

Stability programme for 2005-2007

French economic policy is based on three main thrusts: priority for reform, containment of public expenditure, reconciliation of this adjustment in public finances with support for growth at a low point in the economic cycle.

Our country is in need of reform: in order to make the economy more efficient and strengthen its growth, in both cases on a lasting basis; and also to safeguard an economic and social model to which the French people are attached. The pension reform voted by the Parliament in the summer of 2003 is exemplary in this respect. It safeguards the pay-as-you-go pension system that is highly appreciated by the population and at the same time makes it more equitable. It does this in a manner that is economically virtuous while at the same time increasing the citizens' freedom of choice and giving preference to increasing the labour force (via the lengthening of working life) over increasing compulsory levies. This social reform also constitutes a decisive contribution to the sustainability of public finances. The government estimates that the long-term effects of this reform are equivalent to a lasting reduction of 1.5 GDP points in the public deficit.

The reform of the health insurance system, planned for 2004 at the conclusion of a phase of consultation with the social partners, responds to a similar concern, namely the introduction of a social reform that restores the financial viability of a system to which the French people are attached.

In order to reduce the deficits, the government is giving preference to keeping expenditure under control rather than increasing levies. There is additional justification for this choice at a time of a worsening in cyclical developments which the European Commission has described as "abrupt and unexpected".

In 2003, the government introduced at a very early stage in the process an arrangement for budgetary regulation aimed at keeping central government expenditure within the limit set by the Initial Budget Act. This objective will be met.

The 2004 Budget Bill respects the same orientation. It targets stable budget spending at constant prices which, considering unavoidable expenditure on debt and pensions, implies a substantial effort towards discipline in which all ministerial departments will participate.

This effort must be on a lasting basis. The stability programme confirms the objective set out in the multi-year programme annexed to the Budget Bill: central government expenditure is to be stabilised at constant prices over 2005-2007. Keeping expenditure under control in this way is meaningful only if it is the result of genuine reform, ministry by ministry. These reforms have been launched and will be facilitated by the introduction of the new budget constitution, namely the constitutional bylaw on budget acts (LOLF) that will come fully into force in 2006.

All in all, for the 2004-2007 period, attainment of the target of stable central government expenditure at constant prices will represent a discretionary effort of 0.4 GDP points per year. The reform of the health insurance system will complement this effort. Here too, the stakes are considerable, since bringing expenditure back to a growth rate parallel to that of potential GDP constitutes a structural adjustment amounting to $\frac{1}{4}$ of a GDP point per year in the 2005-2007 period compared with present trends.

It is this effort on the expenditure side, representing a total of $1\frac{3}{4}$ GDP points over 2005-2007, that will enable France to respect its commitment to a reduction in the structural deficit amounting to at least 0.5 of a point per year. This would bring the structural balance close to equilibrium by 2007.

These major thrusts were already set out at the end of September in the 2004 Budget Bill and the multi-year programme annexed to it.

Since then, there has been the parliamentary debate on the budget and the government has continued to pursue its reform policy. Several decisions have been made that are fully consistent with the action undertaken. The National Assembly has adopted amendments to the Budget Bill going in the direction of reducing the deficit; the government has submitted a Supplementary Budget Act for 2003 that confirms the respect for the expenditure target; in addition, it has submitted a plan in favour of handicapped and dependent persons. This plan respects the approach based on responsible reform that was initiated in the case of the pension system: it serves a major political and social objective and its economic impact is positive. Apart from new expenditure, it provides for the financing of previous programmes that had not hitherto received specific financing. Moreover, it is based on the abolition of a public holiday, demonstrating the national solidarity that will in the medium term permit a strengthening of potential growth.

These measures were presented by the French Minister of the Economy and Finance at the ECOFIN Council meeting on 25 November 2003. They come on top of an adjustment that was already intended to achieve an improvement of 0.7 GDP points in the structural deficit in 2004 and 0.6 points in 2005. They illustrate the determination of the French government to persevere with the approach consisting of reforms and containment of expenditure and to respect the joint commitment to budgetary discipline subscribed to by all Member States.

