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**2003 UPDATE
OF THE STABILITY PROGRAMME OF FRANCE
(2003-2007)**

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS¹

The fifth update of France's stability programme, covering the period 2003-2007, largely complies with the Code of conduct on the content and format of stability and convergence programmes. However, the programme does not provide data which, although not compulsorily required in this code, would have been useful for analytical purposes. In particular, the presence in the programme of explicit projections for government revenues and expenditures categories on a national accounting basis would have allowed a deeper analysis of the quality of the projected adjustment. Moreover, in order to facilitate the computation of potential GDP growth estimates, it would have been suitable that the programme provide projections for the unemployment rate and wages per head for the total economy.

On 3 June 2003, on the basis of a Commission Recommendation, the Council decided in accordance with Article 104 (6) EC that an excessive deficit existed in France and issued a recommendation based on Article 104 (7) EC requesting France to bring this situation to an end by 2004 at the latest. On 8 and 21 October 2003 respectively, the Commission adopted two recommendations on the basis of Articles 104 (8) and 104 (9) respectively for the Council to decide (1) that no effective action had been taken by France in response to the recommendation of 3 June and (2) to give notice to France to take necessary measures to bring the government deficit below 3% of GDP in 2005. On 25 November 2003, the Council did not adopt the two Commission recommendations but adopted instead a set of conclusions endorsing, among other things, the commitments made by France to reduce the cyclically-adjusted deficit by 0.8 per cent of GDP in 2004, and by 0.6 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 per cent of GDP in 2005.

In 2003, government finances continued to deteriorate rapidly. The general government deficit is estimated by the French authorities to have increased from 3.1% of GDP in 2002 to 4.0% of GDP in 2003. According to Commission calculations based on the figures of the programme, the cyclically-adjusted balance deteriorated by ¼ percentage point of GDP in 2003. The risk for the 2003 government deficit to be worse than expected by the French authorities is large. Indeed, the real GDP growth estimate included in the programme is clearly outdated. Under the more plausible assumption of real GDP increasing by 0.1% in 2003, as against 0.5% according to the French authorities, the Commission expects the 2003 general government deficit to have reached 4.2% of GDP. Therefore, the starting point for the medium-term government finances projections could turn out to be higher than estimated by the French authorities, as was the case for the 2001 and 2002 updates of the stability programme.

For 2004, the French authorities project real GDP growth at 1.7%, a rate in line with the Commission forecast, and the government deficit at 3.55% of GDP, down from 4.0% in 2003. Most of the reduction in the deficit is planned to be achieved through a tight control of expenditures. The deficit reduction envisaged in the 2003 update is 0.05 percentage point of GDP larger than in the draft budget presented to Parliament in September, reflecting the impact of measures taken in the meantime.

According to the calculations of the French authorities based on their own method, the budgetary plans for 2004 are consistent with an improvement in the cyclically-adjusted balance by 0.8 percentage point of GDP, in line with the commitment taken on 25 November 2003. Commission estimates based on the application of the agreed method to

¹ This assessment has been carried out on the basis of information available as of 22.01.2004.

the figures of the programme suggest that budgetary plans for 2004 are consistent with a reduction in the cyclically-adjusted balance by only 0.6 percentage point of GDP.

For the period 2005-2007, the budgetary projections are based on the same two macroeconomic scenarios as in previous updates: a so-called “cautious” scenario, in which real GDP growth averages 2.5% a year over the period, and a “favourable” scenario where real GDP growth reaches 3% per year. Although not fully implausible, the assumptions of the favourable scenario appear not consistent with the degree of caution that should underpin a prudent fiscal strategy. Indeed, even if a recovery seems to be finally under way, the uncertainties concerning its strength and duration are large. The “cautious” scenario, projecting real GDP growth slightly above potential, was therefore considered as the reference scenario for assessing budgetary projections.

Under these assumptions, the government deficit is projected in the reference scenario of the update to decline from 3.6% of GDP in 2004 to 2.9% of GDP in 2005, 2.2% in 2006 and 1.5% in 2007. The primary balance is projected to improve from -0.6% of GDP in 2004 to 1.6% of GDP in 2007. According to Commission estimates based on the projections of the programme, the cyclically-adjusted balance would improve by about 0.6 percentage point per year, and would reach -1.3% of GDP in 2007. The average yearly reduction in the cyclically-adjusted deficit would be larger in the favourable scenario (0.8 percentage point of GDP); this would not be the result of concrete policy measures, but of an upward revision to potential growth estimates implied by a more favourable set of assumptions about the underlying determinants of growth.

The medium-term budgetary strategy is the same as in previous updates. The cornerstone of this strategy is the setting of multi-annual targets for the increase in real general government expenditures. In this update, real expenditures are planned to increase by 1.1% per year on average over the period 2005-2007. The ratio of revenues to GDP being projected to remain roughly stable, the reduction of the expenditure to GDP ratio resulting from expenditures increasing slower than GDP triggers a parallel decline in the deficit.

This budgetary strategy is economically pertinent: clear norms for expenditures growth support a transparent budgetary adjustment, and fiscal consolidations based on expenditure cuts are more likely to be permanent and to have medium-term expansionary effects than those based on tax increases. However, recent experience feeds some concerns on the achievability of the expenditure targets. Indeed, expenditure targets set in previous updates, although less ambitious than that of the 2003 update, were missed by a large margin. This contributed to the continuous deterioration in the cyclically-adjusted budgetary position of France since 1999. While expenditures targets were generally respected in the State sector, with the notable exception of the year 2002, the overruns were recurring in the social security and in the local authorities sectors. It should be noted that the expenditure restraint planned for the period 2005-2007 relies on measures which still have to be designed and implemented, particularly the reform of the health insurance system. Beyond the potential impact on deficit outcomes, 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. In order to secure the attainment of objectives, the French authorities should ensure automatic compensation across years of eventual overspending in the government sector.

The 2003 update introduces two new budgetary rules which will frame the conduct of budgetary policy until 2007: (1) any higher-than-expected revenue stemming from more favourable cyclical developments will be allocated to deficit reduction; and (2) any margin stemming from a slower-than-planned increase in expenditures will be allocated to tax relief. The first rule, which ensures the full operation of automatic stabilisers in good

cyclical phases, is to be welcomed. However, given the seriousness of the budgetary situation, it would be appropriate, in the event of more favourable macroeconomic developments, to accelerate the reduction in the cyclically-adjusted deficit through the implementation of additional measures, and not only through the automatic impact on potential output figures of better macroeconomic conditions.

The second rule implicitly excludes the possibility of a larger discretionary reduction in the cyclically-adjusted deficit in the years 2005 to 2007 than currently envisaged. This is a source of concern. Indeed, the medium-term budgetary plans lack ambition.

In the reference scenario, the projected yearly improvement in the cyclically-adjusted balance is only slightly larger than the minimum of 0.5 percentage point of GDP per year. As a consequence, a close to balance budgetary position in cyclically-adjusted terms is not reached over the time span of the update. The current budgetary situation calls for more decisive moves towards a close to balance position, particularly in the early years of the projection period.

This would in particular reduce the risk for the deficit to remain above the 3% of GDP Treaty reference value in 2005. Because the deficit is planned to be reduced only marginally below 3% of GDP in 2005 (2.9% of GDP), any unfavourable development on the macroeconomic or on the budgetary side would compromise the achievement of this objective. For instance, should the 2003 deficit be in line with the Autumn 2003 Commission forecast (4.2% of GDP) and real GDP grow in line with the projections of the 2003 updated stability programme, the cumulated reduction in the cyclically-adjusted deficit currently planned by the French authorities for the years 2004 and 2005 would not be sufficient to bring the nominal deficit below the 3% of GDP reference value in 2005.

A larger budgetary effort in the early years of the period covered by the programme would also allow to move more rapidly towards a budgetary position providing a sufficient safety margin to avoid in the future breaching the 3% of GDP Treaty reference value under normal cyclical conditions. Under current projections, such a position would not be reached before 2007. Finally, speeding up the budgetary adjustment would ensure an earlier and larger decline in the debt to GDP ratio, which is projected to remain above 60% throughout the period covered by the programme, and to start declining only in 2006.

Finally, on the basis of current policies, the risk of persistent budget imbalances in the long term cannot be excluded. France has recently passed a comprehensive pension reform that increases the number of contribution years entitling to a full pension, raises the financial incentives to remain active until and after the legal retirement age, and changes the reference for the indexation of pensions in the public sector from wages to prices. This reform is clearly to be welcomed, as France is now in a considerably better position to meet the budgetary costs of ageing population. Despite this major improvement, risks of unbalances in the long term cannot be ruled out. The impact of the pension reform plus the consolidation efforts for the next years will bring debt to GDP ratio down for the next 15 years but, once the impact of ageing intensifies, the debt to GDP ratio could go back to values around the Maastricht reference value. A different pattern emerges if consolidation efforts do not materialise. Debt to GDP ratio would indeed follow an explosive path, the pension reform solely not ensuring long term sustainability.

