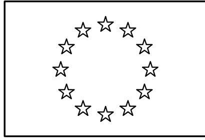

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 27 February 2007
ECFIN/50813/07-EN

ECONOMIC ASSESSMENT OF THE STABILITY PROGRAMME OF FRANCE (UPDATE OF DECEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of France's stability programme was submitted on 6 December 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 22 January 2007. Comments should be sent to Stéphanie Riso and/or Hervé Piffeteau (stephanie.riso@ec.euorpa.eu, herve.piffeteau@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2006. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

* * *

All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as France, has to submit a stability programme and annual updates thereof. The most recent programme, covering the period 2006-2010, was submitted on 6 December 2006.

Although over the last ten years the French business cycle moved much in line with that of the euro area and showed similar levels in growth, the unemployment rate averaged 10% in the last decade in France, exceeding the euro area unemployment rate by one percentage point, and was still relatively high in 2006 at 9.1%. The growth performance of the French economy was largely fuelled by domestic demand and especially by private consumption, thanks to supportive developments in the purchasing power of households. The demand side of the economy benefited from the effects of a favourable policy mix but this came at the cost of an increase in the budget deficit and the debt-to-GDP ratio. The consolidation effort, which started in 2004, reduced the deficit to below the 3% Treaty reference value in 2005, leading to the abrogation of the excessive deficit procedure in January 2007.

Regarding long-term sustainability, the budgetary situation in France, with a current structural primary deficit, constitutes a risk to sustainable public finance even before the long-term budgetary impact of ageing is considered. Notably, France faces the challenge of creating the necessary fiscal policy leeway for future economic downturns and of increasing resilience of public finances to population ageing. Even though the projected increase in age-related spending in France is slightly below the EU average, notably thanks to the implementation of major pension reforms, their full implementation remains crucial to obtain the expected results. Moreover, further progress is also needed in increasing employment rates, particularly among older workers. Wit regards to efficiency, France suffers from the decline in the intensity of use of human resources revealing the low participation of specific social groups such as young people, workers over 55 years of age and low-skilled workers. Creating the conditions for a more intensive utilisation of human resources in particular through the strengthening of integrated employment strategies should contribute to raising potential output. France also faces the challenge of reforming the functioning of the labour market, notably as regards its segmentation, in order to improve chances for outsiders to enter the labour market and to reduce inequalities stemming from contractual differences.

The stability programme update contains two different scenarios for the macroeconomic and budgetary projections: a “low” scenario and a “high” scenario. The “low” scenario, which is in line with the Commission services' autumn 2006 forecast, is considered the reference scenario for assessing budgetary projections. Assessed against available information, it appears to be based on plausible assumptions, although somewhat on the high side concerning 2006. It envisages that real GDP will grow by 2¼% per year over the programme period. The programme’s projections for inflation also appear realistic. The output gap estimates of the Commission services' autumn forecast are still negative (close to 1% of GDP) throughout the period 2006-2008. Considering that economic activity is largely driven by domestic demand, suggesting tax-rich growth, and that the unemployment rate has been on a downward trend since June 2005, economic conditions in France are considered to be neither good nor bad.

[1] The analysis takes into account (i) the Commission services’ autumn 2006 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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

For 2006, the general government deficit is estimated at 2.7% of GDP in the Commission services' autumn 2006 forecast, against a target of 2.9% of GDP for 2006 set in the previous update of the stability programme (and a deficit outturn of 2.9% of GDP in 2005). Although the GDP growth assumption is the same in the previous and current update, a range between 2% and 2.5%, the composition of growth is more tax rich in the current update as it is based on higher private consumption. The expected improvement in the deficit is supported by an acceleration in GDP growth (from 1.2% to about 2%) which boosts revenues, and by a slowdown in expenditure.

The update is inscribed in the French authorities' overarching strategy of "national commitment to debt reduction" and is presented as a programme for debt reduction targeting a zero deficit and a debt level below 60% of GDP by 2010. The planned fiscal consolidation is expenditure-driven: it is based on multi-annual targets for the increase in the general government expenditures that imply a reduction in the (primary) expenditure-to-GDP ratio by close to 3 percentage points of GDP over the period. Compared with the previous programme, the new update largely confirms the planned fiscal adjustment against a broadly unchanged macroeconomic scenario. The debt-to GDP ratio is projected to decline from 64.6% of GDP in 2006 to 58% in 2010.

The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from a deficit of about 2½% of GDP in 2006 to a surplus of about ¼% at the end of the programme period (2010). As in the previous update of the stability programme, the medium-term objective (MTO) for the budgetary position is a balanced position in structural terms, targeted to be reached in 2010.

The risks to the budgetary projections in the programme appear broadly balanced in the near term (until 2008), but budgetary outcomes could be worse than projected in the outer years. Concerning the near term, the adjustment mainly relies on stronger expenditure control at the State level, which is backed by the progressive implementation of the new Constitutional Bylaw on Budget Bills and the results of the modernisation audits and is plausible, although local authorities' expenditure trends are a risk factor. Regarding the outer years, the planned strong adjustment raises doubts about its full achievement. Indeed, even if the track record of the compliance with the expenditure norm at the State level is good, the drastic restraint envisaged calls for some reforms which are not spelled out in the programme. More generally, the track record related to the achievement of the overall general government expenditure ceilings, at the heart of the French budgetary consolidation strategy, together with the lack of enforcement mechanisms and the absence of expenditure rules for some sub-sectors, notably for local authorities, tilt the risks to the negative side. As regards debt projections, some risks exist in the outer years, given the risks to the budgetary targets mentioned above, and uncertainty about the materialization of planned non-strategic asset sales, which are larger than the historical average.

In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2010 as envisaged in the programme. However, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations towards the end of the programme period, most probably from 2009. Except for 2007, the pace of the adjustment towards the MTO implied by the programme is broadly in line with the Stability and Growth Pact, which prescribes an average improvement of 0.5% of GDP per year. Although France has only just corrected its excessive deficit, the envisaged adjustment for 2007 would be limited to 0.3 percentage point of GDP, while the economic situation cannot be assessed as "bad times" and tax elasticities

even point to "good times". Despite the risks to the debt projections assumed in the programme, the debt ratio seems to be sufficiently diminishing towards the 60% of GDP reference value over the programme period.

The initial budgetary position, albeit improved compared with 2005, still constitutes a risk to sustainable public finances. Moreover, the current level of gross debt is above the Treaty reference value. Further budgetary consolidation would contribute to reducing risks to the sustainability of public finances, which would also benefit from preserving and possibly enhancing the benefits of the pension reform. Overall, France appears to be at medium risk with regard to the sustainability of public finances.

The NRP, provided in the context of the renewed Lisbon strategy for growth and jobs, identifies as priorities the creation of the necessary conditions for strong economic growth, the reduction of unemployment and the increase in employment and the building-up of a knowledge-based economy. The Commission's assessment (adopted as part of its December 2006 Annual Progress Report[2]) of the Implementation Report submitted by the French authorities in October 2006, showed that France is making some good progress with the implementation of its NRP. Indeed, in a context of supportive macroeconomic developments, France has pursued its effort of fiscal consolidation, while trying to raise its potential growth, notably through new commitments towards research and innovation, but the labour market performance is still moderate. Against the background of strengths and weaknesses identified, France was recommended to take action in the areas of long-term sustainability of public finances, competition in gas, electricity and railway freight, as well as employment protection and life-long learning. The stability programme and the NRP are to some extent integrated. In particular, the measures in the area of public finances envisaged in both documents are consistent. While, there is no systematic information on the direct budgetary costs or saving of the reforms, the updated stability programme budgetary projections seem to take into account the public finance implications if the actions outlined in the NRP.

To conclude, after the correction of the excessive deficit and in a context of strong revenue growth, the updated stability programme gives priority to debt reduction and envisages progress towards the MTO through an expenditure-based but back-loaded adjustment. There are risks to the achievement of the budgetary targets, especially in the outer years. The track record related to the achievement of budgetary targets and the lack of enforcement mechanisms for expenditure rules, especially for local authorities, raise some concerns about the planned budgetary consolidation. Although the budgetary adjustment assumed in the programme seems to provide a safety margin against breaching the 3% of GDP threshold, further consolidation could be needed both to improve the sustainability of public finances and to prepare for future economic downturns. In this context, the planned reduction in the debt to below the 60% of GDP reference value would strengthen the resilience of public finances to adverse shocks, notably in view of the ageing of population. In this context, the full implementation of the pension reform enacted in recent years and a greater increase in the low employment rate of older workers than currently assumed remain crucial both to reduce the risks of possible pressures on public finances in the future and to raise potential output.

[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**SP Dec 2006**	**1.2**	**2.0-2.5**	**2.0-2.5**	**2 ¼**	**2 ¼**	**2 ¼**
	COM Nov 2006	1.2	2.2	2.3	2.1	n.a.	n.a.
	SP Jan 2006	*1.5-2.0*	*2.0-2.5*	*2 ¼*	*2 ¼*	*2 ¼*	*n.a.*
HICP inflation (%)	**SP Dec 2006**	**1.9**	**2.0**	**1.9**	**1 ¾**	**1 ¾**	**1 ¾**
	COM Nov 2006	1.9	2.0	1.8	1.9	n.a.	n.a.
	SP Jan 2006	*1.9*	*1.8*	*1 ¾*	*1 ¾*	*1 ¾*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2006[1]**	**-0.8**	**-0.6**	**-0.6**	**-0.5**	**-0.4**	**-0.3**
	COM Nov 2006[5]	-0.8	-0.8	-0.7	-0.9	n.a.	n.a.
	SP Jan 2006[1]	*-0.5*	*-0.4*	*-0.6*	*-0.8*	*-0.9*	*n.a.*
General government balance (% of GDP)	**SP Dec 2006**	**-2.9**	**-2.7**	**-2.5**	**-1.8**	**-0.9**	**0.0**
	COM Nov 2006	-2.9	-2.7	-2.6	-2.2	n.a.	n.a.
	SP Jan 2006	*-3.0*	*-2.9*	*-2.6*	*-1.9*	*-1.0*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2006**	**-0.2**	**-0.1**	**0.1**	**0.7**	**1.7**	**2.5**
	COM Nov 2006	-0.2	-0.1	0.0	0.4	n.a.	n.a.
	SP Jan 2006	*-0.3*	*-0.3*	*0.0*	*0.6*	*1.6*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2006[1]**	**-2.5**	**-2.4**	**-2.2**	**-1.6**	**-0.7**	**0.2**
	COM Nov 2006	-2.5	-2.3	-2.3	-1.8	n.a.	n.a.
	SP Jan 2006[1]	*-2.8*	*-2.7*	*-2.3*	*-1.5*	*-0.6*	*n.a.*
Structural balance[2] (% of GDP)	**SP Dec 2006[3]**	**-3.0**	**-2.5**	**-2.2**	**-1.6**	**-0.7**	**0.2**
	COM Nov 2006[4]	-3.1	-2.6	-2.3	-1.8	n.a.	n.a.
	SP Jan 2006	*-3.3*	*-2.9*	*-2.3*	*-1.5*	*-0.6*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2006**	**66.6**	**64.6**	**63.6**	**62.6**	**60.7**	**58.0**
	COM Nov 2006	66.6	64.7	63.9	63.3	n.a.	n.a.
	SP Jan 2006	*65.8*	*66.0*	*65.6*	*64.6*	*62.8*	*n.a.*

Notes:
[1]Commission services calculations on the basis of the information in the programme.
[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3]One-off and other temporary measures taken from the programme (0.5% of GDP in 2005,0.1% in 2006 and 0 thereafter; all deficit-reducing).
[4]One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (0.6% of GDP in 2005, 0.2% in 2006, and 0 thereafter; all deficit-reducing).
[5]Based on estimated potential growth of 2.0%, 2.2%, 2.2% and 2.3% respectively in the period 2005-2008.
Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services calculations

1. INTRODUCTION

The 2006 update of the French stability programme (henceforth "the update") was submitted to the Commission on 6 December 2006[3]. It covers the period from 2006 to 2010. The update was adopted by the government on 5 December 2006. It has not been formally adopted by parliament, but builds on the multi-annual projection attached to the Budget law for 2007, which was adopted by the government on 27 September 2006 and on 19 December by the national Parliament.

The update broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct although it does not discuss in detail one-off and other measures temporary measures. It has gaps in the compulsory data[4] prescribed by the new code of conduct, and some optional data[5] (especially data for long-term sustainability) are missing. The medium-term objective (MTO) for the budgetary position can be inferred from the update (see also Section 4.2.3 below). Annex 3 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

The section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second presents the results of a growth accounting exercise and tries to identify the main reasons for the average annual economic growth performance vis-à-vis the euro area. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies . The fourth part focuses on trends in public finances. Based on the picture outlined in the first four parts, the fifth identifies major economic challenges and implications for public finances.

2.1. Economic performance

Over the last ten years, real GDP grew in France at an annual average of 2.2%, matching the euro area average very closely (see Table 1). During the first half of this period, annual growth reached 2¾% on average, as in the euro area as a whole. As shown in Figure 1, the subsequent economic slowdown was slightly less pronounced in France, with annual average growth decelerating to 1.5% in 2001-2005, compared to 1.4% in the euro area. Yet the unemployment rate in France averaged 10% over the last ten years, exceeding the euro area unemployment rate by one percentage point. It peaked at 12.1% in 1997 and although it has been on a downward trend since then, it remains at a high level (9.7% in 2005). Inflationary

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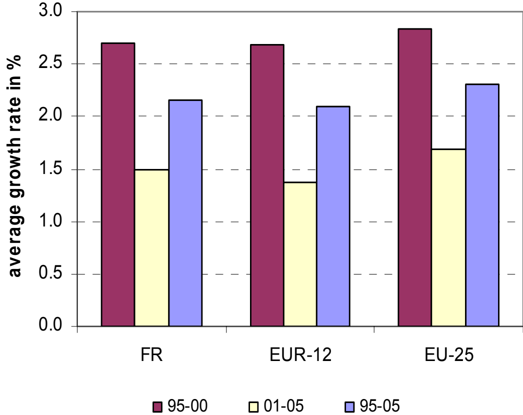
[3] The English version was not available on the cut-off date (22 January 2007).

[4] Referring to the tables of the Code of Conduct fully presented in Annex 2, missing compulsory data are collective consumption in table 2 (General government budgetary prospects) and short- and long-term interest rates for the years 2008 to 2010 in table 8 (Basic assumptions).

[5] Referring to the tables of the Code of Conduct presented in Annex 2, 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 statistical discrepancy in table 1d (Sectoral balance), selected components of revenue for the years 2009 and 2010, social transfers' decomposition and compensation of employees 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.

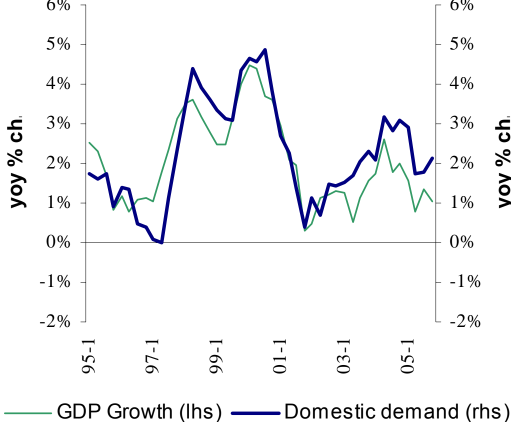
pressures, on the other hand, were lower in France than in the euro area (1.7% on average during the period, against 1.9%, respectively), supporting households' purchasing power.

Figure 1: Average GDP growth: France vs. EU25 and euro area



Source:
Commission services

Figure 2: France – GDP and domestic demand



Source:
Commission services

Economic growth in France was supported by domestic demand, and especially by private consumption, which was the main driving force in the last decade. Throughout the period, the contribution of domestic demand to GDP growth was 0.3 percentage point higher in France than in the euro area, and even 0.6 percentage point higher in the first half of the 2000s.

The strength of private consumption relied on the strong increase in real gross disposable income (see Figure 3). Between 1997 and 2002, this was trigged notably by robust employment growth, as a result of the French employment policy implemented since the mid-1990s, which focused on three pillars: (i) the reduction of social contributions, targeting notably workers at the low end of the wage scale (implemented since the summer of 1993); (ii) the reduction of working time (legislation adopted in 1998-2002); and (iii) some relaxation of the labour market legislation through the development of new contracts (between 1990 and 2001, the share of interim and temporary contracts in the private sector increased from 6% to 11%). Consequently, between 1997 and 2002 employment grew by 1.5% per year, against 1% per year over the period 1996-2005.

Based on several studies, cuts in social contributions explain one quarter of total employment creation observed between 1994 and 1997 (about 470 000 new employees, or 2% of total domestic employment). According to official estimates[6], an additional 300 000 jobs were created over the period 1999-2002 when working time reduction laws were implemented, which included large social contribution exemptions aiming at partly neutralising the effect of the reduction of working time on labour costs[7]. The implementation of the working time

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[6] The French Ministry of Finance, 2002, Rapport économique et financier (p.64-65).

[7] Most working time reduction agreements guaranteed unchanged monthly wages, implying a marked increase in hourly wages. This increase did not trigger a parallel rise in unit labour costs, since it was compensated by

reduction policies also led to the creation of several levels of minimum wages, which over the 2002-2005 period converged towards the upper range. Consequently, the average hourly minimum wage (SMIC) rose by about 6% in real terms, which accounts for about 20% of the increase in the real wage of employees per head in the private sector and has undoubtedly contributed to the growth in households' purchasing power.

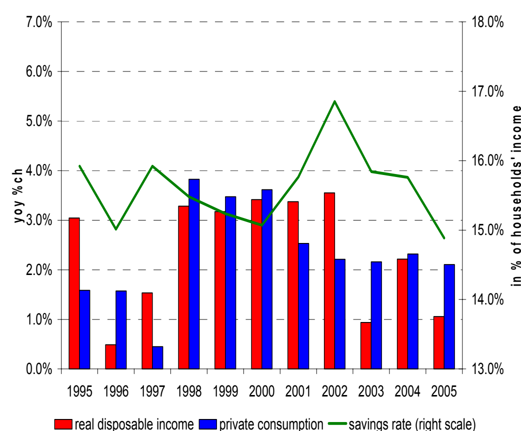
Strong consumer demand in the first half of the 2000s was also supported by a global tax alleviation strategy, which encompassed different measures, including *inter alia* a number of reductions in direct and indirect taxes[8]. In 2003 and 2004, to encourage households to free up savings the French authorities introduced temporary measures, such as tax exemptions on intergenerational transfers and on the withdrawal of balances held by employees in companies' savings schemes. These measures are likely to have produced an impact on the households' savings rate, which decreased to 15% in 2005 from a peak of 17% in 2002. Sustained improvements in consumer confidence may also have contributed to the decline in the savings rate. In particular, the decrease in the unemployment rate in the second half of 1990s and the implementation of reforms on pensions and healthcare may have reduced households' concerns about their financial situation and encouraged them to partly reduce their precautionary saving rate. Developments in housing markets may also have supported consumer confidence, but there is little empirical evidence that the boom in housing prices has been a major determinant of the resilience of private consumption in France, as (i) residential mortgage debt remains weak and (ii) the debt of French households largely consists of fixed interest rate contracts.

