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**JANUARY 2006 UPDATE**  
**OF THE STABILITY PROGRAMME OF FRANCE**  
**(2005-2009)**  
**AN ASSESSMENT**

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## SUMMARY AND CONCLUSIONS<sup>1</sup>

The most recent update of the French stability programme was submitted to the Council and the Commission on 13 January 2006, i.e. 6 weeks after the deadline of 1 December as specified in the code of conduct. According to the French authorities, the late submission was due to their wish to incorporate some of the proposals for debt-reduction of the “Pébereau report”<sup>2</sup> in their intensified debt-reduction strategy. The update covers the period from 2005 to 2009 but also refers to 2010. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.<sup>3</sup>

On 3 June 2003, the Council decided that France was in excessive deficit and recommended, based on Article 104(7), that the excessive deficit be corrected by 2004. In its Communication to the Council of December 2004 on “the situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice”, the Commission concluded that 2005 should be considered as the relevant deadline for the correction. In January 2005, the Council concurred with this view. In its opinion of 17 February 2005 on the December 2004 update of the stability programme, covering the period 2004-2008, the Council invited France to do the necessary to ensure the correction of the excessive deficit in 2005 and the continued budgetary consolidation thereafter and to implement structural reforms and control expenditure in order to secure the respect of the multi-annual expenditure targets.

French GDP growth was over the last 10 years close to the euro-area average at 2.3%; since 1998 it was about half a percentage point higher, sustained by relatively buoyant domestic demand. Despite this relatively good performance, the employment rate increased only slightly and the unemployment rate remained persistently high. Following a record deficit level of 6% of GDP in 1993 the budgetary situation improved and the 3% of GDP Treaty reference value was respected from 1997 onwards. However, the reference value was breached again from 2002 onwards as the budgetary situation deteriorated, which was only partly due to the slowdown in growth. Since 2004, the deficit ratio is declining.

Real GDP growth is estimated in the update to have reached 1.5%-2.0% in 2005 and is forecast to pick up to 2.0-2.5% in 2006. Beyond 2006, the update presents two macroeconomic scenarios:

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<sup>1</sup> This technical analysis, which is based on information available up to 14 February 2006, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 22 February 2006. 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 Stéphanie Riso ([stephanie.riso@cec.eu.int](mailto:stephanie.riso@cec.eu.int)) and Hervé Piffeteau; ([herve.piffeteau@cec.eu.int](mailto:herve.piffeteau@cec.eu.int)). The analysis takes into account (i) the Commission services’ autumn 2005 forecast, (ii) the code of conduct (“Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

<sup>2</sup> Report from an independent high level committee appointed by the French government to analyse the public debt and to determine debt-reduction possibilities, published in mid-December 2005.

<sup>3</sup> The programme has gaps in the compulsory data and optional data prescribed by the new code of conduct are missing. Missing compulsory data mainly concern short and long-term interest rates assumptions. Missing optional data mainly concern the general government expenditure by function, data on long-term sustainability of public finances and labour market developments.

a “low scenario” in which real GDP growth reaches 2¼% per year over the period 2007-2009, and a “favourable scenario” where GDP growth is forecast at 3%. The “low scenario” is taken as the reference scenario in this assessment as it is the closest to the Commission services’ estimates of potential growth. Assessed against currently available information, the reference scenario seems to be based on plausible growth assumptions, although it may be somewhat favourable in 2006. The inflation forecasts embedded in the two scenarios, which are characterised by a lack of inflationary pressure, also appear realistic (though possibly on the low side).

As regards budgetary implementation in 2005, the general government deficit was estimated at 3.2% of GDP in the Commission services’ autumn 2005 forecast, against a target of 2.9% of GDP set in the previous update and 3% of GDP in this update. Despite somewhat less favourable macroeconomic conditions compared to the previous programme, the deficit in 2005 is likely to have been reduced to around 3% of GDP, notably thanks to a strong performance of non-fiscal receipts and taxes based on asset prices as well as additional one-off revenues in end-December linked to a change in the corporate tax legislation.

The update aims at bringing the public accounts back to balance and reducing the public debt-to-GDP ratio below the 60% reference value by 2010. It also confirms that the deficit should be brought back to the 3% reference value in 2005 and below it from 2006 onwards. A reduction by 2 percentage points of GDP in the general government deficit is foreseen over the period covered, bringing the deficit down from 3.0% of GDP in 2005 to 1.0% of GDP in 2009. A primary surplus would be restored from 2007 onwards. As in previous updates, the planned consolidation is expenditure-driven. The medium-term strategy is based on multi-annual targets for the increase in government expenditures in real terms that imply a reduction of the expenditure-to-GDP ratio. The revenue-to-GDP ratio is expected to slightly decline over the same period. While tax reductions are front-loaded to take place in 2006 and 2007, the reduction in the expenditure ratio is assumed to accelerate over time. Compared with the previous programme, the planned deficit reduction has been postponed in the new update against a slightly less favourable macroeconomic scenario. It should also be noted that the deficit reduction relies on substantial one-offs in 2005 and 2006 which amount to 0.6% of GDP in 2005 and about 0.2% of GDP in 2006 according to the Commission services’ most recent estimate.

Based on Commission calculations according to the agreed methodology, the planned improvement in the structural balance, i.e. in cyclically-adjusted terms and net of one-off and other temporary measures, would reach 0.6% of GDP per year on average over the period 2005-2009, bringing the deficit down from ¾% in 2005 to about ½% of GDP in 2009. The fiscal effort is back-loaded while cyclical conditions, as measured by the output gap, are slightly worsening. The French programme does not clearly identify a medium-term objective (MTO) for the budgetary position in structural terms. However, since one of the two announced medium-term targets in the programme is the return to balance of the public accounts by 2010, a balanced structural position has been considered as the French MTO in this assessment. As it is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme’s MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is more demanding than implied by the debt ratio and average potential output growth in the long term.

On balance, the risks to the budgetary projections in the programme appear to be negative. First, concerning 2006, there are risks stemming from the macroeconomic scenario and from the budget implementation so that revenues are likely to be lower<sup>4</sup> and expenditures in the areas of local administration and health higher. For the rest of the period, the ambitious targets set in the update are welcome. The enhancement of expenditure-growth rules at the different levels of the general government will improve the oversight of public finance and raise the accountability of all public stakeholders for spending control. However, the track record related to the achievement of overall budget balance objectives and the lack of enforcement mechanisms for expenditure rules raise some concerns. The new targets imply a drastic expenditure restraint compared to previous targets, which will require large structural reforms that are not always detailed in the update, especially concerning local authorities for which the planned reduction in expenditure is the largest compared to the previous update.

In view of this risk assessment and taking into account most recent information, a reduction of the deficit below 3% of GDP beyond 2005 would require additional measures in 2006 of over ¼ percentage point of GDP. In these circumstances, the 2006 Budget would still rely on significant one-off revenues (about ¼% of GDP) and therefore not ensure a permanent reduction below the threshold. The planned structural adjustment in 2006 is below 0.5% of GDP in structural terms, which is generally prescribed for countries in excessive deficit. The adjustment towards the ambitious MTO planned thereafter is in line with the 0.5% of GDP benchmark specified in the Pact for euro area and ERM II Member States, but does not ensure that an appropriate budgetary position in structural terms as defined by the Pact is achieved by the end of the programme period. Given the risks, a safety margin against breaching the 3% of GDP deficit threshold with normal cyclical fluctuations may not be provided until the very end of the programme period.

The debt-to-GDP ratio has exceeded the 60% of GDP Treaty reference since 2003. The update projects a quasi-stabilisation of the debt-to-GDP ratio at 66% of GDP in 2006 and a progressive decrease thereafter, to below 60% in 2010. The reduction in the debt would be mainly triggered by nominal GDP growth and the shift to primary surpluses from 2007 onwards. Stock-flow adjustments would mainly reflect the sales of non-strategic assets. Given the uncertainties associated to the budgetary targets and the realisation of the planned sales of non-strategic assets, the debt ratio may not be sufficiently diminishing towards the 60% of GDP reference value.

With regard to the sustainability of public finances, France appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. Recent reforms, notably the 2003 pension reform, have helped to contain the future rise in public expenditure and their full implementation will be crucial to ensure the expected results. The current level of government gross debt is above the Treaty value of 60% of GDP and the currently high structural deficit, if unchanged, will prevent the necessary reduction of debt in view of the future cost of ageing. Therefore, in the absence of additional reforms, strong budgetary consolidation is needed in order to reduce the risks to long-term sustainability.

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<sup>4</sup> The proceeds to be received by the State in connection with the liquidation of a precautionary fund associated with subsidized mortgages as well as exceptional dividends related to the privatisation of government-owned motorways companies appear in the 2006 Budget as deficit reducing. Although full information is not yet available, preliminary indications from Eurostat suggest that these transactions have a financial nature and should be recorded below the line without a direct impact on the deficit. If this is confirmed, both the French authorities' and the Commission services' (autumn 2005) forecast for the 2006 deficit will have to be revised upwards by about 0.1% of GDP.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, France plans to implement a number of structural reforms in order to secure the deceleration in government expenditures and improve the sustainability of government finances in the medium to long run. Furthermore, while the correction of the excessive deficit may require additional measures, thereafter sufficient progress is planned towards the MTO.

France's national reform programme (NRP), submitted on 7 November 2005 within the context of the renewed Lisbon strategy for growth and jobs, identifies three main priorities: (a) to create the necessary conditions for strong economic growth including sustainable public finances, (b) to reduce unemployment and increase employment and (c) to build a knowledge-based economy. Similarly, the improvement of potential output – notably thanks to the so-called emergency plan for employment and other labour market reforms – is one of the three pillars of the French budgetary strategy mentioned in the update. Overall, the measures in the area of public finances envisaged in the stability programme are broadly in line with the actions foreseen in the National Reform Programme. The stability programme complements these measures with changes in the institutional features of the public finances, namely a definition and enhancement of expenditure-growth rules to all levels of the sub-sectors of the general government and the set-up of a basis of a better coordination among stakeholders. However, not all budgetary implications of the actions outlined in the NRP are sufficiently reflected in the budgetary projections of the stability programme.

In view of the above assessment, the priority given to debt reduction in the French stability programme is welcome but there are risks linked to the achievement of the budgetary targets and to long-term sustainability of public finances. Also in the light of the Commission's communication of December 2004 endorsed by the Council in January 2005, it would be appropriate for France to:

- Ensure without delay the necessary structural adjustment to bring the general government deficit below 3% of GDP in 2006 in a credible and sustainable manner;
- Identify and implement the necessary measures to ensure the planned fiscal consolidation towards the medium-term objective and improve long-term sustainability; and
- Strengthen the monitoring and enforcement of expenditure rules defined for the sub-sectors of the general government so as to ensure the respect of the ambitious multi-annual expenditure ceilings.

## Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	<b>SP Jan 2006<sup>1</sup></b>	<b>2.3</b>	<b>1.5-</b> <b>2.0</b>	<b>2.0-</b> <b>2.5</b>	<b>2 ¼</b>	<b>2 ¼</b>	<b>2 ¼</b>
	COM Nov 2005	2.3	1.5	1.8	2.3	n.a.	n.a.
	<i>SP Dec 2004</i>	2.5	2.5	2.5	2.5	2.5	n.a.
HICP inflation (%)	<b>SP Jan 2006<sup>1</sup></b>	<b>2.3</b>	<b>1.9</b>	<b>1.8</b>	<b>1 ¾</b>	<b>1 ¾</b>	<b>1 ¾</b>
	COM Nov 2005	2.3	2.0	2.1	1.9	n.a.	n.a.
	<i>SP Dec 2004<sup>7</sup></i>	2.2	1.8	1.5	1.5	1.5	n.a.
Output gap (% of potential GDP)	<b>SP Jan 2006<sup>2</sup></b>	<b>-0.3</b>	<b>-0.5</b>	<b>-0.4</b>	<b>-0.6</b>	<b>-0.8</b>	<b>-0.9</b>
	COM Nov 2005 <sup>6</sup>	-0.2	-0.5	-0.9	-1.0	n.a.	n.a.
	<i>SP Dec 2004</i>	-0.5	-0.4	-0.4	-0.4	-0.4	n.a.
General government balance (% of GDP)	<b>SP Jan 2006</b>	<b>-3.7</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-1.9</b>	<b>-1.0</b>
	COM Nov 2005	-3.7	-3.2	-3.5	-3.5	n.a.	n.a.
	<i>SP Dec 2004</i>	-3.6	-2.9	-2.2	-1.6	-0.9	n.a.
Primary balance (% of GDP)	<b>SP Jan 2006</b>	<b>-0.8</b>	<b>-0.3</b>	<b>-0.3</b>	<b>0.0</b>	<b>0.6</b>	<b>1.6</b>
	COM Nov 2005	-0.8	-0.5	-0.7	-0.7	n.a.	n.a.
	<i>SP Dec 2004</i>	-0.7	0.1	0.8	1.5	2.2	n.a.
Cyclically-adjusted balance (% of GDP)	<b>SP Jan 2006<sup>2</sup></b>	<b>-3.5</b>	<b>-2.8</b>	<b>-2.7</b>	<b>-2.3</b>	<b>-1.5</b>	<b>-0.6</b>
	COM Nov 2005	-3.6	-3.0	-3.0	-3.1	n.a.	n.a.
	<i>SP Dec 2004<sup>3</sup></i>	-3.4	-2.7	-2.0	-1.4	-0.7	n.a.
Structural balance <sup>2</sup> (% of GDP)	<b>SP Jan 2006<sup>4</sup></b>	<b>-3.5</b>	<b>-3.3</b>	<b>-2.9</b>	<b>-2.3</b>	<b>-1.5</b>	<b>-0.6</b>
	COM Nov 2005 <sup>5</sup>	-3.6	-3.5	-3.3	-3.1	n.a.	n.a.
	<i>SP Dec 2004</i>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	<b>SP Jan 2006</b>	<b>65.1</b>	<b>65.8</b>	<b>66.0</b>	<b>65.6</b>	<b>64.6</b>	<b>62.8</b>
	COM Nov 2005	65.1	66.5	67.1	68.0	n.a.	n.a.
	<i>SP Dec 2004</i>	64.8	65.0	64.6	63.6	62.0	n.a.