Within the time frame of the stability programme, the government laid down, as far back as last September, rules governing budgetary management that reflect this commitment in favour of a reduction in the deficits and the sustainability of public finances. In particular, should faster-than-expected economic growth produce an increase in revenue, the proceeds from this will be used to reduce the deficit. This commitment matches the conclusions of the ECOFIN Council.

1. A programme based on conservative assumptions

A - Realistic growth scenarios

Like the one submitted last year, the stability programme for 2005-2007 is based on two alternative scenarios for actual growth: one taking a conservative assumption of 2.5% growth per year; the other, 3.0%.

These scenarios are based on estimated potential growth of 2¼% per year over the period. This estimate in turn takes the latest available demographic forecasts for France and a set of assumptions that can be described as conservative in view of the reforms introduced by the government in order to stimulate employment and productivity in the French economy. It falls within the range of between 2% and 2½% contained in the latest independent estimates (see box below for a recapitulation of the differences compared with the estimates by the European Commission). The abolition of a public holiday that has just been decided as part of the new plan for dependent persons will, however, help to raise this potential growth by roughly 0.1% per year over 2005-2007, on the assumption of a gradual materialisation of the impact of the new measure.

The weakening of the economic situation in recent years has, in addition, contributed to an output gap estimated at almost 2½ GDP points in 2003. The gradual pick-up in activity (1.7%) anticipated in 2004 would then bring it to around 3 GDP points:

- in these circumstances, the scenario based on actual growth of 2.5% is deliberately intended to be cautious: the output gap would in that case hardly be reduced at all during the period, remaining around 2½ GDP points by 2007,
- on the basis of the previous estimates, the scenario based on actual growth of 3% has a greater economic probability: it would lead to a more rapid reduction in the output gap; against a favourable macroeconomic background, the reforms launched in favour of employment and innovation could, moreover, lead to higher potential growth and a more substantial upturn in activity during the period.

Potential growth and the "output gap" in France

The economic slowdown that took place in 2003 implies a substantial revision in the assumed growth in 2003-2004 by comparison with the preceding stability programme. Cumulative lost growth in the two years amounts to 2.8 GDP points. Since this revision is essentially of a cyclical nature, it has repercussions on the output gap, which was forecast to be 1% of GDP in 2004 but is now put at almost 3%.

This is the most important revision to the macroeconomic assumptions. Potential growth is put at 2¼% for 2005-2007 (compared with a range of 2¼ to 2¾% for 2004-2006 in the preceding programme).

The Commission's estimate of the output gap differs fairly substantially from that of the French government. This was already the case last year with an output gap estimated at 0.3% in both 2003 and 2004. This year, the Commission estimates the output gap in 2004 to be approximately 1 GDP point, meaning that it has revised its estimate by a smaller amount than the government.

This is not the result of a smaller revision in actual growth, for which the estimates by the Commission and the government are both around 3 points, cumulative, for 2003-2004, but rather to a revision in potential growth (estimated last year by the Commission at an average of 2½% for 2003-2004 and this year at an average of 2% for the same two years).

The differences between the estimates of potential growth by the government and the Commission for 2003-2004 are clearly identifiable, emanating from the estimates of trend growth in factor productivity and from the measurement of labour factor utilisation, with the Commission taking the number of workers whereas the government has taken the number of hours worked in order to make better allowance for the negative effect on potential production over the 1999-2002 period of the statutory reduction in working hours.

On this basis, the estimates of potential growth and of the output gap in the updated programme seem extremely conservative: the potential growth corresponds to the low end of the range used in the preceding programme, while the new estimate of the output gap for 2003 reflects the downward revision in actual growth in the past year, due essentially to short-term factors (war in Iraq, adjustments in balance sheets, etc).

B - Conservative assumptions for public revenue

The elasticity of compulsory levies to GDP (excluding new measures) applied in the programme is unity on average over the 2005-2007 period. This unit elasticity, which is in conformity with the expected long-period average, is a reflection of conservative assumptions for central government revenue: the elasticity of tax revenue is put at between 1.0 and 1.1 on average over 2005-2007, which represents a conservative assumption in an upswing phase, implying an average of only 0.8 over the 2003-2007 period, compared with an average of 1.5 for the 1997-2001 period. This unit elasticity results also from the assumed stabilisation of the total private wage bill as a proportion of GDP.