The economic policies as reflected in the 2003 update are not consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. Indeed, even if the budgetary plans for 2004 and 2005 include an improvement in the cyclically-adjusted balance consistent with the minimum of 0.5 percentage point of GDP recommended by the Council, the cumulative improvement in

the cyclically-adjusted balance under way may be insufficient to bring the nominal deficit below 3% of GDP even in 2005. In addition, the 2003 update does not foresee the attainment of a budgetary position close to balance or in surplus in the horizon of the programme.

1. INTRODUCTION

The 2003 update of the stability programme of France was submitted to the Commission on 11 December 2003² and covers the period from 2003 to 2007. The update largely complies with the revised Code of conduct on the content and format of stability and convergence programmes. However, the programme does not provide data which, although not compulsorily required in the Code of conduct, would have been useful for analytical purposes. In particular, the presence in the programme of explicit projections for revenues and spending categories for the general government sector in national accounts would have allowed a deeper analysis of the quality of the projected budgetary adjustment. Moreover, in order to facilitate the computation of the potential output growth estimates, it would have been suitable that the programme provide projections for the unemployment rate and for wages per head for the total economy.

The update confirms the strategy of consolidating government finances by setting objectives for the increase in general government expenditure in real terms. The budgetary margins generated by a lower-than-GDP growth in expenditures are planned to be almost entirely allocated to deficit reduction.

In a context of considerably weaker real GDP growth in 2003 and 2004 than assumed in the previous update, and with practically unchanged macroeconomic assumptions for the medium-term, the budgetary targets are revised significantly downwards. After having discussed the macroeconomic assumptions and proceeded to a brief evaluation of the implementation of the French budgetary strategy, compliance of the adjustment path presented in the 2003 update with the provisions of the stability and growth pact will be assessed.

2. MACROECONOMIC ASSESSMENT

2.1. External economic assumptions

Apart from those concerning the exchange rate of the euro (1euro = 1.10 us dollar, while the Commission in its Autumn forecast projected the euro at 1.15 dollar), the external assumptions are very close to those used by the Commission in its Autumn 2003 forecasting round, and relatively balanced compared to the prevailing consensus view. These assumptions assume a relatively firm recovery in world activity, driven by a rebound in the US economy and a gradual acceleration in the euro area. Oil prices would remain at around 26 US dollars during the forecast period, a level roughly in line with the Autumn 2003 Commission forecast.

2.2. Domestic macroeconomic developments

As regards France, the 2003 update of the stability programme estimates real GDP growth at 0.5% in 2003 and projects it at 1.7% in 2004, the same rates as in the draft budget law released in September. For the years from 2005 to 2007, the projections mentioned in the updated programme are built, as in the previous updates, on two scenarios: a so-called "cautious" scenario, where real GDP growth averages 2.5% a year, and a so-called "favourable" scenario, where real GDP growth reaches 3% per year.

² This is 11 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.

According to the 2003 updated stability programme, these two scenarios are underpinned by the same assumption for potential real GDP growth, estimated at 2¼% a year. In both cases, the inflation rate is projected to remain stable between 2004 and 2007 at 1.5% a year, the acceleration in real GDP to an above-potential growth rate remaining, according to the French authorities, insufficient to close the output gap³ (see table below).

Table 1					
Real GDP growth, potential real GDP growth and output gap projected by the French authorities in the 2003 update of the stability programme					
	2003	2004	2005	2006	2007
“Cautious” scenario					
Real GDP growth	0.5	1.7	2.5	2.5	2.5
Potential real GDP growth	2½	2¼	2¼	2¼	2¼
Output gap	-2.5	-3.1	-2.8	-2.6	-2.3
“Favourable” scenario					
Real GDP growth	0.5	1.7	3.0	3.0	3.0
Potential real GDP growth	2½	2¼	2¼	2¼	2¼
Output gap	-2.5	-3.1	-2.3	-1.6	-0.8

Source: Commission calculations based on the figures of the 2003 update of the stability programme.

2.3. Evaluation by Commission services

The estimate for the 2003 real GDP growth appears clearly outdated. According to the release of quarterly national accounts of 6 January 2004, the carryover for real GDP growth in 2003 at the end of the third quarter is slightly negative (-0.1%). Reaching the real GDP growth assumption for 2003 of the programme (+0.5%) would therefore require a quarterly increase in real GDP by about 2% in the fourth quarter of 2003. The Commission forecast of an increase in real GDP by +0.1% in 2003 appears a more likely outcome.

By contrast, the real GDP growth projection of the 2003 update for the year 2004 is in line with the Commission’s Autumn 2003 forecast: in both cases, real GDP growth is projected to accelerate to 1.7% in 2004.

Concerning the years 2005 to 2007, the two scenarios of the 2003 update appear to be coherent. They show a substantial recovery in economic activity, driven by a marked acceleration in domestic demand, especially in consumption and investment expenditures. The recovery is also sustained by a strong rebound in exports, which seems consistent with the assumptions made on the developments of the world economy. The general macroeconomic equilibria are respected in both scenarios⁴: the decrease in the private sector saving, reflecting the fact that the substantial recovery in domestic demand is partly fed by a decline in the saving rate of private economic agents, finds its counterpart in the gradual improvement in the net borrowing of the general government sector⁵.

³ The fact that the inflation rate is identical in both scenarios is however surprising. Indeed, in the favourable scenario, the level reached by the output gap in 2007 is according to the French authorities 1.5 percentage point of GDP higher than in the reference scenario. One could have reasonably expected a slightly higher inflation rate in this scenario.

⁴ Although the programme does not provide explicit projections for developments in the net lending / borrowing of institutional sectors, it is possible to compute, modulo reasonable assumptions, sectoral balances consistent with the developments projected for the other variables.

⁵ The external balance does not show large fluctuations.

The main difference between the two medium-term growth scenarios is related to the speed to which the French economy will close its negative output gap. According to Commission calculations, this gap would be slowly reduced from 2005 in the so-called “cautious scenario”. In the case of the “favourable” scenario, the negative output gap would be fully eliminated already in 2007, despite a sharp acceleration in potential growth (to 2.6% per year on average over the period 2005-2007) reflecting a set of markedly favourable assumptions about the underlying determinants of growth, especially concerning the labour market and the capital stock⁶.

Table 2						
Real GDP growth, potential real GDP growth and output gap						
(Results based on the method agreed by the Council applied to the figures of the programme)						
	2002	2003	2004	2005	2006	2007
“Cautious” scenario						
Real GDP growth	1.2	0.5	1.7	2.5	2.5	2.5
Potential real GDP growth	1.8	1.9	2.1	2.4	2.5	2.3
<i>Contribution of :</i>						
<i>Labour factor</i>	<i>0.3</i>	<i>0.5</i>	<i>0.6</i>	<i>0.8</i>	<i>0.8</i>	<i>0.6</i>
<i>Capital accumulation</i>	<i>0.7</i>	<i>0.6</i>	<i>0.6</i>	<i>0.7</i>	<i>0.7</i>	<i>0.7</i>
<i>Total factor productivity</i>	<i>0.8</i>	<i>0.8</i>	<i>0.9</i>	<i>0.9</i>	<i>1.0</i>	<i>1.0</i>
Output gap	1.0	-0.5	-0.9	-0.8	-0.8	-0.6
Commission Autumn forecasts						
Real GDP growth	1.2	0.1	1.7	2.3	-	-
Potential real GDP growth	2.1	2.0	2.1	2.3	2.3	2.2
Output gap	1.3	-0.7	-1.1	-1.0	-	-
“Favourable” scenario						
Real GDP growth	1.2	0.5	1.7	3.0	3.0	3.0
Potential real GDP growth	2.0	2.1	2.2	2.5	2.7	2.5
Output gap	0.9	-0.8	-1.2	-0.8	-0.4	0.0
<i>Note:</i> the 2003 update of the stability programme omits some indicators necessary to the calculation of the potential output through the production function method. For the computation of the Nairu, the Commission services assumed that the change in wage inflation for the whole economy is the same as that provided for the private sector. For the same purpose, Commission services computed an unemployment rate consistent with the assumptions of the programme, using a growth in labour force equal to that projected by Insee between 2002 and 2007.						
<i>Source:</i> Commission calculations applying the production function method endorsed by the Council to the inputs provided by the French authorities in the 2003 update of the stability programme, and to the Commission Autumn forecasts.						