**Notes:**

<sup>1</sup>For further calculations, the corresponding point estimate has been used

<sup>2</sup>Commission services calculations on the basis of the information in the programme

<sup>3</sup>Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

<sup>4</sup>One-off and other temporary measures as calculated by the Commission services (0.6% of GDP in 2005 (the apparent smaller difference between the structural and the cyclically-adjusted is due to rounding effect), 0.2% of GDP in 2006; all deficit-reducing)

<sup>5</sup>One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (0.5% of GDP in 2005 and 0.2% in 2006; all deficit-reducing)

<sup>6</sup>Based on estimated potential growth of 2.3% in 2004, 1.9% in 2005, 2.2% in 2006 and 2.4% for the period 2007-2009.

<sup>7</sup>CPI change instead of HICP.

**Source:**

*Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations*

## 1. INTRODUCTION

The most recent update of the French stability programme (henceforth “the update”) was submitted to the Commission on 13 January 2006<sup>5</sup>. According to the French authorities, the late delivery was due to their wish to include some proposals for debt-reduction of the “Pébereau report”<sup>6</sup> in their intensified debt-reduction strategy. The update covers the period from 2005 to 2009 but also refers to 2010. The programme was adopted by the government on 13 January 2005. It has not been formally adopted by parliament, but builds on the multi-annual projection attached to the Budget law for 2006, which was adopted by the government and the parliament in December 2005.

The update broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct. It has gaps in the compulsory data<sup>7</sup> prescribed by the new code of conduct, and some optional data<sup>8</sup> (especially data for long-term sustainability) are missing. The update does not explicitly define the medium-term objective (MTO) for the budgetary position, which can however be inferred from the programme (see also Section 3.2.3 below). Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

## 2. ECONOMIC OUTLOOK

Over the last decade, French GDP growth averaged about 2.3%, close to the euro-area performance. Since 1998, France posts a positive growth differential with the euro area of about half a percentage point, sustained by strong domestic demand. Despite relatively good economic growth, the French employment rate has remained lower than the European Union average, even though it slightly increased over the last ten years (from 59.1% in 1994 to 63.1% in 2004), and unemployment has remained stubbornly high (the ILO unemployment rate was 9.9% in 2005). Over the last ten years, inflation remained subdued averaging 1.8%, notably due to a persistent negative output gap. Movements in the overall price index have been largely dominated by energy and food prices.

The most recent update of the stability programme presents two macroeconomic scenarios for the years 2007-2009: a so-called “low scenario”, in which real GDP growth is foreseen to be at 2¼% per year, and a so-called “high scenario” in which real GDP would reach 3%. The “low scenario”

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<sup>5</sup> The English version was delivered on 23 January 2006.

<sup>6</sup> Report from an independent committee appointed by the French government to analyse the public debt and to determine debt-reduction possibilities, published in mid-December 2005 (see Box 2).

<sup>7</sup> Missing compulsory data are collective consumption in table 2 (General government budgetary prospects) and short and long-term interest rates for the years x+1, x+2, x+3 in table 8 (Basic assumptions).

<sup>8</sup> Missing optional data are employment (hours worked) and labour productivity (hours worked) in table 1c (Labour market developments), net lending/borrowing of the private sector and of the general government, statistical discrepancy in table 1d (Sectoral balance), selected components of revenue for the year x+3 and social transfers' decomposition for the whole period in table 2 (General government budgetary prospects), table 3 on general government expenditure by function is empty. Details of the stock-flow adjustment are missing such as the liquid financial assets and net financial debt - table 4 (General government debt developments) and in table 7, dedicated to long-term sustainability of public finance, all data are missing apart from age related and long-term care expenditures.



is considered to be the reference scenario in this assessment as it is the closest to the Commission services' autumn forecast scenario.

For 2005 and 2006, the update confirms the GDP growth ranges presented last autumn in the 2006 Budget law, namely 1.5-2.0% for 2005 and 2.0-2.5% for 2006. In the reference scenario, real GDP is expected to average 2¼% in 2007-2009 (see Table 1). Final domestic demand is the main driving force behind this economic recovery. From 2007 onwards, the contribution of net exports to GDP growth no longer acts as a drag on growth. The negative output gap, based on the Commission services' calculations on the basis of the information in the update according to the commonly agreed methodology, is expected to slightly widen towards the end of the update period, from ½% of GDP in 2005-07 to close to 1% in 2009. This slight widening is due to an increase in potential growth over the period, linked to an underlying improvement especially in the labour market and in total factor productivity (see Table 2).

The latest macroeconomic indicators suggest that GDP growth is likely to reach 1½% in 2005 which is line with the Commission services' autumn 2005 estimate (1.5%). Consequently, real GDP growth in 2005 is likely to remain at the lower end of the range foreseen by the French authorities. For 2006, the update is more optimistic than the Commission services' autumn forecast and remains on the high side. The stronger cyclical upswing in 2006 foreseen by the update relies on a stronger recovery in employment. In 2007, the growth outlook is similar to the Commission services' 2005 autumn forecast. For the period beyond 2007, the growth projections seem plausible given the Commission services' estimates of potential growth.

**Table 1: Comparison of macroeconomic developments and forecasts**

	2005		2006		2007		2008	2009
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.5	1.5-	1.8	2.0-	2.3	2 ¼	2 ¼	2 ¼
<i>Contributions:</i>		2.0		2.5				
- Final domestic demand	2.0	2.0	2.0	2.4	2.5	2.2	2.1	2.1
- Change in inventories	0.2	0.5	0.1	0.1	0.1	0.1	0.1	0.1
- External balance on g&s	-0.7	-0.8	-0.2	-0.2	-0.3	0.0	0.0	0.0
Output gap <sup>1</sup>	-0.5	-0.5	-0.9	-0.4	-1.0	-0.6	-0.8	-0.9
Employment (% change)	0.2	0.3	0.5	0.9	0.9	0.6	0.6	0.6
Unemployment rate (%)	9.6	n.a.	9.3	n.a.	8.9	n.a.	n.a.	n.a.
Labour productivity growth (%)	1.5	1.5	1.3	1.4	1.4	1.7	1.7	1.7
HICP inflation (%)	2.0	1.9	2.1	1.8	1.9	1 ¾	1 ¾	1 ¾
GDP deflator (% change)	1.4	1.3	1.7	1.4	1.9	1 ¾	1 ¾	1 ¾
Compensation of employees (% change)	3.0	2.9	3.2	3.3	4.0	3.5	3.5	3.5
External balance (% of GDP)	-0.8	-0.8	-1.0	-0.2	-1.1	0.0	0.0	0.0
<b>Note:</b>								
<sup>1</sup> In percent of potential GDP, with potential GDP growth as reported in Table 2 below.								
<b>Source:</b>								
Commission services' autumn 2005 economic forecasts (COM); stability programme update (SP)								

The composition of growth in the update is broadly similar to that in the Commission services' 2005 autumn forecasts, with macroeconomic growth in both cases driven by domestic demand. However, the update foresees a faster re-adjustment between the driving forces of economic growth than assumed by the Commission services. The contribution of net exports to GDP growth, which was largely negative over the last four years, would become neutral from 2007 onwards in the programme, while the Commission services' estimate that in 2007 it would still hamper economic growth by 0.3 percentage point.

The update's higher forecast for household consumption growth (which is the tax base for indirect taxes) in 2006 compared to the Commission services' forecast could be explained by a slightly lower projection for inflation, despite similar assumptions on oil price developments (see below). In 2007, on the other hand, the projections for household consumption growth are very close. As regards total compensation of employees, which is the tax base for the personal income tax and social contributions, for 2006 the projected annual average increase in the update and in the Commission services' autumn 2005 forecast is similar, while for 2007 the update's projection is marginally lower.

On the whole, and taking into account the most recent developments, the growth assumptions presented in the update can be considered plausible, although somewhat favourable for 2006 compared to the Commission services' autumn 2005 forecasts.

The external assumptions are in line with the Commission services' 2005 autumn forecast, with a gradual increase in world demand for French goods and services. As regards oil prices, the update assumes that they remain stable at USD 60/barrel until 2006 and thereafter at the same level in real terms, which is close to the Commission services' assumptions of a slight decrease from USD 61/barrel in 2006 to USD 60/barrel in 2007.

Both the update and the Commission services' projections assume a recovery in employment. However, the pace of this recovery is stronger in the update than in the Commission services' 2005 autumn forecast. In a context characterised both by uncertainties concerning the durability of the recovery and difficulties for companies to fully pass on the increase in commodity prices to consumers, employment growth may only be gradual, in line with what was observed over the last cyclical upswing. In 2006, even if the recent measures to encourage job creation were to bear fruit, companies may prefer to first increase their productivity levels and restore their financial situation before boosting their recruitment. In a context of a still high – although decreasing – unemployment rate wage moderation can be expected to continue in the coming years. However, due to slightly lower inflation projections, the update expects somewhat weaker wage developments than assumed by the Commission services. The update's inflation projections are plausible although somewhat low given the past increase in commodity prices, and the fact that second round effects cannot totally be ruled out. However, the persistent negative output gap should limit inflation pressures by the end of 2009.

Table 2 presents the potential growth estimate on the basis of the Commission services' calculations according the commonly agreed methodology, based on the information in the programme. These estimates are consistent with the Commission services' 2005 autumn forecast. Potential growth rates, which remain largely supported by investment, are also boosted in the short term by the increase in employment. Beyond 2007, potential growth remains on a slightly increasing trend driven by gradually higher contributions from labour and total factor productivity.

**Table 2: Sources of potential output growth**

	2005		2006		2007		2008	2009
	COM	SP <sup>2</sup>	COM	SP <sup>2</sup>	COM	SP <sup>2</sup>	SP <sup>2</sup>	SP <sup>2</sup>
Potential GDP growth <sup>1</sup>	1.9	1.9	2.2	2.2	2.4	2.4	2.4	2.4
<i>Contributions:</i>								
- Labour	-0.2	-0.2	0.1	0.1	0.3	0.2	0.2	0.1
- Capital accumulation	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
- TFP	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.4

Notes:  
<sup>1</sup>based on the production function method for calculating potential output growth  
<sup>2</sup>Commission services' calculations on the basis of the information in the programme

Source:  
*Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations*

### 3. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance<sup>9</sup> in the new update with those presented in previous stability programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

#### 3.1. Targets in successive programmes and implementation in 2005

The update foresees the general government deficit to decrease from 3.0% of GDP in 2005 to 1.0% of GDP in 2009, which represents an annual average improvement of 0.5 percentage point of GDP per year over the period 2006-2009. The decrease in the deficit between 2006 and 2009 is smaller by about 1% of GDP compared to that foreseen in the 2003 and 2004 updates<sup>10</sup> and somewhat more back-loaded. While the previous updates anticipated a return to a positive primary balance as from 2005, the most recent update postpones this shift to 2007.

Regarding the 2005 budgetary implementation, the 2004 update targeted a 2.9% of GDP general government deficit based on a 2.5% output growth assumption. In the current update, the estimated outcome for 2005 is a deficit at 3.0% of GDP with GDP growth assumed to be in a range of 1.5% - 2%. The Commission services' autumn 2005 forecast projected a deficit at 3.2% of GDP with 1.5% growth. Despite less favourable macroeconomic conditions than in the previous update, the deficit in 2005 is likely to have been reduced to around 3% of GDP due to better-than-expected non-fiscal revenues and taxes not directly linked to GDP but rather to asset prices. It should be underlined that most of the nominal adjustment (0.6% of GDP) comes from one-off payments to the general government linked to (a) the inclusion of the specific electricity and gas companies' pension schemes in the general regime for 0.5% of GDP as already foreseen in the 2004 update and (b) a change in the corporate tax legislation for 0.1% of GDP decided at the end of 2005.

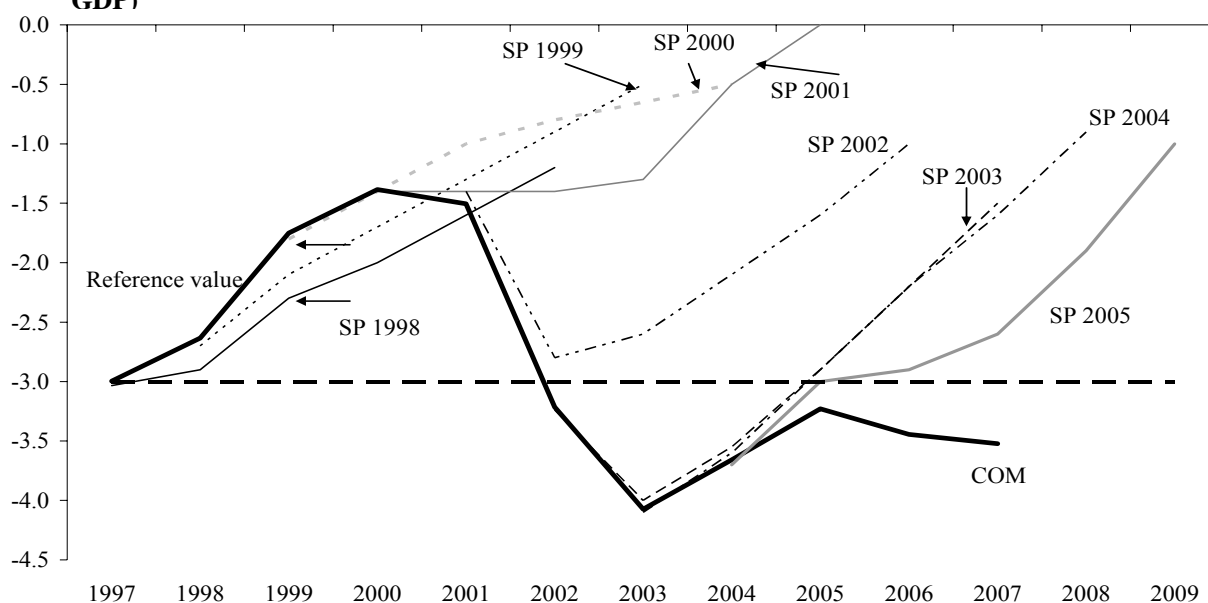
<sup>9</sup> The general government figures considered in this and the following sections are those of the reference scenario unless specified differently (as in section 3.4).

<sup>10</sup> The projections of the 2003 and 2004 updates were very close.

