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DECEMBER 2004 UPDATE
OF THE STABILITY PROGRAMME OF FRANCE
(2004-2008)
AN ASSESSMENT

Table of contents

SUMMARY AND CONCLUSIONS	3
1. INTRODUCTION	6
2. MACROECONOMIC DEVELOPMENTS	6
3. BUDGETARY IMPLEMENTATION IN 2004	8
4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES	9
4.1. Evolution of budgetary targets in successive programmes	9
4.2. Budgetary targets in the updated programme.....	10
4.3. Sensitivity analysis	13
5. EVOLUTION OF THE DEBT RATIO	13
6. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES	16
7. THE SUSTAINABILITY OF THE PUBLIC FINANCES.....	19
 Annex 1: Summary tables from the stability programme update.....	 23

SUMMARY AND CONCLUSIONS¹

The 2004 update of the stability programme of France was submitted to the Commission on 7 December 2004. It covers the period 2004-2008 and broadly complies with the data requirements of the “code of conduct on the content and format of stability and convergence programmes”². However, it does not provide projections for total employment growth according to the national accounts definition, which are compulsory, presenting only projections for employment growth in the private sector. Neither does it supply some optional data which would have been useful for the assessment of the programme.

For the period 2004-2008, the programme projects real GDP growth at 2.5% per year. According to Commission calculations applying the commonly agreed methodology to the figures of the programme, real GDP growth would be slightly higher than potential. The output gap would however remain negative until 2008. For the years 2004-2006, the projections of the Commission services are slightly less favourable than those of the programme, with real GDP growth being projected at 2.4% in 2004 and 2.2% in 2005 and 2006. Overall, while somewhat on the high side, the macroeconomic projections of the programme can be considered plausible.

The programme is aimed at reducing the general government deficit to below 3% of GDP in 2005 and at ensuring its continuous decline in the following years. The deficit reduction in 2005, from 3.6% of GDP in 2004 to 2.9% of GDP, would be achieved notably by a one-off revenue item amounting to 0.4% of GDP³. In the subsequent years, the deficit is projected to decline by 0.6-0.7 percentage point of GDP per year to 0.9% of GDP in 2008. Compared with the previous update, the current update broadly confirms the planned adjustment against a slightly more favourable macroeconomic scenario. The primary balance would improve from a deficit of 0.7% of GDP in 2004 to a surplus of 2.2% of GDP in 2008. According to Commission calculations based on the projections of the update and the commonly agreed methodology, the cyclically-adjusted balance would also improve by 0.6-0.7 percentage point per year as from 2005 and would reach -0.7% of GDP in 2008. The medium-term budgetary strategy is based, as in previous updates, on the setting of multi-annual targets for the increase in government expenditures in real terms that imply a reduction of the expenditure-to-GDP ratio. The ratio of revenues to GDP is projected to remain roughly stable.

As far as it is possible to judge on the basis of current information, measures taken by the French authorities should be sufficient to reduce the deficit to 3% of GDP in 2005. However, the budgetary situation remains vulnerable and any unfavourable development

¹ This technical analysis, which is based on information available up to 26 January 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 2 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Laurent Moulin (laurent.moulin@cec.eu.int) and Stéphanie Riso (stephanie.riso@cec.eu.int).

² Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

³ Since the presentation of the draft Budget for 2005 in September 2004, this one-off payment has been revised to 0.5% of GDP. While the revision was incorporated in the Commission services' Autumn forecast, the projections of the programme are still based on the initial estimate of 0.4% of GDP.

on the macroeconomic or budgetary side could compromise the objective of correcting the excessive deficit in 2005. The budgetary adjustment projected for the years after 2005 is significant, which is warranted given the seriousness of the budgetary situation. However, the projections are subject to risks and, on some points, insufficiently documented. In particular, the reduction of the deficit projected for 2006 seems out of reach under current policies. The programme foresees a decline in the deficit from 2.9% of GDP in 2005 to 2.2% of GDP in 2006, though tax cuts worth 0.2% of GDP have already been announced and one-off revenues will vanish. The programme does not give sufficient information on the measures intended to compensate for these developments. On the assumption of unchanged economic policies, the Commission services' 2004 Autumn forecasts project an increase in the general government deficit from 3.0% to 3.3% of GDP in 2006. This means that, under current growth assumptions, measures leading to a deficit reduction by about one percentage point of GDP in 2006 would have to be taken in order to achieve the target set in the programme. In addition, the general government expenditure target set for the period 2006-2008, namely an increase by 1.2% per year in real terms, implies a significant deceleration compared to recent trends, which is likely to be difficult to reach under current policies. The structural reforms implemented in 2003 and 2004, notably the pension and health reforms, constitute clear steps in the right direction but appear insufficient to secure the foreseen deceleration of expenditure. There are also concerns about the credibility of the expenditure targets since the objectives set in the previous updates were missed by a large margin. In view of this risk assessment, the projected adjustment, although significant, does not provide a sufficient safety margin against breaching the 3% of GDP threshold with normal macroeconomic fluctuations until 2007. It is also insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved within the programme period.

After increasing by 8 percentage points between 2001 and 2004 to 64.8% of GDP, the debt-to-GDP ratio is projected to remain above 60% of GDP throughout the period covered by the programme (62% in 2008). A gradual reduction would start only in 2006, triggered by nominal GDP growth and the shift to primary surpluses. The projected path for the debt is affected by the same uncertainties as the deficit ratio.

The update reviews the structural reforms recently introduced by the French authorities. Notably, the programme presents in detail the reform of the health insurance system implemented in summer 2004, which aims to bring the health insurance system to budgetary balance in 2007 (from a deficit of 0.8% of GDP in 2004), while preserving the quality of the health service. The reform, which also aims at improving the overall governance of the system, introduced an independent alert committee charged with formulating recommendations if it should identify a risk of slippage from the official target. The health reform followed the major reform of the pension system adopted in 2003, which significantly raised the financial incentives to remain active until and after the legal retirement age. Finally, the programme underlines that the new budgetary framework for the State sector (Loi Organique relative aux Lois de Finances) should enable further progress in enhancing the quality and efficiency of public spending programmes while also facilitating the attainment of budgetary objectives. Although these reforms are probably insufficient to meet the expenditure targets set in the update and to secure the long-term sustainability of government finances, they are going in the right direction.

There are some risks with regard to the long-term sustainability of the public finances on grounds of the large projected budgetary cost of an ageing population. This is despite the

implementation of major structural reforms of the pension and health-care systems in 2003 and 2004 respectively. In the absence of further reforms, additional consolidation would thus also be needed in the years ahead.

Overall, the economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. France has implemented major structural reforms, notably concerning the pension and health systems, which place it in a better position to face the consequences of an ageing population. However, the reduction of the cyclically-adjusted deficit in 2004 will be significantly lower than recommended and France did not take measures in order to accelerate the reduction in the cyclically-adjusted deficit when growth conditions improved. In addition, although significant, the medium-term adjustment projected in the 2004 update will not be sufficient to reach a close-to-balance budgetary position within the time span covered by the update and it is subject to uncertainties.