Even if a recovery seems to be finally under way, the uncertainties concerning its strength and duration are still relatively large. Although not fully implausible, the “favourable” scenario appears therefore not in line with the degree of caution that should underpin a prudent fiscal strategy. The so-called “cautious” scenario, encompassing less downside risks, was therefore be considered as the reference scenario for assessing budgetary projections in this assessment.

The analysis of potential growth estimates confirms that it is reasonable to consider the so-called “cautious” scenario as the reference scenario. When applying the agreed method to the figures of this scenario, the rate of potential growth over the period 2004-2007 averages 2.3% per year, a level close to that estimated by the Commission in its Autumn 2003 forecasts⁷, and broadly in line with estimates made by other international institutions.

⁶ In this scenario, private investment is indeed expected to increase by 7.4% per year on average, a rate which goes well beyond the historical norms. The current low level of profit margins and the subsistence of cash problems in companies render even more uncertain future developments in firms’ demand in the new few years.

The calculations made by the Commission using the figures provided in the updated stability programme evaluate the 2003 output gap at about $-1/2$ percentage point of GDP.

Box 1: Differences in potential output growth estimates computed using the method agreed by the Council and the French authorities' own method.

In the 2003 update of the stability programme, the French authorities present potential output estimates computed through a method which departs from the production function method agreed by the Council (this method is not the "Commission's method", as stated in the 2003 update of the stability programme). Both methods rely on a production function approach to calculate potential growth. The main differences between the two methods are:

(1) The trend total factor productivity is estimated through an HP filter in the method agreed by the Council, while the French authorities use a linear trend. *Ceteris paribus*, this implies that the method agreed in the Council leads to estimates of potential output growth which are more sensitive to macroeconomic developments.

(2) The French authorities define the potential level of labour as the product of the potential number of workers by the average working time per worker, while the method agreed by the Council defines the potential level of labour as the potential number of workers. The EPC working group on these issues proposed in December that the information on hours worked will be incorporated in the agreed method as soon as harmonised data will be available in all EU countries. This should be the case in the next few months.

These differences lead to estimates for the potential output growth which are relatively small. The application of both methods to the reference scenario of the programme leads to a potential output growth which in both cases averages $2/4$ over the period 2003-2007. The profile is however slightly different: according to the method of the French authorities, potential growth will remain constant at this level over the period 2004-2007, while the agreed method leads to potential growth estimates that are slightly lower in the early part of the period, and slightly higher in the years 2005-2007.

Although having converging estimates concerning the potential output growth of the French economy, the two methods lead to significantly different results for the current output gap of the French economy. While the French authorities argue that the output gap reached about $-2 1/2$ percentage point of GDP in 2003, the calculations made by the Commission using the figures provided in the updated stability programme estimate the 2003 output gap at about $-1/2$ percentage point of GDP. This difference is more difficult to explain, because it depends heavily on past developments. However, a significant part of it seems to stem from the fact that the estimates of potential growth made using the agreed method are more sensitive to developments in actual growth. The fact that real GDP growth has remained significantly below its potential rate in the last few years (according to both methods), has contributed to increase the difference in output gap estimates. It must be stressed that the level of the 2003 output gap estimated by the French authorities seems difficult to reconcile with the stickiness in underlying inflation observed in recent months (part of it may be due to the impact of supply shocks on oil and food prices).

3. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF PUBLIC FINANCES

3.1. Introduction and programme overview

Compared to the previous update, general government balance objectives are revised significantly downwards for all the years which overlap with the previous programme. After reaching 4.0% of GDP in 2003, the general government deficit is projected to gradually decrease as from 2004. It is planned to be reduced to 3.55% of GDP in 2004, 0.05 percentage point lower than planned in the draft Finance Law presented in September to Parliament.

From 2005 to 2007, the budgetary projections are based on the same strategy as in the previous updates. This strategy is based on the definition of multi-annual norms for the increase of general government expenditures in real terms⁸. In this update, real expenditures are planned to increase by 1.1% per year on average over the period 2005-2007, a rate lower than actual and potential growth. The ratio of revenues to GDP being projected to remain roughly stable over the projection period, the projected fall of the expenditure to GDP ratio triggers a parallel decline in the deficit, in actual and cyclically-adjusted terms.

	2003	2004	"Cautious scenario" (2.5% GDP growth rate)			"Favourable scenario" (3% GDP growth rate)		
			2005	2006	2007	2005	2006	2007
General government balance	-4.0	-3.55	-2.9	-2.2	-1.5	-2.6	-1.6	-0.7
Expenditure	54.3	53.9	53.0	52.4	51.8	52.8	51.9	50.9
Tax burden	43.8	43.7	43.6	43.6	43.6	43.5	43.6	43.6
Interest payments	3.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Primary balance	-0.9	-0.6	0.1	0.9	1.6	0.4	1.4	2.3
Debt ratio	61.4	62.8	63.2	62.8	61.8	62.6	61.4	59.4

Source: 2003 update of the stability programme.

Under these assumptions, the general government deficit is projected in the reference scenario of the programme to decline by 0.7 percentage point of GDP per year as from 2005 to reach 1.5% of GDP in 2007⁹. In the "favourable" scenario, the government deficit is projected to decline by about 1 percentage point of GDP per year as from 2005 to reach 0.7% of GDP in 2007.

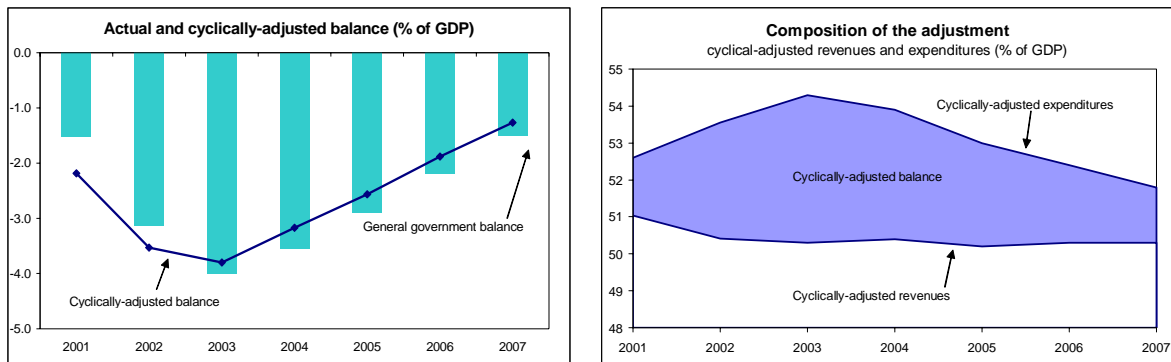
The 2003 update introduces two new budgetary rules which will frame the conduct of budgetary policy until 2007: (1) any higher-than-expected revenue stemming from more favourable cyclical developments will be allocated to deficit reduction; and (2) any budgetary margin stemming from a slower-than-planned increase in real expenditures will be allocated to tax relief. Such rules are appropriate. Indeed, the first rule will ensure the full operation of automatic stabilisers on the revenue side in good cyclical phases, and the second rule increases the incentives to respect the expenditure targets.

However, given the seriousness of the current budgetary situation, the French authorities should go beyond what these rules imply. In particular, in good cyclical times, they should seek an acceleration in the budgetary adjustment based on the implementation of discretionary measures. The second rule, which implies that the margins which could stem from a tighter control of expenditures will not be allocated to deficit reduction, implicitly excludes the possibility of a larger reduction in the cyclically-adjusted deficit in the years 2005 to 2007 than that currently envisaged, except that which could stem from an upward

⁸ The target is set for aggregate general government expenditures in real terms. In particular, the norms are not split between current and capital expenditures, and cyclically-sensitive items such as unemployment benefits are not excluded from the aggregate.

⁹ It should be noted that the budgetary adjustment does not rely on one-off measures. However, at least one pending operation, not mentioned in the 2003 update of the stability programme, could lead to a one-off improvement in the 2004 or in the 2005 general government deficit: on 16 December 2003, the Commission adopted a decision on a tax concession granted to the electricity public company EDF in 1997. The Commission considered that this tax concession was incompatible with the common market. It has accordingly called on France to recover €1.2 billion. Should this be the case, and the payment be made in 2004, the general government deficit would be reduced by 0.08% of GDP.

revision of potential growth estimates or from positive surprises on the tax to GDP elasticity¹⁰. Because the deficit is currently at a level which leads to a sharp increase in the debt to GDP ratio, priority should be given to deficit reduction.



Source: Commission calculations based on the figures of the reference scenario of the 2003 update of the stability programme.

