EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 12 February 2008
ECFIN/50396-EN

FRANCE: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE NOVEMBER 2007 UPDATE OF THE STABILITY PROGRAMME

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 30 November 2007.

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 (DG ECFIN) of the European Commission, was finalised on 12 February 2008. Comments should be sent to Suzanne Casaux and Jocelyn Guitton (suzanne.casaux@ec.europa.eu and jocelyn.guitton@ec.europa.eu). The main aim of the 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.

The analysis takes into account (i) the Commission services' autumn 2007 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. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 30 January 2008. The ECOFIN Council adopted its opinion on the programme on 12 February 2008.

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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

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 2007-2012, was submitted on 30 November 2007.

Between 2001 and 2005, annual real GDP grew by just above 1½% on average. This was in line with average growth in the euro area, while inflation was marginally below the euro average. Since 2006, GDP growth in France has fallen below the euro area average, with increasing evidence of structural problems and a related deterioration in competitiveness. Although the unemployment rate has improved since 2005, it remains well above the euro area average, and the employment rate and the hours worked are still low. In this context, the adopted measures and envisaged wide-ranging labour and product market reforms planned by the government over the coming five years would, if fully implemented, increase potential growth and competitiveness, and improve the long-term sustainability of public finances. Government deficits and debt ratios, though decreasing, remain high. Positive steps have been taken to curb spending. This includes a tightened expenditure rule for the state, which now also covers most of transfers to local authorities, and an alert mechanism to detect healthcare slippages during the year and recommend measures to limit the breach in the national health insurance spending objective. Nevertheless, France has the highest expenditure-to-GDP ratio in the euro area and its deficit is still fairly close to the 3% of GDP threshold. Thus, key challenges for the coming years will be to implement reforms to increase potential growth, improve the competitiveness of the French economy and help sustain the budgetary consolidation process as well as to forcefully restrain expenditure at all levels of government and improve its efficiency.

The programme contains two different scenarios for the macroeconomic and budgetary projections: a “low” growth scenario and a “high” growth scenario. The “low” growth scenario is considered the reference scenario for assessing public finance projections. It envisages that real GDP growth will pick up from 2% in 2007 to 2-2.5% in 2008 and to 2.5% over the rest of the programme period, which is higher than the Commission services’ estimate of potential growth of just above 2%. Assessed against currently available information, even this scenario appears to be based on favourable growth assumptions, especially for 2009. Less buoyant growth in the medium term than foreseen in the programme is a distinct possibility, not only because the programme builds on optimistic assumptions concerning the international environment, but also because the announced growth-enhancing labour and product market reforms still have to be specified and implemented and will only gradually increase growth potential. So far, the government has notably adopted a university reform and additional incentives to corporate research and has agreed on reforming the special pension regimes. Moreover, reforms under discussion cover a wide range of areas such as further reforming the pension system and the labour market including through a review of the labour contracts, as well as the modernisation of the French economy taking into account the proposals of the "Attali Commission". In the light of the latest developments in oil and food prices, the programme’s projections for inflation appear to be on the low side over the entire programme period. This also has implications for plausibility of the competitiveness and net exports assumed in the programme.

For 2007, the general government deficit is estimated at 2.6% of GDP in the Commission services' autumn 2007 forecast, against a target of 2.5% of GDP set in previous update of the stability programme. In the new update the deficit is expected to come out at 2.4% of GDP, also thanks to some one-off revenue. Revenue windfalls, which partly result from a positive base effect following higher-than-expected revenues in 2006, broadly offset the negative impact of the fiscal package adopted in summer aimed at supporting growth (mainly involving tax cuts) and especially the higher-than-budgeted expenditure increase (notably in healthcare). Thus, despite the possible achievement of the budgetary objective set in the previous update, the budgetary implementation in 2007 cannot be considered to be in line with the policy invitation included in the Council opinion of 27 February 2007 on the previous update of the stability programme to "frontload the adjustment towards the MTO … with a view to achieving [it] in 2010 as planned and in particular to fully and effectively implement the 2007 budget and seize any opportunity to step up the structural adjustment". The budgetary implementation also does not appear to be in line with the April 2007 Eurogroup orientations for budgetary policies since unexpected extra revenues were not fully used to reduce government deficit and debt.

The main goal of the budgetary strategy in the update of the stability programme is to gradually curb public expenditure, in a context in which growth is assumed to strengthen through the adopted and announced structural reforms, in order to achieve the medium-term objective (MTO) of a balanced position in structural terms (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) in 2012 at the latest. According to the reference scenario, the headline deficit would fall marginally in 2008, from 2.4% of GDP in 2007 to 2.3% of GDP, and then more rapidly, by 0.6 percentage point per year, until a balanced position is reached in 2012. At the same time, the primary surplus would improve from 0.2% of GDP in 2007 to 2.5% of GDP in 2012. Against the background of more favourable macroeconomic growth assumptions, the programme significantly revises the adjustment planned in the previous update, which had set 2010 as a target year to achieve the MTO. The budgetary consolidation is back-loaded in spite of a better initial budgetary position, as the structural adjustment is almost negligible in the first programme year and it is spread over a longer period. The deficit reduction is planned to be fully expenditure-based, with the expenditure ratio decreasing by nearly 3 percentage points of GDP. The revenue-to-GDP ratio would also decline somewhat in 2008 and 2009 and stabilise thereafter. Government gross debt, estimated at 64.2% of GDP in 2007 in the update, i.e. above the 60% of GDP Treaty reference value, is projected to decline by over 4 percentage points of GDP over the programme period and reach the reference value in 2012.