**Table 3: Evolution of budgetary targets in successive programmes**

		2004	2005	2006	2007	2008	2009
General government balance (% of GDP)	<b>SP Jan 2006</b>	<b>-3.7</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-1.9</b>	<b>-1.0</b>
	SP Dec 2004	-3.6	-2.9	-2.2	-1.6	-0.9	n.a.
	SP Dec 2003	-3.6	-2.9	-2.2	-1.5	n.a.	n.a.
	COM Nov 2005	-3.7	-3.2	-3.5	-3.5	n.a.	n.a.
General government expenditure (% of GDP)	<b>SP Jan 2006</b>	<b>53.8</b>	<b>53.8</b>	<b>53.6</b>	<b>53.0</b>	<b>52.1</b>	<b>51.1</b>
	SP Dec 2004	54.0	53.6	53.0	52.4	51.7	n.a.
	SP Dec 2003	53.9	53.0	52.4	51.8	n.a.	n.a.
	COM Nov 2005	53.8	53.9	53.9	53.5	n.a.	n.a.
General government revenues (% of GDP)	<b>SP Jan 2006</b>	<b>50.1</b>	<b>50.8</b>	<b>50.7</b>	<b>50.3</b>	<b>50.2</b>	<b>50.1</b>
	SP Dec 2004	50.4	50.7	50.8	50.8	50.7	n.a.
	SP Dec 2003	50.4	50.2	50.3	50.3	n.a.	n.a.
	COM Nov 2005	50.1	50.6	50.5	50.0	n.a.	n.a.
Real GDP (% change)	<b>SP Jan 2006</b>	<b>2.3</b>	<b>1.5-2.0</b>	<b>2.0-2.5</b>	<b>2 ¼</b>	<b>2 ¼</b>	<b>2 ¼</b>
	SP Dec 2004	2.5	2.5	2.5	2.5	2.5	n.a.
	SP Dec 2003	1.7	2.5	2.5	2.5	n.a.	n.a.
	COM Nov 2005	2.3	1.5	1.8	2.3	n.a.	n.a.

*Source:*  
Stability programmes (SP) and Commission services' autumn 2005 economic forecasts (COM)

**Figure 1: General government balance projections in successive stability programmes (% of GDP)**

*Source:* Commission services' autumn 2005 forecast (COM) and successive stability

On the revenue side, the 2005 State sector budgetary execution reveals a better-than-expected outcome compared to the initial 2005 Budget Bill. Fiscal receipts over-performed compared to expectations by about EUR 0.5 bn (0.03% of GDP) despite a weaker-than-expected economic environment. Better fiscal receipts resulted in particular from personal income tax and taxes based on asset prices (notably capital and housing markets). Other fiscal receipts under-performed compared to anticipations, notably corporate tax, VAT and taxes on petroleum products. Corporate tax receipts were lower than anticipated by about EUR 1.7 bn (0.1% of GDP), despite exceptional revenues (about EUR 1 bn according to a Ministry of finance's

declaration<sup>11</sup>) due to a last-minute change in the legislation in December 2005. However, the relative over-performance on the revenue side largely stemmed from non-fiscal revenues that outperformed anticipations by EUR 2.8 bn (0.2% of GDP). Some of these non-fiscal revenues are not of a permanent nature, such as the extra-dividend of EUR 0.7 bn withdrawn from the electricity company, and thus are not expected to have a positive base effect for next years' revenues.

On the expenditure side, the State sector again respected its zero-volume expenditure-growth rule and health-care related expenditures should also have been in line with the national target, which foresaw an annual growth of about 4% in 2005, for the first time in years. Moreover, expenditures of local authorities might be lower than estimated at the time of the Commission services' 2005 autumn forecast by about EUR 0.8 bn (about 0.05% of GDP).

Most recent information indicates that the 2005 deficit outcome would tend to be around the 3% of GDP targeted in the most recent update of the stability programme. This compares to 3.2% of GDP projected in the autumn forecast, and reflects a lower state sector deficit and somewhat lower expenditure growth in local administrations.

#### **Box 1: The excessive deficit procedure for France**

On 3 June 2003 the Council decided that France was in excessive deficit. On the same date, the Council recommended that France 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 decided not to endorse the Commission's recommendations but instead adopted conclusions stating that, in light of the commitments by France, the excessive deficit procedure (EDP) 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.

Although the Council recommendations under Article 104(7) specified that the excessive deficit needed to be corrected by 2004 at the latest, the Commission Communication of 14 December 2004\* concluded that, in view of the unique circumstances created by the Council conclusions of 25 November 2003 and of a ruling of the European Court of Justice of 13 July 2004, the relevant deadline for the correction should be 2005. At the time, based on a growth forecast of 2.2%, the Commission considered that France was on track to correct its excessive deficit by 2005 and thus that no further steps under the EDP were necessary, although its budgetary situation remained vulnerable. At the same time, the Communication stated that "should failures in implementing the envisaged correction emerge at a later stage, the Commission would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action within the provisions of the Treaty and the Stability and Growth Pact". In its conclusions of 18 January 2005, the Council concurred with the Commission's conclusions and confirmed that, in cooperation with the Commission, it stood "ready to take steps under the EDP, as appropriate".

The Council Opinion of 17 February 2005 on the 2004 update of the stability programme of France confirmed the assessment of the December Commission communication. Specifically, the Council opinion stated that, on the basis of then available information, a budgetary outturn of 3% in 2005 should be possible, on condition that the envisaged measures are fully implemented and that additional measures are

<sup>11</sup> 2005 State budgetary execution presentation by Mr. Copé, Government spokesman, on 24 January 2006.

taken in case of adverse developments. On the other hand, the Council opinion pointed out that as regards 2006, the outturn could be worse than targeted. The Council opinion recommended that France do the necessary to ensure the correction of the excessive deficit in 2005 and make sure that budgetary consolidation continues thereafter so as to reach a close-to-balance position by 2008.

\* “*The situation of Germany and France in relation to their obligation under the excessive deficit procedure following the judgement of the Court of Justice*”, document COM(2004)-813, available at the following website: [http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/edp/com\\_com\\_2004\\_en.pdf](http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_com_2004_en.pdf).

### **3.2. The programme’s medium-term budgetary strategy**

This section covers the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme’s medium-term objective and the adjustment path towards it in structural terms.

#### *3.2.1. The main goal of the programme’s budgetary strategy*

The most recent update of the stability programme defines its overarching objectives as achieving “a credible reduction of public debt, in line with the medium-term objectives set by the Government” with “the public accounts ... expected to return to balance” and public debt falling below 60% by the end of the decade”. The strategy, which integrates some recommendation from the “Pébureau report” on the French public debt developments (see Box 2), is based on three pillars: increased efforts to rationalise public spending, increased efforts to boost potential growth, and acceleration of sales of non-strategic assets.

The programme confirms that the deficit would respect the 3.0% of GDP Treaty reference value in 2005 and aims at reducing it slightly below 3.0% in 2006 (at 2.9% of GDP). It foresees an overall reduction in the general government deficit by 2 full percentage points of GDP, from 3.0% of GDP in 2005 to 1% of GDP in 2009, with a balanced budget being envisaged for 2010. A primary surplus would be restored from 2007 onwards (see table 4). The reduction in the deficit is back-loaded as it would amount to 0.1 and 0.3 percentage point of GDP in 2006 and 2007, and increase to 0.7 and 0.9 percentage points in 2008 and 2009, respectively.

Compared with the previous update, starting from a slightly weaker position in 2005 (deficit higher by 0.1% of GDP), the new update postpones the planned adjustment against a slightly less favourable macroeconomic scenario over the 2006-2009 period: for every year after 2005, the deficit is expected to be substantially higher compared to the previous update (by 0.7 to 1 percentage point of GDP). The projected improvement in 2006 compared to 2005 would be 0.6 percentage point of GDP less than in the previous update; the improvement in 2007 has been halved to 0.3 percentage point of GDP, while that of 2008 is unchanged at 0.7 percentage point of GDP. The explanation for the postponement of the adjustment given in the update refers to the lagged effects of a weaker-than-expected economic environment in 2005.

**Table 4: Composition of the budgetary adjustment**

(% of GDP)	2004	2005	2006	2007	2008	2009	Change: 2009-2005
<b>Revenues</b>	<b>49.8</b>	<b>50.8</b>	<b>50.7</b>	<b>50.3</b>	<b>50.2</b>	<b>50.1</b>	<b>-0.7</b>
<i>of which:</i>	<b>4</b>						
- Taxes & social contributions		45.4	45.7	45.3	n.a.	n.a.	n.a.
- Other (residual)	44.5	5.4	5.0	5.0	n.a.	n.a.	n.a.
	5.3						
<b>Expenditure</b>	<b>53.5</b>	<b>53.8</b>	<b>53.6</b>	<b>53.0</b>	<b>52.1</b>	<b>51.1</b>	<b>-2.7</b>
<i>of which:</i>							
- Primary expenditure		51.1	51.0	50.4	49.6	48.5	-2.6
<i>of which:</i>	50.7						
Total transfers		23.7	23.6	23.2	22.9	22.7	-1.0
Subsidies	23.5	1.5	1.5	1.4	1.4	1.4	-0.1
Gross fixed capital formation	1.5	3.2	3.2	3.2	3.1	3.0	-0.2
Other (residual)	3.2	22.7	22.7	22.6	22.2	21.4	-1.3
- Interest expenditure	22.5	2.7	2.6	2.6	2.5	2.6	-0.1
	2.7						
<b>General government balance (GGB)</b>	<b>-3.7</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-1.9</b>	<b>-1.0</b>	<b>2.0</b>
<b>Primary balance</b>	<b>-0.8</b>	<b>-0.3</b>	<b>-0.3</b>	<b>0.0</b>	<b>0.6</b>	<b>1.6</b>	<b>1.9</b>
One-off and other temporary measures	0.0	0.6	0.2	0.0	0.0	0.0	-0.6
<b>GGB excl. one-off &amp; other temporary measures</b>	<b>-3.7</b>	<b>-3.6</b>	<b>-3.1</b>	<b>-2.6</b>	<b>-1.9</b>	<b>-1.0</b>	<b>2.6</b>
<i>Source:</i>							
<i>Stability programme update; Commission services' calculations</i>							

**Box 2: The “Pébureau Report”**

The Pébureau Commission, an independent committee appointed by the French Minister of Finance, T. Breton, in July 2005 to analyse the public debt and to determine debt-reduction possibilities, published its report in mid-December 2005 and received large attention from the media and political scene stakeholders.

Presentation of the report

The report (130 pages) presents an overarching objective: “put French public finances in order within 5 years”. Achieving this objective rests on 3 main principles: (a) all levels of the general government should participate in the effort, (b) no new tax exemptions should be granted before stable public finances are restored and any room for manoeuvre should be entirely allocated to debt reduction, and (c) there is an urgent need for – and large gains to be expected from – reforms in the administration itself and a stock-taking exercise on rationality and efficiency of all existing expenditures. To achieve these results, the report presents 20 recommendations (summarised below).

The report clearly describes the situation of the French public finances and insists on important points such as the fact that indebtedness is not inevitable, that restoring a balanced budget is not impossible and that it will not automatically lead to austerity, that the viability of the French model is at stake, etc. It stresses the importance of addressing the fiscal issue as soon as possible, as the current situation is not sustainable but without overly dramatizing the situation.

The first (descriptive) part makes it clear that the increase in the French debt only reflects a lack of concern about the level of indebtedness and a deficit-bias of the French administrative system. Therefore, it is not the result of bad times or any other specific circumstances nor does it reflect a particular effort in terms of public investment.

The second part of the report underlines that raising taxes to address the issue is not an option in France, given the already high level of taxation. Thus efforts should be concentrated on the expenditure side. The report proposes concrete actions, which are very similar to some recommendations made by the

Commission (e.g. automatic rules of compensation in case of intra-annual slippage). Notably, the report calls for increased efforts in expenditure control by actors other than the State sector and in particular by the local authorities and social security organisms and it advocates the implementation of automatic corrective rules in case of slippages.

Such a report is very welcome as it demonstrates increased awareness of the importance of urgently tackling the deficit and debt issues in the spirit of the Stability and Growth Pact.

#### Summary of the recommendations

##### \* Recommendations on rules and principles for each actor

- For the State sector (which accounts for about 80% of the general government debt), the report recommends to go further than the present zero-volume-growth rule for expenditures and implement a zero-value-growth rule. According to the report, applying this rule would restore a balanced budget at the State level within 5 years. Any gain stemming from expenditure restraint should be allocated to debt reduction. On the revenue side, all possible exceptional receipts (notably stemming from partial and/or complete privatisation) should be considered, and the resulting revenues should always be allocated to debt reduction. ***This recommendation has been implemented in the present update.***

- Concerning local administration, the report recommends that the transfers from the State sector should also respect a zero value-growth rule. ***This recommendation has been implemented in the present update.*** The report also proposes to progressively increase the financial autonomy of the local administrations. Although the definition of a budgetary rule would be optimal, the report recognises that legal and institutional obstacles exclude this option in the short-term.

- Concerning the pension system, relying on the 2003 reform which changed the parameters of the pay-as-you-go system, the report stresses that the planned 2008 revision of the parameters (see also Section 6 below) must ensure financial neutrality of the system until 2020. The report stresses that this goal should also apply to the specific pension schemes and not only to the general regime. Concerning the health-care sector, the report highlights the necessity to respect the 2006 health-care budget Bill target of restoring a balanced budget by 2009. To this end, the report recommends to set up a mechanism that would impose restoring a balanced budget in case of slippages in one year. This would rely on reductions in expenditure targets, increases in taxes and improvements in efficiency. To smooth this process, the report proposes to create a precautionary fund that would accumulate funds in good times which would be mobilized in bad times. Concerning the unemployment benefit system, it is proposed to decide on an annual balanced budget objective, the achievement of which should be eased by a more active participation of the existing smoothing fund.

##### \* Recommendations on rationalising expenditures

- The report recommends implementing a 3-year stock-taking exercise in order to identify non-strategic expenditure that could be suppressed in order to focus on the most important areas (in line with the Lisbon agenda). Existing functions should be questioned. Parliament should be active in this exercise and focus more on budgetary execution and results rather than on budgetary plans as laid down in the Budget laws.

- No new expenditure should be announced without clearly identifying and announcing the suppression of an equivalent existing expenditure.