In view of the above assessment, it would be appropriate for France to (i) do the necessary to ensure the correction of the excessive deficit in 2005; (ii) make sure that the budgetary consolidation continues in the years after 2005 so as to reach a close to balance budgetary position in 2008; and (iii) continue structural reforms and control expenditure in order to secure the respect of the multi-annual expenditure targets set in the programme.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	SP Dec 2004	2.5	2.5	2.5	2.5	2.5
	COM Oct 2004	2.4	2.2	2.2	n.a.	n.a.
	SP Dec 2003	1.7	2.5	2.5	2.5	n.a.
HICP inflation (%)	SP Dec 2004	2.2	1.8	1.5	1.5	1.5
	COM Oct 2004	2.3	2.0	1.8	n.a.	n.a.
	SP Dec 2003	1.5	1.5	1.5	1.5	n.a.
General government balance (% of GDP)	SP Dec 2004	-3.6	-2.9	-2.2	-1.6	-0.9
	COM Oct 2004	-3.7	-3.0	-3.3	n.a.	n.a.
	SP Dec 2003	-3.55	-2.9	-2.2	-1.5	n.a.
Primary balance (% of GDP)	SP Dec 2004	-0.7	0.1	0.8	1.5	2.2
	COM Oct 2004	-0.7	-0.1	-0.4	n.a.	n.a.
	SP Dec 2003	-0.6	0.1	0.9	1.6	n.a.
Cyclically-adjusted balance (% of GDP)	SP Dec 2004¹	-3.4	-2.7	-2.0	-1.4	-0.7
	COM Oct 2004	-3.5	-2.8	-3.1	n.a.	n.a.
	SP Dec 2003 ¹	-3.2	-2.6	-1.9	-1.3	n.a.
Government gross debt (% of GDP)	SP Dec 2004	64.8	65.0	64.6	63.6	62.0
	COM Oct 2004	64.9	65.5	66.3	n.a.	n.a.
	SP Dec 2003	62.8	63.2	62.8	61.8	n.a.
Note: ¹ Commission services calculations on the basis of the information in the programme Sources: Stability programme; Commission services autumn 2004 economic forecast; Commission calculations						

1. INTRODUCTION

The 2004 update of the stability programme of France (henceforth “the update”) was submitted to the Commission on 7 December 2004 and covers the period from 2004 to 2008. The programme is a document from the government. It has not been formally adopted by Parliament, but it builds on the multi-annual projection attached to the Finance Law for 2005 which was adopted by the government and the Parliament.

The update broadly complies with the “code of conduct on the content and format of stability and convergence programmes”. It does not provide projections for total employment growth in the national accounts definition, which are compulsory. Instead, the programme provides information on employment in the private sector. It also does not provide some optional data which 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.

2. MACROECONOMIC DEVELOPMENTS

The external assumptions underlying the macroeconomic projections of the programme are more favourable than those used by the Commission services in their Autumn 2004 forecasting round. Notably, the programme assumes a slightly larger increase in world trade in 2005 (7.4% as against 7% for the Commission) and an exchange rate of the euro at 1.22 dollar (as against 1.24 for the Commission). More significantly, the update assumes oil prices at USD 36.7 in 2004 and USD 36.5 in 2005, as against USD 39.3 and USD 45.1 assumed by the Commission. According to the update, the external assumptions of the Commission would lower the growth projections of the programme by 0.2 percentage point in 2005 and 0.1 percentage point in 2006. These quantifications, which are based on standard elasticities, appear plausible.

The update estimates real GDP growth in France at 2.5% in 2004 (see Table 1 below). The same rate is projected for the years 2005-2008⁴. The recovery in economic activity is driven by the strength of domestic demand, especially consumption and investment expenditures. It is also supported by a strong rebound in exports, which is consistent with the assumptions made on the developments of the world economy⁵.

⁴ For the first time since 1998, the programme presents only one macroeconomic scenario. The original stability programme and all its updates were based on two scenarios: a so-called “cautious” scenario, projecting real GDP growth at 2.5% a year over the medium-term, and a so-called “favourable” scenario, where real GDP growth was expected to reach 3% per year. In the past, the Commission has always considered the cautious scenario as the reference scenario for the assessment of budgetary projections.

⁵ The general macroeconomic equilibria are respected, the decline in private sector saving finding its counterpart in the gradual improvement in the net borrowing of the general government sector. Although the programme does not provide explicit projections for developments in the net lending / borrowing of institutional sectors, it is possible to compute, using reasonable assumptions, sectoral balances consistent with the developments projected for the other variables.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007	2008
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.4	2.5	2.2	2.5	2.2	2.5	2.5	2.5
<i>Contributions:</i>								
- Domestic demand	2.6	3.1	2.1	2.6	2.3	2.4	2.4	2.4
- Change in inventories	0.7	0.5	0.3	0.1	0.0	0.1	0.1	0.1
- External balance on g&s	-1.0	-0.6	-0.2	0.0	-0.2	0.1	0.1	0.1
Employment (% change) ¹	-0.3	0.3	0.6	1.2	0.7	1.1	1.1	1.1
Unemployment rate (%)	9.6	n.a.	9.5	n.a.	9.3	n.a.	n.a.	n.a.
HICP inflation (%) ²	2.3	2.2	2.0	1.8	1.8	1.5	1.5	1.5
GDP deflator (% change)	1.9	1.9	1.7	1.7	1.7	1.5	1.5	1.5
Current account (% of GDP)	-0.2	n.a.	-0.5	n.a.	-0.3	n.a.	n.a.	n.a.
Sources: ¹ employment in the private sector for the figures of the 2004 update of the stability programme ² national consumer price for the figures of the 2004 update of the stability programme <i>Sources: Commission services autumn 2004 economic forecasts (COM); stability programme update (SP)</i>								

These projections are plausible, even though somewhat on the high side. For 2004, the estimate is slightly higher than that of the Commission services. Given the carryover for real GDP growth in 2004 at the end of the third quarter and the positive effect of working days in 2004, a large increase in real GDP in the fourth quarter of 2004 (by at least 1%) would be required to reach the growth assumption of the programme for 2004. For 2005 and 2006, the real GDP growth projections of the update also appear slightly optimistic compared to the Commission services' Autumn 2004 forecast. The difference between the two forecasts stems notably from the more favourable set of external assumptions underlying the projections of the programme. Commission services' calculations according to the commonly agreed methodology applied to the figures of the programme estimate potential growth over 2004-2008 at 2.4% per year on average, i.e. only slightly lower than the growth projections of the update. According to the same calculations, the output gap of the French economy would however remain slightly negative over the period. For the years 2004-2006, the potential growth and output gap estimates calculated on the basis of the figures of the programme are very close to those of the Commission services' Autumn forecast (see Table 2)⁶.

⁶ In the update, the French authorities argue, based on their own method, that the output gap reached about -2% of GDP in 2004. On the basis of the figures provided by the update, the Commission estimates the 2004 output gap at -½% of GDP. This leads to different interpretations on whether a close-to balance budgetary position is reached in cyclically-adjusted terms by the end of the projection period. While the French authorities argue that it is the case, the Commission considers that such a position is not reached within the programme period.

Table 2: Sources of potential output growth

	2004		2005		2006		2007	2008
	COM	SP ³	COM	SP ³	COM	SP ³	SP ³	SP ³
Potential GDP growth	2.1	2.2	2.3	2.4	2.4	2.5	2.5	2.5
<i>Contributions:</i>								
- Labour	0.6	0.7	0.7	0.8	0.8	0.8	0.7	0.7
- Capital accumulation	0.6	0.6	0.7	0.6	0.7	0.7	0.7	0.7
- TFP	0.8	0.9	0.9	1.0	0.9	1.0	1.1	1.1
Output gap ^{1,2}	-0.4	-0.5	-0.5	-0.4	-0.7	-0.4	-0.4	-0.4
Notes: ¹ based on the production function method for calculating potential output growth ² in percent of potential GDP ³ Commission services calculations on the basis of the information in the stability programme update <i>Sources: Commission services autumn 2004 economic forecasts (COM); Commission services calculations</i>								

3. BUDGETARY IMPLEMENTATION IN 2004

The update confirms the deficit target for 2004 (3.6% of GDP, down from 4.1% of GDP in 2003) contained in the 2003 update of the stability programme. This is despite the clear improvement in macroeconomic conditions that occurred in the meantime: real GDP growth in 2004 is now expected by the French authorities at 2.5%, as against 1.7% one year ago. The Commission, in its Autumn 2004 forecast, projected the 2004 deficit at 3.7% of GDP, under the assumption of real GDP increasing by 2.4% in 2004.

The lack of improvement in the 2004 deficit despite the additional revenues stemming from better growth is due to a number of factors. First of all, the 2003 deficit estimate was revised slightly upward (0.1% of GDP), causing an unfavourable base effect. Second, the government decided not to compensate for the loss of revenues (0.1% of GDP) triggered by the cancellation of a reform of the unemployment insurance system that foresaw a substantial tightening of eligibility conditions (the reform was considered illegal by the *Conseil d'Etat*). Finally, contrary to the State sector where the expenditure target was met, expenditures were more dynamic than planned in the health and the local authorities sectors.