The budgetary outcomes could be worse than targeted in the programme, taking into account macroeconomic risks as well as uncertainties on budget implementation. The macroeconomic scenario, which relies upon a significant improvement in the international environment, appears favourable over the entire programme period. This is to some extent linked to the fact that it relies on the implementation of structural reforms including those of the special pension regimes and the review of the labour contracts already broadly agreed, as well as other reforms that are yet to be decided. Such reform measures could entail significant implementation risks, e.g. in the case of the labour market or administrative reforms. For the near term there are some concrete measures to support expenditure restraint (e.g. the introduction of a minimum payment charged to patients for certain healthcare expenditures and the partial replacement of retirees in public administration). For the medium term, when the consolidation is expected to be larger, there could indeed be a positive effect from structural reforms, but the precise measures are not yet fully specified and hence their budgetary impact is uncertain.

Moreover, while the extension of the state rule to cover transfers to local government could contribute towards containing expenditure, the fact that local government and the social security sector are not adequately covered by expenditure rules still weighs on the assessment of the government's plans. In view of these risks attached to the budgetary targets, the evolution of the debt ratio could also be worse than projected in the programme.

In view of the risk assessment above and the fact that the structural balance would hardly improve in 2008 and thereafter improve by 0.4-0.5 percentage points of GDP per year, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2010 as indicated by the Eurogroup or even by 2012 as envisaged in the programme. According to the programme, a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations would only be reached in 2009. In view of the risks to the budgetary targets, it is more likely to be achieved towards the end of the programme period. The pace of the adjustment towards the MTO implied by the programme is inadequate, especially in 2008, when the minimal adjustment is neither in line with the 0.5% of GDP benchmark in the Stability and Growth Pact nor with the orientations of the April 2007 Eurogroup. Taking into account the risks to the deficit projections mentioned above, the debt ratio may not be sufficiently diminishing towards the reference value over the programme period.

France is at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is slightly lower than the EU average, with pension expenditure showing a somewhat more limited increase, as a result of the pension reforms already adopted. The budgetary position in 2007, as estimated in the programme, 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. Progress with budgetary consolidation would contribute to reducing risks to the sustainability of public finances.

The October 2007 implementation report of the national reform programme identified as key challenges: creating the conditions for strong economic growth, reducing unemployment and raising employment levels, and building a knowledge-based economy. In its Strategic Report, the Commission considered that France has made steady progress in implementing its national reform programme over the 2005-2007 period. The stability programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. In particular, both programmes present the government's wide ranging reform agenda, including the labour market reform, the reorganisation of the public administration, and the improvement of the competitive framework of companies. The implementation report covers a broader range of issues, while the stability programme contains more information on recent developments. Both programmes do not provide systematic information on the direct budgetary costs (or savings) associated with the main reforms envisaged, although they are reported to underpin the budgetary consolidation of the stability programme. In this respect, more information could be expected after the planned structural reforms have taken a more concrete shape and additional measures have been identified following the general reviews of public policies and taxes. The budgetary strategy in the programme is only partly consistent with the country-specific broad economic policy guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy. In particular, France is unlikely to achieve its medium-term budgetary objective by 2010 and the pace of government debt reduction remains unsatisfactory.

The overall conclusion is that the pace of budgetary consolidation and debt reduction has slowed down in 2007 and is planned to be much less ambitious in the coming years than planned in the previous update of the stability programme, especially as concerns 2008. The envisaged consolidation is back-loaded and the achievement of the MTO through an expenditure-based adjustment is postponed from 2010 to 2012 under the more plausible of the two macroeconomic scenarios presented by the French authorities. Moreover, even this adjustment path is subject to important risks. While tax cuts adopted in summer 2007 are already impacting on public finances, the authorities have also adopted measures to curb public expenditure in 2008, notably in social security, broadened the coverage of expenditure rules for the state, and have embarked on structural reforms. Structural reforms will be crucial to increase potential growth, improve competitiveness, and sustain the budgetary consolidation process. However, measures underlying the ambitious planned reduction in the expenditure ratio over the programme period have still to be further specified and their effectiveness will have to be tested. The programme objectives are also subject to risks stemming from the macroeconomic assumptions, which are favourable, in view of optimistic assumptions on the international environment and since they rely on still to be fully specified structural reforms. In view of the debt and deficit levels and the projected increase in age-related expenditure, France appears to be at medium risk with regard to the sustainability of public finances.