##### \* Recommendations on reforming the administration

- The report is highly critical about the efficiency of the French administration. It notably calls for a simplification of the administrative structure in order to suppress redundant entities, a reduction of civil servant posts, and an increase in civil servants' mobility. ***This issue is being tackled by the French authorities, notably through the implementation of audits of the different Ministries.***

### 3.2.2. *The composition of the budgetary adjustment in the programme*

As in previous updates, the medium-term strategy is based on multi-annual targets for the increase in government expenditures in real terms (0.6% annual growth over the period 2007-



2009 after 1.6% in 2006) that imply a reduction of the expenditure-to-GDP ratio. The planned consolidation would be expenditure-driven, with the expenditure-to-GDP ratio decreasing by 2.7 percentage points of GDP from 53.8% of GDP in 2005 to 51.1% of GDP in 2009. The revenue-to-GDP ratio would also decline over the same period although to a lesser extent (from 50.8% of GDP in 2005 to 50.1% of GDP). However, while the tax cuts underlying the reduction in the revenue ratio are front-loaded, taking place in 2006 and 2007<sup>12</sup>, the reduction in the expenditure ratio is assumed to become larger over time.

The planned reduction in the expenditure-to-GDP ratio would mainly stem from new and enhanced definitions of expenditure-growth rules for the different sub-sectors of the general government. In past years, only two sub-sectors of the general government had explicit rules, namely the State sector and the social security funds. One of the innovations of the update is that it defines expenditure-rules for all sub-sectors. At the *State sector* level, the rule is to be progressively enhanced from the current “zero real spending growth” rule to a “zero nominal spending growth” rule starting from 2007 onwards<sup>13</sup>. This tighter control of State expenditure should be attained thanks to a more effective public management related to the full impact of the Constitutional Bylaw on the Budget Act (LOLF: Loi organique relative aux lois de finances, see section 5) and to potential savings identified by the audits conducted as part of the State modernisation process. The programme envisages that the new rule will help speed up the reduction of the State deficit from 3.0% of GDP estimated in 2005 to 1.4% of GDP in 2009 (instead of 1.9% of GDP as expected under a zero-volume growth rule).

Concerning the *social security funds*, the previous norm defined a national health insurance spending target (ONDAM: Objectif National des Dépenses d’Assurance Maladie) which was consistently exceeded by a large margin in the recent past but seems to have been achieved in 2005. The new rule aims at limiting the average real increase in the overall social security sector expenditure to about 1% per year in real terms from 2007 to 2009. In terms of health-care expenditures, the increase would be limited to 2.2% per year in nominal terms on average over the period. This would represent a clear slowdown compared to recent trends (health-care expenditure increased by 6% on average over the period 2000-2004). The slowdown is expected to result from the effects of the reform of the health insurance system implemented in the summer of 2004 and new measures taken in the context of the 2006 Budget Bill for social security funds (see Box 3). The expenditure restraint in this sector should also be facilitated by the expected improvement on the unemployment front. The programme expects the social security funds to return to balance over the projection period from a deficit of 1.0% of GDP in 2004.

At the *local authorities’* level, for which no rule in terms of expenditure-growth previously existed, the update announces that the local authorities, which are “aware of the need to take part in the debt-reduction effort”, will curb their expenditures and let them only increase by 0.5% per year in real terms, approaching the “zero real spending growth rule” by 2009<sup>14</sup>. No specific measures to reach this target are spelled out, but the programme anticipates that intermediate

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<sup>12</sup> The 2006 Budget Bill announcing tax cuts both for 2006 and 2007 is in clear contradiction with the “Pébereau” recommendations not to grant new tax exemptions before sound public finances are restored and to allocate any room for manoeuvre to debt reduction.

<sup>13</sup> After 2007, State sector expenditure should be retrenched in real terms, by 1.25% in 2008, 1.5% in 2009 and, so that 0% nominal growth applies from 2010.

<sup>14</sup> Local authorities’ expenditure should grow in volume by 1% in 2007, 0.5% in 2008 and 0% in 2009.

consumption and the wage bill of local authorities will become relatively stable with the expected deceleration in the increase in staff.

On the revenue side, the overall 0.7% of GDP decline in the revenue-to-GDP ratio is largely explained by the reduction in the tax burden by 0.6 percentage point of GDP between 2006 and 2009 as a result of tax cuts in the first years of the programme period (amounting to 0.1% of GDP in 2006 and 0.4% of GDP in 2007). In 2007, in particular, on the basis of the 2006 Budget Bill two fiscal reforms with revenue-decreasing effects will take place (see Box 3 for details): (a) a change in the tax brackets of the income tax system characterised by a move of the higher marginal rate back towards the European average (for a total cost estimated at EUR 3.6 bn or 0.2% of GDP), and (b) a reform of the local business tax (“taxe professionnelle”) (0.1% of GDP).

It should be noted that in 2006, as in 2005, the reduction in the general government deficit relies on substantial one-offs and other temporary measures. The update does not provide any information on one-off measures beyond 2005, which is not in line with the new code of conduct. According to Commission services’ estimate, one-off payments amount to about 0.2% of GDP in 2006 (following one-offs of 0.6% of GDP in 2005). The 2006 one-off measures are mainly linked to the integration of the postal company’s specific pension scheme (see Box 3).

### **Box 3: The budget for 2006 and the 2007 tax system reform**

The draft Budget Bill for 2006 was presented on 28 September 2005 and adopted by the Parliament on 30 December 2005. Under the assumption of real GDP growth between 2 and 2.5%, the 2006 Budget Bill foresees a decline in the general government deficit from 3.0% of GDP in 2005 to 2.9% of GDP in 2006. This is projected to be mainly a result of expenditure restraint.

Expenditure restraint is planned to stem notably from (i) the stabilisation of State expenditures in real terms for the fourth year in a row and (ii) a clear slowdown of health expenditure resulting from the full effect of the 2004 health-care system reform and additional measures incorporated in the 2006 Budget Bill for the social security sector, notably the “pharmaceutical plan”, the “hospital plan” as well as continued efforts to control the cost of medical treatment.

The decrease in the revenue-to-GDP ratio reflects the impact of discretionary measures on the fiscal side (about -0.1% of GDP). Revenue projections also include one-off revenues of about ¼% of GDP linked to the integration in the general regime of the specific pension scheme of the postal company as well as the exceptional collection of accumulated social contributions on specific subsidised saving plans that will thereafter be collected on an annual basis. Concerning 2006 revenues, it should be noted that while two transactions, namely, the liquidation of a precautionary fund (“fonds de garantie de l’accession sociale”, FGAS) associated with subsidised mortgages and exceptional dividends obtained from the sales of motorways public companies had been recorded both in the Budget Bill and in the Commission services’ 2005 deficit forecast as deficit reducing (and in the case of the Commission services as one-off revenue for the FGAS as well), first indications from Eurostat indicate that this is not the case. If confirmed, this statistical treatment would negatively impact the 2006 budget outcome by about 0.1 percentage point of GDP in both the official and the Commission services’ forecasts.. The payment of a EUR 0.5 bn fine to be paid by mobile phone companies could also improve the deficit perspective for 2006.

It should be noted that the 2006 Budget includes measures to be implemented in 2007. The most important ones are (i) an income tax reform aiming at lowering the higher marginal rate of the income brackets in the system and at limiting the total amount paid on account of different direct taxes (income tax, solidarity tax on wealth - “impôt de solidarité sur la fortune” as well as local taxes) by each taxpayer to a maximum of 60% of their income (“bouclier fiscal”), (ii) an increase in the employment premium and in the income tax allowance for young children, and (iii) a reform of the local business tax (“taxe professionnelle”) which

caps it at 3.5% of value added while maintaining the exemption on new investments. All in all, these measures will account for a reduction in revenues by about ¼% of GDP in 2007.

### 3.2.3. *The programme's medium-term objective (MTO) and the adjustment path in structural terms*

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments, as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The French programme does not clearly identify an MTO in the sense of the Stability and Growth Pact as outlined above. However, as discussed in section 3.2.1, since one of the two announced medium-term targets in the programme is the return to balance of the public accounts by 2010, a structural balance of 0% of GDP can be regarded as the programme's MTO. It should be noted that the update envisages that the MTO will be reached in 2010, beyond the programme horizon.

The structural balance shown in Table 5<sup>15</sup> has been calculated using the common agreed methodology on the basis of the programme information and corrected for the most recent Commission services' estimates of publicly-known one-off measures.<sup>16</sup>

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<sup>15</sup> It should be noted that there are some differences between the output gap recalculations reported in table 5 and the output gaps published in the update. Commission services' calculations on the basis of the programme according to the commonly agreed methodology lead to a negative output gap of ½% of GDP in 2005 compared to 1% of GDP in the programme. Moreover, the commonly agreed methodology leads to a slight widening of the output gap over the programme period, from -0.5% of GDP to -0.9 % of GDP, contrary to the programme's projections of a closing output gap at the end of the programme horizon. This divergence stems from different calculations of potential growth: the commonly agreed method estimates potential growth at 2.4% per year over the period 2007-2009, close to Commission services' autumn forecast estimates, but slightly above the programme estimate (2.1% per year on average).

<sup>16</sup> The 2005 figure includes on top of the payments resulting from the inclusion of the specific electricity and gas companies' pension schemes in the general regime (EUR 8.4 bn – 0.5% of GDP) that were known at end of 2004, exceptional revenues of EUR 1bn (0.1% of GDP - as announced by the French authorities at the time of the presentation of the 2005 State budgetary execution) linked to the change in the corporate tax legislation. Total one-offs for 2005 represent 0.6% of GDP (due to rounding, the difference between the structural and the cyclically-adjusted balance in table 5 amounts to 0.5% of GDP). For 2006, the structural balance incorporates the most recent estimates of one-off measures by the Commission services taking into account first indications of Eurostat statistical treatments of some measures included in the 2006 Budget bill (see Bow 3). These one-offs refer to the one-off payments linked to the integration in the general regime of the specific pension schemes of the postal companies as well as the exceptional collection of accumulated social contributions on specific

The planned improvement in the structural balance would average 0.6 percentage point of GDP per year over the period 2005-2009. The fiscal effort can be regarded as back-loaded as efforts are stronger towards the end of the programme despite a slight widening of the output gap over the period.

**Table 5: Output gaps, cyclically-adjusted and structural balances**

	2004		2005		2006		2007		2008	2009	Change: 2009-2005
	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	COM	SP <sup>1</sup>	SP <sup>1</sup>	SP <sup>1</sup>	SP <sup>1</sup>
Gen. gov't balance	-3.7	-3.7	-3.2	-3.0	-3.5	-2.9	-3.5	-2.6	-1.9	-1.0	2.0
One-offs <sup>2</sup>	0.0	0.0	-0.5	-0.6	-0.2	-0.2	0.0	0.0	0.0	0.0	-
Output gap <sup>3</sup>	-0.2	-0.3	-0.5	-0.5	-0.9	-0.4	-1.0	-0.6	-0.8	-0.9	-
CAB <sup>4</sup>	-3.6	-3.5	-3.0	-2.8	-3.0	-2.7	-3.1	-2.3	-1.5	-0.6	2.2
<i>change in CAB</i>	<i>0.4</i>	<i>0.4</i>	<i>0.6</i>	<i>0.7</i>	<i>0.0</i>	<i>0.1</i>	<i>0.0</i>	<i>0.4</i>	<i>0.8</i>	<i>1.0</i>	-
CAPB <sup>4</sup>	-0.8	-0.7	-0.3	-0.1	-0.3	-0.1	-0.3	0.3	1.0	2.0	2.1
Structural balance <sup>5</sup>	-3.6	-3.5	-3.5	-3.3	-3.3	-2.9	-3.1	-2.3	-1.5	-0.6	2.8
<i>change in struct. bal.</i>	<i>0.4</i>	<i>0.4</i>	<i>0.1</i>	<i>0.2</i>	<i>0.2</i>	<i>0.4</i>	<i>0.2</i>	<i>0.6</i>	<i>0.8</i>	<i>1.0</i>	-
Struct. prim. bal. <sup>6</sup>	-0.8	-0.7	-0.8	-0.6	-0.5	-0.3	-0.3	0.3	1.0	2.0	2.7

**Notes:**  
<sup>1</sup>Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme  
<sup>2</sup>One-off and other temporary measures  
<sup>3</sup>In percent of potential GDP  
<sup>4</sup>CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.  
<sup>5</sup>CAB excluding one-off and other temporary measures  
<sup>6</sup>Structural primary balance = CAPB excluding one-off and other temporary measures

**Source:**  
*Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations*

### 3.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

#### 3.3.1. Appropriateness of the programme's medium-term objective

As the authorities' MTO implied by the update is more demanding than the minimum benchmark (estimated at a deficit of around -1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit.

As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is more demanding than what is implied by the debt ratio and average potential output growth in the long term.

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subsidised saving plans that will thereafter be collected on an annual basis. One-offs would amount to about 0.2% of GDP.

### 3.3.2. Risks attached to the budgetary targets

The budgetary targets contained in the update are subject to a number of risks.

Concerning 2006, the risks to the budgetary projection are on the negative side. First, regarding the macroeconomic scenario, the update remains on the optimistic side. In particular, the stronger cyclical upswing in 2006 foreseen by the update relies on a stronger employment recovery than anticipated by the Commission services. Second, there are risks linked to the budget implementation. The 2006 budget plans are those established at the time of the 2006 Budget Bill. The update does not modify them. In particular, the multi-annual strategy defined in the 2006 Budget Bill and that in the update of the stability programme only differ from 2007 onwards when some suggestions from the “Pébureau report” have been incorporated. Thus the Commission services’ assessment of the Budget Bill measures made at the time of the 2005 autumn forecast remains broadly valid. In view of this assessment and taking into account most recent budgetary developments and also first indications from Eurostat (see Box 3 and footnote 16), a preliminary estimate by the Commission services would suggest a higher deficit than officially targeted on account of lower non-fiscal revenues and a somewhat lower revenues-to-GDP elasticity and still higher expenditures in the areas of local administration (although somewhat lower than estimated at the time of the 2005 forecast) and healthcare expenditures.<sup>17</sup> Taking into account the most recent information, including a better general government outcome in 2005 than anticipated at the time of the autumn 2005 forecast, preliminary estimates would tend to show that additional structural efforts of over ¼ percentage point of GDP would still be necessary to ensure that the 2006 deficit is reduced below the 3% of GDP threshold. Even in these circumstances, the 2006 Budget would still rely on significant one-off revenues (about 0.2% of GDP).