Non-tax government revenue is put at €32.9 billion per year over the 2005-2007 period, compared with 31.6 billion in 2003 and 33.2 billion in 2004. Total general government revenue excluding compulsory levies would then amount to 7.0 GDP points on average over the 2004-2007 period, a figure that is in line with the average for 2000-2003.

2- A policy centred on containment of expenditure and on reform

French strategy is based on keeping the rise in public expenditure below the potential growth rate, so as to create structural room for manoeuvre in reducing the structural deficit by a minimum of 0.5 GDP points per year until 2007, and also to finance cuts in taxes and social security contributions.

During the year, the government has demonstrated its commitment to, and its capacity for, respecting the ceiling placed on central government expenditure, despite a difficult economic context. This policy of keeping public expenditure under control will be maintained on a lasting basis. It will be based on the reforms launched since the beginning of the present legislature: modernisation of government and public management, pension reform, health insurance reform, decentralisation, etc.

Clarifying the responsibilities of all involved, rationalising and simplifying administrative structures and processes, introducing efficient management instruments, ending waste: these are the main thrusts of the policy of reform which the government intends to pursue until 2007.

In total, the rise in public expenditure over the duration of the programme will be 1.1% on average per year.

Average annual growth in public expenditure (at constant prices)

	2005-2007 programme
Public expenditure, of which	1.1%
Central government (<i>budget accounting</i>)	0 %
Central government (<i>national accounts</i>)	0.3 %
Social Security funds	1.7 %
<i>Health insurance (falling under the scope of ONDAM)*</i>	2.25 % (<i>potential GDP</i>)
Local government	2.0

A – Respect for the budgetary expenditure norm in 2003

The ceiling on budget expenditure for 2003 amounts to €273.8 billion. The Supplementary Budget Act tabled on 19 November shows that the government will respect the ceiling despite the substantial needs that have emerged during the year.

The severe weakening of the economic situation has placed stress on the instruments of employment policy and minimum social benefits. In addition, numerous unforeseen demands, linked to natural catastrophes or calamities, have also had to be financed. These include, notably, the requirements associated with the damage to the coastline caused by the wreck of the "Prestige" (€100 million) and the consequences of the exceptional drought in the summer of 2003 (totalling €520 million).

It was possible to meet these needs thanks to the contingency arrangements set up by the government at the beginning of the year and which consisted of putting credits into reserve at an early stage in order to cope with unforeseen elements in the management of the year 2003. The government accordingly constituted, in several stages, reserve credits of €10.6 billion, of which a total of more than €5 billion were cancelled so that in the final analysis the expenditure ceiling voted by Parliament could be respected.

B – Confirmation of the zero-growth target at constant prices will be made possible by improved efficiency of government

Stabilising central government expenditure is a matter of simple logic: the government has to become more efficient and more effective every year in just the same way as any other economic agent. This is the duty it owes to taxpayers, citizens or firms, confronted daily with the challenge of productivity. In concrete terms, this means that the State must year after year provide a better service at lower cost or at the very least at stable overall cost.

* *Objectif national des dépenses d'assurance maladie* : national health insurance spending target

Stabilisation of central government expenditure at constant prices is written into the 2004 Budget Bill. This effort will be pursued throughout the duration of the programme, requiring increased redeployment efforts. Given the trend rise in debt service and expenditure on pensions and the build-up of cuts in social security levies and the financing of the government's priorities, it will be necessary to find sources of savings in other items of expenditure.

This objective will be attained through the implementation of reforms and an unprecedented effort aimed at modernising public administration.

- The instruments provided by the new financial constitution (constitutional bylaw of 1 August 2001) will be fully operational as of 1 January 2006. In advance on its work programme, the government will already in mid-January 2004 present the new model of its budget set out in terms of missions, programmes and activities and this will make it possible to provide government with instruments for measuring performance.

This means that the State is launching a gradual shift from resource-based reasoning to results-based reasoning that will show its full effects as of 1 January 2006.