The 2003 updated stability programme provides cyclically-adjusted balance estimates. However, the adjustment method applied by the French authorities leads to significantly different results compared to those resulting from the application of the method agreed by the Ecofin Council on 12 July 2002 to the figures of the programme. At its meeting of 7 March 2003, the Council confirmed that “the estimation of cyclically-adjusted balances should be made using the methodology endorsed by the Council on 12 July 2002”.

The application of this method to the data of the programme shows that the macroeconomic and budgetary projections of the **reference scenario** are consistent with an improvement in the cyclically-adjusted balance by about 0.6 percentage point of GDP per year on average. The cyclically-adjusted deficit would still amount to 1.3% of GDP in 2007.

According to Commission estimates, the average yearly reduction in the cyclically-adjusted deficit would be larger in the “**favourable**” scenario (0.8 percentage point of GDP). However, this is not the result of discretionary policy measures, but of an upward revision in potential growth estimates implied by a more favourable set of assumptions about the underlying determinants of growth. Indeed, according to Commission calculations based on the figures of the programme, potential growth would average 2.6% over the period 2005-2007 in the “favourable scenario”, as against 2.4% in the reference scenario. This leads to attribute a part of the larger reduction in the deficit stemming from better macroeconomic developments to non-cyclical factors¹¹.

3.2. Implementation of the previous updates of the stability programmes

Before going further into the assessment of the budgetary projections, and because the budgetary strategy underlying the 2003 update is the same as in the previous programmes, it appears appropriate to draw a rapid assessment of the implementation of this budgetary strategy five years after it was defined in the initial stability programme. In particular, it is today possible to assess the implementation of the original stability programme, which covered the period 2000-2002, and of its first update, which covered the period 2001-2003. The table below provides information on the origins of the difference between the

¹⁰ Of course, a larger reduction in the cyclically-adjusted deficit could also stem from the implementation of discretionary tax increases. However, this seems to be excluded in the 2003 updated stability programme.

¹¹ If potential output growth was fixed at the same level in both scenarios, the improvement in the cyclically-adjusted balance would be the same in both scenarios.

budgetary objectives – expressed in terms of change in the deficit - set in the previous updates of the stability programme and the outcomes. The decomposition used has the characteristic to be fully independent from the fluctuations in potential output estimates.

Table 4	
From the deficit planned in the 1998 programme and its successive updates to the outcome	
Change in the GG balance planned between 1999 and 2002 in the 1998 SP ⁽¹⁾	+1.1 pp of GDP
Change in the GG balance observed over the same period	-1.3 pp of GDP
Difference	2.4 pp of GDP
Of which impact of (in percentage point of GDP):	
Lower revenues due to the shortfall in real GDP growth ⁽²⁾	0.1
Overrun in real expenditures compared to plans ⁽³⁾	1.7
Of which higher expenditures due to the shortfall in real GDP growth	0.0
Others (in particular, tax elasticities)	0.6
Change in the GG balance planned between 2000 and 2003 in the 1999 USP ⁽¹⁾	+1.2 pp of GDP
Change in the GG balance observed over the same period	-2.6 pp of GDP
Difference	3.8 pp of GDP
Of which impact of (in percentage point of GDP):	
Lower revenues due to the shortfall in real GDP growth ⁽²⁾	1.2
Overrun in real expenditures compared to plans ⁽³⁾	1.8
Of which higher expenditures due to the shortfall in real GDP growth	0.3
Others (in particular, tax elasticities)	0.8
⁽¹⁾ The original programme, presented in January 1999, projected a decline in the government deficit from 2.3% of GDP in 1999 to 1.2% of GDP in 2002. The first update projected a decline in the deficit from 1.7% of GDP in 2000 to 0.5% of GDP in 2003. According to latest figures from the national accounts, the general government deficit reached 1.8% of GDP in 1999, 1.4% in 2000, 1.5% in 2001 and 3.1% in 2002. It is estimated to have reached 4.0% of GDP in 2003.	
⁽²⁾ GDP growth was projected in the original SP to average 2.5% over the period 2000-2002. It averaged 2.4%. Using the standard Commission elasticity from tax revenues to real GDP (0.7), it can be estimated that the cumulated growth differential over the three years explains a loss in tax revenues by 0.1 percentage point GDP. When applying the same reasoning to the plans / outcomes of the 1999 USP, it can be estimated that the growth differential over the three years, i.e. 3.7 percentage point of GDP, explains a loss in tax revenues by 1.2 percentage point of GDP.	
⁽³⁾ The original SP targeted an increase in real expenditures by 3.5% between 2000 and 2002 (the original figure in ESA 79 accounting system was 3.0%). The increase will in fact reach 6.8%. The 1999 USP targeted an increase in real expenditures by 4.0% between 2000 and 2003. The increase will in fact reach 7.4%.	

This table shows that the main element explaining the non-respect of the deficit objectives set in the previous stability programmes is the non respect of the expenditures norms. This contributed to the continuous deterioration in the cyclically-adjusted budgetary position of France since 1999.

In particular, it should be noted that, if the spending norm set in the 1998 stability programme for the period 2000-2002 had been respected, the 2002 general government deficit would *ceteris paribus*¹² have been 1.7 percentage point of GDP lower. Hence, despite the severe economic downturn of the last two years, the French deficit would have never breached the 3% of GDP ceiling. The same conclusion would be reached if the expenditure norm set for the period 2001-2003 had been respected.

Even if the large slippage in expenditures occurred in the year 2002 can be seen as somewhat exceptional, it can also be argued that the yearly expenditures increases were never consistent with the respect of the previously fixed targets (see table 5 below). This was true both in good cyclical times (2000 and 2001) and in bad times (2003). It is in the social security and in the local authorities sectors that the overruns were the largest. Expenditures targets were generally respected in the state sector, with the notable exception of the election year 2002.

¹² Estimates do not include the possible impact of the non respect of expenditure limits on economic growth.

These developments feed some concerns about the achievability of the structural budgetary adjustment planned for the period 2005-2007 in the 2003 update. Under current policies, the objectives set in the 2003 update appear at risk. This underlines the need for bold and ambitious structural reforms with a budgetary impact. The recent reform of the pensions system is undeniably a major step in the right direction. The other reforms currently implemented or planned for the next few years (reform of the health insurance system, decentralisation) provide scope for expenditure restraint, but, at the current juncture, some of them have still to be designed and their overall impact remains uncertain.

Beyond the direct consequences on the deficit outcomes, the non-respect of expenditure ceilings will, if repeated, undermine the overall credibility of the budgetary strategy. In such a context, it would be appropriate, in order to safeguard the credibility of the medium-term budgetary framework, to introduce a mechanism ensuring automatic compensation across years of eventual overspending in the general government sector.

Table 5
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	2007
Target set in the 1998 programme	+3.5% cumulated ⁽¹⁾							
Target set in the 1999 update		+4.0% cumulated						
Target set in the 2000 update			+4.5% cumulated					
Target set in the 2001 update				+4.0% cumulated				
Target set in the 2002 update					+3.9% cumulated			
Target set in the 2003 update						+3.2% cumulated		
Growth in real GG expenditures	1.5	2.1	3.2	2.1				

⁽¹⁾The original figure in ESA 79 accounting system was 3.0%.

3.3. Budgetary developments in 2003

Public finances continued to deteriorate rapidly in 2003. The general government deficit is estimated by the French authorities to have increased from 3.1% of GDP in 2002 to 4.0% of GDP in 2003. According to Commission calculations based on the figures of the 2003 update of the stability programme, two thirds of the worsening in the government deficit compared to 2002 can be attributed to cyclical factors, the remaining, representing ¼ percentage point of GDP, resulting from a deterioration in the cyclically-adjusted balance.

Compared to the plans of the 2002 update of the stability programme, which projected the general government deficit at 2.6% of GDP in 2003 under the assumption of an increase in real GDP by 2.5%, the slippage in the 2003 general government deficit can be mainly attributed to the deterioration in cyclical conditions. However, a significant part of the slippage is directly linked to a significant overspending. According to the French authorities, general government expenditures in real terms increased by slightly more than 2.0% in 2003, a higher rate than the 1.2% planned in the previous stability programme. The largest part of the expenditure overrun can be attributed to a slippage in categories of expenditures which are not directly influenced by cyclical developments, namely health expenditures and local authorities' expenditures. On the contrary, the strict target on State expenditures was fully respected.

There is a clear risk that the 2003 deficit will result higher than currently expected by the French authorities. Indeed, as already mentioned, the growth assumption on which the

forecast for 2003 is based is outdated. Under the assumption of real GDP increasing by 0.1% in 2003, the Commission expects the 2003 general government deficit to reach 4.2% of GDP. Recent data tend to confirm that the 2003 deficit will be higher than estimated by the French authorities¹³. Therefore, the starting point for the medium-term general government deficit projections could result higher than estimated by the French authorities. This was already the case in the 2001 and 2002 updated stability programme.