Comparison of key macroeconomic and budgetary projections

		2006 [4]	2007	2008	2009	2010	2011	2012
Real GDP (% change)	**SP Nov 2007**	**2.0**	**2 - 2.5**	**2 - 2.5**	**2.5**	**2.5**	**2.5**	**2.5**
	COM Nov 2007	2.0	1.9	2.0	1.8	n.a.	n.a.	n.a.
	SP Dec 2006	*2.0-2.5*	*2.0-2.5*	*2¼*	*2¼*	*2¼*	*n.a.*	*n.a.*
HICP inflation (%)	**SP Nov 2007**	**1.9**	**1.4**	**1.7**	**1.6**	**1.6**	**1.6**	**1.6**
	COM Nov 2007	1.9	1.5	1.7	1.6	n.a.	n.a.	n.a.
	SP Dec 2006	*2.0*	*1.9*	*1¾*	*1¾*	*1¾*	*n.a.*	*n.a.*
Output gap [1] (% of potential GDP)	**SP Nov 2007**	**-0.5**	**-0.8**	**-0.8**	**-0.6**	**-0.5**	**-0.3**	**0.0**
	COM Nov 2007 [2]	-0.2	-0.3	-0.3	-0.6	n.a.	n.a.	n.a.
	SP Dec 2006	*-0.6*	*-0.6*	*-0.5*	*-0.4*	*-0.3*	*n.a.*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**-2.1**	**-2.3**	**-2.5**	**-2.3**	**-2.2**	**-2.1**	**-2.0**
	COM Nov 2007	-2.1	-2.3	-2.2	-2.2	n.a.	n.a.	n.a.
	SP Dec 2006	*-2.0*	*-1.8*	*-1.8*	*-1.7*	*-1.6*	*n.a.*	*n.a.*
General government balance (% of GDP)	**SP Nov 2007**	**-2.5**	**-2.4**	**-2.3**	**-1.7**	**-1.2**	**-0.6**	**0.0**
	COM Nov 2007	-2.5	-2.6	-2.6	-2.7	n.a.	n.a.	n.a.
	SP Dec 2006	*-2.7*	*-2.5*	*-1.8*	*-0.9*	*0.0*	*n.a.*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2007**	**0.0**	**0.2**	**0.5**	**0.9**	**1.4**	**2**	**2.5**
	COM Nov 2007	0.0	0.0	0.0	-0.1	n.a.	n.a.	n.a.
	SP Dec 2006	*-0.1*	*0.1*	*0.7*	*1.7*	*2.5*	*n.a.*	*n.a.*
Cyclically-adjusted balance [1] (% of GDP)	**SP Nov 2007**	**-2.3**	**-2.0**	**-1.9**	**-1.4**	**-1.0**	**-0.4**	**0.0**
	COM Nov 2007	-2.5	-2.4	-2.5	-2.4	n.a.	n.a.	n.a.
	SP Dec 2006	*-2.4*	*-2.2*	*-1.6*	*-0.7*	*0.2*	*n.a.*	*n.a.*
Structural balance [3] (% of GDP)	**SP Nov 2007**	**-2.5**	**-2.0**	**-1.9**	**-1.4**	**-1.0**	**-0.4**	**0.0**
	COM Nov 2007	-2.8	-2.5	-2.6	-2.4	n.a.	n.a.	n.a.
	SP Dec 2006	*-2.5*	*-2.2*	*-1.6*	*-0.7*	*0.2*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2007**	**64.2**	**64.2**	**64**	**63.2**	**61.9**	**60.2**	**57.9**
	COM Nov 2007	64.2	64.3	64.1	64.1	n.a.	n.a.	n.a.
	SP Dec 2006	*64.6*	*63.6*	*62.6*	*60.7*	*58.0*	*n.a.*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 2.0%, 2.1%, 2.0% and 2.1% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2006 and 0 for the rest of the period covered (2007-2012) according to the most recent programme. According to the Commission services' autumn forecast they are 0.3% of GDP in 2006, 0.05% of GDP in 2007 and 0.1% of GDP in 2008.

[4]As the most recent programme does not provide information for 2006 (except for cyclical developments), figures were taken from the Commission services' autumn 2007 forecast.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations.

1. INTRODUCTION

The 2007 update of the French stability programme (henceforth "the update") was submitted to the Commission and the Council on 30 November 2007[1]. It covers the period from 2007 to 2012, one year more than the mandatory horizon. The update has not been formally adopted by Parliament, but builds on the multi-annual projection attached to the Budget law for 2008, which was adopted by the government on 26 September 2007 and by the national Parliament on 18 December.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in France, with a particular focus on the past developments and current issues in public expenditure. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON PUBLIC EXPENDITURE: PAST DEVELOPMENTS AND CURRENTS ISSUES

2.1. Introduction

In his memoirs, Napoléon wrote "*Il est injuste d'engager une génération par la précédente. (...) Il faut trouver le moyen de préserver les générations à venir contre la cupidité des générations présentes*"[2]. Almost two centuries later, this statement still describes the challenge for public finances in France.

The expenditure-to-GDP ratio in France, at around 53%, is the highest in the euro area (Table 1). The rise in public expenditure over the past decades was only partially financed by higher revenues, with the tax burden now standing at around 44% of GDP. This has contributed to high deficit and debt levels, which have affected the long-term sustainability of French public finances and limit the room for manoeuvre for the automatic stabilizers to operate effectively without breaching the Stability and Growth Pact (SGP). This situation has raised increasing concerns, notably in the Camdessus and

[1] The English version was submitted on 17 January 2008.

[2] "It is unfair for a generation to be tied up by the previous one (…) One must find a way to preserve the coming generation from the cupidity of the current one" in "Mémoires pour servir l'Histoire de France sous Napoléon écrits à Sainte Hélène par les Généraux qui ont partagé sa captivité", 1823.

Pébereau reports[3]. Against this background, France needs to make rapid progress towards a balanced budget in structural terms through an adjustment on the expenditure side[4]. At the same time, it needs to continue to move towards growth-enhancing expenditure.

Table 1: General government expenditure, peer comparison (in percent of GDP)

	1997-2001	2002-2006	2003	2004	2005	2006	2007	2008	2009
France	52.5	53.2	53.4	53.2	53.7	53.4	53.2	52.8	52.7
Germany	47.7	47.2	48.5	47.1	46.9	45.4	43.8	43.3	42.8
Italy	48.3	48.3	48.3	47.7	48.2	50.1	48.6	48.6	48.4
United Kingdom	39.2	42.6	42.0	42.5	43.7	43.7	44.0	44.0	44.1
Sweden	59.3	56.8	58.0	56.6	56.3	55.4	53.6	53.0	52.6
Euro area	-	47.5	48.1	47.4	47.5	47.1	46.4	46.2	46.0
EU 27	-	46.8	47.3	46.7	46.9	46.5	45.9	45.8	45.6

Source : Ameco, Commission services' autumn forecast from 2007 onwards

This chapter is structured in three parts. Section 2.2 analyses the composition and evolution of public expenditure since 1990. Section 2.3 examines the main factors of spending inflexibility in France. Section 2.4 describes the instruments which aim at improving control of spending trends.