- New sources of savings will be explored in order to rationalise the utilisation of public moneys.

The modernisation of the management of the stock of government-owned property has already begun and involves the entirety of the State's property functions. This will result, notably, in the disposal already in 2004 of a sizeable first tranche of property assets.

At the same time, new management methods associating the public sector with private stakeholders will be developed through "public-private partnerships" in order to arrive at more effective management of outsourced tasks. The statutory and economic framework for these contracts will be in place at the beginning of 2004.

Finally, public procurement procedures will be modernised in 2004 following an ongoing experiment in the Ministry of the Economy, Finance and Industry that has made it possible to highlight substantial potential sources of savings. Pooling of orders at central level, containment of consumption and the use of innovative purchasing procedures (reverse electronic auctions through e-sourcing) have made it possible to envisage gains for the Ministry of between 5 and 40%, depending on the product segment.

- The government has made in-depth modifications to its working methods in order to promote the reforms. On the initiative of the Prime Minister, structural reform meetings between the ministry in charge of the budget and the spending ministries were set up at the beginning of 2003 in order to identify the sources of potential savings earlier than with the traditional budget procedure. The first results of this new procedure are positive: the initiation of far-reaching reforms, leading, notably, to a reduction in the number of central government employees, has been made possible thanks to the carrying out of prior surveys by experts and to the organisation of the indispensable consultations.

C- Pension reform

Following a period of in-depth consultations, the government has conducted a reform of the pension system that will ensure the long-term viability of the pay-as-you-go system and help to improve the long-term sustainability of public finances.

The reform adopted by Parliament last July safeguards the pay-as-you-go system to which the French people are attached and reinforces equity as between the various retirement pension schemes. The reform also provides the French people with more flexibility and freedom of choice in preparing for their retirement.

In particular, the law provides for the alignment between now and 2008 of the contribution period under the scheme applied to the public service on that of the general scheme, i.e. 40 years, followed starting in 2008 by a parallel evolution in the schemes that takes account of increases in life expectancy. This evolution is intended to hold constant until 2020 the balance between average working lives and time spent in retirement.

Concern for equity lies at the heart of the reform, which also aims to revive the "1945 spirit" by providing guarantees to the lowest-paid workers who have spent their careers at the level of the minimum wage, by abolishing the inequalities affecting independent workers and people affiliated to more than one scheme, by taking into account the situation of those who began work at a very early age, by improving the situation of widows and by modernising the pension-related advantages for families.

One effect of the reform will be to increase the ratio between the number of active workers and the number of pensioners. This will considerably ease the financing requirement of the pension schemes. The deficit of the general scheme should as a result be reduced by between €4.3 and 5.3 billion in 2020 and by between €8 and 10 billion in 2040 at constant prices. In the case of the public-sector scheme, the reduction would be around €13 billion in 2020 and €27 billion in 2040.

The impact of the reform on public finances and on their long-term equilibrium is substantial: taking the macroeconomic assumptions used by the Retirement Guidance Council and assuming an interest rate that is 2% above the growth rate, the implicit debt¹ of the pension schemes prior to reform was 150 GDP points and the associated present discounted value of the financing gap² amounted to 3 GDP points. The 2003 reform makes it possible to reduce the implicit debt by a third and the financing gap by 1 GDP point, which for 2003 represents a gain equivalent to a lasting reduction of 1 GDP point in the structural public deficit.

In addition, the positive effects of the reform will be felt in the public accounts over and over the pension schemes themselves. This is because the reform will increase the number of active workers by comparison with the base situation, as a result of the lengthening of the standard contribution period and the introduction of a "premium" for those who prolong their working lives. This increase in the number of active workers will lead to a rise in potential growth, which is determined in the long term by the evolution in productivity and in the supply of labour. The increase in potential growth will mean an increase in government revenue of all kinds. The additional gain, expressed in terms of the discounted financing gap, amounts to roughly 0.5 of a GDP point. In total, the pension reform would reduce the financing gap by 1.5 GDP points. In other words, the long-term financial effects of this reform are equivalent to a lasting structural effort amounting to 1.5 GDP points.