Over the last five years, French economic growth was limited by a significant drag from the external sector, which reflected buoyant imports and a relative weakness of exports, especially compared to developments in some other euro area countries. Exports recorded an average growth rate of 2%, which was 1½ percentage point lower than that of the euro area as a whole, while imports increased more strongly in France than in the euro area in response to the robustness of domestic demand. Despite the strong rebound in exports in the second half 2005, concerns about the export performance and competitiveness have not fully disappeared, also since exports weakened in the second and third quarters of 2006, when net trade again made a negative contribution to growth. While the performance of exports deteriorated by 10% in France between 2001 and 2005, it improved by 10% in Germany during the same period (see Figure 4).

(1) higher hourly productivity gains resulting from work re-organisation leading to a more intensive use of existing capital, (2) moderate wage growth in the years following the reduction of working time and (3) large cuts in social contributions.

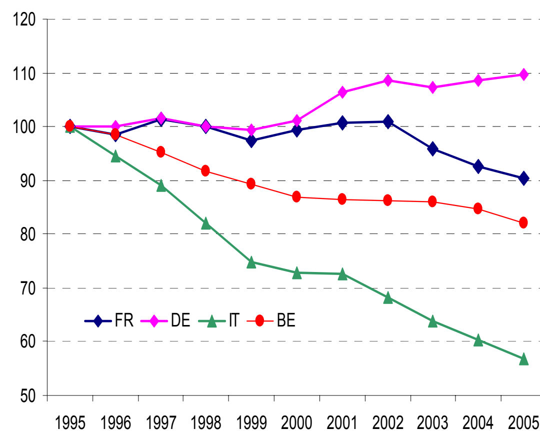
[8] This included, on top of the reductions in social contributions described above, the quasi-permanent reduction in personal income taxes which started in 2000, the introduction of a tax credit for low paid workers, a reduction in the corporate tax, the creation of a negative tax with the so-called premium for employment, a 1% cut of the VAT rate from 20.6% to 19.6%, the reduction in the VAT rate for home refurbishment in 1999 and the elimination of the road vehicle tax in 2000. The tax reduction package for the years 2000-2003 amounted to about 2% of GDP.

Figure 3: Households' consumption and real disposable income



Source:
Commission services

Figure 4: Export performance
(1995 = 100)



Note:
Export performance: Index for exports divided by an index for growth of export markets (imports of goods and services in France's trading partners – including EU trading partners – weighted according to their share in France's exports of goods).

Source:
Commission services

France's disappointing export growth over recent years mainly reflects (i) a slowdown in world demand addressed to France, and (ii) a deterioration in price competitiveness.

The slowdown in world demand addressed to France ensued both from the deterioration of world trade in the late 1990s and an unfavourable geographical trade structure. Not only did the French economy suffer from the decrease in world trade, but it was also unable to fully take advantage of the subsequent upturn in the early 2000s. Since 2000, world demand addressed to France (which is defined as the weighted sum of import volumes of all its trading partners) increased by around 5%, while world trade rose by 7%. In part, this was due to the weakness of intra-euro area trade, and in particular sluggish domestic demand growth in Germany and Italy, France's most important trade partners which together absorb 25% of total exports. A deterioration in price competitiveness also hampered French export growth over the last five years[9].

More worryingly, French export market losses may have gone beyond what might be explained by these traditional determinants: other factors, difficult to quantify (such as non-price competitiveness) may have hampered export growth[10]. This deterioration of non-price competitiveness raises concerns, as the reversal of such a trend could take time.

[9] According to econometric analysis carried out by the Commission services, changes in price competitiveness contributed to the deterioration in export growth by 0.3 percentage point per year over the last five years.

[10] According to Commission services' calculations, the part of export dynamics not explained by world demand developments or by developments in price competitiveness, amounted to 2½% percentage points on average in 2001-2005.

France's exposure to international competition has increased, mainly as a result of growing trade with Spain and China. French exports are structurally more oriented toward slow growing areas (in 2004, 40% of French exports went to countries whose annual GDP growth rate over the last ten years did not exceed 2¼%). However, according to several studies this unfavourable geographical composition of trade may have contributed no more than 10% to the slowdown in exports[11].

The French economy does not suffer from unfavourable product specialisation as exports mainly consist of products for which demand has been relatively buoyant in recent years (growing at a higher pace than the average growth of total import markets)[12]. However, since French manufacturing exports concentrate on products with a medium-high degree of technology sophistication and with a limited degree of product differentiation, the rapid development of China and India but also of other emerging economies has intensified the international competition that France faces. Globalisation entails a reallocation of resources which may generate frictions especially on the labour market: cost adjustments could be high in a country such as France, which has a high degree of employment protection[13].

2.2. Anatomy of medium-term growth

Within the framework of a traditional growth accounting exercise, this section dissects the sources of average growth as well as possible differences in average economic growth vis-à-vis the euro area The growth accounting exercise is carried out on the basis of the Cobb-Douglas production function underlying the commonly agreed method for the assessment of stability and convergence programmes.

Figure 5 and Figure 6 illustrate the growth performance of France in absolute terms and relative to the euro area average. As underlined in the previous section, throughout the period 1996-2000 French GDP growth was very close to GDP growth in the euro area. Nevertheless, despite labour deepening between 1997-2002[14], the decomposition of growth reveals, *inter alia*, that the net contribution from labour inputs in France is somewhat weaker than in the euro area throughout the period 1996-2005.Whereas favourable demographic developments sustained GDP growth in France, the decrease in average hours worked and a sluggish rise of the participation ratio hampered it.

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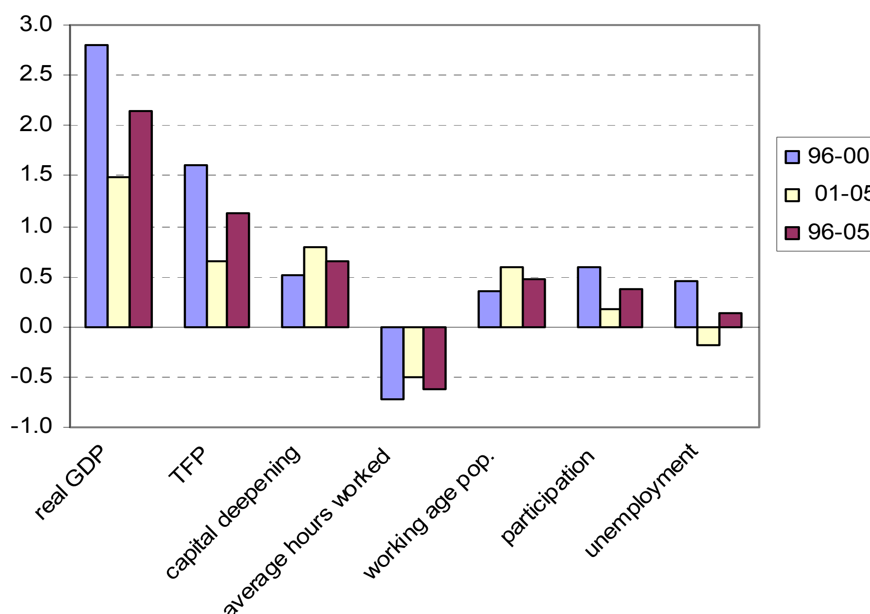
[11] J.P Villetelle (Bulletin de la Banque de France), février 2006, "les mauvaises performances du commerce extérieur de la France sont-elles liées à un problème de demande ?"; P.artus and L. Fontagné, novembre 2006, "Evolution récente du commerce extérieur français".

[12] A common indicator highlighting the pattern and degree of specialisation is the Balassa index. For the period 1996-2004, the hypothetical growth rate of total exports of France that would have been observed if, at the level of sectors, exports had grown at the rate observed at the global level, is higher than the actual growth of total exports. Consequently, one can assume that the French export performance does not suffer from unfavourable product specialisation.

[13] According to OECD indicators, employment protection for permanent workers is high in France.

[14] Between 1997-2002, GDP growth was on average 2.5% per year with employment growth of 1.5% while throughout the period 1996-2005, GDP growth reached on average 2.2% with employment growth of 1.0%.

Figure 5: Real GDP growth and its components



Note:
Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP, L* employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as:

$$Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)$$

where *WP* stands for working age population, *PART* denotes the participation ratio as a share of *WP* and *ur* the rate of unemployment. In terms of growth rates *g* this is:

$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source:
Commission services

France is characterised by a weak use of its labour force, with a lower employment rate and less hours worked per employee than the euro area averages.

While the employment rate increased by 6 percentage point in the euro area, it only grew by 3 percentage points in France between 1996 and 2005. With only 62% of people of working age in employment against 66% for the euro area as whole in 2005, France is among the worst performers. The modest increase of the employment rate reflects both the weak increase in the participation rate over the last ten years (from 66% in 1996 to 68% in 2005) and a persistently high unemployment rate (9.7% in 2005). This performance hides significant differences between age groups, with clear problems at both ends of the age distribution. Between 1999 and 2003 the increases in employment rates at both ends of the age distribution were twice as high in France as in the euro area. Despite this improvement, youth and older worker employment rates are still lower than the euro area averages. For young people the low employment rate is due to a combination of high unemployment (23% of the labour force, as against 17% in the euro area) and low participation rates (38% of the working age population as against 45% in the euro area). For people aged 55 and above it is essentially an issue of low participation (40% of the working age population as against 44% in the euro area).

Although low youth employment is in part explained by better and more extended education opportunities compared to the past, France still performs worse than other countries with similar enrolment rates. In the case of persons aged between 55 and 64, the decline of the employment rate came to an end at the end of the 1990s, mostly due to the implementation of pension reform in the private sector[15] but it barely reached 38% in 2005 (40% in the euro area).

The low number of hours worked is also one of the explanations for the low intensity of use of the labour force. As in most industrialised OECD countries, the number of hours worked per person in France followed a downward trend over the last decade, and this decrease has even been stronger since 2000[16]. This reduction of working time mainly reflects the implementation of specific policy measures aiming to reduce the legal weekly working time (see section 1.1). However, since 2003, the French authorities introduced more flexibility by allowing a large recourse to overtime hours in order to partly offset the impact of working time reduction implemented between 1998 and 2000.

Considering that the use of the labour force has hardly risen over the last ten years, developments in GDP growth depend on productivity performance. Productivity growth results from various factors, such as human capital, training, research and development, the incorporation of information and communication technologies into the economy. Throughout the period 1996-2005, the net contribution of TFP (total factor productivity) to GDP growth reached on average 1.1 percentage point, reflecting the good performance of labour productivity (+1.2% over the last ten years). Nevertheless, in France labour productivity is partly biased by the fact that the high levels of minimum wages result in the exclusion of the least productive workers from the labour market. Conversely, policies aiming at reducing the cost of labour, in particular at the low end of the wage scale, contributed to labour deepening in the years 1998-2002. This led to a slowdown of labour productivity and to deteriorating TFP growth in the years 2001-2005.

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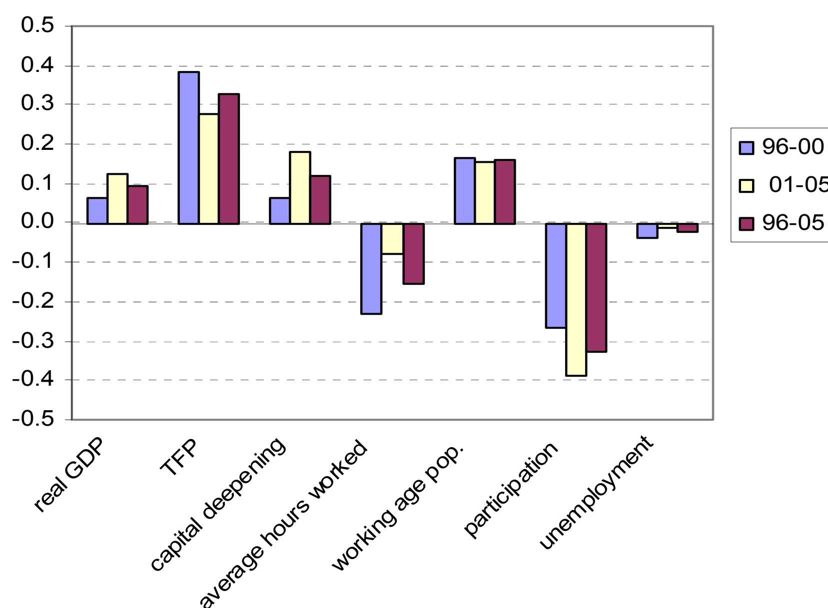
[15] The reform implemented in 1993 for the private sector progressively increased the number of contribution years entitling to a full pension. In 2003, a similar reform was introduced for the public sector.

[16] The number of hours worked in France per employee was in 2005 10% lower in France than in EU-15.

Figure 6: Real GDP growth and its components:
Difference vis-à-vis euro area average



Note:
See note of Figure 5.
Source:
Commission services

2.3. Macro-policies against the backdrop of the economic cycle

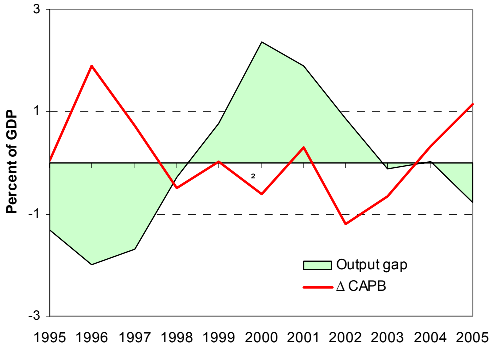
The marginally higher growth rate recorded in France compared to the euro area over the last ten years reflects a substantial recovery after the dismal performance of the mid-1990s, when the economy was weighed down by high real interest rates and the necessary substantial budgetary consolidation effort in preparation of EMU. In 1997, the output gap was more negative in France than in the euro area as whole (respectively -1.9% and -0.7% of the potential output). From 1998, real GDP growth sharply accelerated and remained high up to 2000. The growth differential with the euro area became positive and remained favourable to France until 2005.

The strong recovery of the French economy could also be ascribed to the implementation of a more favourable policy mix, in particular concerning the budgetary component. Figure 7 shows that the fiscal stance (approximated by the change in the cyclically-adjusted primary balance, CAPB) was broadly supportive between 1998 and 2002. The developments of public finances over the cycle can be split into a cyclical and a non-cyclical component. The cyclical component of the development of the budget balance – by definition – mutes the deviations of actual growth from potential, i.e. the working of the automatic stabilisers[17].

[17] On the revenue side, the automatic changes stem from the correlation between the tax base (income, compensation, wealth) and the cycle. On the expenditure side, social security benefits move with economic developments.

A commonly used measure of "discretionary fiscal policy" is the change of the cyclically-adjusted primary balance (CAPB). Since this variable is also influenced by other factors such as changes in the budgetary elasticities or growth surprises, it has to be interpreted with care. Figure 8 shows that since 1995 the non-cyclical component of the change in the budget deficit has counteracted the working of the automatic stabilisers in France in 7 out of 11 years. Considering that the budget was not in balance or in surplus, as prescribed by the Pact, a tightening fiscal stance, reflected by a positive change in the non-cyclical component over the cycle, should have been adopted (as in 1996 and 1997). Instead, starting from 1998, a deterioration was observed: the non-cyclical component of the change in the budget deficit played against the automatic stabilisers and aggravated the deficit. Indeed, a large part of the higher-than-expected cyclical fiscal revenues of the years 1998 to 2001 – especially income and corporate tax – was used to finance tax cuts and additional expenditure rather than to accelerate the reduction of the general government deficit[18].

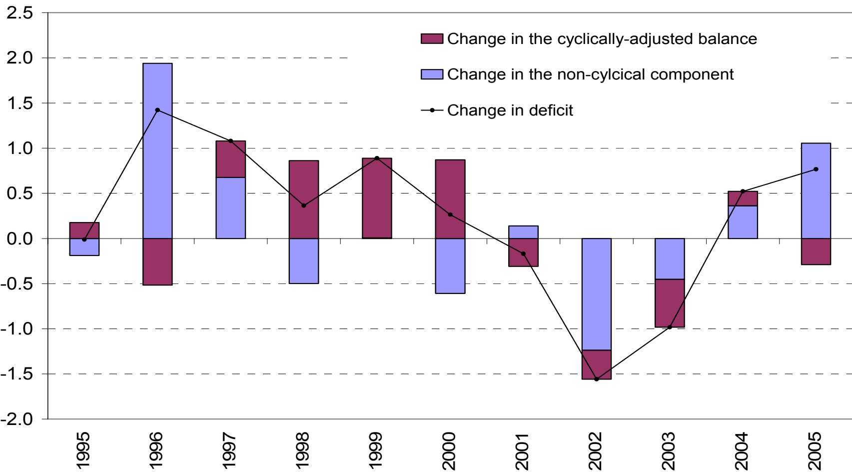
Figure 7: Output gap and fiscal stance



Note:
ΔCAPB denotes the change in the cyclically-adjusted primary budget balance

Source:
Commission services

Figure 8: Automatic and discretionary annual changes in the French budget deficit

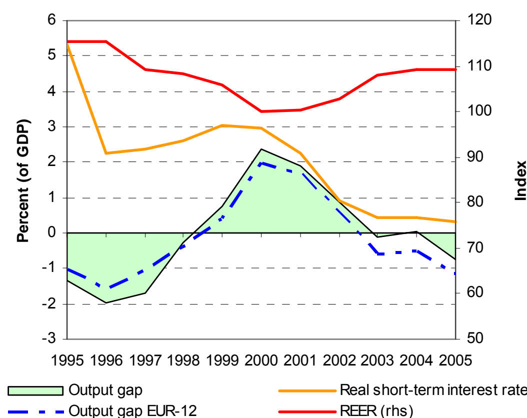


Source:
Eurostat, European Commission services' calculations

[18] In 2000, higher-than-expected revenues reached about 0.5% of GDP, 4/5 of which was allocated to a fiscal package amounting to 1% of GDP, aimed at reducing the tax burden and encouraging employment and the remaining part to higher expenditure through an upward revision of the expenditure ceilings (cf. footnote 8).

In 2002, the fiscal stance was loosened considerably, with the cyclically-adjusted deficit and primary balance both deteriorating by over one percentage point of GDP. This led to a marked increase in the nominal deficit, which jumped from 1.5% of GDP in 2001 to 3.2% of GDP in 2002 and resulted in the launching of an excessive deficit procedure in 2003. The deterioration of the deficit continued in 2003, when it reached 4.2% of GDP, a further widening of the deficit by 0.5% of GDP in cyclically-adjusted terms.