For the subsequent years, the reference macroeconomic scenario appears broadly plausible and the enhancement of expenditure-growth rules at all levels of the general government will improve the oversight of public finance and raise the accountability of all public stakeholders for spending control. This global mobilisation might create some “peer pressure” and thus help the different actors to respect their multi-annual expenditures ceilings, in the spirit of an “internal stability and growth pact”. However, the track record related to the achievement of overall budget balance objectives<sup>18</sup> and the lack of enforcement mechanisms for expenditure rules raise some concerns. The new targets imply a drastic expenditure restraint<sup>19</sup> compared to previous targets, which will

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<sup>17</sup> While the Commission services’ central projection for growth in healthcare outlays has been noticeably curbed following the health reform to 3.2%, it is still somewhat higher than envisaged by the government (at 2.7%) due to a more prudent assessment of some of the measures announced in the 2006 Budget Bill for social security funds.

<sup>18</sup> 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.

<sup>19</sup> The consolidation path relies on an important restraint of public expenditures, which are expected in the update to increase by only 0.6% per year on average over 2007-2009, i.e. half of the previous update’s target (1.2% over the 2006-2008 period). This compares to an actual increase in expenditures at 2½% on average per year over the last 5 years in real terms. At the sub-sector level, this implies that compared to the previous update, expenditure growth for the local authorities sector will be reduced to about one third of the previous target (0.9% against 1.7%), for the social security sector expenditure will be halved (0.9% against 1.7%), for the other central government bodies the target will be a fourth of the previous one (0.3% against 1.1%), while it will be lowered by -1.25% for the State sector (against 0%).

require large structural reforms that are not always detailed in the update notably in terms of quantitative estimates but also concerning the timing of their implementation and sometimes even their nature. The measures concerning the State sector are relatively explicit (a more effective public management stemming from the full impact of the Constitutional Bylaw on Budget Act (LOLF), potential savings linked to redeployment efforts, efforts to contain the wage bill excluding pensions<sup>20</sup>). Measures backing the social security sector's target are those presented in the 2006 social security Budget Bill, for which, as discussed above, the Commission services has a more cautious assessment. There is no measure announced to back the local authorities' target, the sector for which the reduction in expenditure is the largest compared to previous update's target.

Table 6 presents the annual changes in the overall tax-to-GDP ratio and the elasticity relative to GDP. As can be seen, the assumptions about the tax intensity of economic activity on which the update is based are roughly in line with those in the Commission services' autumn 2005 forecasts. In 2006, the slight difference in the anticipated change in the tax-to-GDP ratio stems from a higher elasticity component in the update compared to that in the Commission services' forecast (for taxes on production and imports and social contributions as shown in annex 4). For 2007, the small difference is linked to a slightly higher assumption for growth in compensation of employees in the Commission services' forecast. All in all, the assumed tax elasticities in the update do not constitute a major risk for the budgetary projections.

Overall, the risks to the budgetary projections in the programme appear to be on the negative side, and thus, the budgetary outcome could be worse than projected in the programme.

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<sup>20</sup> The programme foresees that the leeway created by the growing number of retirements will be used to adjust recruitment to the changes in structure and missions needed to make the public service more efficient. While this is in line with past Commission suggestions, one may question the credibility of this politically sensitive measure, as it has been implemented with little success in past years. The 2006 Budget Bill is illustrative in this respect as only about 5 000 civil servants full-time equivalents (against 7300 last year) will not be replaced when about 83 000 civil servants will retire in 2006. This compares to the often mentioned replacement ratio of only one pensioner in two, lastly mentioned in the report of the National Assembly economic and finance committee's report on the 2006 draft Budget Bill.

**Table 6: Assessment of tax projections**

	2006		2007		2008	2009	p.m.: OECD <sup>1</sup>
	COM	SP	COM <sup>2</sup>	SP	SP	SP	
<b>Total taxes</b>							
Change in tax-to-GDP ratio	0.1	0.3	-0.3	-0.4	n.a.	n.a.	/
<i>Difference</i>		0.2		-0.1	/	/	/
<i>of which<sup>3</sup>: - elasticity component</i>		0.2		0.0	/	/	/
<i>- composition component</i>		0.0		-0.1	/	/	/
p.m.: Observed elasticity to GDP	1.1	1.2	0.8	0.8	n.a.	n.a.	0.98
<u>Notes:</u>							
<sup>1</sup> OECD ex-ante elasticity relative to GDP							
<sup>2</sup> On a no-policy change basis							
<sup>3</sup> The decomposition is explained in Annex 4							
<u>Source:</u>							
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)							

### 3.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

According to the Commission's communication of December 2004 endorsed by the Council in January 2005 (see Box 1) France is expected to correct its excessive deficit by 2005. The programme anticipates a deficit at 3.0% of GDP in 2005 and most recent information tends to confirm that this could indeed be the case notably thanks to heavy reliance on one-off measures (see section 3.1). However, in view of the above risk assessment, bringing the deficit below this level on a credible and sustainable basis would require additional measures in 2006 and thereafter. Moreover, even taken at face-value and without considering the likely negative risks, the planned structural adjustment in 2006 of 0.4% of GDP would be less than the minimum required adjustment of 0.5% of GDP annually generally prescribed in the Stability and Growth Pact for countries under the excessive deficit procedure, after only 0.2% in 2005.

The budgetary strategy outlined in the programme does not plan to achieve the MTO (structural balance of 0% of GDP) by the end of the programme period but rather in 2010. Instead, based on the commonly agreed methodology, a structural deficit of 0.6% of GDP would be reached in 2009. Thus, the adjustment path outlined in the programme is not sufficient to ensure that the MTO will be reached by 2009. However, as mentioned above, the MTO is more demanding than required by the Stability and Growth Pact. Even so, taking into account the balance of risks to the targets outlined in the programme, the budgetary strategy does not seem sufficient to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact by the end of the programme period. In this context, reaching an appropriate position in structural terms by the end of the programme would require significant additional efforts.

Furthermore, while according to the programme a budgetary position would be reached in 2008 that just meets the "minimum benchmark" of a cyclically-adjusted deficit of about 1½% of GDP providing a sufficient safety margin to avoid in the future breaching the 3% of GDP Treaty reference value under normal cyclical conditions, in view of the risk assessment, the budgetary stance in the programme may not be sufficient to provide such a safety margin within the programme horizon.

Regarding the adjustment towards the MTO, the programme foresees an annual average adjustment in structural terms of 0.6% of GDP in 2007-2009. Even taking into account the above-mentioned risks, the adjustment path for this period appears to be broadly in line with the 0.5% of GDP “benchmark” set in the Stability and Growth Pact and code of conduct for euro area and ERM II Member States.

It should also be noted that, while the output gap is projected to slightly increase in the recalculations applying the common agreed methodology based on the programme data, the economic situation in France cannot be assessed as “bad times” as (a) real GDP growth is close to its historical (10-year) long-term average, (b) economic activity remains largely driven by domestic demand and (c) tax elasticities assumptions on which the Commission services’ forecast was based are relatively close to ex-ante elasticities as calculated by the OECD (table 7). Concerning 2007, the less tax-rich economic growth is mainly explained by a negative elasticity component stemming from the tax cuts decided in the 2006 Budget Bill that negatively impact fiscal receipts (by about ¼% of GDP). Thus, it would be difficult to argue that a smaller adjustment than the 0.5% of GDP benchmark could be justified by “bad times” conditions over the period 2005-2009.

**Table 7: Assessment of tax elasticities**

	2006		2007	
	COM (observed)	Ex-ante <sup>1</sup>	COM <sup>2</sup> (observed)	Ex-ante <sup>1</sup>
<b>Total taxes</b>				
Change in tax-to-GDP ratio	0.1	0.0	-0.3	0.0
<i>Difference</i>		0.1		-0.3
<i>of which<sup>3</sup>: - elasticity component</i>		-0.1		-0.5
<i>- composition component</i>		0.2		0.3
p.m.: Elasticity to GDP	1.1	1.0	0.8	1.0
<b>Notes:</b>				
<sup>1</sup> Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD				
<sup>2</sup> On a no-policy change basis				
<sup>3</sup> The decomposition is explained in Annex 4				
<b>Source:</b>				
Commission services’ autumn 2005 economic forecasts (COM); Commission services’ calculations and OECD (N. Girouard and C. André (2005), “Measuring Cyclically-Adjusted Budget Balances for the OECD Countries”, OECD Working Paper No. 434)				

### 3.4. Sensitivity analysis

The update of the stability programme presents two complete macroeconomic scenarios for the period 2007-2009 (the scenarios coincide over the period 2005-2006). The Commission services’ calculations show a larger improvement in the structural balance in case of the “favourable scenario” than that in the “cautious scenario”. The update also includes a section on the sensitivity of public finances to changes in the international financial environment. As the two scenarios presented in the update are linear, the results foreseen by the sensitivity analysis are the same. Four alternative scenarios are described, taking into account: (i) a 1% stronger increase in external demand for French goods and services, (ii) a USD 10 decrease in oil prices, (iii) a 10% appreciation of the euro, and (iv) a 100 basis point increase in interest rates in the euro area. The update does not spell out implied changes on government revenues and expenditures, but only provides the impact on the general government balance. Considering standard elasticities, results appear to be consistent.



With a 10% higher euro exchange rate, GDP growth would be lower by about 0.8 percentage point each year over 2007-2009 compared to the reference scenario. In this context, the programme indicates that the deficit would be larger than in the reference scenario by 0.2% of GDP in 2007 (2.8% of GDP) and by 0.5% of GDP in 2009 (1.5% of GDP). This illustrates that the budgetary situation in France remains fragile. If interest rates were to be higher in the euro area by 100 basis points than in the baseline scenario, this would negatively impact the general government deficit by a total of 0.6 percentage point of GDP over 2008-2009. On the contrary, with lower oil prices by USD 10 per barrel, the programme assumes that GDP growth would be boosted by 0.2 percentage point of GDP in 2007 and by 0.5 percentage point of GDP in the two following years and the deficit reduced by a total of ½ percentage point of GDP over the period 2007-2009. Under the assumption of a 1% higher external demand, the deficit would be reduced by 0.2% of GDP more than envisaged in the baseline scenario.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2009 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 2009, the cyclically-adjusted balance would be 0.8 percentage point of GDP above/below the central scenario. Hence, in case of persistently lower real growth, additional measures of similar size would be necessary to keep public finances on the path targeted in the central scenario.

#### **4. GENERAL GOVERNMENT GROSS DEBT**

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

##### **4.1. Debt developments in the programme**

Bringing the debt-to-GDP ratio below 60% of GDP by 2010 is one of the two medium-term objectives presented in the update, which integrates some of the proposals of the Pébereau commission's report<sup>21</sup> in its intensified debt-reduction strategy. This strategy is based on three pillars: (i) tightening the control of public expenditures, as elaborated in section 3.2.2, (ii) raising potential growth notably thanks to the so-called emergency plan for employment ("plan d'urgence pour l'emploi") and other labour market reforms (see section 5 below), and (iii) the allocation of receipts from the sales of non-strategic assets for an estimated amount of EUR 5 to 10 bn (0.3 to 0.6% of GDP) per year over 2007-2009.

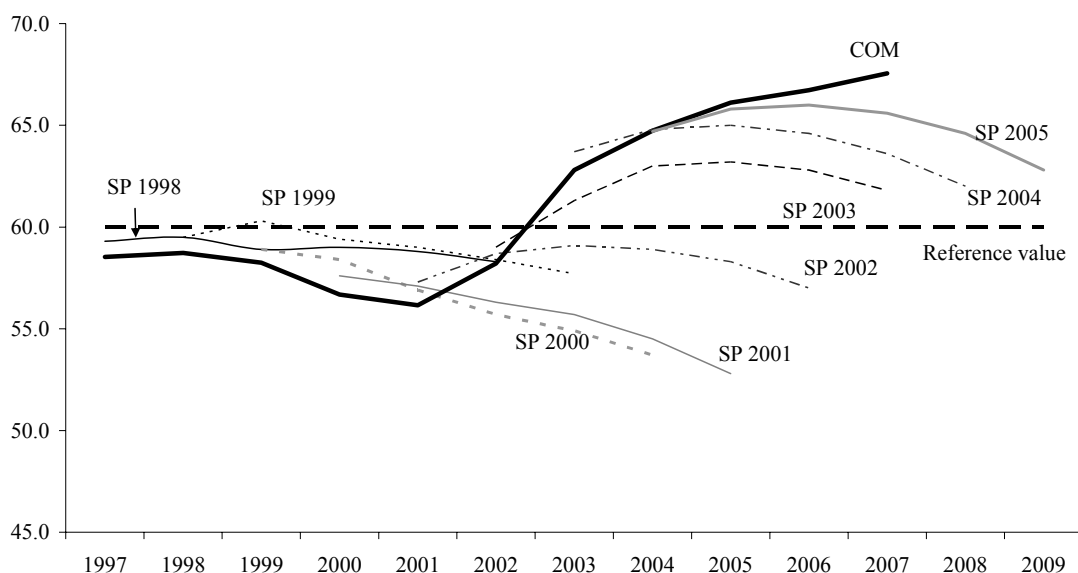
The update projects that the debt-to-GDP ratio would slightly increase in 2006 (to 66.0% of GDP from 65.8% of GDP at the end of 2005) and progressively decrease thereafter to 62.8% of GDP in 2009 (and below 60% in 2010). Compared to the previous update, which anticipated the debt-to-GDP ratio to be at 65.0% of GDP in 2005 and to decrease from 2006 onwards, the decrease in the debt-ratio is postponed by one year. The reduction in the debt ratio would be mainly triggered by GDP growth and the shift to primary surpluses from 2007 onwards. Stock-flow adjustments (SFA) are projected to be negative and broadly constant at -0.4% of GDP over the period 2006-2009 (table 8). While no information on the composition of the SFA is provided (decomposition

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<sup>21</sup> See Box 2.

data are optional), one may infer that they will be mainly linked to the planned sales of non-strategic assets, all the more so as other SFA components in France are traditionally small.