¹ *The implicit debt represents the difference between the present discounted values of the totality of the benefits (i.e., expressed in today's euros) that will be paid by the schemes and the present value of the contributions they will receive.*

² *The present discounted value of the financing gap corresponds to the immediate increase in revenue which, carried forward on an identical basis as a share of GDP in coming years, would make it possible to guarantee the long-term financial equilibrium of the pension schemes.*

D – Reform of the health insurance system

Health insurance reform is a priority for the government in coming months. This reform is needed because today's deficits corresponding to the benefits enjoyed by present generations are financed by borrowing. It is not equitable that future generations should have to pay for this.

This past autumn the government has launched a consultation process designed to lead to the adoption of an ambitious reform of the health insurance system during 2004. What is at stake is the adaptation of the health system to the new challenges posed by the ageing of the population and by technical progress, while at the same time introducing methods of regulation and governance that make those involved, on both the supply and demand sides of health care, fully aware of their responsibilities.

On the basis of the diagnosis to be drawn up by the *Haut conseil pour l'avenir de l'assurance maladie* set up on 13 October by the Prime Minister, the government will submit its reform proposal before the summer so that it can be transcribed into the necessary legislative texts.

All paths to reform will be explored and subjected to consultation: the relations between government and the health insurance system, improvement in management and in awareness of their responsibilities on the part of those involved, containment of medical expenditure, policy towards accredited healthcare professionals, the respective roles of basic and supplementary insurance providers.

The Prime Minister has laid down a clear objective: the social security funds must by 2007 have returned to financial equilibrium. This objective will be attained by keeping health insurance expenditure firmly under control, allowing them over the programme period to rise no faster than average long-period GDP (or potential GDP, i.e. 2.25% per year).

E- Expenditure at local level and decentralisation

The latest stage in the decentralisation that is an objective of the government opens up substantial margins for improved efficiency in the management of public and social services. Decentralisation will make it possible to clarify the responsibilities of the various administrative echelons. By reducing overlapping structures and disentangling the respective responsibilities, it will be a source of savings and act as a lever for the reform of the State.

The decentralisation of responsibility for the "minimum integration income" (RMI) to the *départements* is an illustration of this approach aimed at simplification and the promotion of efficiency. Until now, central government paid the RMI allowance, while the *département* was responsible for the integration aspect. Decentralisation puts an end to this incoherent organisation by transferring responsibility for the management of the entire system to the *départements*.

The new decentralised organisation of the French republic, a principle now written into the constitution, will entrust:

- the *départements*, *communes* and groupings of *communes*, the echelons closest to the populations concerned, with the management of public services and the implementation at grass-roots level of solidarity policies;

- the regions and central government, the echelons needed for consistency, with the definition of strategic orientations and with ensuring the consistency of the policies carried out in the whole of the territory;

In total, local government expenditure is expected to rise at a rate of 2.0% per year at constant prices over the 2005-2007 programme period. In the case of investment, the rise would remain relatively strong, amounting to an annual average of the order of 3% at constant prices. On the other hand, debt service would decline thanks to the continued repayment of the debt of local authorities.

3 – Bringing expenditure under control will make it possible to reduce the deficit and to continue to cut compulsory levies.