2.2. The composition and evolution of public expenditure

2.2.1. The economic composition of public expenditure

Figure 1: Total public expenditure (lhs) and public deficit (rhs) 1990-2006 (as percent of GDP)

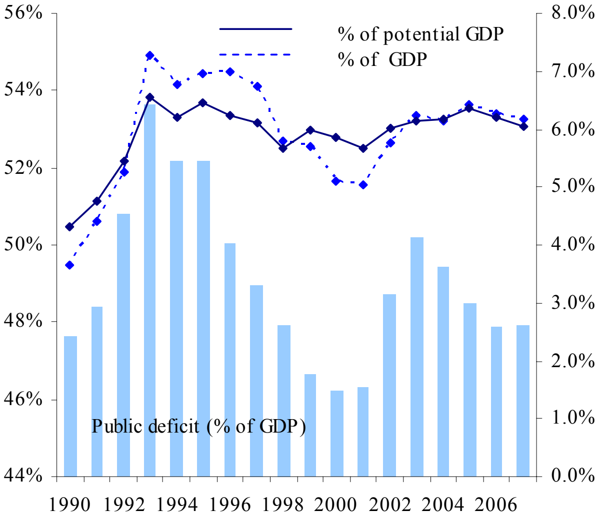
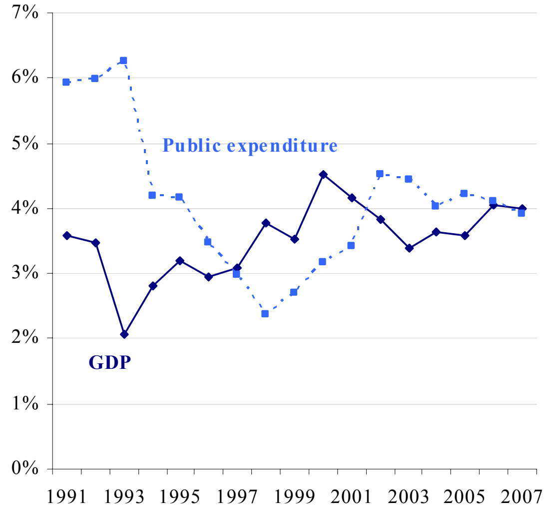


Figure 2: Public expenditure and GDP evolution 1991-2006, (growth in nominal terms, 2 years' moving average)



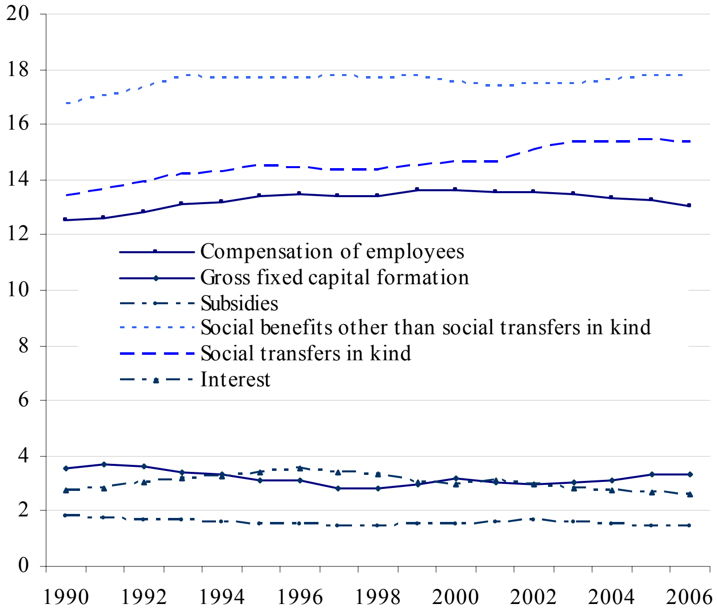
Source: Ameco, Commission services' autumn forecast

[3] Pébereau, M. (2005), *Des finances publiques au service de notre avenir. Rompre avec la facilité de la dette publique pour renforcer notre croissance économique et notre cohésion sociale*, and Candessus, M. (2004), *Le sursaut, vers une nouvelle croissance pour la France.*

[4] Also considering that economic literature suggests that expenditure-based consolidation is more sustainable than budgetary adjustments resulting from tax increases and more likely to have medium-term expansionary - non-Keynesian - effects.

Total expenditure of the general government in France as a ratio of GDP increased sharply between 1990 and 1993, as a result of increasing outlays for pensions and social protection benefits. In the late 1990s, it followed a downward trend (by 2.9 percentage points between 1996 and 2001) in the context of the preparation of the introduction of the euro, after which it rebounded to over 53% (Figure 1). Since 1996, the expenditure-to-potential GDP ratio has been rather stable, around 53%. In nominal terms GDP and public expenditure have followed a reverse year-on-year path over the period while growing on average at a similar rate (Figure 2).

Figure 3: Economic composition of public expenditure 1990-2006 (as % of GDP)



Source: *Ameco*

The economic decomposition of public expenditure according to its economic classification (Figure 3) highlights somewhat different evolutions of its components over the 1990-2006 period. Social benefits other than transfers in kind, which represent the largest share of GDP, were broadly stable around 18% of GDP over the last decade after a rise in the early 1990s. On the other hand, social transfers in kind increased by 2.2 percentage points of GDP over the 1996-2006 period, notably because of the rise in healthcare expenditure. The evolution of compensation of employees was more moderate: following the strong growth during the 1990s (explained by active public employment policies in a context of a high unemployment rate and also higher staff needs in healthcare), it broadly stabilized reflecting both the moderation in wages and a limited change in the number of staff.

Interest and investment expenditure are roughly at the same level in 2006 as they were in 1990. Indeed, in spite of the rising debt-to-GDP ratio, the cost of debt servicing declined by around 1 percentage point of GDP between 1996 and 2006, thanks to favourable interest rates developments in the early years of EMU, as well as to better debt management. However, following the recent rise in interest rates[5], this situation, which

