed to compensate for the impact on the cost of labour stemming from the harmonisation of the minimum wages[8]. Finally, the projection for non-fiscal revenues is reasonable and can be considered as a positive evolution for the quality of public finances.

4.2. The budget for 2003

The budget for 2003 projects the general government deficit at 2.6% of GDP, after 2.8% in 2002, despite an expected acceleration in real GDP growth to 2.5%. It is recalled that the draft budget for 2003 presented in September projected a stabilisation in general government deficit at 2.6% in 2003. During the parliamentary process, the estimate for the 2002 general government deficit was increased to 2.8% of GDP. To compensate for the negative base effect resulting from this revision, taxes were increased marginally (by roughly 0.1% of GDP). Moreover, in December, the social partners agreed a series of measures increasing social contributions and reducing unemployment benefits for a comparable amount.

The absence of significant improvement in the general government deficit in 2003 is due to the fact that the margins created by control in real expenditures growth are just sufficient to accommodate the implementation of tax cuts. Indeed, expenditures in real terms are projected to grow by 1.2%[9], well below real GDP growth, but tax cuts worth 0.2

[8] The implementation of the Aubry's Laws on the reduction of working time led to the creation of different minimum wages. These different minimum wages will converge in the next few years towards the highest level. The impact on the labour cost of this convergence will be offset by cuts in social contributions.
[9] The ceiling was 1.4% in the draft budget bill presented to Parliament in September

percentage point of GDP and a small reduction in non fiscal revenues by 0.1 percentage point of GDP are planned.

The main measures on taxes are a cut in the *taxe professionnelle*, a local tax on production factors, by 0.1 percentage point of GDP; a cut in the income tax by 0.1 percentage point of GDP, a cut in employers social contributions by 0.1 percentage point of GDP. On the other side, the taxes on tobacco will be increased by 0.05 percentage point of GDP, and a marginal rise in the corporate tax is also implemented. Revenues are forecast to increase by less than nominal GDP growth, due to the impact of the slow growth of 2002 on the 2003 revenues (through lags in the income tax and corporate tax receipts in particular).

The figures of the programme are consistent with a decrease in the cyclically-adjusted deficit by 0.2 percentage point in 2003, to 2.6% of GDP, after a deterioration of about 1.0 percentage point of GDP in 2002[10]. Then, the 2003 draft budget does not provide a correction to the significant divergence occurred in 2002.

In the Commission's view, the risk for the general government deficit to breach the 3% of GDP threshold in 2003 is large, even after the measures taken in December. Indeed, the real GDP growth assumption on which the 2003 draft budget was built (+2.5%) appears on the very high side of possibilities; it is recalled that the Commission Autumn forecasts project an increase in the general government deficit by 0.2 percentage point of GDP between 2002 and 2003 under the assumption of an increase in real GDP growth by 2.0%[11]. Moreover, a further deterioration in the 2002 position, which appears likely in view of recent budgetary indicators, could contribute to an increase in the general government deficit in 2003. On the expenditure side, the target set for the increase in general government expenditures in 2003, i.e. +1.2% in real terms, implies a sharp slowdown compared to the increase observed in 2002 (+3.6%), and appears at risk. Finally, the measures decided recently in order to restore a balanced budgetary situation in the unemployment insurance could be insufficient in the event of a further deterioration of the situation on the labour market[12].

All in all, the underlying budgetary adjustment in 2003 is clearly insufficient.

4.3. Government balance projections for 2004-2006

The cyclically-adjusted balance estimates track closely the path of actual deficit, given that the output gap is projected to hover close to zero over the period 2002-2006 in both scenarios. Therefore, the cyclically-adjusted balance is projected to reach –1.0% of GDP under the "cautious" macroeconomic scenario, considered in this assessment as the reference scenario, and –0.6% of GDP in the favourable scenario.

The analysis of the time profile and the size of the budgetary adjustment underlines the lack of ambition of the consolidation effort (measured as the change in the cyclically-

[10] These calculations are based on the production function method endorsed by the Council.

[11] This forecast, which showed a deterioration in the cyclically-adjusted balance by 0.1 percentage point of GDP in 2003, was based on the draft budget presented in September and did not take into account the measures introduced in December. Even after these measures, the Commission considers as large the risk for the deficit to breach the 3% of GDP threshold for the reasons mentioned in section 4.2.