A – French public finances are set on a path of structural consolidation

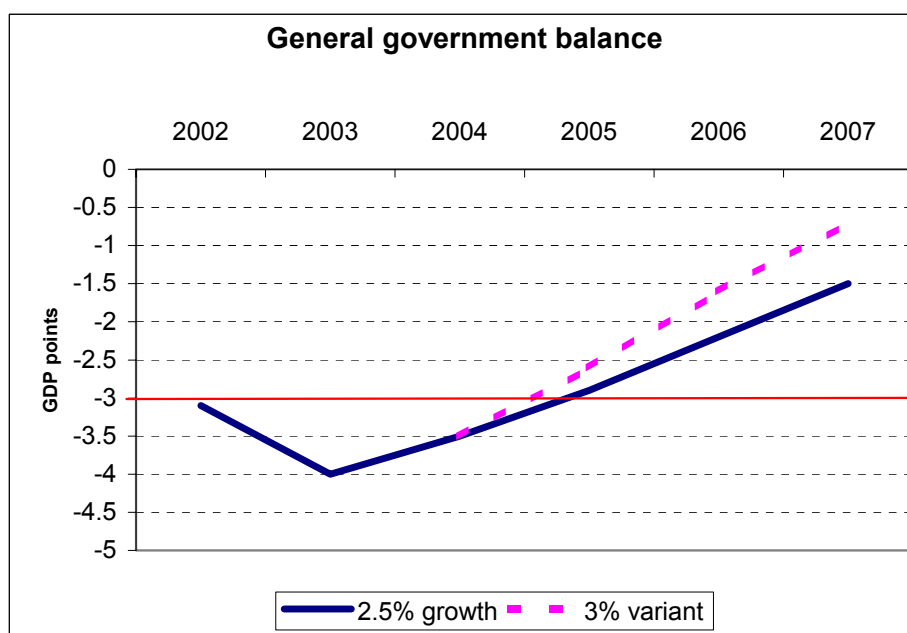
Bringing public expenditure under control in relation to GDP will enable France gradually to consolidate its public accounts. Already in 2005, the public deficit will be reduced below the threshold of 3% of GDP. The effort planned for the years 2003 to 2005 is substantial, with the actual deficit reduced by 1.1 GDP points in relation to 2003, while the structural balance will be improved by 1.5 GDP points in the space of three years.

This consolidation effort will be pursued on a lasting basis: the public deficit will be brought down to 1.5 GDP points in 2007 (to 0.7 GDP points under the 3% growth scenario). With a reduction of more than 0.5 GDP points per year over the 2005-2007 period, the structural deficit will therefore be brought down to 0.2 GDP points in 2007, representing virtual equilibrium.

Baseline scenario of 2.5% growth	2004 (*)	2005	2006	2007
Public deficit	-3.6%	-2.9 %	-2.2 %	-1.5 %
Structural balance	-2.0%	-1.4%	-0.8%	-0.2%
Variation in the structural balance	0.8%	0.6%	0.6%	0.6%

(*) growth of 1.7% in 2004

Evolution in the general government balance (GDP points)



This consolidation effort planned for the 2004-2007 period is in contrast to the structural deterioration seen during the years when the economy was strong (1999-2001), partly concealed by the spontaneous strength of tax and social security revenue. A so-called "structural effort" indicator aimed at separating out the discretionary measures taken as regards levies and expenditure³ shows:

- a relaxation of 2.4 GDP points in the period 1999-2001: an exceptionally high elasticity of tax revenue to GDP (of the order of 2) limited the deterioration in the structural balance as conventionally calculated to 0.4 GDP points during the period;
- in contrast, a discretionary consolidation effort amounting to 3.2 GDP points for the 2003-2007 period: the low elasticity of compulsory levies in the early part of the period resulted in the limitation of the improvement in the structural balance to 2.7 GDP points over the period;

% of GDP	1999	2000	2001	2002	2003	2004	2005	2006	2007
Δ Structural bal.	0.6	-0.7	-0.3	-1	0.1	0.8	0.6	0.6	0.6
Structural effort	-0.3	-1.3	-0.8	-0.7	0.5	0.9	0.7	0.5	0.6

In a concern not to repeat past errors made when the economy was strong, the government has committed itself to bringing the public deficit below the level of 3 GDP points in 2005, to reducing the structural deficit by at least 0.5 GDP points per year until 2007 and to maintaining a policy of fiscal prudence (see below).

³ See in the annex the box "structural balance and discretionary variation" and also pages 70-71 (French version) of the "Economic, social and financial report" annexed to the 2004 Budget Bill.

