COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.2.2005
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of France, 2004-2008

(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 coordination of economic policies[1] stipulates that participating Member States, that is, those which have adopted the single currency, had 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 assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their stability programmes, which may also be examined by the Council in accordance with these same procedures.

In view of a government deficit exceeding 3% of GDP in 2002, the Council decided that France was in excessive deficit on 3 June 2003 and recommended that the excessive deficit be corrected by 2004 at the latest. In its Communication 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" adopted on 14 December 2004[2], the Commission concluded that 2005 should be considered the relevant deadline for the correction of the excessive deficit. On the basis of the measures detailed in the 2005 budget and of the Commission services' Autumn 2004 forecasts, the Commission stated in the Communication that the action taken by the French authorities 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. It noted, however, that if failures in implementing the envisaged correction measures emerged at a later stage, it would have to recommend that the Council enhance budgetary surveillance and take the necessary action within the provisions of the Treaty and the Stability and Growth Pact.

The first stability programme of France, covering the period 1999-2002, was submitted on 18 January 1999 and assessed by the Council on 15 March 1999. Updates have been presented every subsequent year, the most recent one having been submitted on 7 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of their own Autumn 2004 economic forecasts, and having regard to the code of conduct[3], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies, endorsed by the Council[4]. This evaluation is as follows:

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1 OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 COM(2004) 813, 14.12.2004.

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

4 COM(2002) 668 final, 27.11.2002.

- 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". 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 GDP[5]. 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 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 polices, the Commission services' 2004 Autumn forecasts project an

5 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.

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.

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On the basis of 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 Art. 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of France, 2004-2008

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 coordination 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:

(1) On [17 February 2005] the Council examined the updated stability programme of France, which covers the period 2004 to 2008. The programme broadly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". However, it does not provide projections for total employment growth according to the national accounts definition, which are compulsory, and does not contain some optional variables. Accordingly, France is invited to achieve full compliance with the data requirements.

(2) The macro-economic scenario underlying the programme envisages real GDP growth at 2.5% from 2004 to 2008, a rate marginally above potential. On the basis of currently available information, this scenario seems to reflect plausible growth assumptions, although somewhat on the high side. The programme's projections for inflation also appear realistic.

(3) On 3 June 2003, the Council decided that an excessive deficit existed in France and recommended that this be corrected by 2004 at the latest. In its Communication 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"

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[6] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

adopted on 14 December 2004[7], the Commission concluded that 2005 should be considered the relevant deadline for the correction of the excessive deficit since the Council conclusions of November 2003 had produced legal effects until annulled by the Court. The primary aim of the budgetary strategy of the programme is to bring the deficit below 3% of GDP by 2005. The programme is also aimed at ensuring a continuous decline in the general government deficit in the subsequent years. The deficit is projected to decline steadily by 0.6-0.7 percentage point of GDP per year from 2005 to reach a level of 0.9% of GDP in 2008. Compared with the previous programme, the current update broadly confirms the planned adjustment against a slightly more favourable macroeconomic scenario. According to Commission calculations based on the projections of the programme and the commonly agreed methodology, the cyclically-adjusted balance would also improve by about 0.6-0.7 percentage point per year from 2005, and would reach -0.7% of GDP in 2008. As in previous updates, 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 expenditure-to-GDP ratio. The ratio of revenues to GDP being projected to remain roughly stable, this triggers a parallel decline in the deficit.

(4) 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. Moreover, since the projected decline of the deficit in 2005 stems notably from a one-off payment amounting to ½% of GDP, the underlying budgetary adjustment projected for 2005 is relatively modest. In the years after 2005, the budgetary outcome could be worse than projected in the programme. In particular, the deficit objective for 2006 appears at risk under current policies, given that tax cuts are announced for that year and that major one-off revenues will vanish. In addition, under current policies the expenditure target set for the period 2006-2008 appears difficult to achieve, even if the structural reforms implemented in recent years constitute clear steps in the right direction. There are concerns about the credibility of the expenditure targets since the objectives set in the previous updates were missed by a large margin.

(5) In view of this risk assessment, 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.

(6) The debt ratio is estimated to have reached 64.8% of GDP in 2004, above the 60%-of-GDP Treaty reference value. The programme projects the debt ratio to decline from 2006 onwards and to reach 62% of GDP in 2008. The evolution of the debt ratio is subject to the same risks as the deficit targets.

(7) With regard to the long-term sustainability of the public finances, France appears to be at some risk on grounds of large projected budgetary cost of an ageing population. This is despite the implementation of major structural reforms of the pension and

[7] COM(2004) 813, 14.12.2004.

health systems in 2003 and 2004 respectively. In the absence of further reforms, additional budgetary consolidation would be needed in the years ahead in order to ensure the sustainability of government finances.

(8) The economic policies as reflected in the 2004 update are partly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. France has implemented important structural reforms, notably concerning the health and pension 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, moreover, France did not take measures in order to accelerate the reduction in the cyclically-adjusted deficit when growth conditions became favourable. In addition, although significant, the medium-term adjustment planned in the 2004 update is subject to uncertainties, and will not lead to a close-to-balance budgetary position over the period covered by the programme.

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In view of the above assessment, the Council is of the opinion that France should:

(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 2004[1]**	**-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.