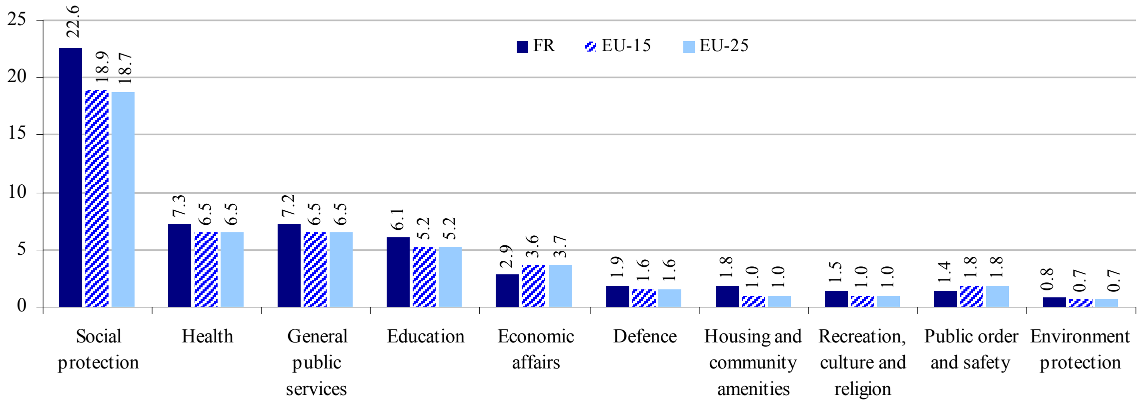
[5] The apparent rate of the OAT TEC 10 (one month average), a treasury bond used as a benchmark to analyse the rates evolution, rose from 3.04% on 22 September 2005 to 4.47% on 31 December 2007. Interest rate developments are no longer supportive of a reduction in the cost of the debt service. Further major savings cannot even be expected from a restructuring of the debt. In these conditions,

contributed to dampening the overall expenditure evolution, is coming to an end. Finally, the share of gross fixed capital formation in GDP was stable over the period, slightly above 3%.

2.2.2. *The functional composition of public expenditure*

The analysis by function (see Figure 4) highlights the importance of social protection and healthcare expenditure in France compared to the rest of the European Union. Combined, they exceed the EU and euro-area averages by striking 4.7 and by 4.5 percentage points of GDP, respectively. Education expenditure is also higher by 1 percentage point, while expenditure in economic affairs (support for businesses, certain kind of employment policies…) is lower, by a similar amount. These are actually the most noticeable differences between France and the rest of the European Union.

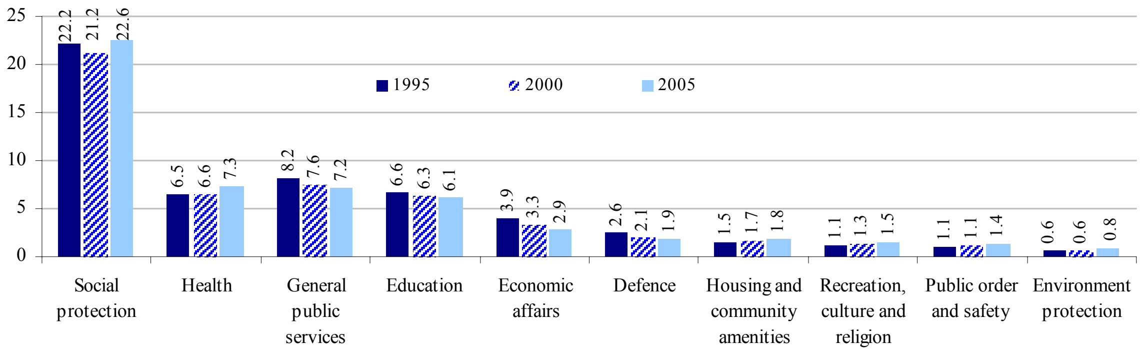
Figure 4: Public expenditure by function in 2005 (as percent of GDP)



Source: Ameco

Over the last decade, the analysis of expenditure by function shows a rather subdued development (Figure 5): social protection and healthcare expenditure rose by around 1.0 percentage point, in spite of monitoring measures adopted in 1996 (see Section 2.4.2.2), while economic affairs and public services decreased by a similar amount. Changes in other public functions were less than 0.5 percentage point.

Figure 5: Public expenditure by function in France (% of potential GDP)



Source: Ameco

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interest expenditure savings can only originate from a substantial fiscal retrenchment that increases the primary surplus and leads to the reduction of the debt.

The most important driver of the overall evolution of public expenditure, both in terms of level and increase, is the rise in social protection and healthcare, which had an impact on most of the previously described categories according to the economic decomposition, notably expenditure for compensation of employees, social benefits but also interest expenditure with the rise of the "social" debt (managed by a dedicated fund, the *Caisse d'amortissement de la dette sociale*).

The increase of social protection and healthcare expenditure (see Table 2), by more than 1 percentage point of GDP during the last decade, can be explained by the rise in the expenditure for healthcare (which includes work accident/professional illnesses) and pensions. The latter represent the largest part of social benefits (around 46.0% in 2006) and have grown rather steadily over the period. The figures also reflect the short-term costs entailed by the 2003 reform (to ease retirement for workers under 60 with at least 40 years of contributions), as well as demographic factors. The third "branch" of the French social security system (family benefits which includes support to lower-income families as well as aids for children) represents a smaller part of social benefits (9.1% in 2006); it has followed a path similar to the average nominal GDP. Social exclusion (notably the *Revenu Minimum d'Insertion*, a minimum benefit paid to those with no other source of income) and housing benefits represent together less than 5% of social protection expenditure, with a less dynamic evolution over recent years. Unemployment benefits (6.8% of social protection in 2006) have been more volatile, in line with GDP developments.

Table 2: Social protection and healthcare expenditure, 2000-2006 (in billion euro)