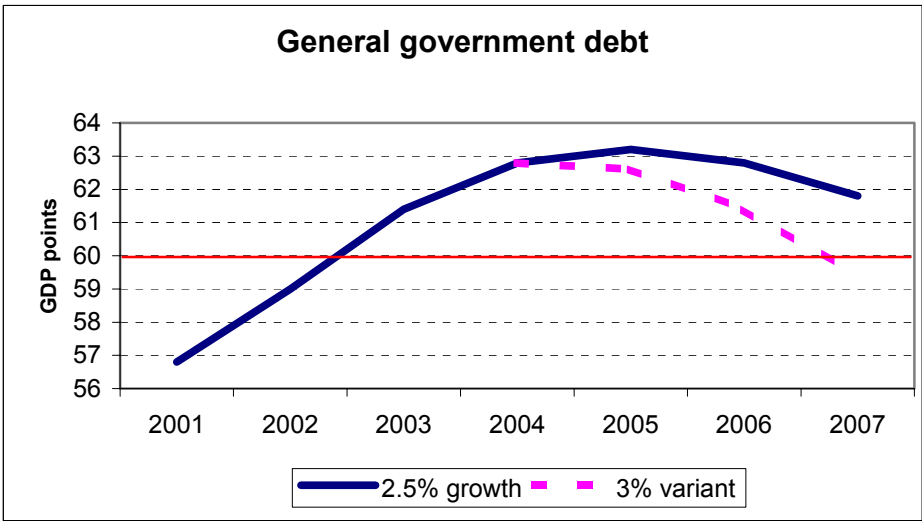
B- The reduction in the deficit and the resumption of growth will make it possible to start to reduce the public debt beginning in 2006.

The recent rise in the debt/GDP ratio is the consequence of the widening of the deficits from 2001 on and the sharp slowdown in growth.

It was also the consequence of events independent of fiscal policy, such as the reclassification in 2001 of Charbonnages de France as part of general government (the organisation's debt of €5.3 billion is now included in the overall public debt) and the recapitalisation of France Télécom in 2002 (an impact of €9 billion). These two transactions had the effect of worsening the debt/GDP ratio by 0.8%.

The rapid reduction in the deficit starting in 2004 and the return to a growth path of 2.5% starting in 2005 will make it possible to start the reduction of the debt/GDP ratio as of 2006, bringing it down to 61.8 GDP points in 2007 after peaking at 63.2 GDP points in 2005. With growth of 3% a year, the debt/GDP ratio would fall back below the 60% threshold in 2007.

Evolution in the general government debt (GDP points)



C. Bringing public expenditure under control will also make it possible to pursue the reduction in compulsory levies.

In the past 18 months, the government has already taken major steps to cut compulsory levies with a view to restoring lasting momentum to French potential growth and employment.

These measures took the form of:

- an intensification of the cuts in employers' social security contributions for the lower-paid in order to limit the rise in labour costs induced by the convergence of the large variety of minimum wages inherited from the move to the 35-hour week. These cuts, which will amount to almost €8 billion in the period 2003-2007, will be refocused on the lowest-paid and hence will improve the job opportunities for unskilled workers;
- a reduction in income tax amounting to almost 10% over the 2002-2004 period and a substantial increase in the "earned income tax credit" in 2003-2004, intended to ensure that work pays more for those at the bottom of the wage ladder. In combination with the major upward adjustment in the minimum wage, these measures will add to the supply of manpower;
- a wide range of tax measures intended to encourage business creation and innovation (overhaul of the research tax credit, status of start-up companies), to improve the attractiveness of France as a place for investment and to encourage the constitution of savings to supplement retirement pensions by those who so wish.

The government intends to persist with this reduction in levies, which continue to have a severe impact on labour and innovation. In order to safeguard the sustainability of public finances, this cut in levies must go hand-in-hand with the reduction in the deficit.

D. Forward-looking management based on clear rules will underpin the consolidation of French public finances.

So as not to repeat the management errors seen in the upswing phase at the end of the 1980s and 1990s, the government has set itself clear and transparent "rules of the game", in accordance with its commitments to its European partners:

- the deficit will be brought down below 3 GDP points in 2005 and its structural component by at least 0.5 GDP points each year until 2007;
- any "windfalls" on the revenue side that might result from an economic situation better than envisaged in this programme will be used for the reduction of the deficit;
- on the other hand, the structural savings that may possibly result from a better ability to keep expenditure under control will be recycled in the form of additional cuts in compulsory levies. At the same time, efforts to rearrange the tax burden, incorporating both rises and falls, will be implemented in order to give more encouragement to employment and innovation and to enhance the attractiveness of France as a host country for investment.