Figure 9: Output gap and monetary stance



Source:
Commission services

As regards the monetary conditions, they were also broadly accommodative throughout the period 1996-2005. The real interest rate started to decline in 1999 and reached a low of 0.5% at the beginning of the current decade, facilitating access to credit and thereby supporting household demand and underpinning the boom in the housing market. Nevertheless, despite the boom in house prices the wealth effect seems to have been limited in France, as the size of the households sector's residential mortgage debt remained weak. Moreover, the appreciation of the real exchange rate around the year 2000 partly hampered GDP growth due to the deterioration of competitiveness, although the poor performance of the external sector is also related to structural factors (as discussed in the previous sections).

2.4. Public finances

Three periods can be distinguished when looking at the French public finances evolution over the last 10 years: a period of deficit reduction in the run-up to the euro, from 5.5% in 1995 to 1.5% of GDP in 2000, followed by a significant re-orientation of fiscal policy, with the authorities attaching a higher priority to the alleviation of the tax burden, which led to a continuous increase in the deficit from 1.5% in 2000 to 4.2% in 2003.

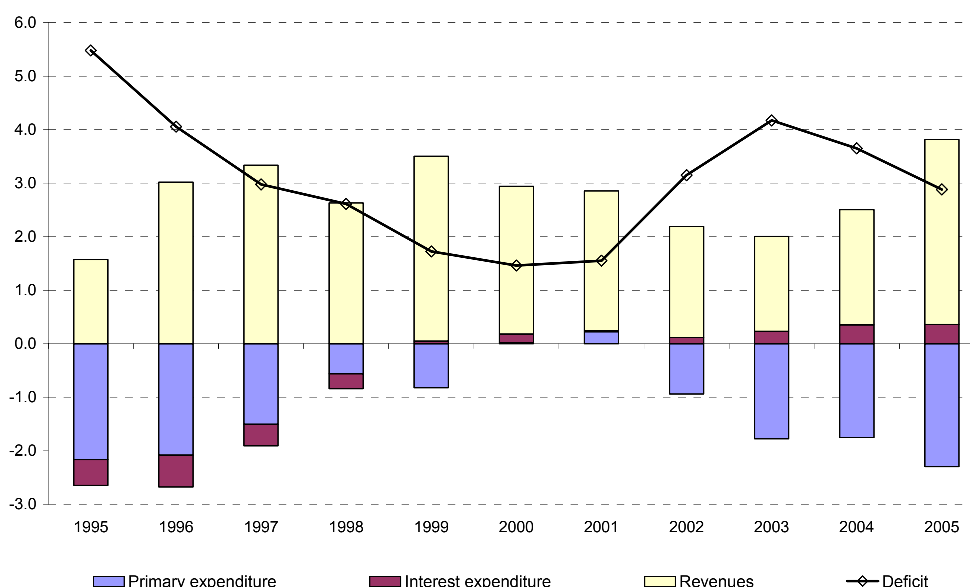
France returned on a consolidation course in 2004: the deficit was reduced to 3.7% of GDP, against the background of strengthened GDP growth. In 2005, the deficit fell further to 2.9% of GDP, a revenue-driven adjustment (the revenue-to-GDP ratio increased by 1.3% of GDP, over-compensating the 0.5% of GDP rise in the total expenditure-to-GDP ratio). The reduction in the deficit substantially relied on one-off revenues amounting to 0.6% of GDP[19]. In structural terms the deficit improved that year by 0.6% of GDP and the cyclically-adjusted primary balance improved by 1.2% of GDP.

Economic literature suggests that fiscal consolidations based on expenditure cuts are more likely to be permanent than those based on revenue increases, and to have medium-term expansionary effects. Since 1998, France's budgetary strategy relies on multi-annual objectives for increases in real general government expenditures that imply a reduction in the

[19] Chiefly (a) a lump-sum in exchange for the transfer to the social security of responsibility for the payment of pensions in public electricity and gas companies (the so-called "soulte EDF") and (b) a change in the corporate tax code decided in December 2005.

expenditure-to-GDP ratio[20]. However, this did not lead to the expected results and the objective of consolidating public finances through a structural decline in the expenditure-to-GDP ratio was not achieved. It is clear from Figure 10 that consolidation was built on increased revenues (and to a lesser extent on reduced interest expenditure), while the increase in primary expenditure played in the opposite direction. Following a functional classification, primary expenditure composition has been fairly stable between 1995 and 2005 at 51% of GDP[21].

Figure 10: Government deficit and composition of the fiscal consolidation since 1995 (in % of GDP, cumulative changes compared to 1995)



Source:
Commission services

Initial budgetary targets were always missed and most of the time by a large margin[22] (Figure 11), despite the fact that the State expenditure target (zero volume growth) was respected (except in 2002, a presidential election year). In 2005, for the first time in many years, the national health insurance spending target (ONDAM: Objectif National des Dépenses d'Assurance Maladie) was almost achieved, notably thanks to the health-care reform of 2004, which, among other things, put into place an alert committee that recommends measures in

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[20] For a detailed presentation of these rules and their implementation, see Moulin, L., (2004), "Expenditure rules *à la française*: an assessment after five years", Country Focus, European Commission – DG Ecfin, volume 1 issue 5, and "Public finances in EMU 2006", (2006), European Economy, No.3, p.230-232.

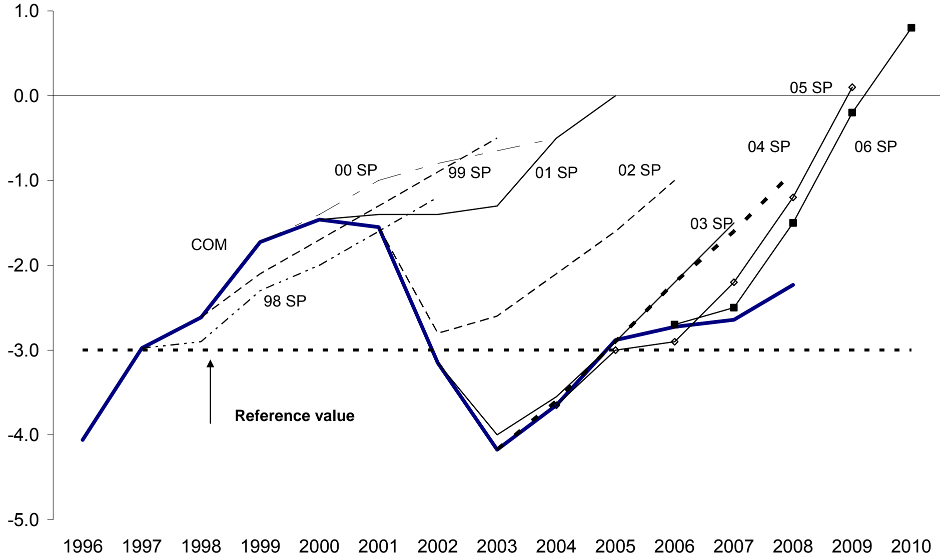
(http://ec.europa.eu/economy_finance/publications/european_economy/2006/ee306_en.pdf).

[21] The main items are: social protection (22.7% of GDP, +0.5% of GDP over 1995-2005), health (7.3% of GDP, +0.8% of GDP over 1995-2005), and "other functions" (7.5% of GDP, +0.5% of GDP over 1995-2005), which include defence, environment, culture and public order.

[22] 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.

case substantial deviations from the target are identified during the year. However, State expenditures now only represent about 40% of the general government expenditure, with social security and local government expenditure representing about 40% and 20% of the total, respectively. Thus, despite the respect of the expenditure targets both at the State and health-care expenditure level, in 2005 a slippage of 0.6% in real terms occurred in the general government expenditure at the level of local governments and social benefits other than healthcare, the two sectors where so far no specific expenditure rules have applied. This suggests that the achievement of the overall general government target requires that all sub-sectors participate in the expenditure restraint effort.

Figure 11: General government balance projections in successive stability programmes (% of GDP)



Source:
Commission services and national stability programmes

The short-term budgetary stimulus between 1998 and 2003 (see section 1.3) also had important consequences for the debt-to-GDP ratio, which continuously increased over the same period, and reached nearly 67% of GDP in 2005. The excess over the 60% reference value (since 2003) was mainly due to developments in the deficit, and in some years amplified by stock-flow adjustments[23] (SFAs).

The initial budgetary position with a structural primary balance of -0.5% of GDP in 2005 constitutes a risk to sustainable public finances even before the long-term budgetary impact of ageing is considered. For example, achieving the medium-term objective would considerably

[23] Stock-flow adjustment (SFA) represents the difference between the change in the outstanding level of the debt and the yearly deficit flow. In 2003, the SFA was 2 percentage points of GDP in connection with the switch of the assets of the pension reserve fund (FRR, *Fonds de Réserve pour les Retraites*) from government bonds to private bonds and shares and the increase of the capital of France Télécom. In 2005, more than 1 percentage point out of the 2 percentage points of SFA were linked to the acquisition by the FRR of substantial financial assets and of complementary pension schemes, and with an accumulation of liquidity. The rest was linked to the difference between cash and accrual expenditure recording in connection with the change in the recording of military expenditures and the recording of the "soulte EDF" (as a large share of the payments already recorded as revenue will be collected over the next 20 years).

reduce the sustainability gap (see section 5.2). This shows the importance of strengthening the structural primary surplus over the medium-term. Moreover, even though the projected increase in age-related spending in France is slightly below the EU average, current pension arrangements might come under pressure at some point due to a projected decrease in the benefit ratio (defined as the average pension per GDP per worker). An increase in the employment rate of older workers, currently below the average of the EU (36% against 43%) would mean that the benefit ratio would decrease less markedly.

2.5. Medium and long-term policy challenges for public finances

Based on the experience of the last ten years, the French business cycle moves in line with that of the euro area and shows similar levels in growth. Nevertheless, the unemployment rate averaged 10% in the last decade in France, exceeding euro area unemployment rate by one percentage point. Although it recently showed a downward trend from 12.1% in 1997 to 9.7 % in end 2005, it is still relatively high. The rather solid growth performance of the French economy was largely fuelled by domestic demand and especially by private consumption thanks to supportive developments in the purchasing power of households. The demand side of the economy benefited from the effects of a favourable policy mix but this came at the price of significant fiscal imbalances. The consolidation effort, which started in 2004, reduced the deficit to below the 3% Treaty reference value in 2005, but further consolidation is needed both to improve the long term sustainability of public finances and to create a budgetary margin for future economic downturns. A greater increase in the low employment of older workers than currently assumed would foster GDP growth and reduce the pressure on public finances.

Consequently, the challenges faced by the French economy are related to sustainability and efficiency.

On long-term sustainability: The budgetary situation in France, with a current structural primary deficit, constitutes a risk to sustainable public finance even before the long-term budgetary impact of ageing is considered. Notably, France faces the challenge of creating the necessary fiscal policy leeway for future economic downturns. Also, increasing the resilience of public finances to adverse developments, and notably the ageing of the population, will strengthen the need for further consolidation and for a reduction in the debt-to-GDP ratio (which peaked to 66.6% of GDP in 2005). Even though the projected increase in age-related spending in France is slightly below the EU average, notably thanks to the implementation of major pension reforms, their full implementation remains crucial to obtain the expected results. The success of the pension reforms will also depend on further progress in increasing employment rates, particularly among older workers. A greater increase in the low employment rate of older workers than currently assumed would foster GDP growth and ensure that workers can accumulate enough pension rights, which would reduce the risk of possible pressures on public finances emerging in the future.

On efficiency: France suffers from the decline in the intensity of use of human resources revealing the low participation of specific social groups such as young people, workers over 55 years of age and low-skilled workers. In parallel, sustained high levels of unemployment not only lead to an underutilisation of human resources but also appear as a threat in terms of social exclusion. Creating the conditions for a more intensive utilisation of human resources in particular through the strengthening of integrated employment strategies should contribute to raising potential output. In particular, demand for labour could be expanded by reducing

labour costs, while a reinforced implementation of back-to-work policies[24] could support labour supply. France faces the challenge of reforming the functioning of the labour market, notably as regards its segmentation, in order to improve chances for outsiders to enter the labour market and to reduce inequalities stemming from contractual differences. Also, budgetary consolidation should allow for a reorientation of public expenditure towards key factors of economic development, such as in the education fields, long-life learning, innovation diffusion and reduction of inequalities, as identified by the French national reform programme[25].

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[24] Incentives to stay out of work created by the tax and benefit system are higher in France than in most EU-15 countries. Nevertheless, the French authorities have started to react to this situation. In 2003 and in 2004, eligibility conditions to unemployment benefits were tightened, through a lengthening of the working period entitling individuals to benefits, and the maximum duration of benefits was reduced.

[25] Available on the Internet at the following address: http://www.ec.europa.eu/growthandjobs/pdf/nrp/FR_nrp_fr.pdf

Table 1: Key economic indicators

	France						Euro area					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.2	2.8	1.5	1.1	2.3	1.2	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
Domestic demand	2.3	2.7	1.9	1.7	3.0	1.9	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	-0.2	0.1	-0.4	-0.6	-0.6	-0.8	0.1	0.1	0.1	-0.7	0.2	-0.2
Prices, costs and labour market												
HICP inflation (% change)	1.7	1.3	2.0	2.2	2.3	1.9	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	1.2	1.5	0.8	1.1	2.3	0.9	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.2	-0.3	0.0	-0.1	-0.6	0.0	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	1.0	1.4	0.6	0.1	0.0	0.3	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	10.0	10.8	9.2	9.5	9.6	9.7	9.1	9.8	8.5	8.7	8.9	8.6
Competitiveness and external position												
Real effective exchange rate (% change) (1)	-0.4	-2.7	1.9	4.7	1.4	0.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	-1.0	-0.1	-1.8	-4.9	-3.5	-2.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	0.9	2.0	-0.2	-0.2	-0.6	-2.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances												
General government balance (% of GDP)	-2.8	-2.6	-3.1	-4.2	-3.7	-2.9	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	59.8	58.0	61.6	62.4	64.4	66.6	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-4.1	-3.8	-3.1	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
Financial indicators (4)												
Long term real interest rate (%) (5)	3.3	4.3	2.3	2.2	2.4	1.5	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP) (6)	38.3	36.2	40.3	39.7	41.5	44.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	66.4	61.3	71.5	70.1	70.2	73.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:
More detailed tables summarising the economic performance of the country are included in Annex 4.
(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.
(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.
(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.
(4) Data available up to 2004.
(5) Using GDP deflator.
(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.
(7) Non-financial corporate sector debt, defined as loans and securities other than shares.
Source:
Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output growth, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

3.1. External assumptions

According to the last update of the stability programme, the world economic activity is expected to be less supportive for the French economy in 2007, since the US economy is projected to slow down on the back of a cooling housing market and economic growth in the German economy projected to ease due to the VAT hike in 2007. Although the external outlook is not fully described beyond 2007, the programme foresees a gradual increase in world demand for French goods and services.

The external assumptions in the programme are broadly in line with the Commission services' autumn 2006 forecast, notably in terms of euro exchange rate assumption (1.28 USD/Euro against 1.27 in the autumn forecasts). However, the update assumes that oil prices remain stable at US-dollar 70 per barrel in real terms[26] until 2007 and thereafter. This is slightly above the Commission services' assumptions of a slight increase from US-dollar 66 per barrel to US-dollar 68 per barrel in 2008.

3.2. Economic activity

For 2006 and 2007, the programme confirms the GDP growth ranges presented last autumn in the 2007 draft budget law, namely 2.0-2.5% for both 2006 and 2007. For the years 2008-2010 the programme presents two macroeconomic scenarios: a so-called "low scenario", in which real GDP growth is foreseen to be at 2¼% per year (see Table 2), and a so-called "high scenario" in which real GDP would reach 3% for the years 2008-2010. The "low scenario" is considered to be the reference scenario in this assessment, as it is the closest to the Commission services' autumn 2006 forecast.

The latest macroeconomic indicators suggest that GDP growth is likely to reach 2% in 2006, which is slightly below the Commission services' autumn 2006 estimate (2.2%). While the GDP turnout in the third quarter of 2006 has been disappointing, it is unlikely to represent the beginning of a downward trend in growth. The French economy is expected to expand in the final quarter of 2006, largely driven by private consumption. Overall, in 2006 the French economy should grow at a pace which should be around the lower end of the range foreseen by the programme. For 2007, the update is broadly in line with the Commission services' autumn 2006 forecast, even if the latter now may appear somewhat optimistic, considering that GDP growth in the second half of 2006 should be less strong than initially envisaged. In 2008, the growth outlook is similar to the Commission services' autumn 2006 forecast. For the period beyond 2008, the growth projections seem plausible given the estimates of potential growth in the Commission services' autumn forecasts for the period 2006-2008 as reported in Table 4.

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[26] According to the programme, the oil price should increase by 1¾ % per year throughout the period 2008-2010.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009	2010
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.2	2.0-2.5	2.3	2.0-2.5	2.1	2 ¼	2 ¼	2 ¼
Private consumption (% change)	2.8	2.8	2.5	2.7	2.3	2.5	2.5	2.4
Gross fixed capital formation (% change)	3.4	3.3	3.5	3.3	3.6	2.9	2.9	2.9
Exports of goods and services (% change)	8.0	7.9	6.0	6.2	5.7	5.9	5.9	5.9
Imports of goods and services (% change)	8.0	8.0	6.3	6.1	6.1	5.6	5.6	5.6
Contributions:								
- Final domestic demand	2.6	2.7	2.4	2.3	2.3	2.1	2.1	2.1
- Change in inventories	-0.1	0.5	0.1	0.1	0.0	0.1	0.1	0.1
- External balance on g&s	-0.1	-0.8	-0.2	-0.2	-0.2	0.0	0.0	0.0
Output gap[1]	-0.8	-0.6	-0.7	-0.6	-0.9	-0.5	-0.4	-0.3
Employment (% change)	0.8	0.8	0.9	1.1	0.8	0.6	0.5	0.5
Unemployment rate (%)	9.3	n.a.	9.0	n.a.	8.7	n.a.	n.a.	n.a.
Labour productivity growth (%)	1.4	1.5	1.3	1.2	1.3	1.7	1.7	1.7
HICP inflation (%)	2.0	2.0	1.8	1.9	1.9	1 ¾	1 ¾	1 ¾
GDP deflator (% change)	2.0	2.0	1.8	2.0	1.9	1 ¾	1 ¾	1 ¾
Comp. of employees (% change)	4.0	3.9	4.0	4.0	3.9	3.7	3.7	3.7
Real unit labour costs (% change)	-0.1	-0.3	-0.1	-0.2	-0.1	-0.3	-0.3	-0.3
External balance (% of GDP)	-2.1	-2.0	-1.9	-1.8	-2.1	-1.8	-1.7	-1.6

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below.
Source:
Commission services' autumn 2006 economic forecasts (COM); Stability programme

The composition of growth in the update is broadly similar to that in the Commission services' autumn 2006 forecasts, with macroeconomic growth driven by domestic demand in both cases. 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 five years, would become neutral from 2008 onwards in the programme, while the Commission services estimate that it would still weigh on economic growth by 0.2 percentage point in 2008.