Box 2: the excessive deficit procedure for France

Triggering of the Excessive deficit procedure (EDP)

The general government deficit in France amounted to 3.1 per cent of GDP in 2002, therefore exceeding the reference value of the Treaty. Based on this evidence, the Commission initiated the Excessive Deficit Procedure for France on 2 April 2003, with the adoption of the report foreseen in Article 104(3) of the Treaty. The Commission adopted on 7 May 2003 an Opinion stating that an excessive deficit exists in France. The Council adopted a decision in this sense, in conformity with Article 104(6), on 3 June 2003. At the same time, the Council adopted a recommendation addressed to France with a view to bringing the situation of an excessive government deficit to an end in 2004 at the latest, according to Article 104(7) of the Treaty. The Council established the deadline of 3 October 2003 for the French government to take appropriate measures to this end.

Recommendations of the Commission in accordance with Article 104(8) and 104(9)

In the view of the Commission, the measures taken by France between June and October 2003 were insufficient to respect the recommendations addressed by the Council in June. Therefore, the Commission adopted on 8 October 2003 a Recommendation under Article 104(8) for the Council to decide that no effective action had been taken in response to the Council recommendation of June. In line with the requirements of the Treaty and the Stability and Growth Pact, the Commission adopted on 21 October a draft recommendation under Article 104(9) for the Council to give notice to France to take measures to correct the excessive deficit. In this recommendation, the Commission proposed to the Council to extend the deadline for the correction of the excessive deficit to 2005 and to achieve in 2004 a reduction in the cyclically-adjusted deficit of one percentage point of GDP. Indeed, in light of the weak economic situation, the Commission considered that extending by one year to 2005 the deadline set by the Council in June for the elimination of the excessive deficit in France was justified.

Council decisions of 25 November 2003

On 25 November 2003, the Council adopted a conclusion putting the excessive deficit procedure for France in abeyance. The Council took note of the commitments made by France to achieve a reduction in the cyclically-adjusted deficit by 0.8 percent of GDP in 2004 and by 0.6 percent of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 percent of GDP in 2005. This is less than the consolidation effort recommended by the Commission.

3.4. Adjustment in 2004

For 2004, the French authorities project the government deficit at 3.55% of GDP, down from 4.0% in 2003. Most of the reduction in the deficit is planned to be achieved through a

¹³ The deficit of the unemployment insurance system reached €4.3 billion in 2003, i.e. about €1 billion (0.07 percentage point of GDP) more than expected by the French authorities in their latest forecast.

tight control of expenditures¹⁴. On the revenue side, the French authorities estimate that discretionary measures will lead to an increase in the tax burden by 0.1% of GDP¹⁵.

Table 6	
The arithmetic of budgetary plans for 2004: from the 2003 deficit to the 2004 deficit	
(Commission calculations, based on the method agreed by the Council)	
General government balance in 2003	-4.0 % of GDP
Impact of (in % of GDP):	
Cyclical developments	-0.2
Non cyclical developments, of which:	+0.6
- measures on the fiscal side	+0.1
- developments in non-tax revenues	+0.1
- slower than potential real GDP growth increase in real expenditures	+0.7
- tax to GDP elasticity lower than 1	-0.2
General government balance in 2004	-3.6 % of GDP

The deficit reduction envisaged in the 2003 update is less than 0.1 percentage point of GDP larger than planned in the draft budget Law submitted to Parliament in September¹⁶. This reflects the impact of measures taken during the parliamentary process¹⁷. Commission estimates based on the application of the agreed method to the figures of the programme suggest that budgetary plans for 2004 are consistent with a reduction in the cyclically-adjusted balance by 0.6 percentage point of GDP. This adjustment is less than 0.1 percentage point higher than that estimated on the basis of the draft budget, reflecting the impact of deficit-reducing measures decided since October 2003.

It should be noted that a part of the additional adjustment corresponding to the measures decided since the release of the budget seems to be non-permanent. Indeed while the deficit target for 2004 is revised slightly downwards, the deficit targets for the years 2005 to 2007 set in the 2003 update are the same as in the multi-annual projection attached to the Budget.

In its Autumn 2003 forecasts, the Commission projected the 2004 general government deficit at 3.8% of GDP in 2004, down from 4.2% of GDP in 2003¹⁸. The Commission considered the assumptions underlying the budget as plausible: real GDP growth is projected to accelerate to 1.7% in 2004, a rate in line with the Consensus forecast, and tax to GDP elasticities are estimated at a plausible level. A crucial assumption of the

¹⁴ Real general government expenditures are planned to increase by only 1.1% in 2004. This is a sharp deceleration compared to recent trends (+3.2% in 2002, and +2.1% in 2003). According to the French authorities, this will be achieved through (1) a stabilisation in State sector expenditures in real terms (budgetary accounting); (2) a sharp deceleration in expenditures in the social security sector, secured by a deceleration in health expenditures and a tightening of eligibility conditions to unemployment benefits; and (3) an increase in local authorities expenditures by 3.5% in nominal terms, after 3.8% in 2003.

¹⁵ Cuts in social contributions at the low end of the wage scale and in the income tax for a total amount of 0.2 percentage point of GDP are compensated by increases in taxes on tobacco and energy, and in overall social contributions for a comparable amount. On the basis of recent trends, the budget includes an increase in local taxes by 0.1 percentage point of GDP, even if the 2004 budgets of local authorities are still not unveiled.

¹⁶ The draft Budget projected a reduction in the deficit from 4.0% of GDP in 2003 to 3.6% of GDP in 2004.

¹⁷ Amendments reducing the general government deficit by about 0.03% of GDP were adopted during the parliamentary process. In addition, on 6 November 2003, the government announced the cancellation of one day of public holiday, and decided at the same time to introduce a new social contribution and to increase the taxation of capital. A part of the additional revenues will be used to finance extra social security expenditures. According to official estimates, the net impact will be a reduction in the 2004 government deficit by 0.04% of GDP.

¹⁸ Ceteris paribus, the measures taken since the finalisation of this forecast would lead the Commission to revise marginally its 2004 deficit forecast.

Commission Autumn forecast is that real expenditures will be kept in line with plans. Even though the measures mentioned in the draft budget appear to be credible, the Commission sees a number of risks to the budgetary execution in 2004. In particular, the target set for the increase in expenditures in 2004 is very ambitious, as it implies a sharp slowdown compared to trends of the past few years. Clear risks surround its achievement, especially in the health sector.

Box 3: Evaluation of the change in the cyclically-adjusted deficit by France and the Commission.

According to Commission calculations applying the agreed method to the figures of the 2003 update of the stability programme, macroeconomic and budgetary plans for 2004 are consistent with an improvement in the cyclically-adjusted balance by 0.6 percentage point in that year. The French authorities consider that the adjustment is 0.8. Two main parameters contribute to this difference:

(1) the 2004 potential growth estimates. According to the Commission, macroeconomic projections of the programme are consistent with an increase in potential output by 2.1% in 2004. According to the French authorities, potential output growth will reach 2¼% in 2004. The origins of differences in potential growth estimates are detailed in box 1.

(2) the budgetary sensitivity parameter (parameter linking fluctuations in the cyclical component of the general government balance to the output gap). This parameter is estimated at 0.5 by the French authorities; it is estimated at 0.41 by the Commission. The budgetary sensitivity parameter used by the Commission is based on tax and expenditure elasticities to the cycle calculated by the OECD.

Because the French authorities have higher estimates for these two variables, they attribute a larger part of the improvement in the general government deficit projected in 2004 to structural efforts, as shown in the table below. This table also shows that the impact of measures taken between the release of the draft Budget in late September and the Ecofin Council meeting of 25 November 2003 is taken into account in the new Commission estimate.

Decomposition of the origins of the change in the cyclically-adjusted balance in 2004

	2003	2004 (projection of the draft budget for 2004)	2004 (projection of the 2003 update)
Real GDP growth	0.5	1.7	1.7
Actual GG balance	4.0	3.6	3.55
Calculations by the French authorities using their own method			
Potential real GDP growth	2.5	2.3	2.3
Output Gap	-2.5	-3.1	-3.1
Budgetary sensitivity parameter	0.5	0.5	0.5
Cyclical component of the GG balance	-1.3	-1.6	-1.6
Cyclically-adjusted balance	2.7	2.0	2.0
<u>Change</u>	0.1	<u>-0.7</u>	<u>-0.8</u>
Calculations by the Commission using the agreed method			
Potential real GDP growth	1.9	2.1	2.1
Output Gap	-0.5	-0.9	-0.9
Budgetary sensitivity parameter	0.4	0.4	0.4
Cyclical component of the GG balance	-0.2	-0.4	-0.4
Cyclically-adjusted balance	-3.8	-3.2	-3.2
<u>Change</u>	-0.2	<u>-0.6 (-0.57)</u>	<u>-0.6 (-0.63)</u>

3.5. Adjustment in 2005 and beyond

In the reference scenario of the 2003 update of the stability programme, the government deficit is projected to be reduced by 0.7 percentage point of GDP per year as from 2005. The general government deficit is therefore projected to be reduced to 2.9% of GDP in 2005.