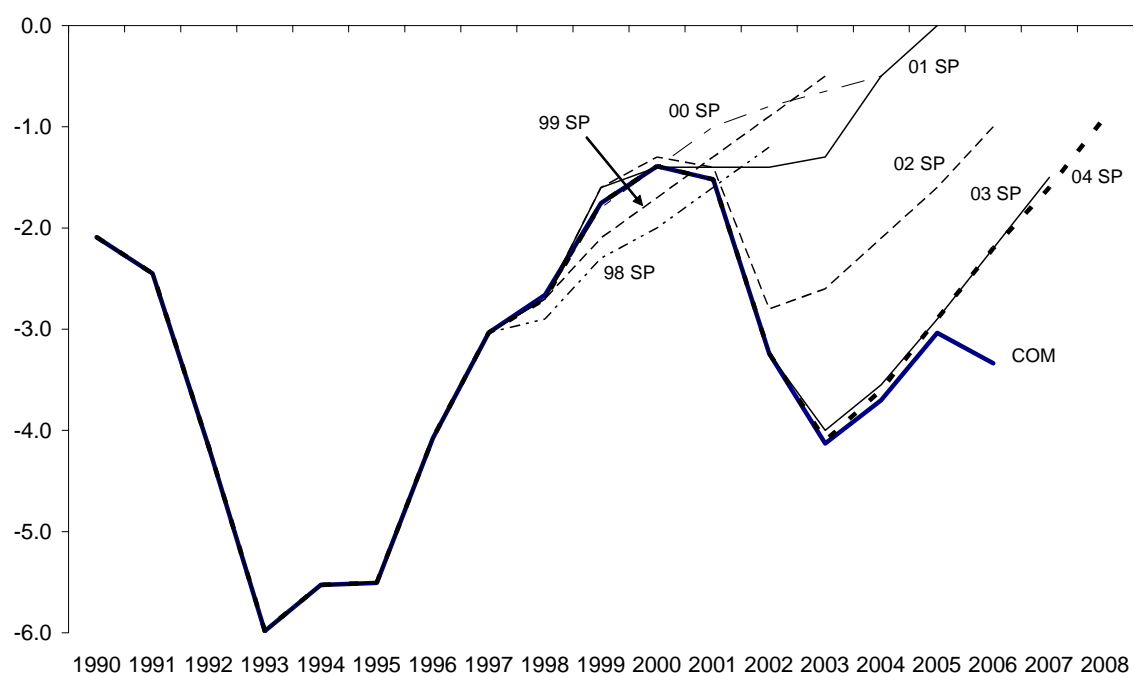
All in all, while the reduction in the deficit in 2004 is likely to have been roughly in line with the plans of the 2003 updated stability programme, the composition of the adjustment in 2004 will have been significantly different. The influence of cyclical factors was stronger than expected, and the improvement in the cyclically-adjusted balance (CAB) was less than half of the 0.8 percentage point initially committed by the French authorities and recommended to France in the 2004 update of the Broad Economic Policy Guidelines (BEPGs); according to the Commission services Autumn 2004 forecast the CAB improved by 0.3 percentage point of GDP in 2004. In addition, contrary to what was recommended in the BEPGs, France did not take measures to accelerate the reduction in the cyclically-adjusted deficit when it became clear that growth developments were more favourable than expected.

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

4.1. Evolution of budgetary targets in successive programmes

In the update, the deficit is projected to be reduced by 0.6-0.7 percentage point of GDP per year as from 2005 onwards. This allows a reduction in the deficit from an estimated 3.6% of GDP in 2004 to 0.9% of GDP in 2008. For the years 2004-2007, the projections of the 2004 update are very close to those of the 2003 update. However, between the 2002 and 2003 updates, general government balance objectives had been revised significantly downwards for all the years which overlap with the current update, as shown in Figure 1 and Table 3 below. This was due to a slippage in general government expenditures and to worse-than-projected macroeconomic developments in 2003.

Figure 1: Evolution of general government deficit targets in successive programmes



Sources:

Commission services Autumn 2004 economic forecasts; stability programmes (SP)

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007	2008
General government balance (% of GDP)	SP December 2004	-4.1	-3.6	-2.9	-2.2	-1.6	-0.9
	<i>SP December 2003</i>	-4.0	-3.55	-2.9	-2.2	-1.5	
	<i>SP December 2002</i>	-2.6	-2.1	-1.6	-1.0		
General government expenditure (% of GDP)	SP December 2004	54.7	54.0	53.6	53.0	52.4	51.7
	<i>SP December 2003</i>	54.3	53.9	53.0	52.4	51.8	
	<i>SP December 2002</i>	53.4	52.8	52.2	51.5		
General government revenues (% of GDP)	SP December 2004	50.6	50.4	50.7	50.8	50.8	50.7
	<i>SP December 2003</i>	50.3	50.4	50.2	50.3	50.3	
	<i>SP December 2002</i>	50.8	50.7	50.6	50.5		
Real GDP (% change)	SP December 2004	0.5	2.5	2.5	2.5	2.5	2.5
	<i>SP December 2003</i>	0.5	1.7	2.5	2.5	2.5	
	<i>SP December 2002</i>	2.5	2.5	2.5	2.5		
<i>Sources:</i>							
<i>Stability programmes (SP)</i>							

Box 1: The excessive deficit procedure for France

The Commission initiated the Excessive Deficit Procedure for France on 2 April 2003 and the Council decided on 3 June 2003 that an excessive deficit existed in France. At the same time, the Council recommended to France to bring the situation of an excessive deficit to an end in 2004 at the latest. In October 2003, the Commission considered that the measures taken by France had been insufficient to respect this recommendation and adopted a recommendation for the Council to give notice to France to take measures to correct the excessive deficit. In this latter recommendation, the Commission proposed to extend the deadline for the correction of the excessive deficit to 2005. On 25 November 2003 the Council did not adopt the recommended decisions but instead adopted conclusions stating that, in light of the commitments by France, the excessive deficit procedure was held in abeyance. The Commission brought the case before the Court of Justice and on 13 July 2004 these conclusions were annulled by the Court.

The Court did not elaborate on the implications stemming from the annulment of the Council conclusions of 25 November for the implementation of the excessive deficit procedure. In its Communication of 14 December 2004 addressed to the Council, the Commission concluded that 2005 should be considered the relevant deadline for the correction of the excessive deficit. The Commission also concluded that action taken by France appeared to be broadly consistent with a correction of the excessive deficit by 2005 and that no further steps were necessary at this point under the excessive deficit procedure. On 18 January 2005, the ECOFIN Council agreed with this conclusion and took note of the French authorities' commitment to take all necessary measures to bring the deficit below 3% of GDP in 2005 and to keep it below 3% in 2006. The Council also stated that it stood ready, in cooperation with the Commission, to take steps under the EDP, as appropriate.

4.2. Budgetary targets in the updated programme

The programme aims at reducing the deficit to below 3% of GDP in 2005 and at ensuring a continuous decline in the following years. The deficit is projected to be reduced from 3.6% of GDP in 2004 to 2.9% of GDP in 2005. This is in line with the requirements under the excessive deficit procedure as clarified by the Communication from the Commission to the Council on "the situation of Germany and France in relation to their obligation under the excessive deficit procedure following the judgement of the Court of Justice"⁷. In the subsequent years, the deficit is projected to decline steadily by 0.6-0.7 percentage point of GDP per year to 0.9% of GDP in 2008. The primary balance would improve from a deficit of 0.7% of GDP in 2004 to a surplus of 2.2% of GDP in 2008. Based on Commission services calculations according to the commonly agreed methodology, the cyclically-adjusted balance would also improve by 0.6-0.7 percentage point per year as from 2005, and reach -0.7% of GDP in 2008. A close to balance budgetary position would therefore be approached but not reached by the end-year of the programme. A budgetary position providing a sufficient safety margin to avoid breaching in the future the 3% of GDP reference value under normal cyclical conditions would be reached in 2007⁸.