[12] The rapid increase in the deficit of the unemployment benefit system observed recently is largely attributable to structural factors. Indeed, a reform implemented in 2000 (Plan d'Aide au Retour à l'Emploi) cancelled the decline in unemployment benefits through time. Some measures designed to restore the financial balance of the system were taken on 20 December 2002 by the social partners; they consist in an increase in social contributions and in some modifications in the benefit system.

adjusted balance in the absence of relevant one-off measures[13]) projected in the 2002 update. First, the budgetary adjustment is strongly back-loaded, as the effort planned for 2003 reaches barely 0.1/0.2 percentage point of GDP. Second, over the period 2004-2006, the underlying budgetary position improves on average by about 0.5 percentage point a year, clearly an insufficient effort to reach a close to balance position in the time horizon covered by the programme. Moreover, according to Commission forecast (see table 8 below) the level of the cyclically-adjusted deficit in 2004 could still be near 2.5% of GDP.

Table 7

Projections for the general government finances in cyclically-adjusted terms,
Based on the projections of the 2002 updated programme

As % of GDP	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Reference "cautious" scenario (2.5% GDP growth rate)						
General government balance	-1.4	-2.8	-2.6	-2.1	-1.6	-1.0
Real GDP growth	1.8	1.2	2.5	2.5	2.5	2.5
Potential output	**2.5**	**2.3**	**2.4**	**2.5**	**2.6**	**2.6**
Output gap	**1.0**	**0.0**	**0.1**	**0.1**	**0.0**	**-0.1**
Cyclically-adjusted balance						
Production Function method	**-1.8**	**-2.8**	**-2.6**	**-2.1**	**-1.6**	**-1.0**
HP filter method	**-1.8**	**-2.7**	**-2.6**	**-2.1**	**-1.6**	**-1.1**
"Favourable" scenario (3% GDP growth rate)						
General government balance	-1.4	-2.8	-2.6	-2.0	-1.3	-0.5
Real GDP growth	1.8	1.2	2.5	3.0	3.0	3.0
Potential output	2.7	2.4	2.5	2.8	2.9	3.0
Output gap	0.9	-0.3	-0.3	-0.1	0.0	0.1
Cyclically-adjusted balance						
Production Function method	-1.7	-2.7	-2.5	-2.0	-1.3	-0.6
HP filter method	-1.8	-2.6	-2.4	-1.9	-1.3	-0.6

Source: Commission calculations applying the production function method endorsed by the Council and the HP filter method to the inputs provided by the French authorities in the 2002 update of the stability programme.

Table 8

Projections for the general government finances, and cyclical-adjustment,
Based on the projections of the Commission Autumn 2002 forecasts

	2001	2002	2003	2004
General government deficit	-1.4	-2.7	-2.9	-2.5
Output gap (PF method)	1.2	0.0	-0.3	-0.3
Cyclical component (PF method)	0.5	0.0	-0.1	-0.1
Cyclically-adjusted deficit (PF method)	-2.0	-2.7	-2.8	-2.4

These plans do not seem in conformity with the understanding of the October 2002 Eurogroup that, as from 2003, countries "which have not yet reached a close to balance position need to pursue continuous adjustment of the underlying balance by at least 0.5 percentage point of GDP per year", neither with the subsequent Commission Communication[14], which stated that countries with high deficits should seek an

[13] The fluctuations in the non-fiscal revenues, which could be considered as one-off revenues, impact the general balance for amounts lower than 0.1 percentage point of GDP.
[14] COM (2002) 668 final of 27.11.2002

improvement in the underlying budget position "higher than 0.5 percentage point of GDP each year".

The two more relevant consequences of the magnitude and of the time profile of the projected budgetary adjustment are:

- a close to balance underlying budgetary position is not reached by the end-year of the programme in the cautious scenario, considered by the Commission as the reference scenario, while in the favourable scenario such a position is reached in 2006 only thanks to a projected sudden improvement in potential output as from 2004, which reflects overly optimistic projections for capital accumulation and labour market developments.

- a budgetary position providing a sufficient safety margin to avoid breaching the 3% of GDP Treaty reference value under normal cyclical conditions would not be reached before 2005[15].

4.4. Revenues

The slow budgetary adjustment path projected in the 2002 update is partly due to the implementation of tax cuts between 2003 and 2006. In the cautious scenario, these tax cuts average 0.2 percentage point of GDP per year; in the favourable scenario they average 0.3 percentage point of GDP per year.