Table 7		
From the 2003 deficit to the 2005 deficit		
	2003 updated SP (reference scenario)	Commission Autumn forecast
General government balance in 2003	-4.0	-4.2
Total reduction, of which:	1.1	0.5
Impact of cyclical developments in 2004 and 2005	-0.1	-0.2
Reduction in the CAB in 2004	0.6	0.6 ⁽¹⁾
Reduction in the CAB in 2005 ⁽²⁾	0.6	0.1
General government balance in 2005	-2.9	-3.7
⁽¹⁾ The Commission figure does not incorporate the impact of measures taken in November.		
⁽²⁾ Figures for 2005 are not fully comparable: the Commission Autumn forecast was based on a no-policy change assumption, while the adjustment projected by the French authorities incorporates the impact of measures still to be taken.		

Several uncertainties surround the objective of bringing the deficit below 3% of GDP in 2005. Indeed, (1) as already stated, the 2003 deficit may result larger than assumed in the programme; (2) the expenditure target set for 2004 is ambitious and its attainment requires the full efficiency of the measures taken in the budget; (3) the acceleration in real GDP growth projected for 2004 and 2005 is plausible, but cannot be taken for certain and the balance of risks does not seem biased on the upside; (4) finally, the measures ensuring the improvement in the cyclically-adjusted balance planned for 2005, particularly the reform of the health insurance system, are still to be designed and implemented.

Because the deficit is planned to be reduced only marginally below 3% of GDP in 2005, the materialisation of only one of the above-mentioned risks would compromise the achievement of this objective. For instance, should the 2003 deficit be in line with the Autumn 2003 Commission forecast (4.2% of GDP) and real GDP growth in line with projections of the 2003 update, the cumulated reduction in the cyclically-adjusted balance currently planned by the French authorities for the years 2004 and 2005 would not be sufficient to bring the nominal deficit below the 3% of GDP reference value in 2005.

Table 8					
Projections for the general government finances in cyclically-adjusted terms, Commission calculations based on the projections of the 2003 updated programme					
As % of GDP	2003	2004	2005	2006	2007
Reference "cautious" scenario (2.5% GDP growth rate)					
General government balance	-4.0	-3.6	-2.9	-2.2	-1.5
Real GDP growth	0.5	1.7	2.5	2.5	2.5
Potential output	1.9	2.1	2.4	2.5	2.3
Output gap	-0.5	-0.9	-0.8	-0.8	-0.6
CAB	-3.8	-3.2	-2.6	-1.9	-1.3
Commission Autumn 2003 forecasts					
General government balance	-4.2	-3.8	-3.6	-	-
Real GDP growth	0.1	1.7	2.3	-	-
Potential output	2.0	2.1	2.3	2.3	2.2
Output gap	-0.7	-1.1	-1.0	-	-
CAB	-3.9	-3.3	-3.2	-	-
"Favourable" scenario (3% GDP growth rate)					
General government balance	-4.0	-3.6	-2.6	-1.6	-0.7
Real GDP growth	0.5	1.7	3.0	3.0	3.0
Potential output	2.1	2.2	2.5	2.7	2.5
CAB	-3.7	-3.0	-2.3	-1.4	-0.7
Source: Commission calculations applying the production function method endorsed by the Council to the inputs (macroeconomic and general government balance projections) provided by the French authorities in the 2003 update of the stability programme.					

Although showing an improvement in the underlying budget position larger than the minimum of 0.5 percentage point of GDP each year, the medium term budgetary plans lack ambition, especially in a context where real GDP growth is projected to remain above its potential rate in the next four years. According to Commission calculations based on the figures of the programme, a close to balance budgetary position in cyclically-adjusted terms is not reached over the time span of the update, neither in the baseline nor in the optimistic macroeconomic scenario.

Box 4: differences in the evaluation of the cyclically-adjusted deficit of 2007.

According to the calculations of the French authorities based on their own method, the macroeconomic and budgetary projections of the programme will lead to a cyclically-adjusted deficit of 0.2% of GDP in 2007. Government finances would therefore be in a close-to-balance position in cyclically-adjusted terms in 2007.

The Commission does not share this conclusion. In the projection by the French authorities, the achievement of a close to balance budgetary position in 2007 in cyclically-adjusted terms is due to the fact the output gap of the French economy is estimated to exceed 2 percentage points of GDP in 2007, while Commission calculations based on the agreed method estimate that the projections of the reference scenario are consistent with an output gap of ½ percentage point of GDP in 2007.

This lack of ambition has other important consequences: (1) in the reference scenario, the government debt to GDP ratio will not start declining before 2006, and will remain above the 60% reference value of the Treaty all over the period covered by the programme; and (2) 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 the end-year of the programme¹⁹, according to Commission calculations based on the figures of the programme.

The current budgetary situation calls for more decisive moves towards a close to balance situation, especially in the early years of the time span of the programme. In particular, given the seriousness of the current budgetary situation, the French authorities should, in the event of better than expected macroeconomic developments, seek an acceleration in the reduction in the cyclically-adjusted deficit which goes beyond that automatically generated by the impact on potential growth estimates of better cyclical developments.

3.6. Sensitivity analysis

The 2003 update of the stability programme presents two complete and internally coherent macroeconomic scenarios. Based on Commission calculations, the improvement in the cyclically-adjusted balance achieved in case of the “favourable” scenario is larger than in the reference scenario. This is not the result of concrete policy measures, but from the upward revision to potential growth estimates implied by a more favourable set of assumptions about the underlying determinants of potential growth. A symmetric phenomenon would occur in case actual growth turns out to be weaker than projected in the reference scenario.

In order to illustrate this point despite the lack of information on the determinants of growth of a possible alternative “prudent scenario”²⁰, Commission services decided to proceed to a sensitivity analysis based on the assumption that potential growth would be

¹⁹ Reference is made here to the “minimal benchmark”. In the case of France, the latest estimate for this benchmark is 1.7% of GDP (see 2002 edition of the Public Finance report).

²⁰ Such a scenario is not mentioned in the 2003 update of the stability programme.

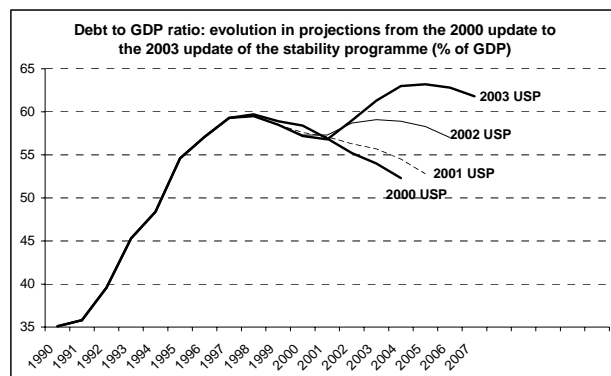
lower than in the reference scenario of the programme in the years 2004 to 2007. Yearly potential output is assumed to be 0.2 percentage point of GDP lower than in the reference scenario (the perturbation is symmetric to that of the “favourable” scenario). Such a revision could be triggered for instance by an increase in actual real GDP growth by about 2% per year in the years from 2005 to 2007, instead of 2.5% per year in the reference scenario. The exercise shows that, should nominal expenditure plans remain unchanged, the cumulated improvement in the cyclically-adjusted balance vis-à-vis the reference scenario would be lower by about ½ percentage point of GDP.

Table 9			
Sensitivity analysis: impact of a lower potential growth on the developments in the cyclically-adjusted balance			
	Reference scenario		Low growth scenario
	Projected budget balance (in % of GDP)	Projected CAB (in % of potential output)	CAB (in % of potential output)
2003	-4.0	-3.8	-3.9
2004	-3.6	-3.2	-3.3
2005	-2.9	-2.6	-2.8
2006	-2.2	-1.9	-2.3
2007	-1.5	-1.3	-1.8

Source: Commission services calculations, on the basis of the figures of the 2003 update of the stability programme

3.7. Debt path

The recent evolution of the debt to GDP ratio underlines again the urgency for reducing decisively the general government deficit. Since 1990, this ratio has increased by about 25 percentage points of GDP. After the temporary decline observed between 1998 and 2001, which was largely favoured by cyclical developments, this ratio started to increase again in 2002, and is now following a clear upward trend. This is partly due to the fact that France was among the rare countries of the euro area with Germany, and, to a lower extent, Luxembourg, to still have a primary deficit in 2003.