	2000	2001	2002	2003	2004	2005	2006	Average
Healthcare	142.7	152.7	161.5	172.0	178.1	188.9	194.9	
% growth		*7.1%*	*5.8%*	*6.5%*	*3.6%*	*6.0%*	*3.2%*	***5.3%***
% of GDP	*9.9%*	*10.2%*	*10.4%*	*10.8%*	*10.7%*	*11.0%*	*10.9%*	***10.6%***
Pensions	185.5	192.5	201.9	209.1	223.3	235.9	247.5	
% growth		*3.8%*	*4.9%*	*3.6%*	*6.8%*	*5.6%*	*4.9%*	***4.9%***
% of GDP	*12.9%*	*12.9%*	*13.0%*	*13.1%*	*13.5%*	*13.8%*	*13.8%*	***13.3%***
Family benefits	42.8	44.2	45.9	46.3	48.3	48.2	50.4	
% growth		*3.3%*	*4.0%*	*0.8%*	*4.2%*	*-0.2%*	*4.6%*	***2.8%***
% of GDP	*3.0%*	*3.0%*	*3.0%*	*2.9%*	*2.9%*	*2.8%*	*2.8%*	***2.9%***
Employment	29.8	28.9	34.8	38.5	40.0	39.6	37.7	
% growth		*-3.1%*	*20.5%*	*10.6%*	*4.0%*	*-1.1%*	*-4.9%*	***4.3%***
% of GDP	*2.1%*	*1.9%*	*2.2%*	*2.4%*	*2.4%*	*2.3%*	*2.1%*	***2.2%***
Housing benefits	13.0	13.1	13.9	14.6	14.9	14.4	14.9	
% growth		*0.9%*	*6.1%*	*5.0%*	*1.8%*	*-3.0%*	*3.5%*	***2.4%***
% of GDP	*0.9%*	*0.9%*	*0.9%*	*0.9%*	*0.9%*	*0.8%*	*0.8%*	***0.9%***
Social exclusion	5.9	6.1	6.5	6.8	8.2	8.0	8.3	
% growth		*4.3%*	*6.1%*	*5.0%*	*20.4%*	*-2.3%*	*3.5%*	***6.2%***
% of GDP	*0.4%*	*0.4%*	*0.4%*	*0.4%*	*0.5%*	*0.5%*	*0.5%*	***0.4%***
Total expenditure (*)	**419.6**	**437.6**	**464.1**	**487.3**	**513.4**	**535.0**	**553.7**	
% growth		*4.3%*	*6.1%*	*5.0%*	*5.4%*	*4.2%*	*3.5%*	***4.7%***
% of GDP	*29.1%*	*29.2%*	*29.9%*	*30.5%*	*31.0%*	*31.2%*	*30.9%*	***30.3%***

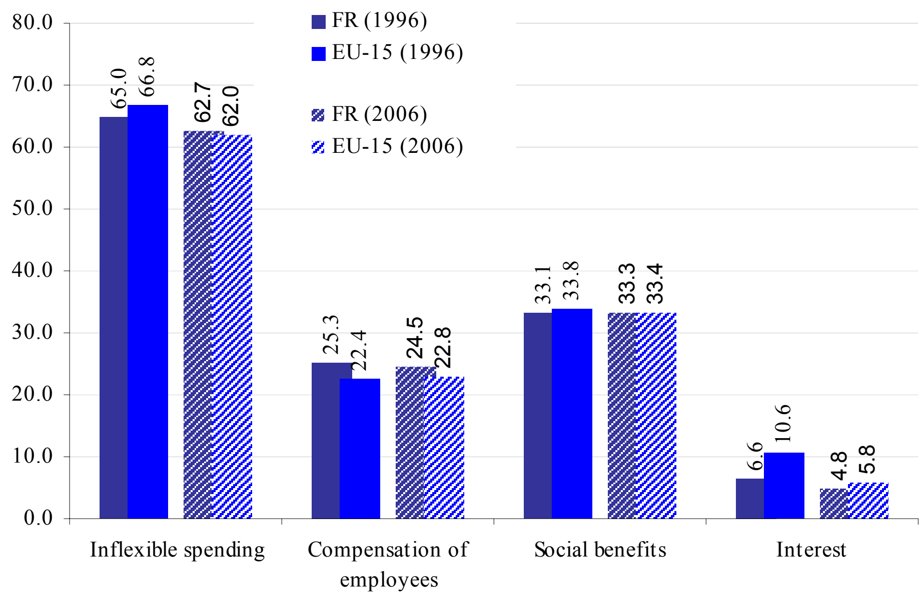
Source: DRESS, Ministère du travail, des relations sociales et de la solidarité
(*) Total differs from AMECO figures due to slighlty different perimeters and healthcare expenditure definition

2.3. Main factors behind the inflexibility in expenditure

Inflexible budgetary structures reduce the government's leeway to adjust the fiscal stance in response to policy changes or macroeconomic fluctuations. Inflexible expenditures are those which are *de facto* not dependent upon the discretionary choices of the authorities in the short term, notably because of their legal basis but also because of their political acceptability.

In terms of categories, the most inflexible expenditures are those on interest, social benefits and compensation of employees. This kind of expenditure cannot be cut in the short term, and in a medium-term perspective it risks increasing: the cost of debt servicing is likely to rise with rising interest rates[6]. At the same time, ageing is foreseen to have a negative impact on social benefits, a trend which is unlikely to reverse soon (see Section 5.2.1, Table 12), in spite of the positive effects of the 2003 pension reform or the 2004 healthcare reform[7]. The ratio of inflexible to total expenditure is broadly the same in France as the EU-15 average (Figure 6 offers a tentative comparison, although the classification may not be unambiguous across Member States), but it represents a higher ratio in percentage of GDP, in line with the level of total public expenditure.

Figure 6: Composition of inflexible spending (as % of total expenditure)



