COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of France, 2006-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. General background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of France was submitted in January 1999. In accordance with the Regulation, the Council delivered an opinion on it on 15 March 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. Background for the assessment of the updated programme

The Commission has examined the most recent update of the stability programme of France, submitted on 6 December 2006, and has adopted a recommendation for a Council opinion on it.

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme) and

(3) the Commission's assessment of the October 2006 national reform programme.

2.1. Recent economic and budgetary performance

Based on the experience of the last ten years, the French business cycle moves much in line with that of the euro area and shows similar levels in growth. Nevertheless, the

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

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 below 9%, 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, leading to the abrogation of the excessive deficit procedure in January 2007. However, further consolidation is needed both to improve the long-term sustainability of public finances and to create a budgetary for 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.

2.2. The assessment in the Council opinion on the previous programme

On 24 March 2006, the Council adopted its opinion on the previous update of the stability programme, covering the period 2005-2009 stating that it "welcomes the priority given to debt reduction in the French stability programme but notes that there are risks linked to the achievement of the budgetary targets and to long-term sustainability of public finances". It invited France to "ensure the necessary structural adjustment to bring the general government deficit below 3% of GDP in 2006 in a credible and sustainable manner; take the necessary measures to ensure the planned fiscal consolidation towards the medium term objective and improve long-term sustainability; and strengthen the monitoring and enforcement of expenditure rules defined for the sub-sectors of the general government so as to ensure the respect of the ambitious multi-annual expenditure ceilings".

2.3. The Commission assessment of the October 2006 national reform programme

The Implementation Report of the National Reform Programme of France, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 5 October 2006. France's National Reform Programme 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]) showed that France is making progress with the implementation of its National Reform Programme. 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 subdued.

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.

[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.

Box: Main points covered by the assessment

As required by Article 5(1) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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3 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

4 "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.

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On the updated stability programme of France, 2006-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated stability programme of France, which covers the period 2006 to 2010.

(2) The programme 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 currently 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.

(3) 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

[5] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

improvement in the deficit is supported by (a) an acceleration in GDP growth (from 1.2% to about 2%) which boosts revenues (about EUR 5bn, i.e. 0.3 percentage point of GDP), and (b) a slowdown in expenditure.

(4) The programme is inscribed in the French authorities' overarching strategy of "national commitment to debt reduction" and is presented as a multi-annual programme for debt reduction targeting a zero deficit and a debt level below 60% of GDP by 2010. It foresees a continuous but back loaded decrease in the headline deficit from 2.7% of GDP in 2006 (2.5% in 2007) to 0% of GDP in 2010, amounting to an overall reduction by 2.7 percentage points of GDP. The primary deficit, of 0.1% of GDP in 2006, would turn into a surplus from 2007 onwards and reach 2.5% of GDP in 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.

(5) 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 inferred from the programme is a balanced position in structural terms, which the programme aims to achieve by 2010. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(6) 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 programme 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[6] and the results of the modernisation audits and is plausible although local authorities' expenditure trends are a risk factor. Regarding the outer years, the strong adjustment targeted raises doubts about its full achievement. Indeed, even if the track record of the compliance with its 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.

[6] The new Constitutional Bylaw on Budget Bills (LOLF), which has been implemented for the first time in 2006, aims at more transparency and efficiency of public expenditure management.

(7) 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 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 and that the adjustment should be higher in good economic times and could be lower in bad economic times. 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".

(8) Government gross debt is estimated to have reached 64.6% of GDP in 2006, above the 60% of GDP Treaty reference value. The programme projects the debt-to GDP ratio to decline by 6½ percentage points over the programme period. The evolution of the debt ratio might be less favourable than projected in the outer years of the programme given (1) the risks to the budgetary targets mentioned above, and (2) uncertainty about the materialization of non-strategic asset sales which tend to be larger than the historical average. Despite these risks, the debt ratio seems to be sufficiently diminishing towards the reference value over the programme period.

(9) 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, albeit improved compared with 2005, 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 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.

(10) 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. However, it provides no systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme but its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[7].

The overall conclusion is that, after the correction of the excessive deficit and in a context of strong revenue growth, the programme gives priority to debt reduction and envisages progress towards the MTO through an expenditure-based but somewhat back-loaded adjustment. There are risks to the achievement of the budgetary targets, especially in the outer years.

In view of the above assessment France is invited to:

(i) exploit the robust growth prospects and the positive base effect from a stronger-than previously expected 2006 outturn to frontload the adjustment towards the MTO, especially in 2007, with a view to achieving the MTO by the end of the period, thereby reducing the level of the debt and improving the long-term sustainability of public finances;

(ii) strengthen the monitoring and enforcement of expenditure rules for all sub-sectors of the general government so as to ensure the respect of the ambitious multi-annual expenditure ceilings.

[7] In particular, the data on collective consumption and short and long-term interest rates (for the years 2008 to 2010) are not provided.

Comparison of budgetary developments and 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 and 0.1% in 2006; 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 and 0.2% in 2006; 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