The programme's higher forecast for household consumption growth (which is the tax base for indirect taxes) both in 2007 and 2008 compared to the Commission services' autumn 2006 forecast could be explained by a slightly higher projection for employment growth in 2007 and by a negative inflation differential in 2008. As regards total compensation of employees, which are the tax base for the personal income tax and social contributions, the projected increase for 2007 in the programme is similar to that in the Commission services' autumn 2006 forecast for 2007, while for 2008 it is marginally lower.

Table 3 presents the output gap estimates based on the commonly agreed method, for both successive Commission services' forecasts and programmes. Although the negative output gap implied by the programme data is slightly lower than that in the Commission services' autumn 2006 forecasts, the changes until the end of 2008 are broadly similar, with real GDP growth in both cases close to potential output.[27]. Moreover, when comparing the latest available estimate of the output gap of the first two years of the programme (2006-2007) with

[27] It should be noted that there are some differences between the output gap recalculations reported in Table 3 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 0.6% of GDP in 2006 compared to 0.2% of GDP in the programme. Nevertheless, the Commission services' recalculations and the programme's projections lead to a slight closing of the output gap over the programme period.

the estimates for the same years made in previous forecast rounds and programmes, it appears that the assessment of cyclical conditions has not significantly change over time.

Table 3: Output gap estimates in successive Commission services' forecasts and stability programmes

	2006		2007		2008	
	COM	SP[1]	COM	SP[1]	COM	SP[1]
SP Dec 2006	-	-0.6	-	-0.6	-	-0.5
Autumn 2006	-0.8	-	-0.7	-	-0.9	-
Spring 2006	-1.0	-	-1.3	-	-	-
SP Jan 2006	-	-0.4	-	-0.6	-	-0.8
Autumn 2005	-0.9	-	-1.0	-	-	-
Spring 2005	-0.7	-	-	-	-	-
SP Dec. 2004	-	-0.4	-	-0.4	-	-0.4

Note:
[1] Commission services' calculations according to the commonly agreed method based on the information in the programme.
Source:
Commission services' forecasts, national Stability programme and Commission services.

3.3. Potential growth and its determinants

As shown in Table 4, the potential growth rate (calculated with the commonly agreed methodology based on the information in the programme) remains stable at 2.2% through the period 2006-2010. Although there are some differences in the composition of the potential growth rate, this figure is close to the estimate of the Commission services' autumn 2006 forecast : the contribution of labour is generally weaker on the basis of the information provided in the update of the stability programme, while the contribution of total factor productivity is higher.

Table 4: Sources of potential output growth

	2006		2007		2008		2009	2010
	COM	**SP[2]**	**COM**	**SP[2]**	**COM**	**SP[2]**	**SP2**	**SP[2]**
Potential GDP growth[1]	2.2	2.1	2.2	2.2	2.3	2.2	2.1	2.2
Contributions:								
- Labour	0.3	0.1	0.3	0.1	0.4	0.1	0.0	0.0
- Capital accumulation	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9
- TFP	1.0	1.2	1.0	1.2	1.0	1.3	1.3	1.4

Notes:
[1]Based on the production function method for calculating potential output growth.
[2]Commission services' calculations on the basis of the information in the stability programme.
Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

3.4. Labour market developments

Both the programme and the Commission services' projections assume a recovery in employment. However, the pace of this recovery is stronger in the programme than in the Commission services' autumn 2006 forecast. In a context characterised by uncertainties concerning the durability of the recovery, employment growth may only be gradual. Even if the recent measures to encourage job creation[28] were to bear fruit, companies may prefer to

[28] Apart from the implementation of the government 's subsidized jobs (development of assisted contracts, active labour market policy with regard to welfare payments), the re-evaluation of the income tax-credit ("Prime pour l'emploi"), which aims to provide an additional income for low-paid workers, should encourage more people to enter and remain in employment. As regards the employment of older workers, France has launched a policy of reforms to encourage more people over 50 to remain in or return.

first increase their productivity levels and restore their financial situation before boosting their recruitment. Beyond 2008, although the GDP growth projections are close to average annual growth observed over the last ten years (2.2% per year between 1996 and 2005) employment growth is expected to be half of that in the past. However, the programme does not provide explanations for justifying this low labour content of GDP growth. These projected labour market developments may highlight difficulties for the French economy to create jobs[29] but also reflect wishes of the French authorities to cut the number of employees in public sectors, in line with the expenditure restraint envisaged in the programme.

3.5. Costs and price developments

In a context of a still high – although decreasing – unemployment rate, wage moderation can be expected to continue in the coming years. Through the period 2006-2008, the projected annual average increase in wages in both the programme and the Commission services' autumn 2006 forecast is similar (around 3%). Beyond 2008, wage moderation is expected to continue. This projection is consistent with the gradual improvement of employment expected in the programme.

Consumer price index inflation (HICP) is assumed to slow down from 2.0% in 2006 to 1¾% in 2008. Over the period 2008-2010, the inflation rate is expected to remain stable. The programme's inflation projections are plausible as productivity growth is expected to fasten for the period beyond 2007 and unit labour cost growth slows down from 1¾ % in 2007 to 1½% from 2008 onwards. In a context where pass-through effects of raw materials remain limited, prices should rise only modestly. In addition, the persistent negative output gap should limit inflation pressures.

3.6. Sectoral balances

As regards sectoral balances, the macroeconomic scenario in the programme implies a slight improvement of net borrowing vis-à-vis the rest of the world, which is expected to decrease from -2.0% of GDP in 2006 to -1.6% of GDP in 2010. This mainly stems from the reduction of the deficit in the trade balance. Indeed, the update projects the deficit of the goods and services balance to decline from 1.6% of GDP in 2006 to 1.2% of GDP at the end of the update period. These projections are consistent with the macroeconomic scenario depicted in the programme in which the contribution of net exports to GDP growth no longer acts as a drag.

Taking into account the planned return to balance of the public accounts and given the slow reduction of the external deficit, the balance of the private sector is assumed to strongly deteriorate by the end of the projected period (from -1.0% of GDP in 2005 to -1.6% of GDP in 2010). Although no detailed explanation is provided in the programme, such scenario is plausible, since the planned general government balance is largely driven by a structural adjustment. In this context, net lending of households is likely to fall, in particular due to the decrease in precautionary saving. Moreover this deterioration should be in line with recent developments regarding the rise of household's indebtedness and the deterioration of financial position of the corporate sector as a result of the strong rise in commodities prices.

[29] As stressed in section 2.2, the French economy is characterized by a poor labour market performance. This latter is mainly a result of distortions stemming from the employment-discouraging tax and benefit system and intuitional factors.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic ‘good’ or ‘bad’ times.

3.7.1. Plausibility of the macroeconomic scenario

Assessed against currently available information, the reference scenario projecting real GDP growth of 2-2½% in 2006 and 2007 and 2¼% thereafter, supported by domestic demand, seems to be based on plausible assumptions, although it is somewhat favourable in 2006 and should be closer to the lower range foreseen by the national authorities. Beyond 2006, the macroeconomic scenario does not present any break compared with past trends. It is broadly in line with the Commission services' autumn 2006 forecast and potential output as estimated by the Commission services. In addition, the composition of growth and price developments are broadly similar both in the programme and the Commission services' autumn 2006 forecasts, as described in section 3.2.

3.7.2. Economic good vs. bad times

The output gap estimates of the Commission services' autumn forecast are negative at close to 1% of GDP. Throughout the forecast period 2006-2008, the output gap remains broadly stable. As underlined in section 3.2, the Commission services' output gaps have not significantly been revised over the last forecast rounds, which suggests that the assessment of cyclical conditions has been fairly stable and the assessment of the planned fiscal stance is likely to be relatively robust. Furthermore, the economic activity is largely supported by domestic demand and especially by private consumption which is tax rich. It should also be noted that the unemployment rate has been on a downward trend since June 2005, declining by 1¼ percentage point over the lasts 18 months. Consequently, based on an overall assessment economic conditions in France are considered to be neither good nor bad.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme's medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

Following a decline from 3.7% of GDP in 2004 to 2.9% of GDP in 2005, the general government deficit is projected both by the French authorities and the Commission services' autumn 2006 forecast to be further reduced to 2.7% of GDP in 2006 (see Table 5).

The January 2006 update targeted the 2006 general government deficit at 2.9% of GDP, while the current update targets it at 2.7% of GDP based on the same output growth assumption (a range comprised between 2 and 2.5%)[30]. The French authorities explain the more ambitious target (by + 0.2 percentage point of GDP) by (a) a positive base effect from a better deficit outcome in 2005 compared to the initial target (2.9% against 3% of GDP previously targeted, also thanks to the March 2006 Eurostat decision[31] which positively impacted the French deficit by 0.1 percentage point of GDP in that year) and (b) higher revenues (about EUR 5bn = 0.3% of GDP)[32] than projected in the previous update. This explanation is not entirely satisfactory as the estimated better-than-expected revenues alone represent 0.3 percentage point of GDP while the improvement in the target is 0.2 percentage point of GDP. Moreover, the 2006 (and 2007) deficit(s) will also benefit from the March 2006 Eurostat decision mentioned above for about 0.1 percentage point of GDP.

In both the Commission services' autumn 2006 forecast and the update scenarios, the deficit reduction compared to 2005 is the result of (a) an acceleration in GDP growth (from 1.2% to 2.2%) which boosts revenues, and (b) a slowdown in expenditure. On the revenue side, buoyant consumption (VAT), higher corporate profits (corporate tax) and a robust employment performance (income tax) are expected to lead to strong revenues, despite the tax cuts implemented in 2006 (increased employment premium, tax exemption for new investment, etc.). On the expenditure side, health-care and other social expenditures growth slowed down thanks to the measures taken under the health-care reform of 2004 and the improvement on the employment front, while State expenditure is expected to respect the zero-volume growth norm. Taken together, these elements would more than compensate the still rapid pace of expenditure growth in the local administration sector notably in connection with a rebound in local investment, which cannot be excluded at the end of the local electoral term.

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[30] Although GDP growth still remains comprised between 2% and 2.5% in the current update, the composition of growth is more tax rich than that foreseen in the previous update as current growth estimate is based on higher private consumption (2.8% in the current update against 2.5% in the January 2006 update).

[31] Concerning the recording of military expenditure at the time of delivery.

[32] The most recent estimate of higher-than-expected revenues at the State level by the French authorities in January 2007 pointed to EUR 10 bn.

In the Commission services scenario, the reduction in the deficit will still rely by up to ¼ percentage point of GDP on one-off elements in connection with the transfer of postal sector employees' pension commitments to social security (soulte "la poste") and the exceptional collection of taxes on specific saving plans that were to be collected at a later stage and on a change in the corporate tax code. The authorities only consider the soulte "la poste" as one-off revenues and thus the latter are limited to 0.1 percentage point of GDP in their scenario (see Table 6).

The decrease of the deficit below the 3% Treaty reference value in 2005 and the prospects of a continuous further decline thereafter led the Commission to recommend on 29 November 2006 to the Council to abrogate its decision on the existence of an excessive deficit in France (see Box 1). The Council is expected to adopt this decision on 30 January 2007.

Table 5: Evolution of budgetary targets in successive programmes

		2005[1]	2006	2007	2008	2009	2010
General government balance (% of GDP)	**SP Dec 2006**	-2.9	-2.7	-2.5	-1.8	-0.9	0.0
	SP Jan 2006	-3.0	-2.9	-2.6	-1.9	-1.0	n.a.
	SP Dec 2004	-2.9	-2.2	-1.6	-0.9	*n.a.*	*n.a.*
	COM Nov 2006	-2.9	-2.7	-2.6	-2.2	n.a.	n.a.
General government expenditure (% of GDP)	**SP Dec 2006**	53.8	53.3	52.9	52.0	51.1	50.4
	SP Jan 2006	53.8	53.6	53.0	52.1	51.1	n.a.
	SP Dec 2004	53.6	53.0	52.4	51.7	*n.a.*	*n.a.*
	COM Nov 2006	53.8	53.5	53.1	52.8	n.a.	n.a.
General government revenues (% of GDP)	**SP Dec 2006**	50.9	50.6	50.4	50.2	50.3	50.3
	SP Jan 2006	50.8	50.7	50.3	50.2	50.1	n.a.
	SP Dec 2004	50.7	50.8	50.8	50.7	*n.a.*	*n.a.*
	COM Nov 2006	50.9	50.8	50.5	50.6	n.a.	n.a.
Real GDP (% change)	**SP Dec 2006**	1.2	2.0-2.5	2.0-2.5	2 ¼	2 ¼	2 ¼
	SP Jan 2006	1.5-2.0	2.0-2.5	2 ¼	2 ¼	2 ¼	n.a.
	SP Dec 2004	2.5	2.5	2.5	2.5	*n.a.*	*n.a.*
	COM Nov 2006	1.2	2.2	2.3	2.1	n.a.	n.a.

[1] SP Dec 2006 and COM Nov 2006 report historical figures for the year 2005.
Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM)

4.2. 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.

4.2.1. The main goal of the programme's budgetary strategy

The most recent update of the stability programme is inscribed in the French authorities' overarching strategy of "national commitment for debt reduction" adopted after the publication of the Pébereau report[33] and first presented in the January 2006 update of the stability programme. The current update is presented as a multi-annual programme for debt reduction targeting a zero deficit and a debt level below 60% of GDP by 2010. The debt-reduction strategy is based on three pillars: an increase of potential growth, a strengthened

[33] For a detailed description of the Pébereau report, please refer to Box 2 of the technical assessment of the January 2006 update of the French stability programme: http://ec.europa.eu/economy_finance/about/activities/sgp/country/commwd/fr/com_fr20052006.pdf

control of public expenditure, and an active debt management policy through a better management of debt cash-flow and the privatisation of non-strategic assets.

The new update largely confirms the adjustment planned in the previous programme, against a broadly unchanged macroeconomic scenario. Notably, it confirms that the general government balance would continue to respect the 3% of GDP Treaty reference value over the programme period, by an increasing margin. It foresees a continuous decrease in the deficit by an overall 2.7 percentage points of GDP from 2.7% in 2006 (2.5% in 2007) to 0% of GDP in 2010. A primary surplus would be restored from 2007 onwards (see Table 6). The medium-term budgetary strategy is still based on the setting of multi-annual targets for the increase in the general government expenditures in real terms (0.6% annual growth over the period 2008-2010). As in the previous programme, the deficit reduction in nominal terms is back-loaded as it would amount to 0.2 percentage point of GDP both in 2006 and 2007, and increase to 0.7, 0.8 and 0.9 percentage points in 2008, 2009 and 2010, respectively.

While the 2006 deficit is expected to be slightly better than in the previous update by +0.2 percentage point of GDP (as discussed in section 4.1), for every year after 2006, the deficit is expected to be better by only 0.1 pp of GDP. The update explains that the more limited deficit reduction from 2007 onwards, compared to that of 2006, is due to a downward revision of the local administration budgetary position from an expected balance in the previous programme to a deficit (of 0.1 percentage point of GDP) in the current update in view of current developments. Nevertheless, some increased efforts in the other sub-sectors could have been envisaged to maintain the overall adjustment as planned.

Box 1: The excessive deficit procedure for France

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 3 June 2003, the Council adopted a decision stating that France had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2004. In particular, France was recommended to implement a significantly larger improvement in the cyclically-adjusted-deficit in 2003 than the 0.1% of GDP planned at the time and by implementing measures ensuring that the cyclically-adjusted-deficit was reduced in 2004 by at least 0.5% of GDP to bring the nominal deficit below 3% in 2004 at the latest.

In 2003, the French budget deficit continued to deteriorate. In October 2003, the Commission considered that the measures taken by France had been insufficient to respect the Council's recommendation under Article 104(7) and adopted recommendations for the Council to (i) decide accordingly under Article 104(8) and (ii) give notice to France to take measures to correct the excessive deficit based on Article 104(9). In particular, the Commission services' autumn 2003 forecast showed a deficit of 4.2% of GDP in 2003 and of 3.8% of GDP in 2004. In the recommended notice, the Commission proposed to extend the deadline for the correction of the excessive deficit to 2005, as part of the slippage could be attributed to the deterioration in cyclical conditions (growth turned out to be just 1.1%). On 25 November 2003, the Council voted on the two recommendations but did not adopt them. Instead, it adopted conclusions addressing recommendations to France for the correction of the excessive deficit by 2005 and stating that, in view of the commitments by France, the EDP was held in abeyance. On 13 July 2004 these conclusions were annulled by the European Court of Justice (Case C-27/04, Commission vs Council, 2004 ECR I-6649).

On 14 December 2004, the Commission adopted a Communication to the Council (Communication from the Commission to the Council: *The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice*, COM (2004) 813 final), which concluded that, in view of the unique circumstances created by the Council conclusions of 25 November 2003 and of the ruling of the European Court of Justice of 13 July 2004, the year 2005 should be considered as the relevant deadline for the correction. It also concluded that actions taken by France until then were broadly consistent with a correction of the excessive deficit by 2005 and that, while the budgetary situation remained vulnerable, no further steps under the EDP were considered necessary at that stage. On 18 January 2005, the Council concurred with this view and endorsed the underlying adjustment. In particular, France was expected to improve the cyclically-adjusted balance by 0.7 percentage point of GDP in 2005, including one-off operations worth 0.5% of GDP – related to the revenue in exchange for the transfer of responsibility for the payment of future pensions to employees in electricity and gas public companies to social security.

As the deficit was reduced below the 3% of GDP Treaty reference value in 2005 and the Commission services' autumn 2006 forecast anticipated a continuous decline in the deficit to about 2% in 2008, the deficit appeared to have been brought below the 3% of GDP ceiling in a credible and sustainable manner. Moreover, after rising for years, the debt-to-GDP ratio had started to decrease from 66.6% in 2005 to 65.4% of GDP in the second quarter of 2006 and was expected to fall further to around 63% of GDP by 2008 according to the Commission services' autumn 2006 forecast. Against this background, the Commission recommended on 29 November 2006 to the Council to decide to abrogate its decision on the existence of an excessive deficit in France (under Article 104(12)). The Council is expected to adopt this decision on 30 January 2007.