The implementation of tax cuts as from 2003 in the two macroeconomic scenarios is not conditioned to the attainment of general government deficit objectives. This contrasts with the previous update of the stability programme which stated that, after 2003, any reduction in the tax burden would be conditional on GDP growth, and that all budgetary margins resulting from lower-than-GDP growth in real expenditures would be allocated to deficit reduction, should real GDP growth remain close to 2.5% from 2003 onwards. Such a condition allowed to secure fiscal consolidation, and was welcomed by the Council in its opinion on the 2001 update.

In the context of the favourable scenario, a part of the margins created by favourable growth conditions are used to implement larger tax cuts, and the budgetary effort is comparable to that of the cautious scenario. These plans are not considered sufficient by the Commission in the light of its Communication of 27 November[16] stating that countries should seek a more ambitious annual improvement in the underlying budgetary position if growth conditions are favourable.

Moreover, if real GDP growth were to reach a rate of 3% during the years 2004-2006, these developments should be a priori considered as cyclical, at least before a clear evidence of change of regime in potential output appears. Then, the decision to implement more tax cuts after 2004 in the event of a rate of GDP growth higher than 2.5% should be taken carefully, if not compensated by measures on the expenditure side, in order to avoid missing an opportunity to reduce the underlying deficit. Indeed, proceeding to tax cuts in a context of dynamic revenues resulting from a cyclical upturn would lead to a deterioration of the underlying budgetary position, as observed in the recent past.

[15] Reference is made here to the "minimal benchmark". In the case of France, the latest estimate for this benchmark published in the 2002 edition of the Public Finance report is 1.7% of GDP.

[16] COM (2002) 668 final of 27.11.2002

Finally, as already underlined in the assessment of the previous updates of the stability programme, the elasticity between revenues and the tax base was high by historical standards between 1999 and 2001. This entails a risk for future tax receipts developments, in particular if the current unfavourable macroeconomic developments were to last longer than expected, or if the job content of growth was to decrease significantly. The 2002 update could have envisaged such a possibility.

4.5. Expenditures

Since the 1998 stability programme, the anchor of the French budgetary strategy is a ceiling for the increases in general government expenditure in real terms. Between 2003 and 2006, the State sector expenditures in real terms are set to increase by 0.3% a year on average (in public accounting). Growth in real expenditures by local administrations (+1.9% a year on average) will remain the most dynamic among the three sub-sectors of general government, mainly due to increased capital expenditures and to a rapid growth of the wage bill. Finally, social security expenditures in real terms are planned to increase on average by 1.7% a year. In total, the 2002 updated stability programme projects an increase in real general government expenditures by 3.9% for the whole period from 2004 to 2006, i.e. 0.1 point lower than in the 2001 update.

Some concerns exist about the capacity to achieve this objective if ambitious reforms are not rapidly implemented:

- First, recent budgetary developments have brought further evidence of the difficulties in meeting the multi-annual targets set for real expenditures in the previous updates; indeed, the expenditure increments targeted for the periods 2000-2002, 2001-2003 and 2002-2004 in the 1998 initial stability programme and its first and second updates will be missed by a large margin due to slippages in the health sector, and, more recently, in the State sector and in the unemployment insurance.

Table 9

Growth in real expenditures projected by the successive updates of the stability programme and realisation (% change in real terms over the preceding period)

.	2000	2001	2002	2003	2004	2005	2006
Growth in real GG expenditures [(1)]	**1.7**	**1.7**	**3.6**	**1.2**	**1.4**	**1.3**	**1.2**
Projections for 3-years cumulated increase in real General government expenditures							
Target set in the 1998 programme	+3.5% cumulated						
Target set in the 1999 programme		+4.0% cumulated					
Target set in the 2000 programme			+4.5% cumulated				
Target set in the 2001 programme				+4.0% cumulated			
Target set in the 2002 programme					+3.9% cumulated		
[(1)] Observed figures until 2001 ; projections of the 2002 update of the stability programme after 2002							

- Second, the constraints arising from the ageing of population and the debt burden will increase during the period covered by the current update, making the environment less favourable for expenditure restraint. Indeed, with the retirement of the cohorts born after the second world war, the pension expenditure will increase by a cumulated 7.7% in real terms between 2004 and 2006 (as against 5.8% as projected for the period 2003-2005).