It is also striking to observe that the level of the debt to GDP ratio currently planned for 2004 is almost 10 percentage points of GDP higher than projected only three years ago. The deviation, mainly due to developments in the deficit, has been amplified by unforeseen stock-flow operations and the shortfall in nominal GDP growth.

Under the projections of the reference scenario, the debt to GDP ratio will remain above 60% of GDP throughout the period covered by the programme. A gradual reduction would start only in 2006, triggered by nominal GDP growth the shift to primary surpluses. The comparison between the Commission forecast and 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 budgetary projections of the stability programme.

Table 10								
Contribution to the changes in the general government gross debt to GDP ratio								
	2003		2004		2005		2006	2007
	COM	USP	COM	USP	COM	USP	USP	USP
Change in government debt ratio	3.7	2.4	1.7	1.4	1.3	0.4	-0.4	-1.0
<i>Contributions from:</i>								
Primary balance	0.9	0.9	0.6	0.6	0.4	-0.1	-0.9	-1.6
Interest payments	3.2	3.1	3.2	3.0	3.2	3.1	3.0	3.1
Nominal GDP growth, of which	-1.0	-1.4	-2.1	-2.0	-2.4	-2.4	-2.5	-2.4
Real GDP growth	-0.0	-0.3	-1.1	-1.1	-1.5	-1.6	-1.6	-1.5
GDP deflator	-1.1	-1.2	-1.1	-1.1	-1.0	-0.9	-0.9	-0.9
Stock-Flow adjustment	0.4	-0.2	0.0	-0.2	0.0	0.0	0.0	0.0
Level of government debt ratio	62.6	61.4	64.3	62.8	65.6	63.2	62.8	61.8

4. QUALITY OF PUBLIC FINANCES

The entirety of the budgetary adjustment is planned to be achieved through a structural decrease in the ratio of government expenditures to GDP. It is usually accepted that fiscal consolidation based on expenditure reductions is more likely to be permanent, and to have medium-term expansionary effects than those based on tax increases.

In order to have favourable effects in the medium-term, a budgetary consolidation based on expenditure cuts must not be achieved at the expense of the most 'productive' government expenditures (public investment, education and research expenditures). Although the information provided in the 2003 update of the stability programme is too scarce to make a deep assessment, it seems that the adjustment planned by the French authorities is mostly based on a reduction in current expenditures. Indeed, the strong deceleration in government expenditures is planned to be achieved through:

- a stabilisation of State sector expenditures in real terms (budgetary accounting), achieved in particular through a tight control of the wage bill (partial replacement of retiring civil servants) and the modernisation of public purchasing procedures. The implementation of the new budgetary framework law (*Loi organique relative aux lois de finances*), which will make the State budget process more output-based oriented, should allow further progress in enhancing the quality and efficiency of public spending programmes.
- A sharp deceleration in social security expenditures. The main savings would come from two sources (i) a deceleration in health expenditures, which will be warranted by the implementation of a new reform of the health sector in the course of 2004, aimed at ensuring a better control of expenditures without damaging the overall quality of the system, and (ii) a deceleration in unemployment transfers, due to a tightening of the eligibility conditions for unemployment benefits.
- An increase in local authorities expenditures by 3.4% in nominal terms, after 3.8% in 2003, the deceleration being mostly due to a tight control of the wage bill in this sector after several years of rapid increase.

On the revenue side, previous multi-annual projections or updates of the stability programme planned to allocate a significant share of the margins created by expenditures growing more slowly than GDP to the reduction of the tax burden. In this multi-annual projection, this share is marginal. New 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 wages²¹. The programme also states that revenue-neutral changes to the tax system could be introduced, in order to reduce labour costs and strengthen work incentives. These intentions clearly go in the right direction.

5. SUSTAINABILITY OF PUBLIC FINANCES

5.1. Quantitative indicators

The assessment of the sustainability of French public finances is based on both quantitative and qualitative indicators. The quantitative indicators are run on the basis of a commonly agreed methodology by the Economic Policy Committee²². The purpose of the indicators is to signal possible unbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear and results of these quantitative indicators need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcomes and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of “no policy change”.

The quantitative indicators project debt and budget balance development according to two different scenarios, to take into account uncertainties over the medium term. A “programme” scenario is calculated on the following basis:

- Macroeconomic assumptions on GDP growth from 2008 onwards, interest rates and inflation are based on the agreed assumptions used in the EPC;
- The projections for age-related expenditures come from several sources. In order to calculate the impact of the recent pension reform on long term trends, the pension expenditure profile used in last year assessment has been adjusted assuming a full impact of the reform. Data on the impact of the reform comes from this year programme and it is assumed that the foreseen impact fully materialise. Health care projections rely on EPC 2001 projections while education and unemployment benefit expenditure projections rely on EPC 2003 harmonised exercise. Since the impact of the pension reform is projected up to 2040, it has been assumed that no additional savings materialise between 2040 and 2050 as a result of the reform. This allows to perform the exercise up to 2050 as for the other countries.
- The projections for government revenues come from the programme. They are kept constant at the (cyclically adjusted) level in 2007.

²¹ 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.

²² See the Report “The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme” (October 2003), available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf.

- The starting point for gross debt and the primary balance are the 2007 levels reported in the programme.

A “2003 position” scenario is based on the budgetary data for 2003 in the programme. Debt levels are extrapolated from 2008 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance in 2007 remains the same as the 2003 level and no stock-flows operations take place.

The table 12 below presents the debt and the budget balance development according to the two different scenarios. Overall, age-related expenditure is foreseen to increase by 2% of GDP between 2008 and 2050. Compared with last year assessment it has been incorporated the new profile for pension expenditures as a result of the reform and some savings foreseen in the education sector and for unemployment benefits.

Table 11. Summary results of the long term sustainability simulations

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	26.0	26.2	27.6	28.5	28.2	28.0	2.0
Pensions ^{''}	12.7	13.0	14.2	14.9	14.5	14.5	1.8
Health care [']	6.4	6.4	6.8	7.1	7.4	7.4	1.0
Education ^{''}	5.9	5.8	5.8	5.7	5.6	5.5	-0.4
Unemployment benefits ^{''}	1.0	1.0	0.9	0.8	0.7	0.7	-0.4
Total primary non age-related spending*	22.8						
Total revenues*	51.6						

['] unchanged from the 2002 update of the Stability programme

^{''} EPC 2003 projections

^{*} calculated from last year program, net of the impact of the pension reform

* constant

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	59.7	56.0	47.5	52.2	62.4	72.0	12.3
Net borrowing	-0.3	-0.4	-1.3	-2.4	-2.8	-3.1	-2.8
2003 scenario							
Debt	69.9	71.8	95.3	142.1	208.8	288.1	218.2
Net borrowing	-3.3	-3.7	-6.3	-9.6	-13.1	-17.2	-13.9

Sustainability gap	S1*	S2**
Programme scenario	0.7	0.8
2003 situation scenario	3.6	3.5

* S1 measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that there is a financing gap to reach this debt level in 2050. P.m. debt to GDP ratio at the end of the period: 15.9%

** S2 indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

It is possible to verify whether the projected level of debt respects the requirement to stay below 60% of GDP reference value for public debt at all times. Failure to do so would a priori indicate that there may be a risk of budgetary imbalances emerging in light of ageing population and that measures may be required to place public finances on a more sustainable footing. In the case of France, debt to GDP ratio should be preliminary run down to reach the 60% reference value.

According to the quantitative indicators risks of unsustainable budgetary position in the long run cannot be ruled out for France. The debt to GDP ratio in the baseline scenario will decrease below 60% during the next 15 years but, once the impact of ageing takes place, it could reverse its trend and go back to values around the Maastricht reference value.

However, if both the consolidation efforts in the medium term and the impact of pension reforms materialise, risks are limited.

A different pattern emerges if consolidation efforts do not materialise and the very low cyclically adjusted primary surplus recorded in 2003 does not upsurge in the next few years. Debt to GDP ratio will likely be on an explosive path and the pension reform solely will not be helpful in ensuring long term sustainability.

A sustainability gap therefore arises of around 0.5-1% of GDP in a baseline scenario while the gap becomes higher than 3% if the consolidation process failed.

5.2. Additional qualitative features

As underlined in the EPC report on “The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme” (October 2003), several qualitative factors should be taken on board to avoid a mechanistic interpretation of the quantitative indicators. In particular, it should be reminded that France passed in 2003 a comprehensive reform of the pension system, briefly presented in the box below, which will lead to a significant improvement in the sustainability of public finances.