Table 6: Composition of the budgetary adjustment

(% GDP)	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**Change: 2010-2006**
Revenues	50.9	50.6	50.4	50.2	50.3	50.3	**-0.3**
of which:							
- Taxes & social contributions	45.6	45.8	45.5	45.2	n.a.	n.a.	**n.a.**
- Other (residual)	5.3	4.8	4.9	5.0	n.a.	n.a.	**n.a.**
Expenditure	53.8	53.3	52.9	52	51.1	50.4	**-2.9**
of which:							
- Primary expenditure	51.1	50.7	50.3	49.4	48.6	47.9	**-2.8**
of which:							
Total transfers	23.7	23.4	23.2	22.9	22.6	22.3	**-1.1**
Subsides	1.4	1.5	1.4	1.3	1.3	1.2	**-0.3**
Gross fixed capital formation	3.2	3.3	3.3	3.2	3.1	3.2	**-0.1**
Other (residual)	22.7	22.5	22.4	22.0	21.6	21.2	**-1.3**
- Interest expenditure	2.7	2.6	2.6	2.6	2.5	2.5	**-0.1**
General government balance (GGB)	**-2.9**	**-2.7**	**-2.5**	**-1.8**	**-0.9**	**0.0**	**2.7**
Primary balance	**-0.2**	**-0.1**	**0.1**	**0.7**	**1.7**	**2.5**	**2.6**
One-offs[1]	0.5	0.1	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-3.4**	**-2.8**	**-2.5**	**-1.8**	**-0.9**	**0.0**	**2.8**

Note:
[1]One-off and other temporary measures.
Source:
Stability programme update; Commission services' calculations

4.2.2. *The composition of the budgetary adjustment*

As in previous updates, the medium-term strategy is based on multi-annual targets for the increase in the general government expenditures in real terms (0.6% annual growth over the period 2008-2010 after 1.4% in 2006 and 2007) that imply a reduction of the expenditure-to-GDP ratio. The planned consolidation would be totally expenditure-driven, with the expenditure-to-GDP ratio decreasing by nearly 3 percentage points of GDP from 53.3% of GDP in 2006 (53.8% of GDP in 2005) to 50.4% of GDP in 2010. The revenue-to-GDP ratio

would also decline over the same period although only slightly (from 50.6% of GDP in 2006 to 50.3% of GDP in 2010). The budgetary adjustment is back-loaded: while the tax cuts underlying the reduction in the revenue ratio are front-loaded, taking place in 2006 and 2007 (see Box 2), the reduction in the expenditure ratio is assumed to become larger over time.

The decrease in the expenditure ratio[34] would nearly entirely rely on a decrease in primary expenditure (by 2.8 percentage point of GDP over 2006-2010) as interest expenditure are expected to be stable (decreasing marginally by 0.1 percentage point of GDP over the period). The decrease in primary expenditure would mainly stem from transfers and restraint in the "other expenditure" category. The strategy cannot be assessed in depth given the absence of a more detailed breakdown of expenditure in the programme. Gross fixed capital formation would be stable around its current level (3.2% of GDP).

The January 2006 update of the stability programme was aiming at a sort of "internal stability pact" which would have been constituted of expenditure norms for all sub-sectors of the general government. However, no concrete progress has yet been made concerning local administrations and the social security sector as a whole although the setting-up of a public finance conference, gathering all actors of public finance management once per year (see section 6), is likely to increase awareness and ownership of the consolidation efforts in public finances.

In the current update, the planned reduction in the expenditure-to-GDP ratio would mainly stem from the enhanced expenditure-growth rules at the *State* level, for which, in line with what was announced in the January 2006 update, the "zero real spending growth rule" will be enhanced gradually to a "zero nominal spending growth rule" by 2010, starting in 2007 with a reduction by 1% in volume terms[35]. As mentioned in the programme, this will require a substantial effort of expenditure redeployment as compulsory expenditure, and especially debt service[36] and civil servant pensions (which increase by about 3% per year), are going to substantially weigh on the French public finances. The tighter control of State expenditure should be possible thanks to a more effective public management related to the progressive implementation of all aspects of the Constitutional Bylaw on the Budget Act (LOLF: Loi organique relative aux lois de finances, see section 6) and to potential savings and increased productivity identified by the audits conducted as part of the State modernisation process. Also, the 2007 budget includes a reduction in the number of State civil servants (by 15,000)[37], which has a lasting positive impact[38] on the deficit and thus helps support the implementation of the new expenditure ceiling. The programme envisages that the new spending rule will help speeding up the reduction of the State deficit from 3.0% of GDP in 2005 to 0.9% of GDP in 2010.

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34 Given the nominal GDP growth rate assumed (at 4% per year over the period), the envisaged reduction in the expenditure ratio is compatible with expenditure growth in nominal terms of about 2½% per year.

35 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.

36 As mentioned in the programme, while interest payments decreased by 1.6% (in volume terms) on average per year over the period 2002-2007 thanks to the refinancing of the existing debt at lower interest rates, they are expected to annually increase by 1.7% (in volume terms) on average over the period 2007-2010.

37 The downsizing is larger than in preceding years (about 1 in 5 retiring civil servants will not be replaced) although less ambitious than the original target of 1 in 2 announced after the 2002 presidential elections.

38 When civil servant pensions and debt service are netted out, State civil servants' wages represent 44% of the State budget.

Concerning the *social security funds*, there is no new norm envisaged contrary to what was announced in the January 2006 update, but the existing one on health-care expenditure is now biting. Indeed, in 2005 the national health insurance spending target (ONDAM: Objectif National des Dépenses d'Assurance Maladie) was almost respected for the first time in years (the deviation from the target growth rate was contained to 0.1 percentage point) notably thanks to the health-care reform of 2004. Moreover, a further decrease of actual growth rate of health care spending is expected following the implementation of the measures adopted in the context of the 2006 and 2007 social security budgets (see Box 2). The expenditure restraint in this sector should also be facilitated by the expected improvement on the unemployment front and by some reforms implemented in 2003 and 2004 which tightened eligibility conditions to unemployment benefits. The programme expects the social security funds to return to surplus over the forecast horizon from a deficit of 0.4% of GDP in 2006.

At the *local authorities'* level no rule in terms of expenditure-growth exists. The previous update announced that the local authorities, aware of the need to take part in the debt-reduction effort, would 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. However, no agreement has been reached and expenditures are expected to still be growing quite rapidly notably in connection with the up-coming local elections in 2008. Indeed, past experience shows that in the years preceding elections, there is a boom in local investment[39].

On the revenue side, the 0.3 percentage point of GDP decline relative to GDP between 2006 and 2010 is explained by the reduction in the tax burden (by 0.4 percentage point of GDP) as a result of tax cuts in 2007 (about ½ percentage point of GDP) and in particular of the income tax reform and a reform of the local business tax ("taxe professionnelle") (see Box 2).

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[39] See notably INSEE première, (2002), " L'investissement des administrations publiques locales - Influence de la décentralisation et du cycle des élections municipales" n°867, October 2002. Available on the Internet at http://www.insee.fr/fr/ffc/docs_ffc/IP867.pdf

Box 2: The budget for 2007

The draft Budget Bill for 2007 was presented on 27 September 2006 and adopted by the Parliament on 19 December 2006. Under the assumption of real GDP growth between 2% and 2.5%, the 2007 Budget Bill foresees a decline in the general government deficit from 2.7% of GDP in 2006 to 2.5% of GDP in 2007. This is projected to be a result of expenditure restraint.

Expenditure restraint is planned to stem notably from (i) a reduction of State expenditures by 1% in real terms after four years of stabilisation in volume, (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 and 2007 Budget Bills for the social security sector, notably the "pharmaceutical plan", the "hospital plan" as well as continued efforts to control the cost of medical treatment and fraud fight, and (iii) a slowdown of unemployment benefits in connection with an improved employment performance.

The decrease in the revenue-to-GDP ratio reflects the impact of discretionary measures on the fiscal side (about ½% of GDP) and especially the impact of (a) the personal income tax reform aiming at lowering the higher marginal rate of the income brackets 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") and (b) the local tax on business reform which caps it at 3.5% of value added while maintaining the exemption on new investments. Revenue projections also include one-off revenues of about 0.05% of GDP in connection with a change in the corporate tax code and the advanced collection of taxes on specific saving plans.

Table: Main measures in the budget for 2007

Revenue measures*	Expenditure measures**
o income tax reform (-0.2% of GDP) o lower tax rates on new capital expenditure (-0.1% of GDP) o increase in the employment premium (-0.05% of GDP) o One offs: change in the corporate tax code and advance payment of taxes on specific saving plans (+0.05% of GDP)	o reduction in the number of civil servants (-0.03% of GDP) o implementation of the audits' recommendations regarding potential savings and productivity gains (-0.05% of GDP) o Ondam (-0.02% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services and 2007 budget bill.

It should be noted that, as in 2005[40], the general government balance benefits from one-offs and other temporary measures in 2006 and 2007, but to a lesser extent. The update does not provide any information on one-off measures beyond 2006, which is not in line with the new code of conduct. According to Commission services' estimate, one-off payments amount to about ¼ percentage point of GDP in 2006 in connection to the integration in the general regime of the specific pension scheme of the postal company. Exceptional revenues (described in Box 2) will amount to 0.05 percentage point of GDP in 2007. As it is not clear whether further one-offs are envisaged over the programme period, it will be assumed for the calculation of the structural balance (next section) that one-offs beyond 2007 are zero.

[40] In 2005, the deficit was reduced by one-off revenues totalling 0.6 percentage point of GDP in connection with (a) the inclusion of the specific electricity and gas companies' pension schemes in the general regime for 0.5 percentage point of GDP (EUR 8.4 bn) and (b) a change in the corporate tax code for 0.1 percentage point of GDP (EUR 2.3 bn).

4.2.3. The medium-term objective (MTO) and the structural adjustment

One of the two announced medium-term targets in the programme is the return to balance of the public accounts by 2010 (see section 4.2.1).[41] This can be interpreted as the medium-term objective (MTO) for the budgetary position in the sense of the Stability and Growth Pact as outlined in Box 3, i.e. cyclically adjusted balance net of one-off and other temporary measures. This is the same objective as in the January 2006 update.

Box 3: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific 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 MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct 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 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

The estimated budgetary position in cyclically-adjusted terms that provides a sufficient margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference, i.e. the "minimum benchmark", is estimated at a deficit of around 1½% of GDP for France. Therefore, the MTO implied by the update, a structural balance, is more demanding and its achievement should indeed fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. Also, it adequately reflects the debt ratio and average potential growth in the long run and lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct.

In the update, the structural balance – based on the Commission services' calculations on the basis of the information in the programme according to the commonly agreed methodology – is forecast to improve substantially from a deficit of 2½% of GDP in 2006 (3.0% of GDP in 2005) to a surplus of 0.2% of GDP in 2010. The planned structural adjustment is back loaded. Indeed, after having reached 0.6 percentage point of GDP in 2005 and an expected ½ percentage point of GDP in 2006, the adjustment would be only ¼ percentage point of GDP in 2007 and then gradually increase up to 0.9 percentage point of GDP by 2010. Based on the magnitude of the change in the structural balance, the stance of the French fiscal policy would be restrictive in 2005 and 2006, then turn neutral to mildly restrictive in 2007 to progressively become more restrictive in the outer years of the programme.

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[41] The other medium-term objective is bringing the debt-to-GDP ratio below 60% of GDP by 2010.

It should be noted that uncertainties are linked to the calculations of cyclically-adjusted and structural balance, notably due to the difficulty of contemporaneous output gap estimates and budgetary elasticity volatility. Thus, any interpretation should be made with caution.

Table 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005	2006		2007		2008		2009	2010	Change: 2010-2006
		COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance	-2.9	-2.7	-2.7	-2.6	-2.5	-2.2	-1.8	-0.9	0.0	2.7
One-offs[2]	0.6[6]	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	-
Output gap[3]	-0.8	-0.8	-0.6	-0.7	-0.6	-0.9	-0.5	-0.4	-0.3	-
CAB[4]	-2.5	-2.3	-2.4	-2.3	-2.2	-1.8	-1.6	-0.7	0.2	2.6
change in CAB	1.2	0.2	0.1	0.1	0.2	0.5	0.7	0.8	0.9	-
CAPB[4]	0.2	0.3	0.2	0.4	0.4	0.9	1.0	1.8	2.7	2.5
Structural balance[5]	-3.1	-2.6	-2.5	-2.3	-2.2	-1.8	-1.6	-0.7	0.2	2.7
change in struct. bal.	0.6	0.5	0.5	0.3	0.3	0.6	0.7	0.8	0.9	-
Struct. prim. bal.[5]	-0.5	0.0	0.1	0.3	0.4	0.9	1.0	1.8	2.7	2.6

Notes:
[1]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.
[2]One-off and other temporary measures.
[3]In percent of potential GDP. See Table 2 above.
[4]CA(P)B = cyclically-adjusted (primary) balance.
[5]Structural (primary) balance = CA(P)B excluding one-offs and other temporary measures.
[6]Commission estimate of one-offs
Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

4.3. Risk assessment

The risks to the budgetary outturn in the **near term (2006-2007)** are broadly neutral. In particular, regarding the macroeconomic scenario, the risk assessment is neutral and the update and the Commission services' autumn 2006 forecast are in line with each other. Second, the budgetary projections for 2006 and 2007 are identical to the multi-annual strategy defined in the 2007 draft Budget. Thus, the Commission services' assessment of the 2007 draft Budget measures made at the time of the 2006 autumn forecast remains valid. The 2006 autumn forecast projected the general government deficit to be at 2.7% of GDP in 2006 and to continue decreasing to 2.6% of GDP in 2007 and 2.2% in 2008. These deficit projections are very similar to that of the update: 2.7%, 2.5% and 1.8% in 2006, 2007 and 2008 respectively. Moreover, the somewhat larger difference for 2008 is explained by the fact that the Commission services' forecast for that year is done under a no-policy-change assumption, while the update integrates the envisaged measures and notably the planned enhancement of the State expenditure norm (see footnote 35). Table 8 shows that the forecasts are also very similar at a more disaggregated level, notably when looking at detailed revenue and expenditure projections.

As noted in section 4.2.2, the main measure behind the reduction in the 2007 deficit is the enhancement of the State expenditure growth rule, which has a quite good track record. Moreover, concerning the social security funds, a better grip on health-care expenditure has been demonstrated in 2005 and 2006 and other social security expenditure growth should be limited thanks to the expected improvement on the unemployment front. Recourse to one-offs should be insignificant in that year (0.05% of GDP) and thus there is no risk stemming from this aspect. There are some concerns linked to local authorities' expenditure growth and in particular investment expenditure in connection with the electoral cycle. But this is recognised and discounted for in both the update and the Commission services' autumn 2006

forecasts. There is however one negative risk that should be mentioned, which is the fact that 2007 is a presidential election year which in the past has led to non-respect of the target even at the State level. Overall, the programme projections for the period 2006-2008 are similar to those of the Commission services (taking into account that the latter are on a no-policy change basis for 2008) and risks around the projections are broadly neutral.

In the **outer years (2008-2010)**, the macroeconomic scenario seems reasonable (see section 3.7). On the budgetary side, the update envisages a gradual improvement in the fiscal effort from 0.7 percentage point in 2008 to 0.9 percentage point in 2009 and 2010. This might be somewhat on the high side, given past experience. Indeed, the track record related to the achievement of the general government expenditure ceilings[42] (see section 2.4) and the lack of enforcement mechanisms for expenditure rules raise some concerns. The new targets imply a drastic expenditure restraint compared to recent experience[43], which will require large structural reforms that are not always detailed in the update. The measures concerning the State sector are relatively explicit as mentioned in the paragraph above. Moreover, the track record of the compliance of the State with its expenditure norm plead in favour of future respect, even though, obviously, it is going to be more difficult as the objective becomes more ambitious. One point of concern is the absence of specific measures backing both the social security sector's target (beyond those concerning health-care expenditure) and the local authorities' target.

Table 9 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 perfectly in line with those in the Commission services' autumn 2006 forecasts for the year 2007. The difference with the OECD ex-ante elasticity is mainly related to the impact of the tax cuts implemented in the income tax reform framework, which negatively impact the discretionary and elasticity component and thus result in a lower total-tax-to-GDP elasticity than the ex-ante elasticity. It should be noted that when new measures are excluded, the tax-to-GDP elasticity is higher than the ex-ante elasticity due to a favourable composition component. For 2008, the Commission services' forecast, based on a no-policy change, anticipates a return to the ex-ante elasticity. All in all, the assumed tax elasticities in the update for the period 2007-2008 do not constitute a major risk for the budgetary projections. The update does not provide the breakdown of tax projections for the years beyond 2008 and therefore the plausibility of the tax assumptions cannot be assessed.

Overall, the risks to the budgetary projections in the programme appear to be broadly neutral in the near term (i.e. until 2008) and somewhat negative for the outer years, for which the budgetary outcome could be worse than projected in the programme.

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[42] 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.

[43] 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 2008-2010. This compares to an actual increase in expenditures at about 2% on average per year over the last 5 years in real terms.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009	2010
		COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenues	50.9	50.8	50.6	50.5	50.4	50.6	50.2	50.3	50.3
of which:									
- Taxes & social contributions	45.6	45.8	45.8	45.5	45.5	45.5	45.2	n.a.	n.a.
- Other (residual)	5.3	5.0	4.8	5.0	4.9	5.1	5.0	n.a.	n.a.
Expenditure	53.8	53.5	53.3	53.1	52.9	52.8	52.0	51.1	50.4
of which:									
- Primary expenditure	51.1	50.9	50.7	50.5	50.3	50.2	49.4	48.6	47.9
of which:									
Total transfers	23.7	23.4	23.4	23.1	23.2	22.7	22.9	22.6	22.3
Subsides	1.4	1.4	1.5	1.3	1.4	1.2	1.3	1.3	1.2
Gross fixed capital formation	3.2	3.3	3.3	3.4	3.3	3.5	3.2	3.1	3.2
Other (residual)	22.7	22.8	22.5	22.7	22.4	22.7	22.0	21.6	21.2
- Interest expenditure	2.7	2.6	2.6	2.7	2.6	2.7	2.6	2.5	2.5
GGB	-2.9	-2.7	-2.7	-2.6	-2.5	-2.2	-1.8	-0.9	0.0
Primary balance	-0.2	-0.1	-0.1	0.0	0.1	0.4	0.8	1.6	2.5
One-offs[2]	0.6	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	-3.5	-3.0	-2.8	-2.7	-2.5	-2.2	-1.8	-0.9	0

Notes:
[1]On a no-policy change basis.
[2]One-offs and other temporary measures, for 2005: Commission services' estimate

Source:
Commission services' autumn 2006 economic forecast (COM); Stability programme update (SP); Commission services' calculations

Table 9: Assessment of tax projections

	2007			2008			2009	2010
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio (total taxes)	-0.3	-0.3	0.0	-0.3	0.1	0.0	n.a.	n.a.
Difference (SP – COM)	0.0		/	-0.4		/	/	/
of which[2]*:*								
- discretionary and elasticity component	0.1		/	-0.3		/	/	/
- composition component	0.0		/	0.0		/	/	/
Difference (COM - OECD)	/	-0.3		/	0.1		/	/
of which[2]*:*								
- discretionary and elasticity component	/	-0.5		/	-0.2		/	/
- composition component	/	0.4		/	0.3		/	/
p.m.: Elasticity to GDP	0.8	0.8	1.0	0.8	1.0	1.0	n.a.	n.a.

Notes:
[1]On a no-policy change basis.
[2]The decomposition is explained in Annex 5.
[3] OECD ex-ante elasticity relative to GDP.
Source:
Commission services' autumn 2006 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)

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the

basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 10: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	from 2008 onwards	Most probably in 2009
b. Achievement of the MTO	At the end of the programme period, in 2010	In 2010 at the earliest
c. Adjustment towards MTO in line with the Pact[2]?	Broadly in line except for 2007: on average over the period 2006-2010 the 0.5% of GDP benchmark is respected but not in 2007 where the adjustment is limited to 0.3 percentage point of GDP without any particular justification.	Broadly in line except for 2007 as on average over the period 2006-2008 the 0.5% of GDP benchmark is respected but not in 2007 where the adjustment is limited to 0.3 percentage point while in good time. Should be broadly in line in 2009-2010 given the large improvement expected, even after considering the risks.