- Finally, while the target remains the same as in the previous update, new priorities have emerged on the expenditure side since the general elections of 2002, in particular in the Law and Order and Defence sectors; financing these priorities will require tight expenditure restraint in other areas.

Beyond the direct consequences on deficit targets, the non respect of expenditure rules could, if repeated, damage the overall credibility of the budgetary strategy, given the relevance of these norms as an anchor. Some positive actions towards improving expenditure control were recently undertaken. First, some structural measures designed to curb ex ante expenditures in the health and unemployment sectors were introduced; in the same vein, the control of budgetary execution in the State sector has been reinforced. Second, the French authorities committed themselves to implement corrective infra-annual measures in the social security sector in the event of an evidence of overspending. These measures constitute clear progresses. However, in view of recent budgetary developments, they should be complemented by the introduction of a mechanism ensuring automatic compensation across years of eventual overspending in the general government sector.

Finally, should GDP growth result lower than expected in the short-term, pressures for additional expenditure could emerge. In such a context, it will be of primary importance not to deviate from the path of cyclically-adjusted deficit presented in the 2002 updated stability programme. This presupposes in particular the respect of currently planned expenditure increases.

4.6. Sensitivity analysis

The 2002 update of the stability programme presents, as previous updates, two complete and coherent macroeconomic scenarios. The need for detailed sensitivity analysis is therefore less crucial than in other situations. The 2002 update provides sensitivity analyses for the overall impact on French real GDP and government finances of a permanent shock in the export markets growth of the French economy, or the level of oil prices or interest rates. The results of the simulations are broadly in line with other existing estimates and with elasticities computed by Commission services.

4.7. Debt ratio

For the first time since 1998, the general government debt-to-GDP ratio will increase in 2002 and 2003, although remaining slightly below the 60% of GDP Treaty reference value. The debt ratio is subsequently projected to decrease gradually from 2004 to reach 57/55.4% of GDP in 2006, depending on the macroeconomic scenario.

The Commission Autumn forecast, which did not take into account the latest unfavourable budgetary developments for 2002, projected the general government debt ratio at 58.6% of GDP in 2002 and at 59.3% of GDP in 2003. The comparison between the scenario of the Commission forecast and the scenario of the current update shows, as expected, that the main differences in the evaluation of the path of the debt to GDP ratio arise from the higher optimism of the macroeconomic and deficit projections contained in the programme.

It is to be recalled that these forecasts do not take into account the possible impact on general government accounts of recently decided financial operations as the capital injection in France Télécom and, on the other side, the privatisation of the Crédit Lyonnais. These decisions could bring the debt ratio to a level closer to 60% of GDP in 2003, and, in the event of higher than projected deficit or lower nominal growth, this threshold might even be breached.

Table 10 **Contribution to the difference in the projections for the general government gross debt**					
In % of GDP	Difference between current and previous update[(1)]		Difference between the projections of the 2002 update and Commission Autumn forecasts[(2)]		
	2001	2002	2002	2003	2004
Debt to GDP ratio	**0.2**	**2.4**	**0.1**	**-0.2**	**-0.4**
Contribution to change in debt					
Difference due to starting position	0.0	0.2	0.0	0.1	-0.2
Primary balance	0.0	1.4	0.1	-0.3	-0.3
Interest payments	-0.1	0.0	-0.1	-0.1	-0.1
Inflation	0.1	0.0	0.0	0.1	0.0
Real GDP growth	0.3	0.7	-0.1	-0.2	0.1
Stock-flow adjustment	-0.3	0.1	0.2	0.2	0.0

[(1)] A positive figure implies that the general government gross debt is projected at a lower level in the 2002 update of the stability programme than in the previous update.
[(2)] A positive figure implies that the general government gross debt is projected at a lower level in the Autumn 2002 Commission forecasts than in the 2002 update of the stability programme.

5. SUSTAINABILITY OF PUBLIC FINANCES

The 2002 updated stability programme contains a section on the sustainability of public finances. It includes the EPC projections for public expenditures on pensions, health care and long term care which show an overall increase in age-related spending of some 5 percentage points of GDP between 2005 and 2040.