**Figure 2: Debt projections in successive stability programmes (% of GDP)**



Source: Commission services' autumn 2005 forecast (COM) and successive stability programmes

**Table 8: Debt dynamics**

	average 2000-2004	2005		2006		2007		2008	2009
	COM	COM	SP	COM	SP	COM	SP	SP	SP
<b>Government gross debt ratio</b>	<b>60.2</b>	<b>66.5</b>	<b>65.8</b>	<b>67.1</b>	<b>66.0</b>	<b>68.0</b>	<b>65.6</b>	<b>64.6</b>	<b>62.8</b>
Change in debt ratio (1 = 2+3+4)	1.3	1.4	0.7	0.6	0.2	0.8	-0.4	-1.0	-1.8
<i>Contributions:</i>									
- <b>Primary balance</b> (2)	<b>-0.2</b>	<b>0.5</b>	<b>0.3</b>	<b>0.7</b>	<b>0.3</b>	<b>0.7</b>	<b>0.0</b>	<b>-0.6</b>	<b>-1.6</b>
- <b>“Snow-ball” effect</b> (3)	<b>0.8</b>	<b>0.9</b>	<b>0.4</b>	<b>0.5</b>	<b>0.3</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.1</b>
- Interest expenditure	3.0	2.7	2.7	2.8	2.6	2.8	2.6	2.5	2.6
- Real GDP growth	-1.2	-1.0	-1.1	-1.1	-1.4	-1.5	-1.4	-1.4	-1.4
- Inflation (GDP deflator)	-1.0	-0.9	-1.2	-1.1	-0.9	-1.2	-1.2	-1.2	-1.1
- <b>Stock-flow adjustment</b> (4)	<b>0.6</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.6</b>	<b>-0.4</b>	<b>0.0</b>	<b>-0.4</b>	<b>-0.3</b>	<b>-0.3</b>

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.

Source:

Stability programme update (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

## 4.2. Assessment

The update projections are more favourable than those of the Commission services' autumn 2005 forecast, which predicts a continuous increase in the debt-to-GDP ratio over the forecast horizon, reaching 68.0% of GDP in 2007, against 65.6% in the stability programme (figure 2). On the basis of recent information concerning growth prospects, budgetary developments and new information on the sales of non-strategic assets, the Commission services' estimate for 2005 may turn out to be on the high side, which will have a carry-over effect on the estimates for the following years.

The debt path contained in the update is clearly subject to the same risks as those attached to the budgetary targets. However, there are also specific risks, notably concerning the expected annual yield of EUR 5 to 10 bn from the programme of sales of non-strategic assets<sup>22</sup>, which is high by historical standards. Indeed, since 1986, EUR 77 bn of asset sales have been collected, out of which only EUR 9 bn were allocated to debt reduction, whereas EUR 56 bn were used for the recapitalization of public companies<sup>23</sup>. An additional risk concerns the expected interest expenditure. The update now assumes a decrease in the implicit interest rate on debt from 2005 to 2006 and a quasi-stabilisation thereafter (from 4.3% in 2005 to 4.1% in 2009) while the previous update anticipated a gradual increase from 4.6% in 2005 to 5.1% in 2008. Therefore, even if the projections for primary surpluses materialised, the targets for the debt ratio could be exceeded.

It is welcome that the government has made debt reduction one of its top priorities and has started to incorporate recommendations of the Pébereau commission's report in its strategy. However, as shown in Box 4, it is only from 2008 that the debt is projected to decline at a yearly rhythm which could be considered as satisfactory. Given the uncertainties associated to the budgetary targets and the realisation of the planned sales of non-strategic assets, the debt ratio may not be sufficiently diminishing towards the 60% of GDP reference value

### **Box 4: The rolling debt reduction benchmark**

The debt ratio has been exceeding the 60% of GDP reference value since 2003.

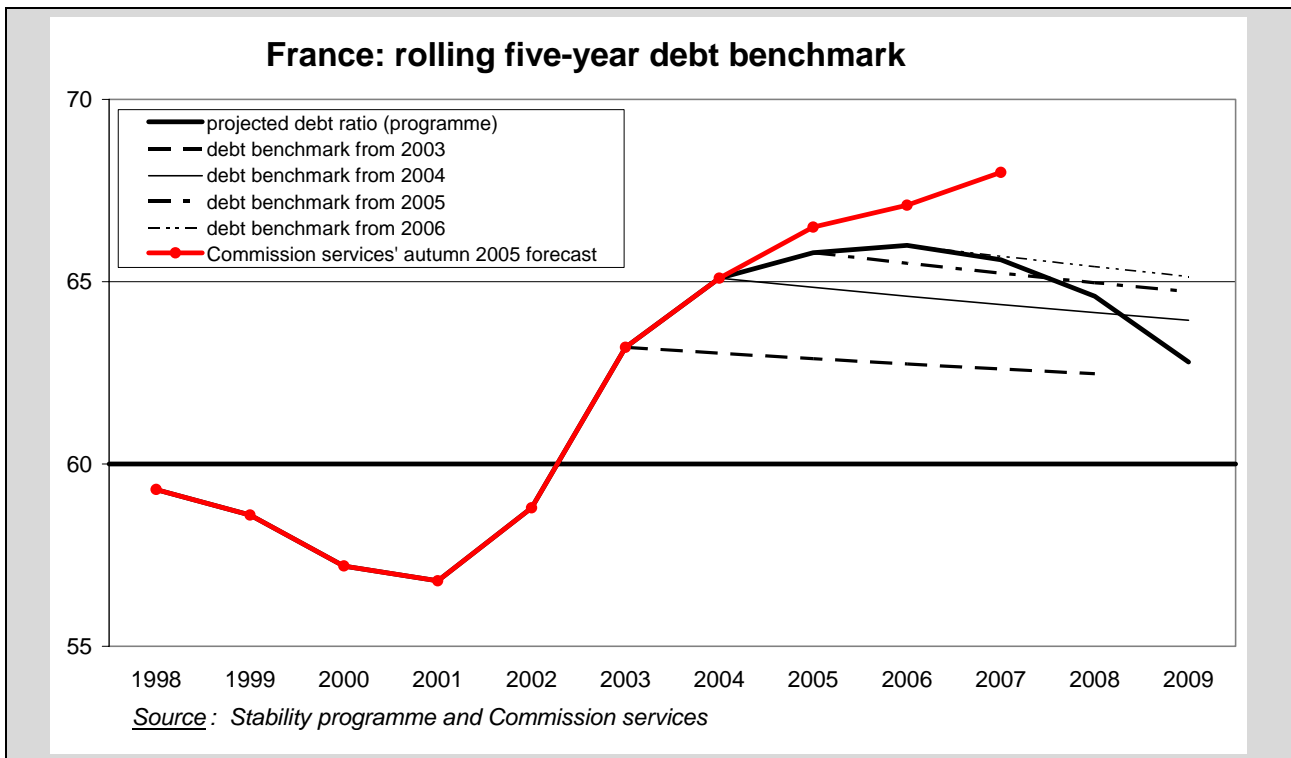
A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2005 forecasts until 2007 (which are on a no-policy change scenario) and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative "rolling debt reduction benchmark" (see Annex 5). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2008 is compared with the value obtained for the same year by applying the formula starting in 2003. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

The graph clearly shows that it is only from 2008 that the debt is projected to decline at a yearly rhythm which could be considered as satisfactory.

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<sup>22</sup> No details available on this programme.

<sup>23</sup> These data are provided by the French Government Shareholding Agency. Caution should be applied when interpreting these data as, according to the Agency, they have not been updated and are expressed in current euros.



## 5. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The update provides an overview of the governance of public finances and recent structural reforms being pursued to improve fiscal consolidation. In France, fiscal consolidation is based on expenditure-restraint, which implies a decrease 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. In the update, the projected adjustment is mostly based on a containment of current expenditures, as the investment-expenditure-to-GDP ratio is expected to only marginally decrease over the programme period.

As reviewed in section 3.2.2, the expected reduction in the government expenditure ratio is planned to be achieved through an enhancement of the expenditure-growth rule at all levels of the general government. In order to improve the oversight of public finance, the government organised in December 2005 the first conference on public finance. This initiative is welcome as it raises the accountability of all public stakeholders for spending control, as highlighted in the update. This is particularly important if one wants to mobilise all actors toward respect of their multi-annual expenditures ceilings, in the spirit of an “internal stability and growth pact”. In this context, the update mentions that setting-up such a conference would help develop a general “governance agreement” between all public expenditure managers.

Concerning the governance of State finances, the update presents two major reforms. First, it recalls that for the first time the 2006 Budget Bill had been implemented in the context of the new Constitutional Bylaw on Budget Bills (LOLF) which aims at more transparency and efficiency. As already presented in December 2004 update and discussed in the corresponding Commission services’ assessment, one of the most important aspects is the fact that in order to

make sure that revenue windfalls are used properly, the government must, following the LOLF requirements, submit a rule for the allocation of any surplus revenues during the execution of the budget. For 2006, it has been decided that any surplus revenues must be used to reduce the budgetary deficit except for extra revenues stemming from oil products, which may be used to finance expenses connected directly with the impact of rising oil prices.<sup>24</sup>

The governance of the social security finances has also benefited from a new Constitutional Bylaw on Social Security Budget Bills (LOLFSS: Loi organique sur les lois de financement de la Sécurité Sociale) adopted in July 2005. Its purpose is to improve the efficiency and credibility of the social security budget and to align social security finance decisions more closely with overall public finance choices. The update recalls that at the time of the 2004 health insurance reform, an “alert committee” responsible for warning Parliament of health insurance expenditure overruns was created. This is a very positive measure, as it allows for better intra-annual budgetary management.

While these reforms are going in the right direction, strengthening the monitoring and enforcement mechanisms for expenditure-rimes would be required to make the budgetary rules enforceable. Currently, there is neither systematic justification of the deviations in the budgetary execution from the target set in the Budget Bill nor have mechanisms been set in place to ensure automatic compensation across years of possible slippages in a given year. Enforceability could be improved by establishing a national independent authority in charge of monitoring compliance with the expenditure targets and, if necessary, of ensuring enforcement of the rule, as was done for health-care expenditure.<sup>25</sup>

The update also reviews public finance statistical governance and notably recalls that information used for fiscal notification purposes for the current year (e.g. in April 2006 for 2006) is less homogeneous than that for the preceding year (e.g. in April 2006 for 2005) and subject to review because it is partly based on non-definitive results and estimates.

Measures aiming at increasing potential growth, one of the three pillars of the French budgetary strategy (see section 3.2), are presented. They concern the modernisation of the labour market (in particular the employment emergency plan - “plan d’urgence pour l’emploi” - and the new recruitment contract - “contrat nouvelle embauche”) but also some innovation in the area of industrial and research-policies (e.g. the regional competitiveness centres). These measures were also detailed in the national programme reform (NRP) submitted on 7 November 2005, in the context of the renewed Lisbon strategy for growth and jobs, which puts emphasis on the need to put France back on a sustainable growth path. Indeed, given the sustained high – although decreasing – unemployment rate and the low participation rate, raising labour market participation and business competitiveness were identified as key challenges in the French NRP for ensuring higher potential growth. While these measures are consistent with the NRP, there is

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<sup>24</sup> In 2005, a commission (“Commission Durieux”) estimated that the VAT receipts surplus linked to higher oil prices had been more than compensated by the losses on the petroleum tax receipts by EUR 0.9 bn.

<sup>25</sup> When giving its opinion on the likelihood of the target achievement, if the independent committee estimates that the target will be missed by more than 0.75%, it should alert the Parliament, the government and the social security funds. Subsequently, the social security agencies should propose corrective measures which will be evaluated by the committee. In May 2005, when the Committee released its first opinion, it estimated that growth in health-care expenditures was in line with the target.

no assessment of their budgetary impact, as already mentioned in the conclusions of the Commission's assessment of the French National Reform Programmes for Growth and Jobs.<sup>26</sup>

Policies described above (regarding the quality of public finances and structural reforms) are also generally consistent with the Broad Economic Policy Guidelines in the area of public finances included in the Integrated Guidelines<sup>27</sup> for the period 2005-2008 (see also annex 3). Especially the modernisation of the labour market should have beneficial effects on France's employment rate and growth potential. Reforms in health care and pensions contribute to improving the long-term viability of these systems. Definition of expenditure-rules, intra-annual budgetary management tools (such as the alert committee) and ex-ante destination of windfall revenues should facilitate the achievement of sound public finances.

## 6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of France's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme scenario" assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005 scenario" assumes that the structural primary balance<sup>28</sup> remains unchanged at the 2005 level throughout the programme period.

On the basis of information in the programme, age-related expenditure is foreseen to increase between 2009 and 2050 by 4.3 percentage points of GDP, to which health-care expenditure contributes the most, with 2.4 percentage points of GDP (see table A2 in annex 6). The present analysis is based on the set of government expenditure items covered by the common projections carried out by the Economic Policy Committee (EPC)<sup>29</sup>. Tax revenues and non-age related expenditures have been kept constant throughout the projection period until 2050.

The gross debt-to-GDP ratio would be on an explosive path in the "2005 scenario". If the budgetary consolidation outlined in the programme were to materialise, gross debt would decrease below the 60% of GDP reference value, but would nevertheless reach an explosive path around 2020<sup>30</sup>. When considering the "adjusted" gross debt/GDP ratio, which takes into account the assets accumulated in the *Fonds de Réserve des Retraites* (public pension fund) and in the

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<sup>26</sup> [http://europa.eu.int/growthandjobs/pdf/2006\\_annual\\_report\\_france\\_en.pdf](http://europa.eu.int/growthandjobs/pdf/2006_annual_report_france_en.pdf)

<sup>27</sup> European Commission, Communication to the spring European Council, Integrated Guidelines for Growth and Jobs, 2005

<sup>28</sup> This refers to the primary balance, where the effect of the cycle and any one-off or temporary measures have been netted out.

<sup>29</sup> Namely, government expenditure on pension and health-care. Long-term care, unemployment benefits and education are missing from the programme. The French programme provides two sets of health-care projections; they derive from different trends in public expenditure compared to GDP growth. The calculations are done on the basis on the less favourable assumption; the results of the alternative scenario (no growth of health-care as a share of GDP) are given as a sensitivity test in the qualitative analysis.

<sup>30</sup> 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 should not be seen as a forecast.

complementary pension schemes (ARRCO-AGIRC), the debt dynamics are somewhat more favourable (see Table A4 in annex 6)<sup>31</sup>.