The medium-term budgetary strategy is based on the setting of multi-annual targets for the increase in government expenditures in real terms that imply a reduction of the

⁷ Document COM(2004) 813 of 14 December 2004, available at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_com_2004_en.pdf

⁸ 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).

expenditure-to-GDP ratio. The ratio of revenues to GDP being projected to remain roughly stable, this triggers a parallel decline in the deficit. In this update, the expenditure-to-GDP ratio is projected to decline from 53.6% of GDP in 2005 to 51.7% of GDP in 2008. Expenditure restraint would be achieved notably through a tight control of State expenditure and a clear slowdown in social security expenditure compared to recent trends, which is expected to result from the effects of the reform of the health insurance system implemented in summer 2004⁹. The update assumes a stabilisation of both tax and non-tax revenues in percent of GDP (see Table 4).

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	2008	Change: 2008-2004
Revenues	50.6	50.4	50.7	50.8	50.8	50.7	0.3
<i>of which:</i>							
- Taxes & social security contributions	43.8	43.6	43.7	43.7	43.7	43.7	0.1
- Other (residual)	6.8	6.8	7.0	7.1	7.1	7.0	0.2
Expenditure	54.7	54.0	53.6	53.0	52.4	51.7	-2.3
<i>of which:</i>							
- Primary expenditure	51.7	51.0	50.6	50.0	49.4	48.7	-2.3
- Interest payments	3.0	3.0	3.0	3.0	3.1	3.1	0.0
Budget balance	-4.1	-3.6	-2.9	-2.2	-1.6	-0.9	2.7
Primary balance	-1.2	-0.7	0.1	0.8	1.5	2.2	2.7
<i>Sources:</i>							
<i>Stability programme update; Commission services calculations</i>							

While the deficit reduction envisaged for 2005 is modest given the exceptional revenues expected in that year (see Box 2), the efforts required for the budgetary adjustment projected in the update for the years after 2005 appear significant especially in 2006 when the vanishing of the 2005 one-off revenues will have to be compensated. Such an adjustment is warranted given the seriousness of the French budgetary situation. Nevertheless, there are concerns about the credibility of the budgetary projections after 2005, which are subject to risks and, on some crucial points, insufficiently documented.

Notably, the reduction of the deficit projected for 2006 seems out of reach under current policies. For that year, the programme foresees a decline in the deficit from 2.9% of GDP to 2.2% of GDP despite the fact that (i) tax cuts worth 0.2% of GDP have already been announced¹⁰ and (ii) one-off revenues amounting to 0.4% of GDP will vanish in that year. The programme argues that the impact of discretionary measures will be neutral on the tax burden over the projection period¹¹. This suggests that tax increases for an amount equivalent to the decided tax cuts are incorporated in the projections. However, these measures are not documented in the programme and recent declarations suggest that the government envisages the implementation of further tax cuts in the context of the

⁹ Nominal health expenditure are projected to increase by 3.6% per year over 2006-2008, which represents a clear slowdown compared to recent trends (health expenditure have increased on average by 6% over 2000-2004).

¹⁰ These measures consist notably in income tax cuts, cuts in the *taxe professionnelle* and social contributions, and tax exemptions on consumer credit and inter-generational financial transfers.

¹¹ The programme also argues that the tax-to-GDP elasticity (before discretionary measures) will be slightly higher than 1 in 2006. Given the composition of growth projected for 2005 and 2006, this does not seem justified. Indeed, private consumption, domestic demand and the wage bill are projected to increase roughly in line with GDP and the rates observed in 2005. In their Autumn forecast, Commission services projected a tax-to-GDP elasticity of 1 in 2006.

2006 budget¹². Another uncertainty is related to the projected developments in non-tax revenues. In the update, these revenues are forecasted to remain constant at a high level between 2005 and 2006 (and in the following years), despite the vanishing of the one-off revenues. How this will be achieved is also not documented in the programme. The Autumn 2004 Commission services' forecast projects the 2006 deficit at 3.3% of GDP. This means that, under current growth assumptions, measures leading to a deficit reduction by about one percentage point of GDP in 2006 would have to be taken in order to achieve the 2006 deficit target set in the programme.

Box 2: The 2005 Budget

Under the assumption of real GDP growth at 2.5%, the 2005 Budget foresees a decline in the general government deficit from 3.6% of GDP in 2004 to 2.9% of GDP in 2005. This is projected to result from expenditure restraint and a significant increase in revenues. Expenditure restraint is planned to stem notably from (i) the stabilisation of State expenditures in real terms for the third year in a row and (ii) a clear slowdown of health expenditure resulting from the first effects of the reform of the health insurance system adopted in summer 2004. The increase in the revenue-to-GDP ratio would reflect (i) the impact of discretionary measures on the fiscal side (0.1% of GDP) and (ii) a one-off payment linked to the transfer of the responsibility for the payment of pensions of the employees in public electricity and gas companies to the social security sector (0.4% of GDP). Since the presentation of the draft Budget in September, this one-off payment has been revised slightly upward (by 0.1% of GDP to 0.5% of GDP), but the amount assumed in the programme is still the original one (0.4% of GDP).

According to Commission services calculations based on the commonly agreed method, the projections of the programme for 2005 are consistent with an improvement in the CAB by 0.7% of GDP. The improvement in the underlying budgetary situation will in fact be more limited. This is due to the fact that the projected improvement of the CAB in 2005 relies partly on a one-off lump sum payment. As a consequence, the budgetary situation of France remains vulnerable. Given that the deficit is projected to be reduced only marginally below 3% of GDP by the French authorities and to exactly 3% of GDP by the Commission, any unfavourable development on the macroeconomic or budgetary side could be sufficient to bring the deficit above 3% and therefore compromise the achievement of the objective of correcting the excessive deficit in 2005.

In addition, the expenditure target set for the period 2006-2008, i.e. an increase by 1.2% in real terms, implies a significant slowdown compared to the recent trend and appears difficult to reach under current policies. The structural reforms recently implemented, notably the pension and health reforms and the reform of the organic framework of the Finance Laws of the State sector, constitute clear steps in the right direction. However, these reforms seem insufficient to achieve the expenditure target set in the programme. The pension reform will not have substantial budgetary effects over the period covered by the programme. In addition, the savings expected from the health reform are, for some part, uncertain. Finally, keeping state expenditure constant in real terms as envisaged in the programme seems difficult to sustain in the medium term without the implementation of structural reforms conducive to efficiency gains. Therefore more decisive cuts in the public wage bill will have to be implemented, taking advantage of the fact that the

¹² On 9 January 2005, the Minister of Finance of France, Mr Gaymard, stated that the government may resume income tax cuts in 2006 after a pause in 2005.

number of State employees leaving the workforce will increase over 2006-2008. There are also concerns about the credibility of the expenditure targets since all the objectives set in previous updates were missed by a large margin (see Box 3), contributing to a systematic postponement of the budgetary adjustment.

Table 5: Output gaps and cyclically-adjusted (primary) balances (CA(P)B)

	2003		2004		2005		2006		2007	2008	Change: 2008-2004
	COM	SP ¹	COM	SP ¹	COM	SP ¹	COM	SP ¹	SP ¹	SP ¹	SP ¹
Budget balance ²	-4.1	-4.1	-3.7	-3.6	-3.0	-2.9	-3.3	-2.2	-1.6	-0.9	+2.7
Output gap ^{1,3}	-0.7	-0.8	-0.4	-0.5	-0.5	-0.4	-0.7	-0.4	-0.4	-0.4	+0.1
CAB ^{1,2}	-3.8	-3.8	-3.5	-3.4	-2.8	-2.7	-3.1	-2.0	-1.4	-0.7	+2.6
CAPB ^{1,2}	-0.9	-0.8	-0.6	-0.3	0.2	0.3	-0.1	1.0	1.6	2.3	+2.6
<p>Notes:</p> <p>¹Commission services calculations on the basis of the information in the stability programme (SP)</p> <p>²in percent of GDP</p> <p>³in percent of potential GDP</p> <p>Sources:</p> <p>Commission services Autumn 2004 economic forecasts (COM); Commission services calculations</p>											

All in all, based on current information, measures taken by the French authorities should be sufficient to bring the deficit to 3% of GDP in 2005. However, the budgetary situation in France remains vulnerable. Correction of the excessive deficit requires effective implementation of all the measures envisaged and of additional measures in the event of adverse developments. For the years after 2005, the adjustment is significant, which is warranted given the seriousness of the budgetary situation of France. The budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% deficit threshold with normal macroeconomic fluctuations before 2007; nor is it sufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved within the programme period, although it is approached (see Table 5 above). Moreover, concerns exist about the credibility of the budgetary projections after 2005.