Source: Ameco

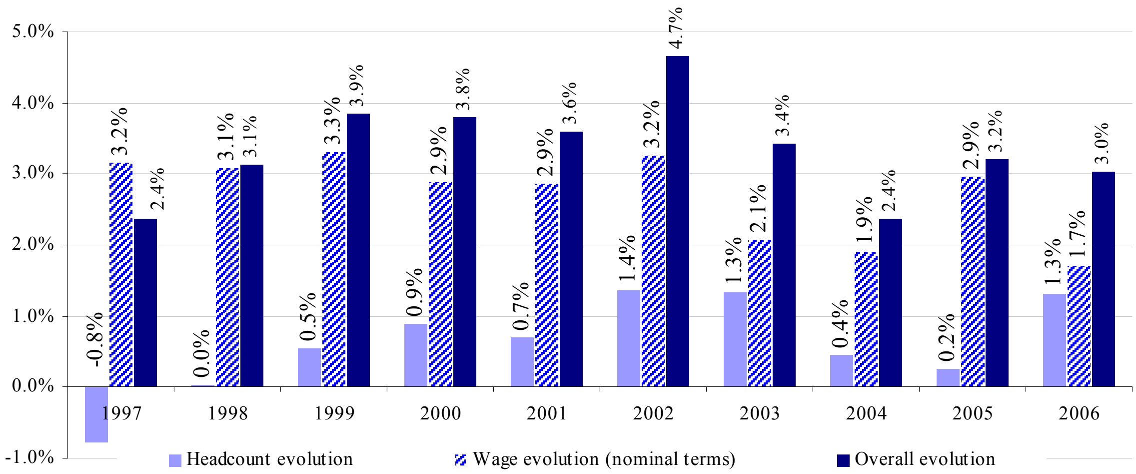
One of the main avenues envisaged by the French authorities to curb inflexible expenditure in the medium term consists in a reduction of the compensation of employees and increasing market-based provision of services, public-private partnerships and outsourcing. So far however, the track record has not been encouraging: in spite of efforts to curb its evolution, public employment rose by 5.5% between 2000 and 2006, and compensation of employees now accounts for 13.3% of GDP (2½ percentage points above the EU27 average of 10.7%). Since in practice life-long employment is the rule for civil servants, the main possibility to reduce public employment is through limited replacement of retirees. This has been increasingly implemented in recent years at the

6 See footnote 5.

7 Respectively, "*Loi portant réforme des retraites*",(also called "Loi Fillon") 21 August 2003 and "*Loi portant réforme de l'assurance maladie*", (also called "Loi Douste-Blazy"), 13 August 2004.

State level, although at a lower pace than initially envisaged[8]. The government's objective of only one replacement every two retirees for the State has also been revised for 2008 (the target set is 22 791, equivalent to two replacements every three retirees, notably through staff reductions in public education). However, room for manoeuvre still exists for the coming years with more than 600 000 departures expected until 2015, and the objective could be achieved through the rationalisation in the public administration (e.g. merging units with similar tasks), but could be hampered by the limited flexibility in staff mobility and transfers between administrations. In any case, one should not overestimate the effect of such cuts in public employment. Indeed, when it comes to limiting the replacement of retirees, the reduction in expenditure is proportionally smaller than the cut in the number of employees since even if newly recruited staff usually costs less per head than retired staff, the overall compensation of previously recruited staffs mechanically increases in line with seniority (*glissement vieillesse technicité* or *GVT*).

Figure 7: Compensation of employees evolution, 1997-2006 (% growth)



Source: *INSEE*

2.4. Current measures to improve the budgetary framework and monitor public expenditure

In the context of the 2005 reform of the Stability and Growth Pact, the Council highlighted the need to improve national fiscal governance and to strengthen national ownership of the medium-term budgetary targets set in countries' stability and convergence programmes. Analysis[9] has shown that countries' deviations from planned adjustment paths generally reflect considerable difficulties in implementing their medium-term expenditure plans, with expenditure overruns apparently independent from macroeconomic developments. A statistically significant relation was found to exist[10] between the quality of the frameworks for medium-term planning and the capacity to

[8] Announced for the first time after the 2002 presidential elections and confirmed during the latest presidential campaign, the government's objective of only one replacement every two retirees (for the State only) has not been achieved yet. According to the finance bill for 2008, the reduction in full time equivalent headcount was of 7 392 in 2005, 9865 in 2006 and 11244 in 2007).

[9] See inter alia European Commission (2007), *Public Finance in EMU*, European Economy n°3, 2007 available from http://ec.europa.eu/economy_finance/publications/publication338_en.pdf.

[10] See European Commission (2007), *Public Finance in EMU*, European Economy n°3, 2007, part III, pp. 163-164.

achieve expenditure targets. Reliance on a proper medium-term budgetary framework (MTBF) allows budgetary authorities to extend the horizon for policy making beyond the annual budgetary calendar and increase budgetary discipline. Such a framework improves time-consistency and transparency in the conduct of budgetary policy. To deliver such returns, it should cover the whole general government sector, should be strongly connected to the annual budget procedure and involve a sufficient degree of political commitment by the government and Parliament. The effectiveness in terms of ensuring better adherence to plans depends on good coordination between all levels of government.

Economic literature[11] also suggests that rules play a positive role in budgetary policies: notably, they prevent authorities from the temptation to raise expenditure in good times (in this regard, expenditure rules are more efficient than deficit targets). However, such norms need to be binding and enforceable, comprehensive, so that the burden of consolidation may be shared between sub-sectors. They also need to be supported by efficient public finance reforms ("*such rules have to be viewed as a catalyst for fiscal reforms that would be necessary anyway to ensure sustainability"*[12]*)*. Ideally, annual and pluri-annual rules should be combined in order to prevent authorities from postponing expenditure to the period immediately following the budget year, but also to delay the adjustment to the latest years of the period.

Since 1998, France's medium-term budgetary strategy is based on the setting of multi-annual objectives for the increase in general government real expenditure that imply the reduction in the expenditure-to-GDP ratio, but initial targets were missed by a large margin[13]. Such objectives are set in the annual updates of the stability programme but are not adopted by Parliament. This therefore can hardly be considered a proper medium-term budgetary framework as commonly defined in the literature (see above). However, in terms of the annual budgetary process, important steps have been taken to strengthen the budgetary framework and rules have been devised and implemented for some sub-sectors of government, with a view to improving the achievement of the annual general government target.

The following two sections examine progress in France to improve the budgetary framework, in particular through the adoption of the organic law on the budget (the *Loi Organique Relative aux Lois de Finance* or LOLF), and to monitor expenditure developments, through the introduction and successive modifications of rules on State and healthcare expenditures. They also highlight shortcomings of measures taken so far, which remain to be addressed.