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1½% of GDP for France). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

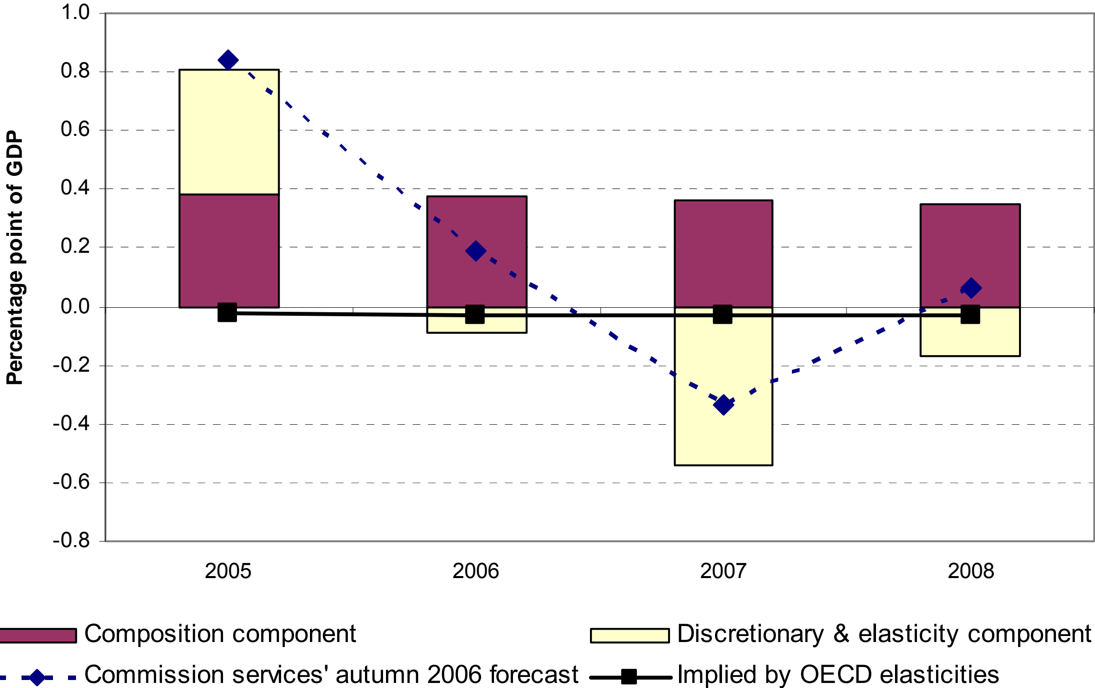
In view of the risk assessment above, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2010 as envisaged in the programme. In addition, towards the end of the programme period, most probably from 2009, it seems to provide an adequate safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

Except for 2007, and adjusting for the risks to the targets in the outer years of the programme, the pace of the adjustment towards the MTO is broadly in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark. On average over the period 2006-2010, the planned adjustment amounts to 0.6 percentage point of GDP and is back-loaded. On a yearly basis, the benchmark is also respected when the programme targets are taken at face value, except for the year 2007 in which the adjustment is limited to 0.3 percentage point of GDP; taking into account the risk of worse-than-targeted outcomes for the outer years, the benchmark is likely to be just respected. For 2007, the update does not explain why the planned structural adjustment is only 0.3 percentage point of GDP; such an explanation would be warranted after France just exited from the excessive deficit procedure. Moreover, in 2007, the economic situation cannot be assessed as "bad times" (see section

3.7.2) and budgetary elasticities considerations even point to "good times". Indeed, the expected change in the tax-to-GDP ratio net of the effect of discretionary measures is higher than that implied by the OECD elasticities. Thus, France should have aimed for a higher fiscal adjustment than the 0.5% of GDP per year benchmark in that year.

As noted in section 4.2.2, structural balances have to be interpreted with caution. Indeed, in France, the projected change in the tax ratio excluding the impact of discretionary measures in 2007 – estimated at about ½ percentage point of GDP in 2007 – would be higher compared to the change implied by the standard ex-ante elasticity the OECD (about +0.2% of GDP against no change). This entails the risk of underestimating the cyclical component (obtained by applying the standard OECD elasticities) and thus overestimating the cyclically-adjusted budget balance (see Figure 12).

Figure 12: Changes in the tax-to-GDP ratio: actual/projected changes vs. changes implied by OECD elasticity



Note:
The dashed line displays the change in the tax ratio in the Commission services' autumn 2006 forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.[44] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the stability programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

After breaching the 60%-of-GDP Treaty reference value in 2003, the French debt continued to increase, reaching 67% of GDP in 2005 (10 percentage points above its 2000 level). The excess over the 60% reference value was mainly due to developments in the deficit, in some years amplified by stock-flow adjustments (mainly accumulation of financial assets).[45]

Bringing the debt-to-GDP ratio below 60% of GDP by 2010 is one of the two medium-term objectives presented in the update. The debt reduction strategy is based on three pillars: (i) raising potential growth through an increase in the employment rate, notably thanks to the so-called emergency plan for employment ("plan d'urgence pour l'emploi"), the "senior plan" (aiming at increasing older employees employment rate), the tax reform and redirection of public expenditure towards investment, (ii) a better grip on public expenditures, as discussed above in section 4.2, and (iii) a better management of debt cash-flow and sales of non-strategic financial assets (for an estimated amount of EUR 5 to 10 bn – i.e. 0.3 to 0.6% of GDP – per year over 2008-2010).

The 2007 draft budget anticipates a reduction by 2 percentage points of the debt-to-GDP ratio in 2006. This reduction results from: (a) full allocation of the privatisation receipts of about 1% of GDP to debt reduction, as well as (b) a better day-to-day cash-flow management by the French Debt Agency and a better overall management of the debt of the different general government entities, which contribute around 1% of GDP. Indeed, the ratio already decreased from 66.6% of GDP at the end of 2005 to 65.4% of GDP at the end of the second quarter of

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[44] On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

[45] In 2003, France switched the assets of the pension reserve fund (FRR, Fonds de Réserve pour les Retraites) from government bonds to private bonds and shares and participated in the increase of the share capital of France Télécom. These operations contributed to the increase in the gross debt-to-GDP ratio by 2 percentage points in 2003, though they had no immediate and direct impact on the net debt. In 2005, more than 1 percentage point of the surge in the debt-to-GDP ratio to 66.6% was linked to stock-flow adjustments. They were mainly linked to a further accumulation of financial assets by the FRR and complementary pension schemes. The rest was linked to the difference between cash and accrual accounting in connection with purchases of military equipment and the "soulte EDF" (as a large share of the payments already recorded as revenue in government accounts will be effectively collected over the next 20 years).

2006. According to the Commission services' autumn 2006 forecast, the general government gross debt is expected to fall further to 64.6% of GDP in 2006.

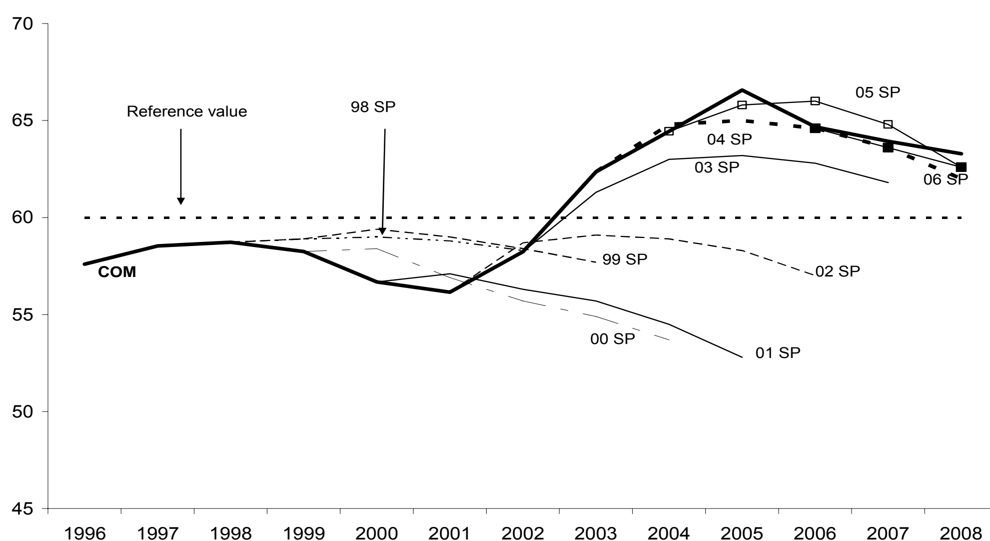
In 2007, the programme anticipates a further reduction in the debt-to-GDP ratio by 1 percentage point, half of which would stem from privatisation receipts and the rest from debt management. The update's debt reduction path would bring the debt ratio close to the Treaty reference value in 2009 (at 60.7% of GDP) and below it in 2010 (at 58% of GDP). According to the Commission services' autumn 2006 forecast, the debt ratio is also expected to fall further to around 63% of GDP by 2008 (on a no-policy change basis).

Compared to the previous update, which anticipated a debt-to-GDP ratio of 65.8% in 2005, the starting point of the current update strongly deteriorated, as the debt-to-GDP ratio reached 66.6% of GDP in 2005. However, the path of the adjustment is now more ambitious and frontloaded, as it implies a reduction in 2006 of 2 percentage point of GDP compared to a slight increase previously anticipated and a larger decrease in 2007 (1 percentage point of GDP against 0.4 in the previous update).

The reduction in the debt ratio would be triggered by GDP growth, the shift to primary surpluses from 2007 onwards and negative (i.e. debt reducing) stock-flow adjustment (SFA). Indeed, stock-flow adjustments are projected to be significantly negative in 2006 and 2007 (-2 and -1% of GDP in 2006 and 2007 respectively), and broadly constant thereafter at -0.4% of GDP (Table 11). While no numerical information on the composition of the SFA is provided (decomposition data are optional), one may infer that they are linked for 2006 and 2007 to the cash-flow management and privatization receipts and for the rest of the programme period to the planned sales of non-strategic assets.

Over the last five years, the debt-to-GDP targets of the successive stability programme updates have constantly been revised upwards and often missed (see Figure 13). Indeed, for example, the debt-to-GDP 2005 target was initially set at 52.9% in the 2001 update and was continuously revised upwards up to 65.8% in the January 2006 update, while the outcome reached 66.6%. Similarly, the 2006 debt-to-GDP target was initially set at 57% in 2002 and revised upwards up to 66% in the January 2006 update. The current projection is 64.6% of GDP.

Figure 13: Debt projections in successive stability programmes (% of GDP)



Source: Commission services' autumn 2006 forecast (COM), stability programme update (SP).

Table 11: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009	2010
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**64.4**	**66.6**	**64.7**	**64.6**	**63.9**	**63.6**	**63.3**	**62.6**	**60.7**	**58.0**
Change in the ratio	1.2	2.1	-1.9	-2.0	-0.7	-1.0	-0.6	-1.0	-1.9	-2.7
Of which[2]:										
Primary balance	-0.1	0.2	0.1	0.1	0.0	-0.1	-0.4	-0.8	-1.6	-2.5
"Snow-ball" effect	0.6	0.7	0.0	-0.1	0.1	0.0	0.2	0.2	0.1	0.2
Of which:										
Interest expenditure	2.8	2.7	2.6	2.6	2.7	2.6	2.7	2.6	2.5	2.5
Growth effect	-1.2	-0.7	-1.4	-1.4	-1.4	-1.4	-1.3	-1.4	-1.4	-1.3
Inflation effect	-1.1	-1.2	-1.3	-1.2	-1.1	-1.2	-1.2	-1.1	-1.1	-1.0
Stock-flow adjustment	0.6	1.2	-2.0	-2.0	-0.8	-0.9	-0.4	-0.4	-0.4	-0.4
Of which:										
Cash/accruals diff.	0.0	0.5	0.0	-	0.0	-	0.0	-	-	-
Acc. financial assets	0.6	0.6	-2.0	-	-0.8	-	-0.4	-	-	-
Privatisation	-0.2	-0.3	-1.0	-	-0.4	-	-0.4	-	-	-
Val. effect & residual	0.0	0.0	0.0	-	0.0	-	0.0	-	-	-

Notes:

[1]End of period.

[2]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 (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Stability programme update (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

5.1.2. *Assessment*

The update projections are similar to those of the Commission services' autumn 2006 forecast, which predicts a continuous decrease in the debt-to-GDP ratio over the forecast horizon to about 63% in 2008, a reduction of about 3 percentage points over 2006-2008.

The debt path contained in the update is 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[46], which is somewhat high by historical standards. Indeed, over the twenty-year period from 1986 to 2005, about EUR 82 bn of asset sales have been collected, out of which only EUR 10 bn were allocated to debt reduction, whereas EUR 70 bn were used for the re-capitalization or investment projects financing of public companies (about EUR 2 bn were allocated to the Fonds de Réserves des Retraites").[47]

The fact 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 is a positive development. Despite the risk associated to the budgetary targets, notably in the outer years of the programme, and to the realisation of the planned sales of non-strategic assets, the debt ratio seems to 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 2006 forecasts until 2008 (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" (*). 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 2007 is compared with the value obtained for the same year by applying the formula starting in 2002. 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 planned reduction of the debt ratio in the update is more than implied by the five-year rolling debt reduction benchmark only from 2009 as shown in the graph.

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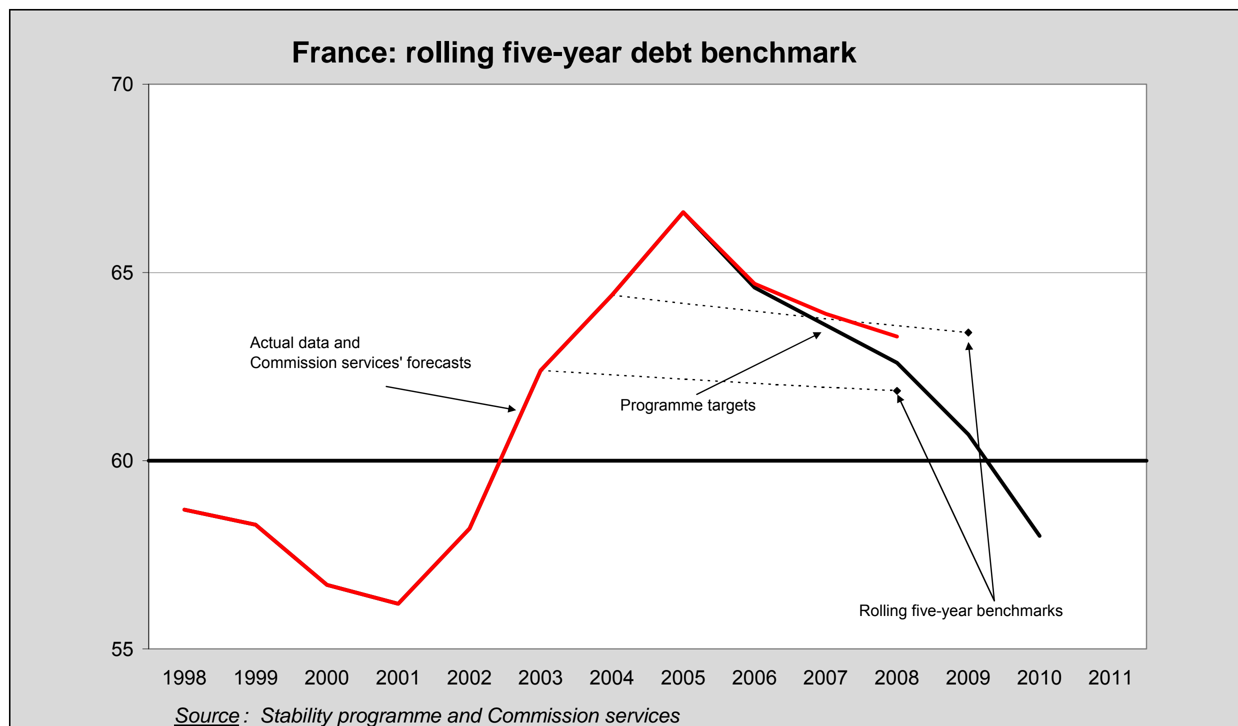
[46] No details are available on this programme.

[47] These data are provided by the French Government Shareholding Agency (http://www.ape.minefi.gouv.fr/sections/basedocumentaire/privatisations_et_ou/donnees_historiques/downloadFile/attachedFile/RecettesCessionTitresPrivat_16012006.pdf?nocache=1143797317.57). Caution should be applied when interpreting these data as, according to the Agency, they have not been updated and are expressed in current euros.



(*) The rolling debt reduction benchmark for successive five-year periods is defined as a reduction in the difference between the debt ratio and the 60% of GDP reference value of 5 percent per year:

$$\left(\frac{D_t}{Y_t}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$$

, where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively. In the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio. Given the usual approximation of the change in the debt ratio $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \frac{y_t}{1+y_t} \times \frac{D_{t-1}}{Y_{t-1}} \cong \frac{DEF_t}{Y_t} - y_t \times \frac{D_{t-1}}{Y_{t-1}}$ and assuming that the stock-flow adjustment is zero, it is easy to show that 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%. In other words, the 5 percent per year benchmark is the value that makes consistent a continuous respect of the 3% of GDP deficit threshold and an asymptotic respect of the 60% of GDP debt reference value.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[48]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (see Box 5), on the basis of two different scenarios. The first scenario

[48] For a detailed analysis of long-term sustainability issues, see “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

assumes that the structural primary balance will remain unchanged from 2006 through 2010, the final year of the stability programme; it is called the "2006 scenario". Debt projections and primary balance in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2010 provided in the stability programme will be fully respected. This is the "programme scenario". Debt and primary balance projections in this scenario start in 2011. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections.[49] Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	changes
Total age-related spending	26.9	27.0	27.9	29.0	30.1	30.1	3.2
Pensions	12.8	12.9	13.7	14.3	15.0	14.8	2.0
Healthcare	7.7	8.0	8.4	8.9	9.3	9.5	1.8
Long-term care	0.3	0.3	0.3	0.4	0.5	0.5	0.2
Education	5.0	4.7	4.6	4.5	4.5	4.5	-0.5
Unemployment benefits	1.2	1.1	0.9	0.9	0.9	0.9	-0.3

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in France is slightly below the average of the EU, rising by 3.2% points of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be relatively limited in France, rising by 2% points over this period due to large reforms enacted in the past (in 1993 for private sector and in 2003 mainly for public sector). The increase in health-care expenditure is projected to be 1.8% points of GDP, slightly higher than on average in the EU. For long-term care, the projected increase of 0.2% points up to 2050 is below the average in the EU.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

Table 13: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	2,3	3,2	3,2	-0.5	0.6	3.2
of which:						
Initial budgetary position	0,6	0,6	-	-2.1	-2.0	-
Debt requirement in 2050	-0,1	-	-	-0.2	-	-
Future changes in budgetary position	1,8	2,6	-	1.8	2.6	-

Source: Commission services.