4.3. Sensitivity analysis

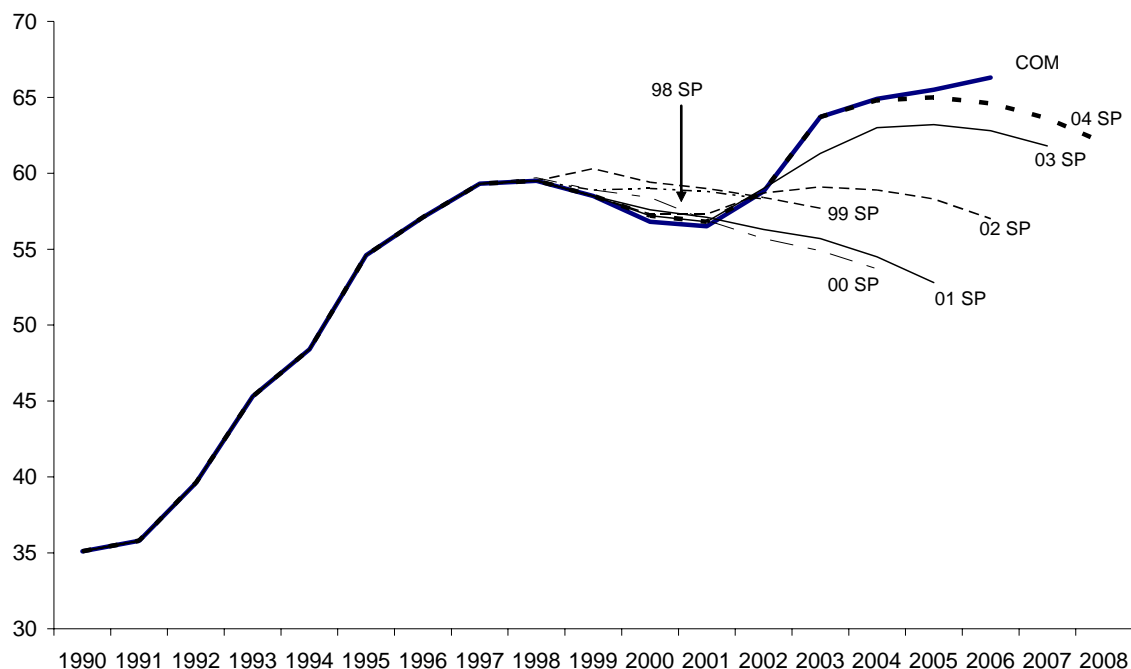
Commission services simulations of developments in the cyclically-adjusted balances under the assumptions of (i) a sustained 0.5 percentage point deviation from the growth targets in the programme over the 2004-2008 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2008, the cyclically-adjusted balance would be 0.9 percentage point of GDP below the central scenario. Hence, in the case of persistently lower growth, additional measures implying a decline in the deficit by around 0.9 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

5. EVOLUTION OF THE DEBT RATIO

The debt-to-GDP ratio has increased by about 30 percentage points of GDP since 1990, and by 8 percentage point between 2001 and 2004. In addition, the level of the debt-to-GDP ratio expected for 2004 is more than 10 percentage points of GDP higher than projected only three years ago in the 2001 update of the stability programme. The

deviation, mainly due to developments in the deficit, has been amplified by unforeseen stock-flow operations¹³ and the shortfall in nominal GDP growth.

Figure 2: Evolution of budgetary targets in successive programmes (debt-to-GDP ratio)



Sources:

Commission services Autumn 2004 economic forecasts (COM); stability programmes (SP)

According to the update, the debt ratio will remain above 60% of GDP throughout the period covered by the programme. A gradual reduction would start in 2006, triggered by nominal GDP growth and the shift to primary surpluses. The comparison between the Commission services' 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 (see Table 6 below).

¹³ In 2003, France switched the funds of the pension reserve fund (FRR, *Fonds de Réserve pour les Retraites*) from public assets to private assets and made a large capital injection in the company France Telecom. These two operations contributed to the increase in the gross debt-to-GDP ratio by 2 percentage points in 2003.

Table 6: Debt dynamics

	Average 2000-2003	2004		2005		2006		2007	2008
	COM	COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	58.9	64.9	64.8	65.5	65.0	66.3	64.6	63.6	62.0
Change in debt ratio (1 = 2+3+4)	1.4	1.2	1.1	0.6	0.2	0.8	-0.4	-1.0	-1.6
<i>Contributions:</i>									
- Primary balance (2)	-0.5	0.7	0.6	0.1	-0.1	0.4	-0.8	-1.4	-2.1
- “Snow-ball” effect (3)	1.1	0.3	0.3	0.5	0.3	0.4	0.5	0.5	0.6
- Interest expenditure	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.1	3.1
- Real GDP growth	-1.0	-1.5	-1.5	-1.3	-1.6	-1.4	-1.6	-1.6	-1.5
- Inflation (GDP deflator)	-0.9	-1.2	-1.2	-1.1	-1.1	-1.1	-0.9	-0.9	-0.9
- Stock-flow adjustment (4)	0.8	0.2	0.2	0.0	0.0	0.0	-0.1	-0.1	-0.1
- Cash/accruals	0.1								
- Accumulation of financial assets	0.6								
of which: Privatisation proceeds	-0.2	-0.4	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects & residual adj.	0.1								

Note:

The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D , PD , Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

Sources:

Stability programme update (SP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

The debt ratio has been exceeding the 60% of GDP reference value since 2003. A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the graph below. It compares the projections for the debt ratio in each year of the programme (starting from the projection for 2004) with the values obtained for the same year by applying an illustrative “rolling debt reduction rule”. This rule describes a minimum reduction in the debt ratio over the previous five/four/three-year period; for example, the projection for 2008 is compared with the values obtained for the same year by applying the formula over the periods 2003-2008, 2004-2008 and 2005-2008¹⁴. If the

¹⁴ The “rolling debt reduction rule” in the graph is shown for successive five-year periods through a recursive application of the formula:

$$\left(\frac{D_t}{Y_t} \right)_{rule} = 0.05 * \left[60 - \left(\frac{D_{t-1}}{Y_{t-1}} \right)_{rule} \right] + \left(\frac{D_{t-1}}{Y_{t-1}} \right)_{rule}$$

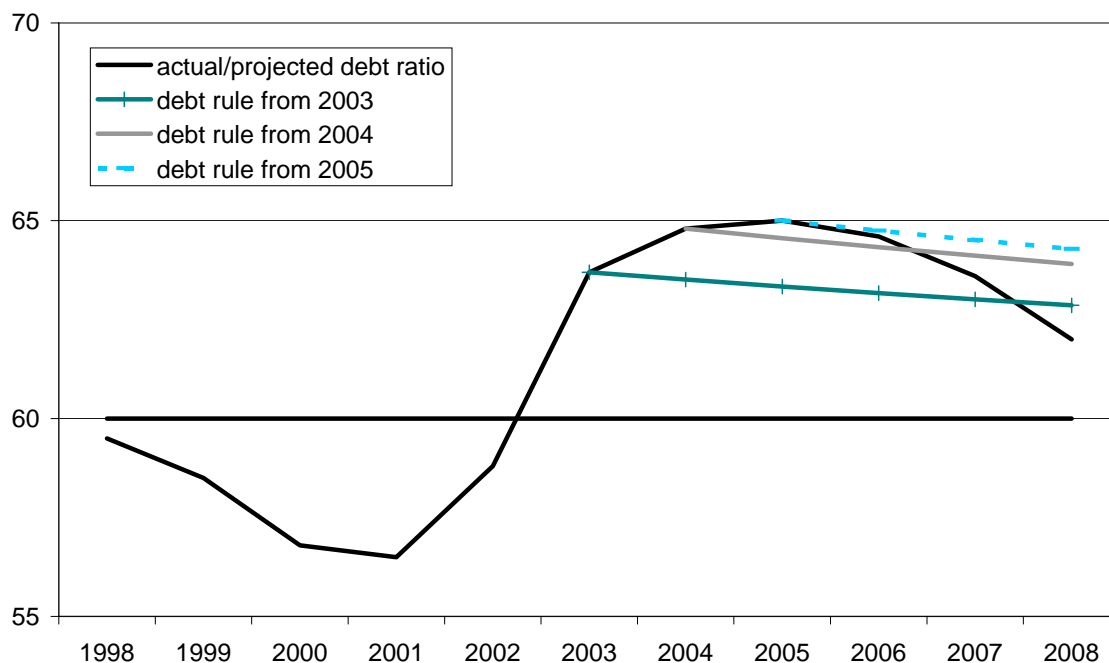
where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively (note that, in the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio). The change in the debt ratio can be decomposed as follows (assuming that the stock-flow adjustment is equal to zero):