It is first necessary to consider whether current budgetary polices can ensure that the SGP will continue to be respected in the future in light of the budgetary implications of ageing populations. The Commission considers that on the basis of current policies, the risk of lasting budget imbalances cannot be excluded. To place public finances on a sustainable footing, a more ambitious medium-term budget target is required, so as to achieve a fast pace of debt reduction.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. The planned move to a deficit of 1% by 2006 of GDP is not in line with SGP requirements, and is inadequate in light of the projected budgetary impact of ageing populations. France should complete the transition to a position of budget balance, in line with SGP requirements, within the time frame of the 2002 updated programme. Moreover, it is imperative that debt actually falls in line with what is planned in the programme and an even faster pace of debt reduction could be achieved by devoting the bulk of windfall gains (say due to privatisation) to debt reduction.

The programme recognises the need to reform the public pension system, and states that a reform will commence in 2003: however, no details are provided on the type of measures envisaged in the reform and indeed such intentions were announced in the 2001 update of the stability programme. The programme also indicates the need to achieve a better control of health care expenditures. Such policies go in the right direction, but they will need to be ambitious if they are to make a significant contribution to mitigating the projected budgetary impact of ageing populations.

Finally, it is necessary to consider the type and scale of the budgetary challenges that will emerge in coming years to ensure sustainable public finances. First and foremost, a greater degree of urgency is required. Budgetary objectives need to be more ambitious: a medium-term target consisting of a deficit will not suffice: France needs to achieve a balanced budget position in underlying terms as soon as possible, and thereafter sustain sound public finance positions over the long run so that a significant fall in the debt ratio is recorded prior to the budgetary impact of ageing populations taking hold (see annex 2 of this report). At the same time, there is a need to proceed the planned reform of pension and health care systems.

6. Overall assessment of compliance with the Stability and Growth Pact

All in all, the current update of the stability programme does not comply with essential requirements of the stability and growth pact, in particular with that of reaching a close to balance budgetary position in the medium term in the most plausible scenario. Indeed, the attainment of such a position in the favourable scenario reflects largely the impact of optimistic macroeconomic assumptions.

In light of the above, the budgetary adjustment planned in the 2002 update lacks of ambition, in particular in the first years of the period covered by the programme. A larger improvement in the underlying budgetary position in 2003 and 2004 would not only allow the attainment of an underlying budgetary position close to balance by the end of the period covered by the programme but also reduce the risk for the general government deficit to breach the 3% of GDP threshold. A more rapid achievement of a close to balance or in surplus budgetary position is also required in order to ensure sustainability of public finances in the medium to long term.

Annex 1 : Summary tables from the 2002 updated stability programme

I. The 2.5% growth scenario

General government budgetary developments (excluding UMTS)

% of GDP	2002	2003	2004	2005	2006
Net lending by sub-sectors (B9)					
General government	-2.8	-2.6	-2.1	-1.6	-1.0
Central government: State	-3.4	-3.0	-2.8	-2.5	-1.9
Central government bodies	0.6	0.5	0.5	0.6	0.7
Local government	0.2	0.1	0.2	0.3	0.3
Social security funds	-0.2	-0.2	0.0	0.0	0.0
General government (S13)					
Total receipts	51.2	50.8	50.7	50.6	50.5
Total expenditure	54.0	53.4	52.8	52.2	51.5
Budget balance	-2.8	-2.6	-2.1	-1.6	-1.0
Net interest payments	3.2	3.2	3.1	3.1	3.1
Primary balance	0.4	0.6	1.0	1.5	2.1

General government debt developments (excluding UMTS)

% of GDP	2002	2003	2004	2005	2006
Gross debt level	58.7	59.1	58.9	58.3	57.0
Change in gross debt	1.4	0.4	-0.2	-0.6	-1.3
Contributions to change in gross debt					
Primary balance	-0.4	-0.6	-1.0	-1.5	-2.1
Interest payments	3.2	3.2	3.1	3.1	3.1
Nominal GDP growth	-1.6	-2.3	-2.3	-2.3	-2.3

Divergence from previous update
2.5% growth scenario

% of GDP	2002	2003	2004	2005	2006
GDP growth					
Previous update	2.5	2.5	2.5	2.5	-
Latest update	1.2	2.5	2.5	2.5	2.5
Difference	-1.3	0.0	0.0	0.0	-
Budget balance					
Previous update	-1.4	-1.3	-0.5	-0.0	-
Latest update	-2.8	-2.6	-2.1	-1.6	-1.0
Difference	-1.4	-1.3	-1.6	-1.6	-
Gross debt level (consolidated general government)					
Previous update	56.3	55.7	54.5	52.9	-
Latest update	58.7	59.1	58.9	58.3	57.0
Difference	2.4	3.4	4.4	5.4	-