[49] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1, 2006.

Box 5: – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) **initial budgetary position (IBP)**; and, (ii) l**ong-term change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2011-2015) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

Table 13 shows the sustainability indicators for the two scenarios. In the "2006 scenario", the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 2.3% of GDP. The sustainability gap (S2) which satisfies the inter-temporal budget constraint would be 3.2% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are smaller in the present assessment, by about ¾% of GDP. This is mainly due to a higher estimated structural primary balance in 2006 (at 0.1% of GDP) compared with the structural primary balance in 2005 estimated in spring 2006 (at -0.5% of GDP) that was used in the Sustainability Report.

The initial budgetary position is not sufficiently high to offset the impact of the increase in age-related expenditure up to 2050 and there is a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. The programme plans an improvement of the structural balance of 2.7% of GDP between 2006 and 2010. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances, reducing the S2 sustainability gaps by about 2½% of GDP, ("programme scenario"). The difference between the initial budgetary position in the 2006 scenario and the programme scenario illustrates how the full respect of the stability programme targets will contribute to tackling the budgetary challenges raised by the demographic developments. According to

both sustainability gaps, the long-term budgetary impact of ageing is relatively limited in particular thanks to the pension reform measures enacted in recent years.

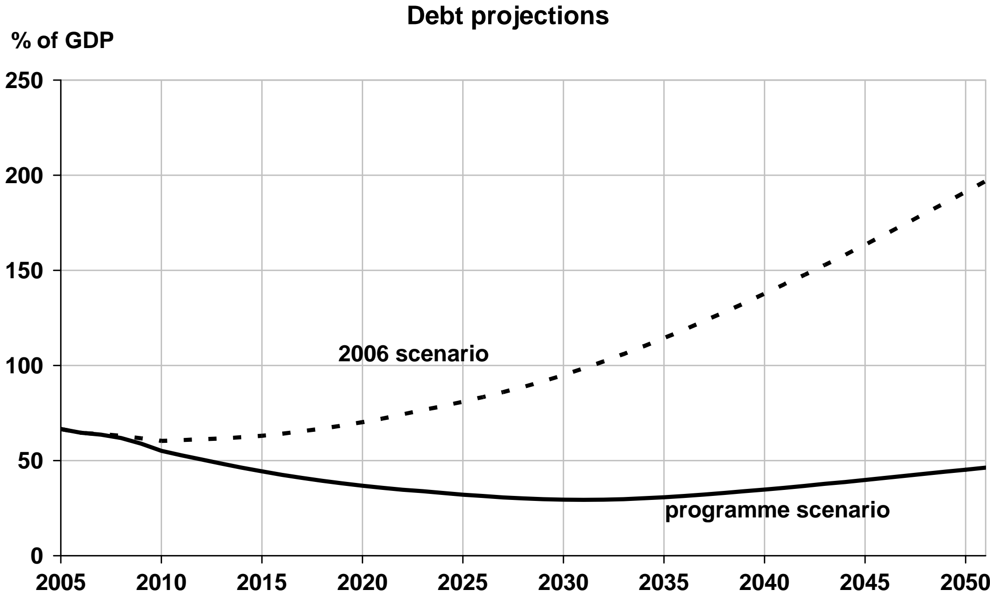
The required primary balance (RPB) is about 3¼% of GDP, higher than the structural primary balance of about 2¾% of GDP in the last year of the programme's period.

Moreover, the sustainability gap indicators would increase by up to 0.4% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 14.

The gross debt ratio is currently above the 60% of GDP reference value, estimated in the programme at close to 65% of GDP in 2006, down by almost 2 p.p. of GDP compared with 2005. According to the "2006 scenario", the debt ratio is projected to decrease slightly, though remain above 60%, up to the mid-2010s and thereafter increase throughout the projections period up to 2050, when it would reach 200% of GDP. In the "programme scenario" debt would fall below 60% of GDP in the mid-2010s and remain so up to the end of the projections period, although it would still be on an upward trend towards 2050.[50]

Figure 14: Long-term projections for the government debt ratio



Source: Commission's services

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[50] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

5.2.2. *Additional factors*

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, France's current level of debt is higher than 60% of GDP and it has been increasing in recent years, though it is estimated to have decreased in 2006 to 2005. A reduction in the debt to below the 60% of GDP reference value, in line with the strategy described in the programme, would strengthen the resilience of public finances to adverse shocks and reduce the risks to public finance sustainability.

Second, the benefit ratio in France is projected to decrease relatively markedly, by around 20%, in the period to 2050. Employment rates of older workers are currently lower in France (36%) than on average in the EU (40%) and, while assumed to rise, they are projected to remain below the EU average up to 2050. A greater increase in the employment rate of older workers than assumed in the projections would mean that the benefit ratio would decrease less markedly, as it would foster GDP growth and ensure that workers can accumulate more pension rights.

5.2.3. *Assessment*

The long-term budgetary impact of ageing in France is slightly lower than the EU average, with pension expenditure showing a somewhat more limited increase than in many other countries, as a result of the pension reforms already enacted.

The initial budgetary position with a structural deficit in 2006, albeit improved compared with last year, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Moreover, the current level of gross debt is above the Treaty reference value. Further budgetary consolidation would contribute to reduce risks to the sustainability of public finances.

Overall, France appears to be at medium risk with regard to the sustainability of public finances.

6. 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 on output. 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 be broadly stable over the programme period.

Two reforms backing the reduction of the State expenditure – at the centre of the budgetary strategy – are highlighted in the programme: the progressive implementation of all the elements of the Constitutional Bylaw on Budget Bills (LOLF) and the implementation of the State modernisation audits. With the end of the 2006 budgetary cycle, the first "performance indicators" will become available, inducing more transparency and public expenditure management efficiency in the budgetary process. As already presented in the December 2004 update and discussed in the corresponding Commission services' assessment, one of the most important aspects of the LOLF is the fact that in order to make sure that revenue windfalls are used properly, the government must submit a rule for the allocation of any surplus revenues during the execution of the budget. For 2007, it has been decided that any surplus revenues must be used to reduce the budgetary deficit. Concerning the modernisation audits, the update recalls that there have been 127 audits covering EUR 120 bn of expenditure. Following these audits, EUR 3 bn of productivity gains have been identified (out of which 40% concern the new "purchase plans") and will be implemented over 3 years.

The update expands on the setting-up of a "Public Finance Conference", annually gathering all actors of public finance management as a major institutional innovation which improves the oversight of public finance. This initiative, which first took place in January 2006, raises the accountability of all public stakeholders for spending control, as highlighted in the update, and is aimed at mobilising all actors toward respect of the multi-annual expenditure ceiling defined at the general government level. In this context, setting-up such a conference helps develop a general "governance agreement" among all public expenditure managers. A new council has also been created, the "Conseil d'Orientation des Finances Publiques", whose composition is very close to that of the Conference, and whose role is to (a) describe and analyse the public finances situation, (b) evaluate the conditions for sustainable public finance and propose a distribution of the burden of achieving the general target among all public administrations, and (c) formulate recommendations on all subjects related to public finance. A first public report will be available in view of the next Conference, at the beginning of January 2007.

While these steps go in the right direction, strengthening the monitoring and enforcement mechanisms for expenditure-rules would be required to make the budgetary rules enforceable. Currently, there is no systematic justification of the deviations in the budgetary execution from the target set in the Budget Bill, nor have mechanisms been put 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 heath-care expenditure.[51]

Measures aiming at increasing potential growth, one of the three pillars of the French commitment to debt reduction as discussed in section 4.2, are also presented (see section 7).

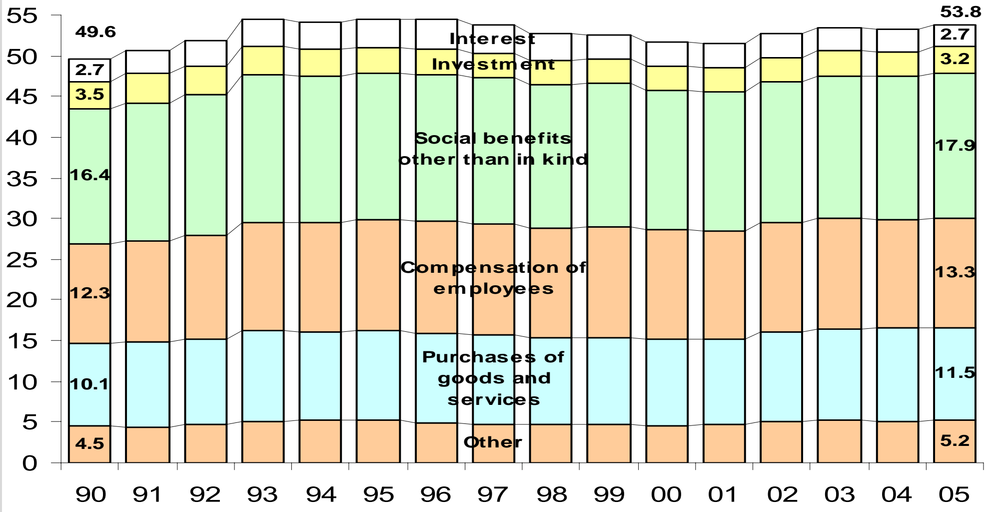
Box 6: The level and composition of government expenditure in France since 1990

Since 1990, the French government expenditure increased from 49.6% of GDP to 53.8% of GDP. According to an economic classification shown in Figure 15, the main expenditure-increasing factors from 1990 to 2005 are social benefits (+1.4 percentage point of GDP) and purchases of goods and services (+1.3 percentage point of GDP), as well as (although to a slightly lesser extent) compensation of employees (+1 percentage point of GDP). It is interesting to note that despite the surge in the debt-to-GDP ratio, which nearly doubled over the same period, the ratio-to-GDP of interest expenditure was stable. This was possible thanks to the refinancing of debt at lower interest rates (the implicit interest rate nearly halved from about 8% in 1990 to 4% in 2005). However, margins for savings in interest expenditure from this source seem to be nearly exhausted, as the market interest rate is expected to increase, which will eventually also have an increasing effect on the implicit interest rate on government debt.

As could be expected, 'social benefits other than in kind' (which include notably unemployment benefits and old-age pensions) are most sensitive to the business cycle. As a percentage of GDP, they reached a maximum in 1993 with 18.1%. At the peak of the cyclical upswing in 2000, they reached a low point at 17.1% of GDP but since then increased again to 17.9%. In view of the ageing population, an underlying upward trend in this category of expenditure can certainly be expected.

Compensation of employees increased mainly at the beginning of the previous decade (+1.5% points of GDP between 1990 and 1996). Since then its share declined but at a very slow pace and reached 13.3% of GDP in 2005. Purchases of goods and services showed a similar pattern, with a steady increase over the 1990s, a decline at the decade and an increase again since the beginning of the 2000s.

Figure 15: The evolution of government expenditure (economic classification) (% of GDP)

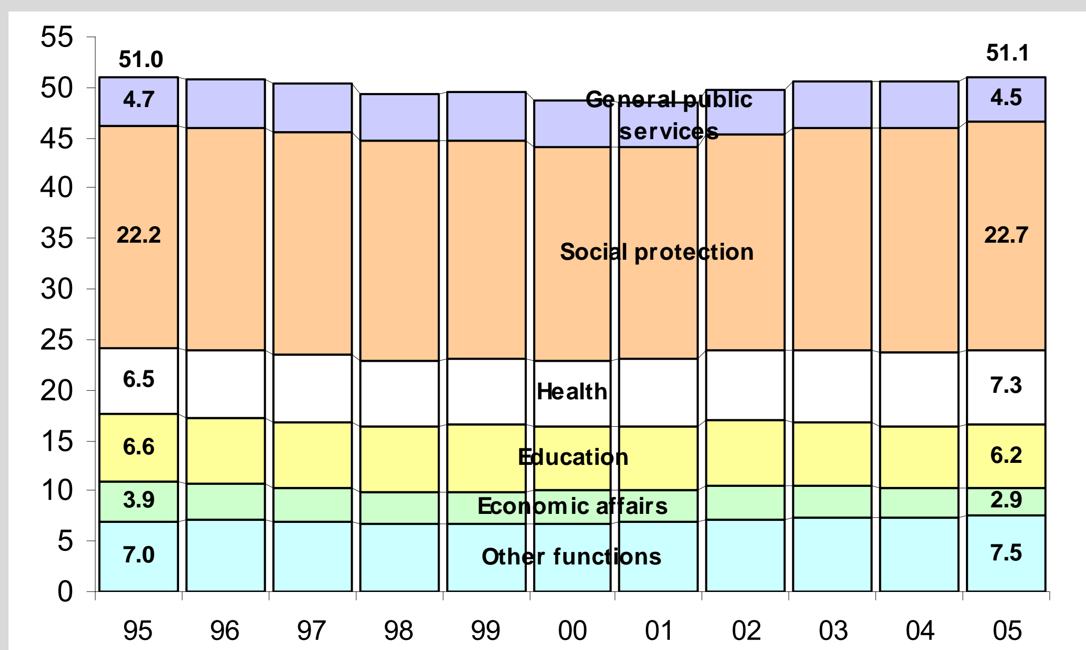


Note: "Other" includes subsidies and other current and capital transfers.
Source: Commission services

[51] When giving its opinion on the likelihood of the achievement of the target, if the independent committee on health-care 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 heath-care expenditures was in line with the target.

Following a functional classification, the stability of primary expenditure, at about 51% of GDP, reveals offsetting movements in the underlying expenditures items. The relative importance of the different items show that while health and education had the same weight in 1995, there is nearly a percentage point of difference in 2005, as share of spending in healthcare in the primary expenditure composition has increasingly expanded and represent the largest increase, +0.8% points of GDP. In view of the ageing population, a further widening in the difference in the trends of these two categories of expenditure can certainly be expected. In relative terms the most pronounced change occurred in primary expenditure on economic affairs (which decreased from 3.9% of GDP in 1995 to 2.9% in 2005).

Figure 16: The evolution of government primary expenditure (functional classification) (% of GDP)



Note: "Other functions" include defence, environment, culture, public order and housing.
Source: Commission services

7. Consistency with the National Reform Programme and with the broad economic policy guidelines

Policies in the stability programme regarding the quality of public finances and structural reforms, as described in section 6, are in line with the National Reform Programme (NRP) and the progress recorded in the Implementation Report of the National Reform Programme.

The NRP did not identify public finance consolidation as a key challenge but rather as a pre-requisite for high and sustainable economic growth[52]. Indeed, the two documents are in line in the sense that they both recommend consolidation, also referring to the European framework. There is no systematic information in the update on the direct budgetary costs (or savings) associated with the main reforms envisaged in the NRP, but its budgetary projections seem to implicitly take into account the public finance implications of the actions outlined in the national reform programme although there is no explicit mention of the costs of the different

[52] The French NRP is based on the concept of "social growth" and identifies three main priorities: to create the necessary conditions for strong economic growth; to reduce unemployment and increase employment; to build a knowledge-based economy. It stresses the need to consolidate the public finances, redress the employment situation and strengthen the competitiveness of business.

actions taken in the Lisbon context – as already indicated in the conclusions of the Commission's assessment of the French National Reform Programmes for Growth and Jobs[53] – the "high scenario" (see section 3.2), where real GDP would reach 3%, could be considered as a "Lisbon scenario", in which the pursuit of the implementation of structural reforms would lead to an increase of potential growth over the programme horizon . However, it provides no systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme.

The stability programme contains a qualitative assessment of the overall impact of France's October 2006 national reform programme within the medium-term fiscal strategy. Also, the programme presents measures aiming at increasing potential growth. 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 submitted on 7 November 2005 and in the autumn 2006 implementation report (submitted on 28 September, see Box 6), 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. 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.

Box 7: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme (IR-NPR) of France, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 5 October 2006. The Commission's assessment, which was adopted on 12 December 2006 as part of its Annual Progress Report, can be summarised as follows.

The IR-NRP recalls the three priorities of the concept of "social growth" – on which the NRP is based – concerning the creation of the necessary conditions for strong economic growth, the reduction of unemployment and the increase in employment and the building-up of a knowledge-based economy. It also re-affirms the need to consolidate the public finances, redress the employment situation and strengthen the competitiveness of business.

In its assessment, the Commission acknowledges that France is making good progress with the implementation of its NRP. Notably in a context of supportive macroeconomic developments, France has pursued its effort of fiscal consolidation, while trying to raise its potential growth, notably through new commitments towards research and innovation. Labour market performance is still mitigated.

Good progress has been realized in the field of research, notably through the commitment to increase to 3% the effort towards research. The reform of public finance governance should also decisively contribute to a better management of public expenditure. The decrease in the employment rate, for the first time since 2001, is a good sign and recent measures geared toward youth unemployed are steps in the good direction.

On the other hand, it stresses that some areas still need to be urgently addressed. Notably, despite the improvement of the budgetary situation, some progress needs to be made concerning the control of general government expenditure and notably at the local administration and social security levels. The sub-optimal level of competition in some network industries as well as in some transportation

[53] http://europa.eu.int/growthandjobs/pdf/2006_annual_report_france_en.pdf.

segments needs to be addressed. Also, an overall strategy is needed to guarantee more fluidity and a greater participation of older workers in the labour market, including a better access to long-life learning.

In this context, the Commission recommended that France ensure long-term sustainability of public finances through a deepening of budgetary consolidation and a reduction of the debt level. Moreover, the planned 2008 revision of the pension system parameters needs to preserve the gains of the 2003 pension reform. Some measures are also needed to reinforce competition for the gas, electricity and railway freight industries. Lastly, the Commission recommended to modernize employment protection and reinforce long-life learning in order to improve flexibility and security on the labour market and fight against segmentations between the different contracts while facilitating changes between fixed and unfixed-term contracts.

Table 14 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, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the stability programme is broadly consistent with the broad economic policy guidelines.

Table 14: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– 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[1].		X		
– Member States should avoid pro-cyclical fiscal policies[2].				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.				X
2. To safeguard economic and fiscal sustainability 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		
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition		X		

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
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.				

Notes:
[1]As further specified in the Stability and Growth Pact and the 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.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

* * *

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific 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, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a "safety margin" that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	1782630	2.0-2.5	2.0-2.5	2 ¼	2 ¼	2 ¼
2. Nominal GDP	B1*g	1782630	4.2	4.2	4.0	4.0	4.0
Components of real GDP							
3. Private consumption expenditure	P.3	1019246	2.8	2.7	2.5	2.5	2.4
4. Government consumption expenditure	P.3	420334	1.8	0.3	0.5	0.4	0.7
5. Gross fixed capital formation	P.51	358165	3.3	3.3	2.9	2.9	2.9
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53		0.2	0.8	0.9	0.8	0.9
7. Exports of goods and services	P.6	487316	7.9	6.2	5.9	5.9	5.9
8. Imports of goods and services	P.7	515935	8.0	6.1	5.6	5.6	5.6
Contributions to real GDP growth							
9. Final domestic demand			2.7	2.3	2.1	2.1	2.1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		0.5	0.1	0.1	0.1	0.1
11. External balance of goods and services	B.11		-0.8	-0.2	0.0	0.0	0.0

(*) at current prices.