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \left(\frac{y_t}{1 + y_t} \right) * \left(\frac{D_{t-1}}{Y_{t-1}} \right) \cong \frac{DEF_t}{Y_t} - y_t * \left(\frac{D_{t-1}}{Y_{t-1}} \right)$$

where DEF is the government deficit and y represents nominal GDP growth. Noting that $0.05 * 60 = 3$, the formula for the “rolling debt reduction rule” describes the path for convergence of the debt ratio towards the 60% of GDP debt reference value consistent with a deficit equal to the 3% of GDP reference value. Consistency is achieved for a nominal GDP growth rate of 5% of GDP. For nominal GDP growth rates higher than 5%, the minimum debt reduction rule can be respected with deficits in

debt levels projected in the programme exceed those obtained by applying the rule, this is taken as an indicator of a slow reduction in the debt ratio. This is consistent with the idea that the minimum debt reduction should not be ensured year after year but over a medium-term horizon. Figure 3 shows that the debt ratio is planned in the programme to diminish by more than implied by the rolling debt rule.

Figure 3: Rolling debt rule



Sources:

Commission services Autumn 2004 economic forecasts; 2004 SP update

6. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

As already mentioned, the budgetary adjustment is planned to be achieved through a decline in the ratio of government expenditures to GDP. Economic literature suggests that fiscal consolidations based on expenditure cuts, as compared to those based on revenue increases, are more likely to be permanent and to have medium-term expansionary effects. However, in order to have positive effects on growth in the medium term, a budgetary consolidation based on expenditure cuts must not be achieved at the expense of the most “productive” government expenditures. Although the information provided in the 2004 update of the stability programme is too scarce to make a thorough assessment, it seems that the projected adjustment is mostly based on a deceleration in current expenditures which is expected to result from a number of structural reforms.

In summer 2004, the French authorities adopted a reform of the health system, the aim of which is to bring the health insurance system to budgetary balance in 2007 (from a deficit of 0.8% of GDP in 2004), while preserving the quality of the health service. About one third of the effort is planned to be achieved through tax increases representing ¼ per cent of GDP, the remainder through expenditure savings. These savings are

excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the minimum debt reduction rule necessitates deficits lower than 3% of GDP.

supposed to stem notably from (i) the introduction of a charge of one euro payable by patients for every medical consultation starting in January 2005; (ii) measures aimed at tackling fraudulent sick leave and at facilitating the development of generic drugs; and (iii) better control of medical cost supposed to stem notably from financial incentives for patients to use general practitioners rather than going straight to specialists and from the introduction of a personal medical record. The reform also aims at improving the overall governance of the system and creates an independent alert committee in charge of formulating recommendations in case it identifies a risk of slippage compared to the official target. Although the reform is likely to trigger substantial savings, the precise budgetary impact of some measures is uncertain. Notably, the large savings expected from the control of medical cost seem at risk. Latest monthly data suggest that health expenditure has shown signs of deceleration since the adoption of the reform and before most of the measures enter into force. While this is a positive sign, the deceleration will have to be more pronounced and lasting to achieve the targets set in the update.

The health reform follows the major reform of the pension system adopted in 2003. The pension reform increased the number of contribution years entitling to a full pension¹⁵, raised significantly the financial incentives to remain active until and after the legal retirement age (which at 60 remains among the lowest in the OECD) and changed the reference for the indexation of pensions in the public sector from wages to prices. According to the French authorities, the reform will reduce the financial needs of the pension system in 2020¹⁶ by around 40%.

The programme also projects a stabilisation of State sector expenditures in real terms up to 2008. This objective is projected to be attained through a tight control of the wage bill and the modernisation of public purchasing procedures. The implementation of the new budgetary framework law (LOLF, *Loi Organique relative aux Lois de Finances*) should allow further progress in enhancing the quality and efficiency of public spending programmes. Recently, the government has also taken measures in order to improve the transparency of the management of public finances in the state sector. The government notably recommended that Parliament amend the LOLF to oblige the government to stipulate in advance, upon presentation of the budget bill, how it would use possible higher-than-projected tax revenue with respect to the projections of the budget bill. However, each government may still decide to allocate part of the cyclical revenues to permanent tax cuts or expenditures. This would lead to a pro-cyclical loosening of fiscal policy during good times.

As recommended in the country-specific BEPGs with budgetary implications, France implemented a number of structural reforms in order to control government expenditures in the medium to long run. Although probably insufficient to meet the expenditure targets set in the update and to secure the long-term sustainability of government finances (see below), these reforms are going in the right direction.

¹⁵ This will be done in two steps. Until 2008, the number of contribution years entitling to a full pension 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 employees proportionally with life expectancy; this is to be ensured through a rule that is set to keep constant the ratio between the number of contribution years and the number of years in pension.

¹⁶ The remainder is foreseen to be financed through two channels. In the private sector, social contributions will be increased. In the public sector, the remaining financial needs will be funded by an increase in government expenditures.

Box 3: Past experience of missed expenditure targets raises doubts about the credibility of the projected budgetary adjustment

Since 1998, the French medium-term budgetary strategy is based on the setting of expenditure targets. Beyond the traditional advantages of budgetary rules (helping forming expectations, enhancing the transparency of the budgetary framework), budgetary rules based on spending limits have specific positive aspects. Notably, they are commitments by the government on those parts of public finances that are under its direct control; they usually cause less measurement and surveillance problems, and they allow automatic stabilisers to work fully on the revenue side. Moreover, expenditure rules help tackling the deficit bias by highlighting possible spending overruns and thereby addressing the principal source of fiscal profligacy: the political and institutional temptation to raise expenditure in good times. Finally, if adequately set and enforced, expenditure rules make tax reductions more credible by making economic agents anticipate that they will be permanent. This is one of the channels triggering possible non-Keynesian effects which would reduce the cost of fiscal consolidation.

In France, multi-annual expenditure targets are set for the cumulated increase in real general government expenditure over a three-year period. Expenditures are deflated by the consumer price index (excluding tobacco). The targets do not distinguish between current and capital expenditure, and cyclically-sensitive items are not excluded from the aggregate. Every year, a new target is set for a three-year period. In the French budgetary strategy, real government expenditure are planned to increase more slowly than potential real GDP. The implied projected decline in the expenditure-to-GDP ratio triggers a reduction in the cyclically-adjusted deficit. So far, this strategy did not lead to the expected results: the objective of consolidating public finances through a structural decline in the expenditure-to-GDP ratio was not achieved. The multi-annual expenditure targets set in the original stability programme and its first two updates were missed by a large margin.

The cumulated increase in real expenditure over the period 2000-2002 reached 6.8%, as against 3.5% targeted in 1998 in the initial stability programme; over the period 2001-2003 real expenditure increased by 7.4%, as against 4.0% targeted in 1999 in the first update; over the period 2002-2004 the increase reached 7%, as against 4.5% targeted in 2000 in the second update. These slippages contributed to the non-respect of the deficit objectives set in the previous stability programmes. If the spending norm set in the 1998 (respectively 1999 and 2000) stability programme for the period 2000-2002 (respectively 2001-2003 and 2002-2004) had been respected, the 2002 (respectively 2003 and 2004) general government deficit would *ceteris paribus* have been 1.7 percentage point of GDP lower (respectively 1.8 and 1.3 percentage point of GDP) and France would have never been in excessive deficit. Even if the large slippage in expenditures occurred in the election year 2002 can be seen as somewhat exceptional, it can also be argued that the yearly expenditure increases were never consistent with the respect of the multi-annual targets. Expenditure targets were generally respected in the state sector, with the notable exception of 2002 and were largely missed in the social security and local authorities sectors.