Box 5: A comprehensive reform of the pension system was implemented in 2003

The French Parliament adopted in the Summer 2003 a comprehensive reform of the pension system. The reform foresees an increase in the number of contribution years entitling to a full pension in two steps: until 2008, this number will increase only in the public sector from 37.5 years to the level of 40 years currently prevailing in the private sector; in a second step starting in 2008, the contribution period is foreseen to increase for all workers proportionally with life expectancy, through a rule meant to keep constant the ratio between the number of contribution years and the number of years in pension. The reform also raises significantly the financial incentives to remain active until and after the legal retirement age, and changes the reference for the indexation of pensions in the public sector from wages to prices.

According to the French authorities, the reform will reduce by around 40% of the financial needs of the pension system in 2020. The remaining will be financed through two channels. In the private sector, social contributions will be increased. The negative impact on labour cost will, according to the government, be offset by a symmetric decrease in unemployment contributions stemming from developments in the unemployment rate. In the public sector, the remaining financial needs will be funded by an increase in government expenditures.

Even if the sustainability of public finances is not yet secured, France is in a considerably better position than before the reform to meet the budgetary costs of ageing population. The reform will indeed not only postpone the average retirement age and thus reduce pension expenditures but it will also probably lead to an increase in participation rates among the elders with positive effects on potential growth.

It must however be stressed that several factors warrant attention. First, the debt to GDP ratio has increased during last years and the return to a downward trend is imperative in order to avoid offsetting the foreseen savings induced by the pension reform through higher interest payments. Second, the whole strategy relies not only on pension reform but also on the budgetary consolidation during the next few years. As emerges from the quantitative indicators, failure to do so will determine an explosive debt path. Third, some of the savings foreseen in the projections are at risk, in particular education expenditures could even increase in the long term to match with the higher demand of skilled workers.

5.3. Overall assessment of sustainability

On the basis of current policies, the risk of persistent budget imbalances cannot be excluded. France has recently passed a comprehensive pension reform that undoubtedly improves the long term sustainability of public finances. However, risks of unbalances in the long term cannot be ruled out for France. The impact of the pension reform plus the consolidation efforts for the next years will bring debt to GDP ratio down for the next 15 years but, once the impact of ageing intensifies, the debt to GDP ratio could go back to values around the Maastricht reference value. A different pattern emerges if consolidation efforts do not materialise. The debt to GDP ratio would indeed follow an explosive path, the pension reform solely not ensuring long term sustainability. Those conclusions are based on an assessment of the results of the previous analysis as well as other qualitative considerations.

Annex 1 : Summary tables of the 2003 updated stability programme

I. The 2.5% growth scenario

General government budgetary developments

% of GDP	2003	2004	2005	2006	2007
Net lending by sub-sectors (B9)					
General government	-4.0	-3.55	-2.9	-2.2	-1.5
Central government: State	-3.8	-3.7	-3.3	-2.7	-2.2
Central government bodies	0.2	0.4	0.5	0.5	0.5
Local government	0.2	0.2	0.2	0.2	0.2
Social security funds	-0.6	-0.5	-0.2	-0.1	0.0
General government (S13)					
Total receipts	50.3	50.4	50.2	50.3	50.3
Total expenditure	54.3	53.9	53.0	52.4	51.8
Budget balance	-4.0	-3.55	-2.9	-2.2	-1.5
Net interest payments	3.1	3.0	3.0	3.0	3.1
Primary balance	-0.9	-0.6	0.1	0.9	1.6

General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	61.4	62.8	63.2	62.8	61.8
Change in gross debt	2.4	1.5	0.3	-0.4	-1.0

Divergence from previous update 2.5% growth scenario

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	2.5	2.5	2.5	2.5	-
Latest update	0.5	1.7	2.5	2.5	2.5
Difference	-2.0	-0.8	0.0	0.0	-
Budget balance					
Previous update	-2.6	-2.1	-1.6	-1.0	-
Latest update	-4.0	-3.55	-2.9	-2.2	-1.5
Difference	-1.4	-1.4	-1.3	-1.2	-
Gross debt level (consolidated general government)					
Previous update	59.1	58.9	58.3	57.0	-
Latest update	61.4	62.8	63.2	62.8	61.8
Difference	2.3	3.9	4.9	5.8	-

II. The 3% growth scenario

General government budgetary developments

% of GDP	2003	2004	2005	2006	2007
Net lending by sub-sectors (B9)					
General government	-4.0	-3.55	-2.6	-1.6	-0.7
Central government: State	-3.8	-3.7	-3.3	-2.5	-1.9
Central government bodies	0.2	0.4	0.5	0.5	0.5
Local government	0.2	0.2	0.2	0.2	0.3
Social security funds	-0.6	-0.5	0.0	0.2	0.4
General government (S13)					
Total receipts	50.3	50.4	50.1	50.3	50.2
Total expenditure	54.3	53.9	52.8	51.9	50.9
Budget balance	-4.0	-3.55	-2.6	-1.6	-0.7

General government debt developments

% of GDP	2003	2004	2005	2006	2007
Gross debt level	61.4	62.8	62.6	61.4	59.4
Change in gross debt	2.4	1.4	-0.2	-1.2	-2.0

Divergence from previous update

2.5% growth scenario

% of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	2.5	3.0	3.0	3.0	-
Latest update	0.5	1.7	3.0	3.0	3.0
Difference	-2.0	-1.3	0.0	0.0	-
Budget balance					
Previous update	-2.6	-2.0	-1.4	-0.5	-
Latest update	-4.0	-3.55	-2.6	-1.6	-0.7
Difference	-1.4	-1.5	-1.2	-1.1	-
Gross debt level (consolidated general government)					
Previous update	59.1	58.5	57.3	55.4	-
Latest update	61.4	62.8	62.6	61.4	59.4
Difference	2.3	4.3	5.6	6.0	-

Annex 2 : Macroeconomic assumptions

2.5% growth scenario

% change	2003	2004	2005	2006	2007
GDP growth at constant market prices	0.5	1.7	2.5	2.5	2.5
GDP deflator	2.0	1.7	1.5	1.5	1.5
CPI (excl. tobacco)	1.7	1.5	1.5	1.5	1.5
Private wage employment	0.1	0.4	0.8	0.9	1.0
Sources of growth: percentage changes at constant prices					
Private consumption expenditure	1.3	1.8	2.3	2.3	2.3
Government consumption expenditure	2.5	1.4	1.2	1.2	1.2
Gross fixed capital formation	-0.9	1.9	3.5	3.7	3.7
Changes in inventories and net acquisition of valuables as a % of GDP	0.1	0.1	0.1	0.1	0.1
Exports of goods and services	-1.4	3.6	5.6	5.6	5.6
Imports of goods and services	1.1	4.1	5.7	5.6	5.6
Contribution to GDP growth					
Final domestic demand	1.2	1.8	2.5	2.4	2.4
Changes in inventories and net acquisition of valuables as a % of GDP	0.1	0.1	0.1	0.1	0.1
External balance of goods and services	-0.7	-0.1	0.0	0.1	0.1

3% growth scenario

% change	2003	2004	2005	2006	2007
GDP growth at constant market prices	0.5	1.7	3.0	3.0	3.0
GDP deflator	2.0	1.7	1.5	1.5	1.5
CPI (excl. tobacco)	1.7	1.5	1.5	1.5	1.5
Private wage employment	0.1	0.4	1.2	1.4	1.6
Sources of growth: percentage changes at constant prices					
Private consumption expenditure	1.3	1.8	2.5	2.5	2.5
Government consumption expenditure	2.5	1.4	1.2	1.2	1.2
Gross fixed capital formation	-0.9	1.9	4.5	4.8	4.9
Changes in inventories and net acquisition of valuables as a % of GDP	0.1	0.1	0.3	0.2	0.2
Exports of goods and services	-1.4	3.6	6.1	6.1	6.1
Imports of goods and services	1.1	4.1	6.1	6.1	6.1
Contribution to GDP growth					
Final domestic demand	1.2	1.8	2.9	2.9	2.9
Changes in inventories and net acquisition of valuables as a % of GDP	0.1	0.1	0.3	0.2	0.2
External balance of goods and services	-0.7	-0.1	0.1	0.1	0.1

Annex 3 : General government expenditures in the of the 2003 updated stability programme

Cumulative growth in real expenditure

<i>At constant market prices</i>	2005-2007 programme	2004-2006 programme
General government	3.2%	3.9%
Central government (budget accounting)¹	0.0%	1.0%
Central government (national accounting)¹	1.0%	2.4%
Social security funds ¹	5.3%	5.0%
- <i>Health benefits</i>	6.9%	7.7%
- <i>Retirement pensions</i>	8.7%	7.1%
Local government	5.9%	6.6%

¹ On a like-for-like basis.