Macroeconomic assumptions: 2.5% growth scenario

Internal assumptions

Growth and associated factors

	2002	2003	2004	2005	2006
GDP growth at constant market prices	1.2	2.5	2.5	2.5	2.5
GDP deflator	1.7	1.4	1.5	1.5	1.5
HICP change	1.8	1.6	1.5	1.5	1.5
Employment growth	0.7	1.1	1.1	1.1	1.1
Labour productivity growth	0.5	1.4	1.4	1.4	1.4
Sources of growth: percentage changes at constant prices					
Private consumption expenditure	1.8	2.4	2.6	2.6	2.6
Government consumption expenditure	3.6	1.6	1.1	1.1	1.1
Gross fixed capital formation	0.4	2.1	3.5	3.5	3.5
Changes in inventories and net acquisition of valuables as a % of GDP	-0.5	0.8	0.0	0.0	0.0
Exports of goods and services	0.7	6.0	5.5	5.5	5.5
Imports of goods and services	1.5	8.1	5.5	5.5	5.5
Contribution to GDP growth					
Final domestic demand	1.4	3.0	2.5	2.5	2.5
Changes in inventories and net acquisition of valuables as a % of GDP	-0.5	0.8	0.0	0.0	0.0
External balance of goods and services	-0.2	-0.4	0.0	0.0	0.0

Basic assumptions

	2002	2003	2004	2005	2006
USD/€ exchange rate	0.94	0.98	0.98	0.98	0.98
U.S.	2.3	2.7	2.7	2.7	2.7
Japan	-0.7	1.4	1.4	1.4	1.4
Euro area	0.8	2.1	2.1	2.1	2.1
Growth of relevant foreign markets	2.2	6.8	6.8	6.8	6.8
Oil prices (Brent. USD/barrel)	25	25	25	25	25

II. The 3% growth scenario

General government budgetary developments (excluding UMTS)

% of GDP	2002	2003	2004	2005	2006
Net lending by sub-sectors (B9)					
General government	-2.8	-2.6	-2.0	-1.4	-0.5
Central government: State	-3.4	-3.0	-2.8	-2.5	-1.9
Central government bodies	0.6	0.5	0.5	0.6	0.7
Local government	0.2	0.1	0.3	0.3	0.4
Social security funds	-0.2	-0.2	0.1	0.2	0.4
General government (S13)					
Total receipts	51.2	50.8	50.6	50.3	50.3
Total expenditure	54.0	53.4	52.6	51.7	50.8
Budget balance	-2.8	-2.6	-2.0	-1.4	-0.5
Net interest payments	3.2	3.2	3.1	3.1	3.1
Primary balance	0.4	0.6	1.1	1.7	2.6

General government debt developments (excluding UMTS)

% of GDP	2002	2003	2004	2005	2006
Gross debt level	58.7	59.1	58.5	57.3	55.4
Change in gross debt	1.4	0.4	-0.6	-1.1	-1.9
Contributions to change in gross debt					
Primary balance	-0.4	-0.6	-1.1	-1.7	-2.6
Interest payments	3.2	3.2	3.1	3.1	3.1
Nominal GDP growth	-1.6	-2.3	-2.6	-2.5	-2.5

Divergence from previous update
2.5% growth scenario

% of GDP	2002	2003	2004	2005	2006
GDP growth					
Previous update	2.5	3.0	3.0	3.0	-
Latest update	1.2	2.5	3.0	3.0	3.0
Difference	-1.3	-0.5	0.0	0.0	-
Budget balance					
Previous update	-1.4	-1.0	0.0	0.3	
Latest update	-2.8	-2.6	-2.0	-1.4	-0.5
Difference	-1.4	-1.6	-2.0	-1.7	-
Gross debt level (consolidated general government)					
Previous update	56.3	55.3	53.6	51.8	-
Latest update	58.7	59.1	58.5	57.3	55.4
Difference	2.4	3.8	4.9	5.5	-