The large and recurrent slippages compared to targets, which have weakened the credibility of the medium-term French budgetary strategy, were made possible by the fact that the multi-annual expenditure targets are relatively “weak”. There is no national independent authority for monitoring compliance with the expenditure targets and, if necessary, ensuring enforcement of the rule. In addition, the multi-annual expenditure targets can be overridden by a simple vote in Parliament, and the government is not obliged to justify possible departures from the multi-annual targets. Finally, no rule or mechanism ensuring compensation of overspending across years exists.

Why were the deficit targets set in the successive SP updates missed?

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
Change in the GG balance planned between 2001 and 2004 in the 2000 USP ⁽¹⁾	+0.5 pp of GDP
Change in the GG balance observed over the same period	-2.1 pp of GDP
Difference	2.6 pp of GDP
Of which impact of (in percentage point of GDP):	
Lower revenues due to the shortfall in real GDP growth ⁽²⁾	1.1
Overrun in real expenditures compared to plans ⁽³⁾	1.3
Of which higher expenditures due to the shortfall in real GDP growth	0.3
Others (in particular tax elasticities)	0.2
⁽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. The second update projected a decline in the deficit from 1.0% of GDP in 2001 to 0.5% of GDP in 2004. 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, 3.1% in 2002, and 4.1% of GDP in 2003. It is estimated by the French authorities to have reached 3.6% of GDP in 2006.	
⁽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 (respectively 2000 USP), it can be estimated that the growth differential over the three years explains a loss in tax revenues by 1.2 percentage point of GDP (respectively 1.1 percentage point of GDP).	
⁽³⁾ The original SP targeted an increase in real expenditures by 3.5% between 1999 and 2002 (the original figure in ESA 79 accounting system was 3.0%). The increase will in fact reach 6.8%. The 1999 USP targeted an increase in real expenditures by 4.0% between 2000 and 2003. The increase in fact reached 7.4%. The 2000 USP targeted an increase in real expenditures by 4.5% between 2001 and 2004. The increase in fact reached 7.0%.	
<i>Sources: Commission services autumn 2004 economic forecasts (COM); stability programme update (SP)</i>	

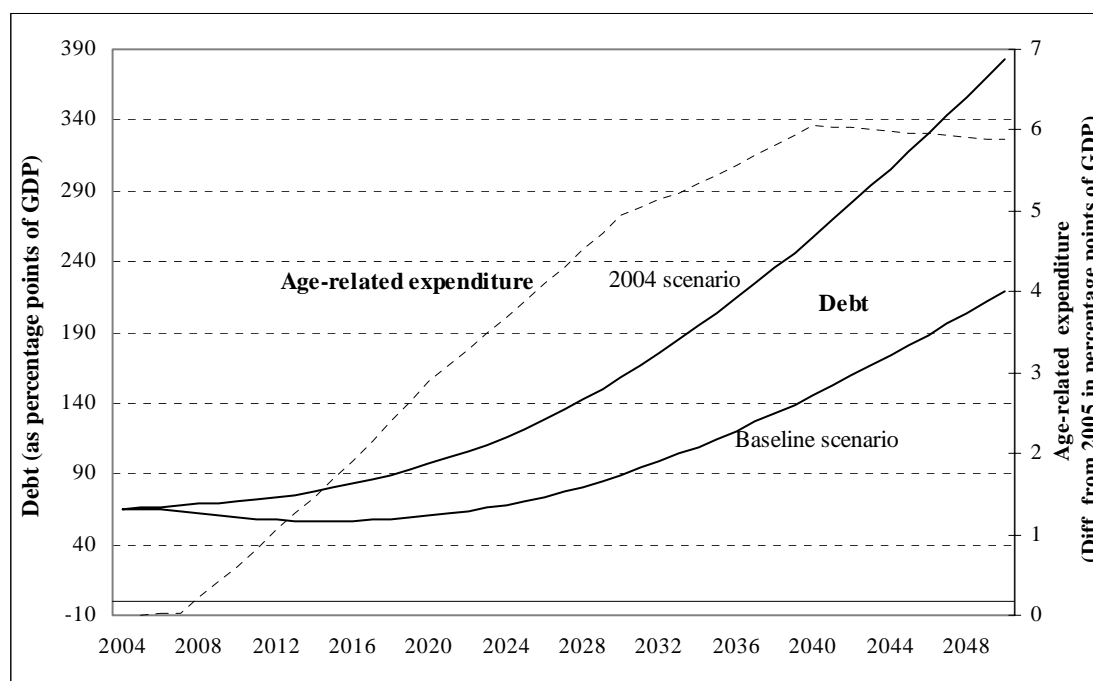
7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of French public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The “programme” scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the “2004” scenario assumes that the underlying primary balance remains at the 2004 level throughout the programme period.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme and additional information provided by the EPC, age-related expenditure is foreseen to increase by 5.5% of GDP between 2009 and

2050 (see Annex 2 for a breakdown of different age-related expenditures). Gross debt is projected to remain broadly stable over the coming 15 years. However, given the low underlying primary balances, the debt dynamics would become unfavourable once the cost of ageing kicks in and would lead to an explosive debt path. An even more accentuated explosive path would emerge if the budgetary consolidation plans in the medium-term do not materialise¹⁷.

Figure 4: Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	2.3	3.2	5.1
2004 scenario	4.6	5.5	5.3

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.

** It indicates the change 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 to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: -5.0%

*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP over the first five years of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

Sources:

2004 update of the programme; Commission services calculations

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change needed in the primary balance in order to have a debt-to-GDP ratio in line with the Maastricht Treaty reference value in the very long run

¹⁷ It should be recalled that, 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 likely outcomes and should not be taken at face value.

(year 2050)¹⁸. S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy France should increase its tax ratio permanently by slightly above 3 percentage points compared with the projected one at the end of the programme period, and by considerably more if it fails to consolidate in the medium term. This would lead to a sustainable debt ratio of -5% of GDP by the middle of the century¹⁹. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of 5.1% of GDP on average, compared with 2.6% of GDP targeted for the last year of the programme period (measured in underlying terms).

In interpreting these results, several factors must be taken into account.

The quantification of the effects of the pension reform in the long term appears plausible. However, these effects are subject to two minor uncertainties. First, after 2008 the increase in the contribution period entitling to a full pension foreseen by the reform will not be fully automatic since it will be conditional upon the agreement of an independent commission. Although unlikely, it cannot be excluded that this commission will counter the application of the rule. Second, there are some uncertainties regarding the reaction of workers to the new structures of financial incentives introduced by the reform. This is especially relevant because the workers will still have the possibility to retire early from the labour market, since the reform did not modify the legal retirement age, which at 60 years remains among the lowest in the OECD.

As already mentioned, the budgetary impact of the health reform is more uncertain than that of the pension reform. While an impact should be visible in the short run, notably through the effect of the tax increases and of some well-defined measures on the expenditure side, assuming that the changes introduced by the reform (new financial incentives and improvement in the governance of the system) will imply a permanent reduction in the pace of growth of health expenditure appears overly optimistic. Projections of the first scenario in the update were therefore used for the simulations presented in this assessment²⁰.

Overall, in France there are some risks with regard to long-term sustainability of the public finances, on grounds of the large projected budgetary cost of an ageing

¹⁸ The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible imbalances after the end of the projection period.

¹⁹ The debt ratio of around -5% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower budgetary strengthening is compatible with the 60% reference value in 2050.