Table 1b. Price developments

	ESA Code	2006	2006	2007	2008	2009	2010
		level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator			2.0	2.0	1 ¾	1 ¾	1 ¾
2. Private consumption deflator			1.6	1.6	1 ¾	1 ¾	1 ¾
3. HICP[1]			2.0	1.9	1 ¾	1 ¾	1 ¾
4. Public consumption deflator			1.8	1.6	1 ¾	1 ¾	1 ¾
5. Investment deflator			3.0	2.6	1 ¾	1 ¾	1 ¾
6. Export price deflator (goods and services)			1.2	1.0	1.2	1.2	1.2
7. Import price deflator (goods and services)			3.3	0.5	1.0	1.0	1.0

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		25000(*)	0.8	1.1	0.6	0.5	0.5
2. Employment, hours worked[2]							
3. Unemployment rate (%)[3]							
4. Labour productivity, persons [4]			1.5	1.2	1.7	1.7	1.7
5. Labour productivity, hours worked[5]							
6. Compensation of employees	D.1	927529	3.9	4.0	3.7	3.7	3.7

(*) thousands, annual average

[1] Occupied population, domestic concept national accounts definition.

[2] National accounts definition.

[3] Harmonised definition, Eurostat; levels.

[4] Real GDP per person employed.

[5] Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9		-2.0	-1.8	-1.8	-1.7	-1.6
of which:							
- Balance on goods and services			-1.6	-1.5	-1.4	-1.3	-1.2
- Balance of primary incomes and transfers			-0.4	-0.3	-0.4	-0.4	-0.4
- Capital account			0.0	0.0	0.0	0.0	0.0
2. Net lending/borrowing of the private sector	B.9						
3. Net lending/borrowing of general government	EDP B.9		-2.7	-2.5	-1.8	-0.9	0.0
4. Statistical discrepancy			optional	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA code	2006 Level	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP
			Net lending (EDP B.9) by sub-sector				
1. General government	S.13	-48.5	-2.7	-2.5	-1.8	-0.9	0.0
2. Central government	S.1311	-41.3	-2.2	-2.2	-1.8	-1.2	-0.6
3. State government	S.1312						
4. Local government	S.1313	-1.5	-0.1	-0.1	-0.1	-0.1	-0.1
5. Social security funds	S.1314	-7.7	-0.4	-0.1	0.1	0.4	0.6
			General government (S13)				
6. Total revenue	TR	901.8	50.6	50.4	50.2	50.3	50.3
7. Total expenditure	TE[1]	950.3	53.3	52.9	52.0	51.1	50.4
8. Net lending/borrowing	EDP B.9	-48.5	-2.7	-2.5	-1.8	-0.9	0.0
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	46.6	2.6	2.6	2.6	2.5	2.5
pm: 9a. FISIM							
10. Primary balance	[2]	-1.9	-0.1	0.1	0.7	1.7	2.5
			Selected components of revenue				
11. Total taxes (11=11a+11b+11c)		491.5	27.6	27.3	27.1	27.1	27.1
11a. Taxes on production and imports	D.2	276.6	15.5	15.4	15.3	15.3	15.3
11b. Current taxes on income, wealth, etc	D.5	206.8	11.6	11.4	11.3	11.3	11.3
11c. Capital taxes	D.91	8.1	0.5	0.5	0.5	0.5	0.5
12. Social contributions	D.61	324.2	18.2	18.2	18.1	optional	optional
13. Property income	D.4	12.4	0.7	0.8	0.9	optional	optional
14. Other (14=15-(11+12+13))		73.6	4.1	4.1	4.1	optional	optional
15=6. Total revenue	TR	901.8	50.6	50.4	50.2	50.3	50.3
p.m.: Tax burden (D.2+D.5+D.61+D.91 -D.995)[3]		779.8	43.7	43.5	43.3	43.3	43.3
			Selected components of expenditure				
16. Collective consumption	P.32						
17. Total social transfers	D.62 + D.63	417.6	23.4	23.2	22.9	22.6	22.3
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	46.6	2.6	2.6	2.6	2.5	2.5
19. Subsidies	D.3	25.9	1.5	1.4	1.3	1.3	1.2
20. Gross fixed capital formation	P.51	58.4	3.3	3.3	3.2	3.1	3.2
21. Other (21=22-(16+17+18+19+20))		401.8	22.5	22.4	22.0	21.6	21.2
22=7. Total expenditure	TE[1]	950.3	53.3	52.9	52.0	51.1	50.4
Pm: compensation of employees	D.1						

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[3] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

Table 3. General government expenditure by function

% of GDP	COFOG Code	Year X-2	Year X+3
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 (= item 7=26 in Table 2)	TE[1]		

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP		2006	2007	2008	2009	2010
1. Gross debt[1]		64.6	63.6	62.6	60.7	58.0
2. Change in gross debt ratio		-2.0	-1.0	-1.0	-1.9	-2.6
Contributions to changes in gross debt						
3. Primary balance[2]		-0.1	0.1	0.7	1.7	2.5
4. Interest expenditure (incl. FISIM) [3]		2.6	2.6	2.6	2.5	2.5
5. Stock-flow adjustment		-2.0	-1.0	-0.4	-0.4	-0.4
- Differences between cash and accruals[4]						
- Net accumulation of financial assets[5]						
of which - privatisation proceeds						
- Valuation effects and other[6]						
p.m. implicit interest rate on debt[7]		4.0	4.1	4.0	4.0	4.1
Other relevant variables						
6. Liquid financial assets[8]						
7. Net financial debt (7=1-6)						

[1] As defined in Regulation 3605/93 (not an ESA concept).
[2] Cf. item 10 in Table 2.
[3] Cf. item 9 in Table 2.
[4] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.
[5] Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.
[6] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.
[7] Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.
[8] 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	**2006**	**2007**	**2008**	**2009**	**2010**
1. Real GDP growth (%)		2.0-2.5	2.0-2.5	2 ¼	2 ¼	2 ¼
2. Net lending of general government	EDP B.9	-2.7	-2.5	-1.8	-0.9	0.0
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 + FISIM	2.6	2.6	2.6	2.5	2.5
4. Potential GDP growth (%) (1)		2.1	2.2	2.2	2.2	2.2
contributions:						
- labour		0.2	0.3	0.3	0.3	0.2
- capital		0.8	0.8	0.8	0.8	0.9
- total factor productivity		1.0	1.0	1.0	1.0	1.1
5. Output gap		-0.2	-0.2	-0.1	0.0	0.0
6. Cyclical budgetary component		-0.2	-0.2	-0.2	-0.1	-0.1
7. Cyclically-adjusted balance (2-6)		-2.6	-2.3	-1.6	-0.8	0.0
8. Cyclically-adjusted primary balance (7-3)		0.1	0.3	1.0	1.7	2.5

(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	**2006**	**2007**	**2008**	**2009**	**2010**
Real GDP growth (%)						
Previous update		2.0-2.5	2 ¼	2 ¼	2 ¼	
Current update		2.0-2.5	2.0-2.5	2 ¼	2 ¼	2 ¼
Difference						
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.9	-2.6	-1.9	-1.0	
Current update		-2.7	-2.5	-1.8	-0.9	0.0
Difference		0.2	0.1	0.1	0.1	
General government gross debt (% of GDP)						
Previous update		66.0	65.6	64.6	62.8	
Current update		64.6	63.6	62.6	60.7	58.0
Difference		-1.4	-2.0	-2.0	-2.1	

Table 7. Long-term sustainability of public finance

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure							
Of which: age-related expenditures							
Pension expenditure							
Social security pension							
Old-age and early pensions							
Other pensions (disability, survivors)							
Occupational pensions (if in general government)							
Health care							
Long-term care *(this was earlier included in the health care)*							
Education expenditure							
Other age-related expenditures							
Interest expenditure							
Total revenue							
Of which: property income							
of which: from pensions contributions (or social contributions if appropriate) Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than government liabilities)							
Assumptions							
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

	2004	2005	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)			2.1	2.1			
Long-term interest rate (annual average)			3.5	3.9			
USD/€ exchange rate (annual average) (euro area and ERM II countries)			1.28	1.25	1.25	1.25	1.25
Nominal effective exchange rate			108.4	107.7	107.7	107.7	107.7
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)							
World excluding EU, GDP growth			4.8	4.6	4.2	4.2	4.2
EU GDP growth			1.4	1.7	2.0	2.0	2.0
Growth of relevant foreign markets			4.2	6.0	6.0	6.0	6.0
World import volumes, excluding EU			7.3	7.7	7.1	7.1	7.1
Oil prices, (Brent, USD/barrel)			55.2	60.0	61.1	62.1	63.2

[1] If necessary, purely technical assumptions.

Annex 3: 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 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.

Guidelines in the code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].		X	Delivered on 6/12/06
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
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		
4. Other information requirements			
a. Involvement of parliament			
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.			Unclear: the programme mentions p.25 that the January 2006 update has been presented to the Parliament but there is no indication of a discussion on the Council opinion.
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.		X	Nevertheless The external assumptions in the programme are broadly in line with the Commission services' autumn 2006 forecasts
Significant divergences between the national and the Commission services' economic forecasts are explained[2].			Not applicable, assumptions is in line with the Commission services' autumn 2006 forecast
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.			Not applicable since external deficit remains limited at 2% of GDP.

Guidelines in the code of conduct	Yes	No	Comments
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
d. Budgetary strategy			
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		
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	Only partial information for the year 2005
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
e. "Major structural reforms"			
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
f. Sensitivity analysis			
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 "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
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
h. Quality of public finances			
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		

Guidelines in the code of conduct	Yes	No	Comments
i. Long-term sustainability			
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		
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		
j. Other information (optional)			
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		

Notes:

[1]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.

[2]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.

Source:
Commission services

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the euro area.

France – Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	2.2	2.8	1.5	1.1	2.3	1.2
Private consumption % change	2.4	2.6	2.2	2.0	2.3	2.0
Government consumption % change	1.4	1.2	1.7	2.0	2.3	1.1
Investment % change	3.3	4.7	1.9	2.2	3.0	3.6
Exports % change	5.2	8.4	2.0	-1.2	3.9	3.1
Imports % change	6.1	8.7	3.5	1.1	6.6	6.1
Contributions to real GDP growth						
Demand						
Domestic demand	2.3	2.7	1.9	1.7	3.0	1.9
Net exports	-0.2	0.1	-0.4	-0.6	-0.6	-0.8
Output gap	0.1	-0.2	0.4	-0.1	0.0	-0.8
Prices and costs						
HICP inflation % change	1.7	1.3	2.0	2.2	2.3	1.9
Unit labour costs % change	1.3	0.7	2.0	1.8	1.0	1.9
Labour productivity % change	1.2	1.5	0.8	1.1	2.3	0.9
Real unit labour costs % change	-0.2	-0.3	0.0	-0.1	-0.6	0.0
Comparative price levels (EUR25=100)	106.4	107.4	105.4	105.9	107.0	106.9
Labour market						
Employment % change	1.0	1.4	0.6	0.1	0.0	0.3
Employment % of pop work age	60.8	59.7	62.0	62.0	61.6	61.6
Unemployment rate in %	10.0	10.8	9.2	9.5	9.6	9.7
NAIRU in %	9.9	10.3	9.5	9.6	9.4	9.2
Participation rate in %	67.5	66.7	68.2	68.5	68.2	68.2
Working age population % change	0.5	0.4	0.6	0.7	0.6	0.4
Competitiveness and external position						
Real effective exchange rate % change (1)	-0.4	-2.7	1.9	4.7	1.4	0.4
Export performance % change (2)	-1.0	-0.1	-1.8	-4.9	-3.5	-2.3
External balance of g & s	1.3	2.0	0.6	1.0	0.2	-1.0
Net borrowing v-à-v RoW	0.9	2.0	-0.2	-0.2	-0.6	-2.1
FDI	n.a.	n.a.	n.a.	2.4	1.2	2.3
Public finances						
Total expenditure % of GDP	53.0	53.0	52.9	53.4	53.2	53.8
Total revenue % of GDP	50.1	50.4	49.8	49.2	49.6	50.9
General government balance % of GDP	-2.8	-2.6	-3.1	-4.2	-3.7	-2.9
General government debt % of GDP	59.8	58.0	61.6	62.4	64.4	66.6
Structural budget balance % of GDP (3)	n.a.	n.a.	n.a.	-4.1	-3.8	-3.1
Fin.a.ncial indicators (4)						
Short term real interest rate (5)	1.8	2.6	0.9	0.4	0.4	0.3
Long term real interest rate (5)	3.3	4.3	2.3	2.2	2.4	1.5
Household debt % change (6)	5.8	4.3	7.4	6.3	8.8	10.2
Corporate sector debt % change (7)	5.7	6.0	5.3	0.9	4.2	7.5
Household debt in % of GDP (6)	38.3	36.2	40.3	39.7	41.5	44.5
Corporate sector debt in % of GDP (7)	66.4	61.3	71.5	70.1	70.2	73.4

Notes:
(1) Unit labour cost relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.
(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).
(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.
(4) Data available up to 2004
(5) Using GDP deflator
(6) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares
(7) Non-financial corporate sector debt, defined as loans and securities other than shares
Source:
Commission services

Euro area –Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption % change	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption % change	1.7	1.7	1.7	1.8	1.2	1.4
Investment % change	2.6	4.3	1.0	1.0	2.2	2.5
Exports % change	5.8	8.1	3.5	1.1	6.8	4.3
Imports % change	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth						
Demand						
Domestic demand	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	0.1	0.1	0.1	-0.7	0.2	-0.2
Output gap	-0.1	-0.1	0.0	-0.6	-0.5	-1.1
Prices and costs						
HICP inflation % change	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs % change	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity % change	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs % change	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour market						
Employment % change	1.2	1.5	0.9	0.7	0.7	0.8
Employment % of pop work age	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate in %	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU in %	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate in %	69.9	68.5	71.2	71.4	71.7	71.8
Working age population % change	0.3	0.2	0.4	0.5	0.5	0.5
Competitiveness and external position						
Real effective exchange rate % change (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance % change (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s	1.9	1.7	2.0	2.1	2.1	1.5
Net borrowing v-à-v RoW	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances						
Total expenditure % of GDP	48.2	48.7	47.7	48.2	47.6	47.6
Total revenue % of GDP	45.8	46.5	45.1	45.1	44.8	45.1
General government balance % of GDP	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt % of GDP	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance % of GDP (3)	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
Financial indicators (4)						
Short term real interest rate (5)	1.7	2.7	0.7	0.2	0.2	0.3
Long term real interest rate (5)	3.1	4.1	2.1	2.0	2.2	1.5
Household debt % change (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt % change (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt in % of GDP (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt in % of GDP (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:
(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.
(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.
(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.
(4) Data available up to 2004.
(5) Using GDP deflator.
(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.
(7) Non-financial corporate sector debt, defined as loans and securities other than shares.
Source:
Commission services

Annex 5: Assessment of tax projections

entire annex is standard text: Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[54].

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 ε_{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 ε_{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[55]. By contrast, if ε_{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:

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

[54] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 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.

[55] 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: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

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

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

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.

Assessment of tax projections by major tax category

	2007			2008			2009	2010
	SP	COM	OECD[1]	SP	COM[2]	OECD[1]	SP	SP
Taxes on production and imports:								
Change in tax-to-GDP ratio	-0.1	0.0	0.0	-0.1	0.1	0.0	0.0	0.0
Difference SP – COM	-0.1			-0.2			/	/
of which[3]:								
- discretionary & elasticity component	-0.1			-0.2			/	/
- composition component	0.0			0.0			/	/
Difference COM – OECD	/	0.0		/	0.1		/	/
of which[3]:								
- discretionary & elasticity component	/	0.0		/	0.0		/	/
- composition component	/	0.0		/	0.0		/	/
p.m.: Elasticity								
- of taxes to tax base[4]	0.8	1.0	1.0	0.8	1.0	1.0	0.9	1.0
- of tax base[4] to GDP	1.0	1.1	1.0	1.1	1.1	1.0	1.1	1.1
Social contributions:								
Change in tax-to-GDP ratio	0.0	0.0	-0.2	-0.1	0.0	-0.2	n.a.	n.a.
Difference SP – COM	0.0		/	-0.1		/	/	/
of which[3]:								
- discretionary & elasticity component	0.0		/	0.0		/	/	/
- composition component	0.0		/	0.0		/	/	/
Difference COM – OECD	/	0.1		/	0.1		/	/
of which[3]:								
- discretionary & elasticity component	/	-0.1		/	-0.1		/	/
- composition component	/	0.2		/	0.2		/	/
p.m.: Elasticity								
- of taxes to tax base[5]	1.1	1.0	1.1	0.9	1.0	1.1	1.1	1.1
- of tax base[5] to GDP	1.0	1.0	0.7	0.9	1.0	0.7	0.9	0.9
Personal income tax[6]:								
Change in tax-to-GDP ratio	-0.2	-0.2	0.1	-0.1	0.0	0.1	0.0	0.0
Difference SP – COM	0.1		/	-0.1		/	/	/
of which[3]:								
- discretionary & elasticity component	0.1		/	-0.1		/	/	/
- composition component	0.0		/	0.0		/	/	/
Difference COM – OECD	/	-0.3		/	0.0		/	/
of which[3]:								
- discretionary & elasticity component	/	-0.3		/	-0.1		/	/
- composition component	/	0.2		/	0.2		/	/
p.m.: Elasticity								
- of taxes to tax base[5]	0.6	0.3	1.7	0.8	1.1	1.7	1.1	1.1
- of tax base[5] to GDP	1.0	1.0	0.7	0.9	1.0	0.7	0.9	0.9
Corporate income tax[6]:								
Change in tax-to-GDP ratio	0.0	-0.1	0.1	0.0	0.0	0.1	0.0	0.0
Difference SP – COM	0.0		/	0.0		/	/	/
of which[3]:								
- discretionary & elasticity component	0.0		/	0.0		/	/	/
- composition component	0.0		/	0.0		/	/	/
Difference COM – OECD	/	0.1		/	0.1		/	/
of which[3]:								
- discretionary & elasticity component	/	-0.1		/	-0.1		/	/
- composition component	/	0.2		/	0.2		/	/
p.m.: Elasticity								
- of taxes to tax base[7]	0.6	0.3	1.1	0.7	1.0	1.1	0.9	0.9
- of tax base[7] to GDP	1.1	1.0	0.7	1.1	1.0	0.7	1.1	1.1

Notes:
[1]Based on OECD ex-ante elasticitiesrelative to GDP.
[2]On a no-policy change basis.
[3]The decomposition is explained in the text above.
[4]Tax base = private consumption expenditure.
[5]Tax base = compensation of employees.
[6]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.
[7]Tax base = gross operating surplus.
Source:
Commission services' autumn 2006 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)