Indeed, according to the S1 indicator, a sustainability gap of almost 4% of GDP emerges for France in the “2005 scenario”, notably due to the low structural primary balance in 2005 which prevents a steady reduction of debt. In the “programme scenario”, the sustainability gap would be significantly reduced thanks to the consolidation planned during the programme period. However, S1 only takes into account changes in the primary balance up to 2050, which underestimates the cost of ageing.

A more demanding measure is the government’s inter-temporal budget constraint, captured by the S2 indicator, according to which a sustainability gap of about 5% of GDP emerges in the “2005” scenario. As for S1, the sustainability gap would be significantly reduced with the planned consolidation in the programme. This sustainability gap translates into a required primary balance (RPB) of about 4% of GDP, higher than the structural primary balance of around 2% of GDP in the last year of the programme period.

Moreover, the sustainability gap, as measured by the S1 indicator, would increase by around 2/3% GDP if the (budgetary or structural) adjustment were to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later (see table A3 in annex 6).

**Table 9: Sustainability indicators and the required primary balance**

	Sustainability indicators and RPB					
	2005 Scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
<b>Value (of which)</b>	<b>3.8</b>	<b>4.9</b>	<b>4.2</b>	<b>1.0</b>	<b>2.2</b>	<b>4.0</b>
<i>initial budgetary position</i>	1.4	1.4		-1.3	-1.3	
<i>debt requirement in 2050</i>	0.1	:		0.0	:	
<i>future changes in budgetary position</i>	2.3	3.5		2.3	3.5	

Note: The S1 indicator measures the sustainability gap as the difference between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator measures the sustainability gap as the difference between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio<sup>32</sup>. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission ((2005), European Economy, ‘Public finances in EMU – 2005’, Section II.3 for a further description.

<sup>31</sup> In the present analysis, the rate of return on assets is assumed to be the same as that paid on government debt. A real interest rate of 3% over the long-term (to 2050) is assumed for all Member States, which together with a uniform assumption of a 2% inflation rate yields a nominal interest rate of 5%. These assumptions are also used in the common long-term budgetary projection exercise by the Ageing Working Group (AWG) and the EPC (see ‘The 2005 EPC projection of age-related expenditure: Agreed underlying assumptions and projection methodologies’, ECFIN/CEFCPE(2005)REP/54772, 8 November 2005).

<sup>32</sup> The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

In interpreting these results, several factors need to be taken into account:

The macroeconomic assumptions underlying the long-term projections are those commonly agreed and used by the EPC in the current common projections exercise<sup>33</sup>. Overall, the underlying assumptions in the programme can therefore be considered plausible.

The French programme provides two hypotheses for the future path of health-care expenditure: the less favourable scenario, which projects health expenditure to increase by 2.5 percentage points of GDP between 2010 and 2050, has been retained in this assessment. If the favourable scenario were to materialize (maintaining health expenditure at its current level compared to GDP), the S1 indicator would be reduced by 1.3% of GDP and S2 by 2.0% of GDP. No projections of long-term care, education and unemployment are available in the programme, which may overall underestimate the cost of ageing.

The 2003 pension reform<sup>34</sup> introduced an increase in the number of contribution years entitling to a full pension over the period 2004-2020. The increase in contribution years first concerns the public sector only, up to 2008, and subsequently most public and private schemes through an automatic rule meant to keep the ratio between the number of contribution years and the number of years in pension constant. As underlined in the programme, the increase in contribution years entitling to a full pension is still subject to change after the opinion of an independent Commission scheduled to meet in 2008. It is therefore not clear at this stage if there will be any modification to the current increase in the contribution period and, if any, whether it will strengthen or soften eligibility criteria for a full pension

## 6.1. Overall assessment

With regard to the sustainability of public finances, France appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. Recent reforms, notably the 2003 pension reform, have helped to contain the future rise in public expenditure and their full implementation will be crucial to ensure the expected results. The current level of government gross debt is above the Treaty value of 60% of GDP and the currently high structural deficit, if unchanged, will prevent the necessary reduction of debt in view of the future cost of ageing. Therefore, in the absence of additional reforms, strong budgetary consolidation is needed in order to reduce risks to long-term sustainability.

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<sup>33</sup> The information is not available in the programme but has been confirmed by the French authorities. The rise in pension expenditure is the same as in the forthcoming AWG projections.

<sup>34</sup> According to the French authorities, the reform has reduced the financial needs of the pension system in 2020 by about 40%.



## Annex 1: Summary tables from the stability programme update

### Provision of data on variables in bold characters is a requirement

Provision of data on other variables is optional but highly desirable

Table 1a. Macroeconomic prospects

	ESA Code	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	1698200	1.5-2.0	2.0-2.5	2 ¼	2 ¼	2 ¼
<b>2. Nominal GDP</b>	B1*g	1698200	3.0	3.7	4.1	4.1	4.1
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	P.3	957310	2.0	2.3	2.3	2.4	2.4
<b>4. Government consumption expenditure</b>	P.3	405263	1.4	1.9	1.2	0.8	0.6
<b>5. Gross fixed capital formation</b>	P.51	332263	3.0	3.3	2.9	2.7	2.7
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53		1.1	1.2	1.3	1.2	1.4
<b>7. Exports of goods and services</b>	P.6	444259	2.5	5.0	5.9	5.9	5.9
<b>8. Imports of goods and services</b>	P.7	461191	5.6	5.6	5.6	5.6	5.6
<b>Contributions to real GDP growth</b>							
<b>9. Final domestic demand</b>		-	2.0	2.4	2.2	2.1	2.1
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	-	0.5	0.1	0.1	0.1	0.1
<b>11. External balance of goods and services</b>	B.11	-	-0.8	-0.2	0.0	0.0	0.0

Table 1b. Price developments

	ESA Code	2004	2005	2006	2007	2008	2009
		level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>			1.3	1.4	1 ¾	1 ¾	1 ¾
2. Private consumption deflator			1.5	1.5	1 ¾	1 ¾	1 ¾
<b>3. HICP<sup>35</sup></b>			1.9	1.8	1 ¾	1 ¾	1 ¾
4. Public consumption deflator			1.3	1.7	1 ¾	1 ¾	1 ¾
5. Investment deflator			2.2	1.8	1 ¾	1 ¾	1 ¾
<b>6. Export price deflator (goods and services)</b>			1.3	1.4	1.2	1.2	1.2
<b>7. Import price deflator (goods and services)</b>			3.0	1.9	1.0	1.0	1.0

Table 1c. Labour market developments

<sup>35</sup> Optional for Stability programmes.

	ESA Code	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons</b> <sup>36</sup>			0.3	0.9	0.6	0.6	0.6
2. Employment, hours worked <sup>37</sup>							
<b>3. Unemployment rate (%)</b> <sup>38</sup>							
<b>4. Labour productivity, persons</b> <sup>39</sup>			1.5	1.4	1.7	1.7	1.7
5. Labour productivity, hours worked <sup>40</sup>							
<b>6. Compensation of employees</b>	D.1		2.9	3.3	3.5	3.5	3.5

**Table 1d. Sectoral balances**

% of GDP	ESA Code	2005	2006	2007	2008	2009
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	-1.9	-2.2	-2.2	-2.1	-1.9
of which:		-1.0	-1.3	-1.2	-1.1	-1.0
- Balance on goods and services						
- Balance of primary incomes and transfers		-0.9	-0.9	-1.0	-1.0	-0.9
- Capital account		0.0	0.0	0.0	0.0	0.0
<b>2. Net lending/borrowing of the private sector</b>	B.9/					
<b>3. Net lending/borrowing of general government</b>	B.9					
<b>4. Statistical discrepancy</b>			optional	optional	optional	Optional

<sup>36</sup> Occupied population, domestic concept national accounts definition.

<sup>37</sup> National accounts definition.

<sup>38</sup> Harmonised definition, Eurostat; levels.

<sup>39</sup> Real GDP per person employed.

<sup>40</sup> Real GDP per hour worked.

Table 2. General government budgetary prospects

	ESA code	2005	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>							
1. General government	S.13	-50.9	-3.0	-2.9	-2.6	-1.9	-1.0
2. Central government	S.1311	-46.2	-2.7	-2.6	-2.5	-2.1	-1.5
3. State government	S.1312						
4. Local government	S.1313	-1.1	-0.1	-0.1	0.0	0.2	0.4
5. Social security funds	S.1314	-3.6	-0.2	-0.2	-0.2	0.0	0.1
<b>General government (S13)</b>							
6. Total revenue	TR	862.1	50.8	50.7	50.3	50.2	50.1
7. Total expenditure	TE <sup>41</sup>	913.0	53.8	53.6	53.0	52.1	51.1
8. Net lending/borrowing	EDP B.9	-50.9	-3.0	-2.9	-2.6	-1.9	-1.0
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	45.6	2.7	2.6	2.6	2.5	2.6
<b>pm: 9a. FISIM</b>							
10. Primary balance	<sup>42</sup>	-5.3	-0.3	-0.3	0.0	0.6	1.6
<b>Selected components of revenue</b>							
11. Total taxes (11=11a+11b+11c)		461.4	27.2	27.4	27.1		
11a. Taxes on production and imports	D.2	264.3	15.6	15.7	15.7	optional	optional
11b. Current taxes on income, wealth, etc	D.5	188.7	11.1	11.2	10.9	optional	optional
11c. Capital taxes	D.91	8.3	0.5	0.5	0.5	optional	optional
12. Social contributions	D.61	309.9	18.2	18.3	18.2	optional	optional
13. Property income	D.4	10.5	0.6	0.8	0.8	optional	optional
14. Other (14=15-(11+12+13))		80.4	4.7	4.2	4.2	optional	optional
15=6. Total revenue	TR	862.1	50.8	50.7	50.3	50.2	50.1
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)<sup>43</sup></b>		739.1	43.5	43.7	43.4	43.2	43.1
<b>Selected components of expenditure</b>							
16. Collective consumption	P.32						
17. Total social transfers	D.62 + D.63	402.4	23.7	23.6	23.2	22.9	22.7
17a. Social transfers in kind	P.31=D.63						
17b. Social transfers other than in kind	D.62						
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	45.6	2.7	2.6	2.6	2.5	2.6
19. Subsidies	D.3	24.7	1.5	1.5	1.4	1.4	1.4
20. Gross fixed capital formation	P.51	54.1	3.2	3.2	3.2	3.1	3.0
21. Other (21=22-(16+17+18+19+20))		386.2	22.7	22.7	22.6	22.2	21.4
22=7. Total expenditure	TE <sup>44</sup>	913.0	53.8	53.6	53.0	52.1	51.1
<b>Pm: compensation of employees</b>	D.1						

<sup>41</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>42</sup> The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

<sup>43</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

<sup>44</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	Year X-2	Year
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure	TE <sup>45</sup>		

**Table 4. General government debt developments**

% of GDP		2005	2006	2007	2008	2009
<b>1. Gross debt<sup>46</sup></b>		65.8	66.0	65.6	64.6	62.8
<b>2. Change in gross debt ratio</b>		1.1	0.2	-0.3	-1.0	-1.9
<b>Contributions to changes in gross debt</b>						
<b>3. Primary balance<sup>47</sup></b>		-0.3	-0.3	0.0	0.6	1.6
<b>4. Interest expenditure (incl. FISIM)<sup>48</sup></b>		2.7	2.8	2.6	2.5	2.6
<b>5. Stock-flow adjustment</b>		0.0	-0.4	-0.4	-0.4	-0.4
<b>of which:</b>						
- Net accumulation of financial assets <sup>50</sup>						
- Valuation effects and other <sup>51</sup>						
<b>p.m. implicit interest rate on debt<sup>52</sup></b>		4.3	4.1	4.0	4.0	4.1
<b>Other relevant variables</b>						
<b>6. Liquid financial assets<sup>53</sup></b>						
<b>7. Net financial debt (7=1-6)</b>						

<sup>45</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>46</sup> As defined in Regulation 3605/93 (not an ESA concept).

<sup>47</sup> Cf. item 10 in Table 2.

<sup>48</sup> Cf. item 9 in Table 2.

<sup>49</sup> The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

<sup>50</sup> Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

<sup>51</sup> Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

<sup>52</sup> Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

<sup>53</sup> AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

**Table 5. Cyclical developments**

% of GDP	ESA Code	2005	2006	2007	2008	2009
<b>1. Real GDP growth (%)</b>		1.5-2.0	2.0-2.5	2 ¼	2 ¼	2 ¼
<b>2. Net lending of general government</b>	EDP B.9	-3.0	-2.9	-2.6	-1.9	-1.6
<b>3. Interest expenditure (incl. FISIM recorded as consumption)</b>	EDPD.41+ FISIM	2.7	2.6	2.6	2.5	2.6
4. Potential GDP growth (%) (1)		2.1	2.25	2.0	2.0	2.0
contributions:						
5. Output gap		-1.0	-1.0	-0.8	-0.5	-0.3
6. Cyclical budgetary component		-0.6	-0.6	-0.5	-0.4	-0.3
7. Cyclically-adjusted balance (2-6)		-2.4	-2.3	-2.1	-1.5	-0.7
8. Cyclically-adjusted primary balance (7-3)		0.3	0.4	0.5	1.0	1.9

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

**Table 6. Divergence from previous update**

	ESA Code	2005	2006	2007	2008	2009
<b>Real GDP growth (%)</b>						
<b>Previous update</b>		2.4	2 ½	2 ½	2 ½	n.a.
<b>Current update</b>		1.5-2.0	2.0-2.5	2 ¼	2 ¼	2 ¼
<b>Difference</b>		-0.9- -0.4	- ½ - 0	- ¼	- ¼	- ¼
<b>General government net lending (% of GDP)</b>	EDP B.9					
<b>Previous update</b>		-2.9	-2.2	-1.6	-0.9	n.a.
<b>Current update</b>		-3.0	-2.9	-2.6	-1.9	-1.0
<b>Difference</b>		-0.1	-0.7	-1.0	-1.0	
<b>General government gross debt (% of GDP)</b>						
<b>Previous update</b>		65.0	64.6	63.6	62.0	n.a.
<b>Current update</b>		65.8	66.0	65.6	64.6	62.8
<b>Difference</b>		0.8	1.4	2.0	2.6	

**Table 7. Long-term sustainability of public finances**

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure						
Of which: age-related expenditures						
Pension expenditure		12.9	13.0	13.8	14.4	14.9
Social security pension						
Old-age and early pensions						
Other pensions (disability, survivors)						
Occupational pensions (if in general government)						
Health care		7.9	7.4 - 7.5	7.4 - 8.2	7.4 - 9.1	7.4 - 10.0
Long-term care ( <i>this was earlier included in the health care</i> )						
Education expenditure						
Other age-related expenditures						
Interest expenditure						
Total revenue						
Of which: property income						
<i>of which: from pensions contributions (or social contributions if appropriate)</i>						
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
<b>Assumptions</b>						
Labour productivity growth						
Real GDP growth						
Participation rate males (aged 20-64)						
Participation rates females (aged 20-64)						
Total participation rates (aged 20-64)						
Unemployment rate						
Population aged 65+ over total population						

**Table 8. Basic assumptions**

**This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.**

	2005	2006	2007	2008	2009
<b>Short-term interest rate<sup>54</sup></b>	2.1	2.1	n.a.	n.a.	n.a.
<b>Long-term interest rate</b>	3.5	3.9	n.a.	n.a.	n.a.
<b>USD/€exchange rate</b>	1.25	1.23	1.23	1.23	1.23
<b>Nominal effective exchange rate</b>	108.4	107.7	107.7	107.7	107.7
<b>(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)</b>					
<b>World excluding EU, GDP growth</b>	4.8	4.6	4.2	4.2	4.2
<b>EU GDP growth</b>	1.4	1.7	2.0	2.0	2.0
<b>Growth of relevant foreign markets</b>	4.2	6.0	6.0	6.0	6.0
<b>World import volumes, excluding EU</b>	7.3	7.7	7.1	7.1	7.1
<b>Oil prices, (Brent, USD/barrel)</b>	55.20	60.00	61.10	62.10	63.20

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<sup>54</sup> If necessary, purely technical assumptions.

## Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the “format” requirements of the code, whereas point (iv) refers to its “content” requirements.

Guidelines in the new code of conduct	Yes	No	Comments
<b>1. Submission of the programme</b>			
Programme was submitted not earlier than mid-October and not later than 1 December <sup>1</sup> .		X	Delivered on 13/01/06
<b>2. Model structure</b>			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
<b>3. Model tables (so-called data requirements)</b>			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.		X	
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
<b>4. Other information requirements</b>			
<b>a. Involvement of parliament</b>			
The programme mentions its status vis-à-vis the national parliament.		X	
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
<b>b. Economic outlook</b>			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.		X	However, the external assumptions are similar to those used by the Commission services.
Significant divergences between the national and the Commission services’ economic forecasts are explained <sup>2</sup> .		X	
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	
<b>c. Monetary/exchange rate policy</b>			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
<b>d. Budgetary strategy</b>			



<b>Guidelines in the new code of conduct</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.		X	
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		No detailed information on the measures
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	Broad measures explained but no quantitative assessment
Information is provided on one-off and other temporary measures.		X	
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
<b><i>e. “Major structural reforms”</i></b>			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible ‘major structural reforms’ over time.			Not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
<b><i>f. Sensitivity analysis</i></b>			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X		
In case of such “major structural reforms”, the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable
<b><i>g. Broad economic policy guidelines</i></b>			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
<b><i>h. Quality of public finances</i></b>			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
<b><i>i. Long-term sustainability</i></b>			
The programme outlines the country’s strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		

<b>Guidelines in the new code of conduct</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (...) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.		X	
<b><i>j. Other information (optional)</i></b>			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
<u>Notes:</u> <sup>1</sup> The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on “budget day”, i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. <sup>2</sup> To the extent possible, bearing in mind the typically short time period between the publication of the Commission services’ autumn forecast and the submission of the programme.			

### Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
<b>1. To secure economic stability</b>			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it <sup>1</sup> .	X (from 2007 onwards)		
– Member States should avoid pro-cyclical fiscal policies <sup>2</sup> .			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits <sup>3</sup> .		X	
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.			X
<b>2. To safeguard economic and fiscal sustainability</b>			
In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.		X	
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (...)	X		
<b>3. To promote a growth- and employment-orientated and efficient allocation of resources</b>			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X		
Notes:			
<sup>1</sup> As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.			
<sup>2</sup> As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”.			
<sup>3</sup> As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

### Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services’ autumn 2005 forecast and Table 7 those of the Commission services’ autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax

categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)<sup>55</sup>. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i*-th tax  $\frac{T_i}{Y}$  can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY} \frac{Y}{T_i} - 1\right) \frac{T_i}{Y} = \left(\frac{dT_i}{dB_i} \frac{B_i}{T_i} \frac{dB_i}{dY} \frac{Y}{B_i} - 1\right) \frac{T_i}{Y} = (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y}$$

where  $\varepsilon_{T_i, B_i}$  and  $\varepsilon_{B_i, Y}$  denote the elasticity of the *i*-th tax  $T_i$  relative to its tax base  $B_i$  and the elasticity of the tax base  $B_i$  relative to aggregate GDP  $Y$  respectively.

To the extent that  $\varepsilon_{T_i, B_i}$  is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity<sup>56</sup>. By contrast, if  $\varepsilon_{T_i, B_i}$  is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity  $\varepsilon_{B_i, Y}$  can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i*-th tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_i \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[ (\varepsilon_{T_i, B_i}' \varepsilon_{B_i, Y}' - 1) \frac{T_i}{Y} - (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

<sup>55</sup>Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

<sup>56</sup>The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures:  $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i, B_i, ex ante} \frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i, B_i, ex post} \frac{dB_i}{B_i}$ .

If  $(\varepsilon'_{T_i, B_i} - \varepsilon_{T_i, B_i}) = \alpha_i$ ;  $(\varepsilon'_{B_i, Y} - \varepsilon_{B_i, Y}) = \beta_i$ ,

$$\text{then } d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[ (\alpha_i \varepsilon_{B_i, Y} + \beta_i \varepsilon_{T_i, B_i} + \alpha_i \beta_i) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

where  $\alpha_i \varepsilon_{B_i, Y} \frac{T_i}{Y} \frac{dY}{Y}$  determines the elasticity component and  $\beta_i \varepsilon_{T_i, B_i} \frac{T_i}{Y} \frac{dY}{Y}$  the composition component. The third component in the equation  $\alpha_i \beta_i \frac{T_i}{Y} \frac{dY}{Y}$  measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as  $\varepsilon = \sum_i w_i \varepsilon_{T_i, B_i} \varepsilon_{B_i, Y}$  with  $w_i$  the share of the  $i$ -th tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

## Assessment of tax projections by major tax category

	2006		2007		2008	2009	p.m.: OECD <sup>1</sup>
	COM	SP	COM <sup>2</sup>	SP	SP	SP	
<b>Taxes on production and imports:</b>							
Change in tax-to-GDP ratio	0.0	0.1	0.0	0.0	n.a.	n.a.	/
<i>Difference</i>		0.1		0.0	/	/	/
<i>of which<sup>3</sup>: - elasticity component</i>		0.1		0.0	/	/	/
<i>- composition component</i>		0.0		0.0	/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base <sup>4</sup>	1.0	1.1	0.9	1.0	n.a.	n.a.	1.00
- of tax base <sup>4</sup> to GDP	1.0	1.0	1.0	1.0	1.0	1.0	1.00
<b>Social contributions:</b>							
Change in tax-to-GDP ratio	0.0	0.1	0.0	-0.1	n.a.	n.a.	/
<i>Difference</i>		0.1		-0.1	/	/	/
<i>of which<sup>3</sup>: - elasticity component</i>		0.1		0.0	/	/	/
<i>- composition component</i>		0.0		-0.1	/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base <sup>5</sup>	1.2	1.3	1.0	1.0	n.a.	n.a.	1.10
- of tax base <sup>5</sup> to GDP	0.9	0.9	0.9	0.9	0.9	0.9	0.70
<b>Personal income tax<sup>6</sup>:</b>							
Change in tax-to-GDP ratio	0.1	0.1	-0.2	-0.2	n.a.	n.a.	/
<i>Difference</i>		0.0		-0.1	/	/	/
<i>of which<sup>3</sup>: - elasticity component</i>		0.0		0.0	/	/	/
<i>- composition component</i>		0.0		0.0	/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base <sup>5</sup>	1.3	1.4	0.5	0.4	n.a.	n.a.	1.7
- of tax base <sup>5</sup> to GDP	0.9	0.9	0.9	0.9	0.9	0.9	0.70
<b>Corporate income tax<sup>6</sup>:</b>							
Change in tax-to-GDP ratio	0.0	0.0	-0.1	-0.1	n.a.	n.a.	/
<i>Difference</i>		0.0		0.0	/	/	/
<i>of which<sup>3</sup>: - elasticity component</i>		0.0		0.0	/	/	/
<i>- composition component</i>		0.0		0.0	/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base <sup>7</sup>	1.1	1.1	0.5	0.3	n.a.	n.a.	1.00
- of tax base <sup>7</sup> to GDP	1.1	1.2	1.1	1.2	1.2	1.2	1.59
<b>Notes:</b>							
<sup>1</sup> OECD ex-ante elasticities							
<sup>2</sup> On a no-policy change basis							
<sup>3</sup> The decomposition is explained in the text above							
<sup>4</sup> Tax base = private consumption expenditure							
<sup>5</sup> Tax base = compensation of employees							
<sup>6</sup> Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period							
<sup>7</sup> Tax base = gross operating surplus							
<i>Source:</i>							
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)							

## Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	ex-ante <sup>1</sup>	COM <sup>2</sup> (observed)	ex-ante <sup>1</sup>
<b>Taxes on production and imports:</b>				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0
<i>Difference</i>	0.0		0.0	
<i>of which<sup>3</sup>: - elasticity component</i>	0.0		0.0	
<i>- composition component</i>	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>4</sup>	1.0	1.0	0.9	1.0
- of tax base <sup>4</sup> to GDP	1.0	1.0	1.0	1.0
<b>Social contributions:</b>				
Change in tax-to-GDP ratio	0.0	-0.1	0.0	-0.2
<i>Difference</i>	0.2		0.1	
<i>of which<sup>3</sup>: - elasticity component</i>	0.0		-0.1	
<i>- composition component</i>	0.1		0.2	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>5</sup>	1.2	1.1	1.0	1.1
- of tax base <sup>5</sup> to GDP	0.9	0.7	0.9	0.7
<b>Personal income tax<sup>6</sup>:</b>				
Change in tax-to-GDP ratio	0.1	0.1	-0.2	0.1
<i>Difference</i>	0.0		-0.2	
<i>of which<sup>3</sup>: - elasticity component</i>	-0.1		-0.3	
<i>- composition component</i>	0.1		0.2	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>5</sup>	1.3	1.7	0.5	1.7
- of tax base <sup>5</sup> to GDP	0.9	0.7	0.9	0.7
<b>Corporate income tax<sup>6</sup>:</b>				
Change in tax-to-GDP ratio	0.0	0.1	-0.1	0.1
<i>Difference</i>	0.0		-0.1	
<i>of which<sup>3</sup>: - elasticity component</i>	0.0		-0.1	
<i>- composition component</i>	0.0		-0.1	
p.m.: Observed elasticity:				
- of taxes to tax base <sup>7</sup>	1.1	1.0	0.5	1.0
- of tax base <sup>7</sup> to GDP	1.1	1.6	1.1	1.6
Notes:				
<sup>1</sup> Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD				
<sup>2</sup> On a no-policy change basis				
<sup>3</sup> The decomposition is explained in the text above				
<sup>4</sup> Tax base = private consumption expenditure				
<sup>5</sup> Tax base = compensation of employees				
<sup>6</sup> Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period				
<sup>7</sup> Tax base = gross operating surplus				
Source:				
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)				

## Annex 5: The rolling debt reduction benchmark

The rolling debt reduction benchmark discussed in Box 4 is calculated for successive five-year periods through a recursive application of the formula:

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

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 benchmark describes the path for convergence of the debt ratio towards 60% of GDP, which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. For nominal GDP growth rates higher than 5%, the benchmark can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the benchmark necessitates deficits lower than 3% of GDP.

## Annex 6: Indicators of long-term sustainability

**Table A1: Underlying assumptions compared**

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	1.6	:	1.8	:	1.7	:	1.7	:
Real GDP growth	2.4	:	1.6	:	1.6	:	1.6	:
Participation rate males (aged 15-64)	75.7	:	76.2	:	77.1	:	77.4	:
Participation rates females (aged 15-64)	64.8	:	66.1	:	67.9	:	68.7	:
Total participation rates (aged 15-64)	70.2	:	71.1	:	72.5	:	73.1	:
Unemployment rate	8.3	:	7.0	:	7.0	:	7.0	:
Population aged 65+ over total population	16.8	:	20.6	:	24.0	:	26.6	:

**Table A2: Long-term projections**

Main assumptions - programme scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes	Impact on S2
<i>Total age-related spending</i>	20.6	20.5	22.0	23.5	24.2	24.9	4.3	3.5
Pensions	13.0	13.0	13.8	14.4	14.7	14.9	1.9	1.6
Health care	7.6	7.5	8.2	9.1	9.6	10.0	2.4	1.9
Long-term care	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Education	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment benefits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Total primary non age-related spending</i>	27.9	27.9	27.9	27.9	27.9	27.9	0.0	0.0
<i>Total revenues</i>	50.5	50.5	50.5	50.5	50.5	50.5	0.0	0.0



**Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2**

	S1	S2
<b>2005 scenario</b>	<b>0.7</b>	<b>0.3</b>
<b>Programme scenario</b>	<b>0.2</b>	<b>0.1</b>

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

**Table A4: Debt development**

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
<i>Programme scenario</i>							
Gross debt	62.8	61.1	54.5	64.2	87.4	121.2	58.4
Gross debt, $i + 1^*$	62.8	61.7	61.3	78.6	113.4	164.7	101.9
Gross debt, $i - 1^*$	62.8	60.5	48.4	52.3	67.8	90.9	28.1
Adjusted gross debt	57.4	55.7	48.5	57.4	79.6	112.3	54.9
<i>2005 Scenario</i>							
Gross debt	68.3	69.2	91.0	132.8	193.4	269.9	201.5
Gross debt, $i + 1^*$	68.3	69.9	99.9	155.3	238.7	350.7	282.4
Gross debt, $i - 1^*$	68.3	68.6	82.8	113.9	158.2	211.2	142.8
Adjusted gross debt	63.7	64.6	85.8	127.0	186.8	262.3	198.6

\*  $i + 1$  and  $i - 1$  represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.