²⁰ In the Commission's projections, updated estimates of health-care expenditures provided by the French Ministry of Finance until 2040 were used. These estimates were given in graphical form (see Figure 2 on p. 25 of the update). The first scenario according to Table 8 (p. 26) was used, in which health-care expenditures rise 1.5% faster than GDP per year from 2008 onwards. Health-care expenditures as a share of GDP would thus rise by 4.7 percentage points of GDP between 2008 and 2040. This is much higher than previous estimates, which showed an increase of 1 percentage point of GDP over the same period (the figures in the 2003 updated stability programme were the same as in the 2002 updated programme), however probably more realistic.

population. This is despite the budgetary effects of the reforms of the pension and health-care systems and the consolidation of public finances in the medium-term. In the absence of further reforms, additional consolidation would thus also be needed in the years ahead. The sustainability gap resulting from a failure of the consolidation path would be of more than 5% of GDP, even incorporating the impact of the pension and health care reforms. Given the projected increase in the old-age dependency ratio (measured as the number of persons over the age of 65 per 100 persons aged 20 to 64) fiscal consolidation, along with structural reforms, becomes a key factor in putting France on a more sustainable path.

Annex 1: Summary tables from the stability programme update

Table 1. Growth and associated factors

	2003	2004	2005	2006	2007	2008
GDP growth at constant market prices (7+8+9)		2.5	2.5	2.5	2.5	2.5
GDP level at current market prices		4.5	4.3	4.0	4.0	4.0
GDP deflator		1.9	1.7	1.5	1.5	1.5
ICP change*		2.2	1.8	1.5	1.5	1.5
Dependent Employment growth in market sector**		0.3	1.2	1.1	1.1	1.1
Labour productivity growth						
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure		2.4	2.4	2.5	2.5	2.5
2. Government consumption expenditure		2.4	2.0	1.2	1.2	1.2
3. Gross fixed capital formation		3.6	3.2	3.1	3.0	3.0
4. Changes in inventories and net acquisition of valuables as a % of GDP		0.5	0.1	0.1	0.1	0.1
5. Exports of goods and services		4.5	6.3	6.1	6.1	6.1
6. Imports of goods and services		7.1	6.7	6.1	6.1	6.1
Contribution to GDP Growth						
7. Final domestic demand (1+2+3)		3.1	2.6	2.4	2.4	2.4
8. Change in inventories and net acquisition of valuables (=4)		0.5	0.1	0.1	0.1	0.1
9. External balance of goods and services (5-6)		-0.6	0	0.1	0.1	0.1

* Instead of HICP

** Instead of total employment growth

Table 2. General government budgetary developments

% of GDP	2003	2004	2005	2006	2007	2008
Net lending by sub-sectors						
1. General government	-4.1	-3.6	-2.9	-2.2	-1.6	-0.9
2. Central government						
Central government agencies	0.4	0.4	0.7	0.3	0.3	0.3
3. State government	-4.0	-3.2	-3.0	-2.3	-2.0	-1.5
4. Local government	0.1	0.0	0.0	0.1	0.1	0.2
5. Social security funds	-0.7	-0.8	-0.6	-0.2	0.0	0.1
General government						
6. Total receipts		50.4	50.7	50.8	50.8	50.7
7. Total expenditures		54.0	53.6	53.0	52.4	51.7
8. Budget balance		-3.6	-2.9	-2.2	-1.6	-1.9
9. Net interest payments		3.0	3.0	3.0	3.1	3.1
10. Primary balance		-0.7	0.1	0.8	1.5	2.2
Components of revenues						
11. Taxes		43.6	43.7	43.7	43.7	43.7
12. Social contributions						
13. Interest income						
14. Other						
15. Total receipts		50.4	50.7	50.8	50.8	50.7
Components of expenditures						
16. Public consumption						
17. Social transfers in kind						
18. Social transfers other than in kind						
19. Interest payments						
20. Subsidies						
21. Gross fixed capital formation						
22. Other						
23. Total expenditures		54.0	53.6	53.0	52.4	51.7

Table 3. General government debt developments

% of GDP	2003	2004	2005	2006	2007	2008
Gross debt level		64.8	65.0	64.6	63.6	62.0
Change in gross debt		1.1	0.2	-0.4	-1.0	-1.6
Contributions to change in gross debt						
Primary balance						
Interest payments		3.0	3.0	3.0	3.1	3.1
Nominal GDP growth						
<i>Other factors influencing the debt ratio¹</i>						
<i>Of which: Privatisation receipts</i>						
<i>p.m. implicit interest rate on debt</i>		4.6	4.6	4.7	4.9	5.1

¹ Stock-flow adjustment

Table 4. Cyclical developments

% of GDP	2003	2004	2005	2006	2007	2008
1. GDP growth at constant prices		2.5	2.5	2.5	2.5	2.5
2. Actual balance		-3.6	-2.9	-2.2	-1.6	-0.9
3. Interest payments		3.0	3.0	3.0	3.1	3.1
4. Potential GDP growth	2.5	2.5	2.25	2.25	2.25	2.25
5. Output gap	-2.0					
6. Cyclical budgetary component						
7. Cyclically-adjusted balance (2-6)	-3.1	-2.6	-2.0	-1.5	-1.0	-0.5
8. Cyclically-adjusted primary balance (7-3)						

Table 5. Divergence from previous update

% of GDP	2003	2004	2005	2006	2007	2008
GDP growth						
SP November 2003		1.7	2.5	2.5	2.5	-
SP November 2004		2.5	2.5	2.5	2.5	2.5
Difference		0.8	0.0	0.0	0.0	-
Actual budget balance						
SP November 2003		-3.55	-2.9	-2.2	-1.5	-
SP November 2004		-3.6	-2.9	-2.2	-1.6	-0.9
Difference		0.0	0.0	0.0	-0.1	-
Gross debt levels						
SP November 2003		62.8	63.2	62.8	61.8	-
SP November 2004		64.8	65.0	64.6	63.6	62.0
Difference		2.0	1.8	1.8	1.8	-

Table 6. Long-term sustainability of public finances ¹

% of GDP	2004	2005	2010	2020	2030	2040	2050	2060	2070
Total expenditure	54.0	53.6							
Old age pensions									
Health care (including care for the elderly)									
Interest payments	3.0	3.0							
Total revenues	50.4	50.7							
<i>Of which:</i> from pensions contributions									
National pension fund assets ²									
Assumptions ³									
Labour productivity growth									
Real GDP growth	2.5	2.5							
Participation rate males (aged 20-64)									
Participation rates females (aged 20-64)									
Total participation rates (aged 20-64)									
Unemployment rate									
¹ Level for 2003, and per cent changes compared to 2003 thereafter ² Percentage of GDP ³ Percentage change									

Table 7. Basic assumptions*

	2003	2004	2005	2006	2007	2008
Short-term interest rate (annual average)						
Long-term interest rate (annual average)						
United States: short-term (three-month money market)						
United States: long term (10-year government bonds)						
€USD exchange rate (annual average)		1.22	1.22	1.22	1.22	1.22
Nominal effective exchange rate (EU)						
World GDP growth, excluding EU						
United States, GDP growth		4.1	2.9			
Japan, GDP growth		4.2	2.3			
EU-15 GDP growth						
Growth of relevant foreign markets						
World import volumes, excluding EU						
World import prices (goods, in USD)						
Oil prices (Brent, USD/barrel)		36.7	36.5	36.5	36.5	36.5
Non-oil commodity prices (in USD)						

International assumptions for 2005 have been carried forward over the 2006-2008 period

Annex 2: Long-term sustainability of public finances in France – quantitative scenarios

Main assumptions - baseline scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Total age-related spending	27.8	28.0	30.3	32.3	33.5	33.3	5.5
Pensions	12.9	13.0	14.2	14.9	14.5	14.5	1.6
Health care	8.1	8.2	9.5	10.9	12.6	12.6	4.6
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	-0.3
Others	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total primary non age-related spending**	21.0						
Total revenues**	51.1						

*EPC projections

** constant

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Baseline scenario							
Gross debt	60.4	59.0	60.4	89.5	145.8	219.3	158.9
i + 0.5*	60.7	59.6	64.3	98.4	164.0	253.0	192.3
2004 scenario							
Gross debt	69.4	70.3	96.8	158.4	257.7	383.3	313.9
i + 0.5*	69.8	71.0	101.9	171.7	286.6	438.5	368.7

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.

