COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.1.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

on the updated stability programme of France, 2003-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 (formerly 109c) of the Treaty (from 1 January 1999, the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

France's first stability programme covering the period 1999-2002 was submitted on 18 January 1999 and assessed by the Council on 15 March 1999[2].

France submitted its fifth and most recent update of the stability programme, covering the period 2003-2007, on 11 December 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> 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.
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> 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

1 OJ L209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 OJ C 124, 5.5.1999

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

4 COM (2002) 668 final, 27.11.2002.

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. In the view of the Commission, 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 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[5]. This is a source of concern. Indeed, in the view of the Commission, 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.

5 An improvement in the cyclically-adjusted balance could however still stem from an upward revision to potential growth figures, or from good surprises on the tax elasticities.

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.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated stability programme of France and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

on the updated stability programme of France, 2003-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[6], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [10 February 2004], the Council examined the 2003 update of the stability programme of France which covers the period 2003 to 2007. The updated programme largely complies with the requirements of the revised "code of conduct" on the content and format of stability and convergence programmes. Even if it is not compulsorily required in the code of conduct, the presence in the programme of explicit projections for general government revenues and expenditures categories on a national accounting basis would have allowed a deeper analysis of the quality of the projected budgetary adjustment.

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 y 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 Article 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 the necessary measures to bring the government deficit below 3% of GDP in 2005 at the latest. 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.

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6 OJ L 209, 2.8.1997.

The medium-term projections of the 2003 updated programme are based on the same budgetary strategy already adopted in previous updates. The cornerstone of this strategy is the setting of multi-annual targets for the increase in real government expenditures implying a fall of the expenditure to GDP ratio and a decline in the general government deficit. In the 2003 update, this strategy is complemented by two new budgetary rules: (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 expenditures will be allocated to tax relief.

A strategy based on clear norms for expenditures growth is appropriate as it supports a transparent budgetary adjustment. However, the previously set expenditure targets were missed by a large margin. Beyond the 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 introduce a mechanism ensuring automatic compensation across years of eventual overspending in the government sector. Concerning the new budgetary rules, in the event of more favourable cyclical developments, it would be appropriate to accelerate the reduction in the cyclically-adjusted deficit through the implementation of additional measures.

The 2003 update projects real GDP growth to accelerate from an estimated 0.5% in 2003 to 1.7% in 2004. For the period from 2005 to 2007, the macroeconomic projections are based on the same two 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. Consumer price inflation is expected to remain moderate at 1.5% throughout the time span of the update. The growth assumption for 2003 is outdated: the Commission forecast of real GDP increasing by 0.1% appears more plausible. The forecast for 2004 appears plausible. Concerning the years 2005-2007, the projections of the so-called “cautious” scenario seem realistic. This scenario was therefore considered as the reference scenario for assessing budgetary projections.

The update targets a general government deficit of 3.6% of GDP in 2004 compared to an expected deficit of 4.0% of GDP in 2003. For 2005, 2006 and 2007, the projections are for headline deficits of 2.9%, 2.2%, and 1.5% of GDP respectively. The primary balance is projected to improve from -0.6% of GDP in 2004 to 1.6% of GDP in 2007. In cyclically-adjusted terms, based on Commission calculations according to the commonly agreed methodology, there is an improvement by 0.6 percentage points to 3.2% of GDP in 2004. In 2005, 2006, and 2007, the cyclically-adjusted deficits amount to 2.6%, 1.9%, and 1.3% of GDP respectively.

Under plausible macro-economic and budgetary assumptions, the adjustment path in the programme may be insufficient to eliminate the excessive deficit in 2005. Indeed, the achievement of this objective is surrounded by several risks: (1) real GDP growth in 2003 was probably lower than assumed in the update, and the 2003 government deficit may consequently turn out to be higher than expected; (2) the achievement of the expenditure target set for 2004 is uncertain and requires full implementation and efficiency of the measures introduced; (3) the improvement in the cyclically-adjusted balance planned for 2005 relies on measures which still have to be designed and implemented, particularly the reform of the health insurance system. Because the deficit is planned to be reduced only marginally below 3% in 2005, the materialisation of only one of the above-mentioned risks would compromise the reduction of the deficit below 3% of GDP in 2005. In such an event, the implementation of additional measures would be necessary to secure the correction of the excessive deficit situation in 2005 at the latest.

The budgetary stance in the update is insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance or in surplus is achieved within the programme period. In addition, a budgetary position providing a sufficient safety margin to avoid in the future breaching the 3% of GDP deficit threshold under normal macroeconomic conditions would not be reached before 2007.

The debt ratio is projected to start declining only in 2006, and to remain above the 60% reference value of the Treaty throughout the period covered by the programme. The evolution of the debt ratio is likely to be less favourable than projected given the risks to the deficit outcomes mentioned above.

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. While France is in a considerably better position than before the reform to meet the budgetary costs of ageing population, risks of unbalances in the long term cannot be ruled out. Securing an adequate primary surplus will be essential to ensure that the public finances are on a sustainable footing. This should be complemented, particularly in the context of the reform of the health insurance system to be designed and implemented in the course of 2004, by measures aimed at controlling the evolution of age-related spending.

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.