Macroeconomic assumptions: 2.5% growth scenario

Internal assumptions

Growth and associated factors

	2002	2003	2004	2005	2006
GDP growth at constant market prices	1.2	2.5	3.0	3.0	3.0
GDP deflator	1.7	1.4	1.5	1.5	1.5
HICP change	1.8	1.6	1.5	1.5	1.5
Employment growth	0.7	1.1	1.8	1.8	1.8
Labour productivity growth	0.5	1.4	1.2	1.2	1.2
Sources of growth: percentage changes at constant prices					
Private consumption expenditure	1.8	2.4	3.1	3.1	3.1
Government consumption expenditure	3.6	1.6	1.1	1.1	1.1
Gross fixed capital formation	0.4	2.1	4.7	4.7	4.7
Changes in inventories and net acquisition of valuables as a % of GDP	-0.5	0.8	0.0	0.0	0.0
Exports of goods and services	0.7	6.0	6.1	6.1	6.1
Imports of goods and services	1.5	8.1	6.1	6.1	6.1
Contribution to GDP growth					
Final domestic demand	1.4	3.0	3.1	3.1	3.1
Changes in inventories and net acquisition of valuables as a % of GDP	-0.5	0.8	0.0	0.0	0.0
External balance of goods and services	-0.2	-0.4	0.0	0.0	0.0

Basic assumptions

	2002	2003	2004	2005	2006
USD/€ exchange rate	0.94	0.98	0.98	0.98	0.98
U.S.	2.3	2.7	2.7	2.7	2.7
Japan	-0.7	1.4	1.4	1.4	1.4
Euro area	0.8	2.1	2.1	2.1	2.1
Growth of relevant foreign markets	2.2	6.8	6.8	6.8	6.8
Oil prices (Brent. USD/barrel)	25	25	25	25	25

Annex 2 : An assessment of the sustainability of public finances

This is the second assessment of the sustainability of French public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group to the EPC.[17]

The French stability programme contains a section assessing the sustainability of public finances and includes national budgetary projections for public expenditures on pensions, health care, and long term care. As the projections provided by the French authorities to the EPC only go up to 2040, the Commission has assumed that age-related spending as share of GDP remains constant at its projected 2040 level for the period 2040 to 2050.

The table below presents the debt and budget balance development according to two different scenarios: a "programme scenario" and a "2002 situation scenario". The "programme scenario" is calculated on the following basis:

- the projections for age-related expenditures come from the stability programme;
- government revenues are held constant at the ratio projected for 2006;
- the starting point for gross debt and the primary surplus are the 2006 levels reported in the programme.

The "2002 situation scenario" is based on the budgetary data for 2002 in the programme. It is that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2006. This allow one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme.

The risk of unsustainable public finances, measured in terms of continued compliance with SGP requirements, is apparent under both scenarios. However, it is evident that the budgetary consolidation planned over the time horizon of the programme will help improve the sustainability of public finances. However, improving the budget balance to a deficit of 1% of GDP fails to ensure the sustainability of public finances: additional budgetary consolidation will be required.

[17] 'How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years', Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

Quantitative indicators on the sustainability of public finances

Main assumptions - baseline scenario (as % GDP)	2006	2010	2020	2030	2040	2050	change 2000-50
Total age-related spending	19,4	20,2	22,7	24,1	24,3	24,3	4,9
Pensions	12,4	13,1	15,0	16,0	15,8	15,8	3,4
Health care	6,3	6,4	6,8	7,1	7,4	7,4	1,1
Other age related expenditures	0,7	0,7	0,9	1,0	1,1	1,1	0,4
*Total non age-related spending**	29,0						
*Total revenues**	50,5						

* constant

Results (as % GDP)	2006	2010	2020	2030	2040	2050	change 2000-50
Programme scenario							
Debt	57,0	54,2	66,8	106,7	169,4	247,8	190,8
Net borrowing	-1,0	-1,7	-4,6	-8,1	-11,7	-16,0	-15,0
2002 situation scenario							
Debt	60,4	61,9	87,2	143,9	229,1	335,3	274,9
Net borrowing	-2,2	-3,1	-6,6	-11,0	-15,9	-21,6	-19,4

Tax gaps	T1*	T2**	T3***
Programme scenario	3,7	3,5	4,6
2002 situation scenario	4,8	4,5	5,7

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 13.7

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

Source: EPC, 2002 Updated stability programme of France, and Commission calculations.