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[11] For a more comprehensive review:

- European Commission (2006), *Public Finance in EMU*, European Economy n°3, 2006, part III: "National numerical fiscal rules and institutions for sound public finances", available from http://ec.europa.eu/economy_finance/publications/publication423_en.pdf
- Moulin, L. (2004), Expenditure rules à la française: an assessement after five years, European Commission, ECFIN Country focus,
- Daban, T., E. Detragiache, G. di Bella, G.M. Milesi-Ferretti and S. Symansky (2003), Rules-based fiscal policy in France, Germany, Italy and Spain, IMF Occasional paper.

[12] Kopits, G. and S. Symansky (1998), Fiscal policy rules, IMF Occasional paper n°162, 1998.

[13] See also European Commission (2006), *Public Finance in EMU*, European Economy n°3, available from http://ec.europa.eu/economy_finance/publications/publication423_en.pdf.

2.4.1. *The framework for budgetary policy*

One of the main purposes of the Constitutional Bylaw on the Finance Acts (LOLF) adopted in 2001 was to move toward "result oriented" public policies, with credits allocated to "missions" subdivided in "programmes", designed to match the key objectives of State public services. Since the full implementation of the LOLF in 2006, budget acts now include objectives (*projets annuels de performance* or *PAP*) for each programme, covering the whole range of State policies. Ministries send reports (*rapports annuels de performance* or *RAP*) on the achievement of these objectives to the Parliament the year after the exercise (t+1) for review in the context of the examination of the *Loi de Réglement* (which closes the budgetary exercise in year t+1) [14]. However, two other instruments were also launched: reform plans at ministry level - *strategies ministérielles de réformes* - (in 2003) and audits on specific public missions (in 2005) in order to identify room for increases in efficiency. Combined with these instruments, the new budgetary framework set in the LOLF could have in the medium term a positive impact on administrative organisation, and therefore entail expenditure reduction, if administrative structures progressively evolve to match with "programmes" and "missions" designed by the LOLF[15].

More generally, a positive aspect of the LOLF, fully implemented since January 2006, is that it abolished the former distinction between new and previously adopted measures (*services votés / mesures nouvelles*), which used to imply that the debate on the budget at the Parliament mostly concerned new measures while existing ones were usually not called into question and mechanically renewed, hence de facto adding to the inflexible expenditure.

The launch in July 2007 of the RGPP (*Revue Genérale des Politiques Publiques*), in line with recommendations from several experts[16] and based on the model of successful foreign examples (notably Canada), is expected by the government to be a milestone in the monitoring of public finances. Compared to the two regular instruments mentioned above (audits and ministerial strategies), this exercise (expect to be a one-off operation) is a significant step for two reasons: first, it is led by a dedicated body, the *Conseil de la modernisation des politiques publiques,* rather than Ministries, and benefits from external expertise. Moreover, this process does not only address the efficiency of public policies but it also calls into question their relevance on the basis of several assessment tests. After a first step in December 2007, where first conclusions were announced (concerning a rationalization in administrative structure and missions, a field in which much room for

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[14] The examination of this law has been considered a rather formal exercise notably in the OECD working paper of October 2004: "La gestion des dépenses publiques en France", working paper n°409, A. Burns, A. Goglio. There is a also a risk of mismatch with the political agenda: since Presidential and legislative elections now take place in the same year (a situation which is unlikely to change in the medium term) and considering that the PAPs are adopted the year before the exercise, and the RAPs the year after, there will be only two years out of five of the mandate where the same government that sets the PAP, and adopts the Budget act is still in office when the RAP is examined.

[15] The forthcoming announced mergers between public administrative units (notably between the Direction Générale des Impôts – taxes – and the Direction Générale de la Comptabilité Publique – public accounts) will be a significant test.

[16] Notably the Pébereau report which recommended a 3-year exercise to identify non-strategic expenditure that could be suppressed, and the mission report on "La mise en œuvre de la loi organique relative aux lois de finances ", 2005, A. Lambert and D. Migaud, who suggested a general review of "*programmes*" as defined in the LOLF.

manoeuvre exist in the context of the decentralization process – see Box 1), results should be issued in spring 2008 and could be incorporated in the budget act for 2009.

Finally, the LOLF does not address the dimensions pertaining to a proper medium-term budgetary framework discussed above, namely coverage of multi-year budgetary targets, connectedness between yearly and multi-year targets, involvement of Parliament in setting multi-year targets, coordination mechanisms between levels of government before setting multi-year targets, monitoring and enforcement in case of deviation from multi-year targets. In the context of first conclusions of the RGPP in December 2007, the implementation of a pluri-annual budget over three years (starting in 2009) was announced by the Government. This would represent a major improvement in terms of management of public finances and enforcement of budgetary discipline, although the effectiveness of this budgetary framework will very much depend on whether it would merely take the form of an informative report annexed to the one submitted to the Parliament during the *Débat d'Orientation Budgétaire* in spring or a more binding *Loi de Programmation* (which would be adopted by the Parliament, but would still need to be confirmed afterwards by a Finance Act).

2.4.2. Expenditure rules

In spite of the commitment announced in the January 2006 update of the stability programme to set up an "internal stability pact" with expenditure norms for all sub-sectors, so far this has not been adopted. Existing rules have been amended but the coverage is still incomplete. Overall, some progress has been achieved regarding the recommendation formulated by the Council in it's opinion of 27 February on the December 2006 stability programme update to "*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*".

2.4.2.1. The expenditure rule for the State[17]

In France, the State represents more than ⅓ of general government expenditures. A first rule, the so-called "0% volume increase expenditure rule" for the State was introduced in 2003. In 2007, the rule was changed to target a decrease in volume by 1% and progressively reach a "0% value increase" by 2010 (see Section 4). From 2008 onwards, a new 0% volume rule has been adopted with reference to a broader category of expenditures including both the State and "*prélèvements sur recettes*" (70.8% of the transfers to local authorities in the budget bill for 2008,and the contributions to the EU). The redefinition of the expenditure rule for the State could turn out to be less restrictive for the State in 2008[18], and the burden of expenditure limitation would be mostly shouldered by local authorities.

[17] "State" refers to the central government, as defined by the perimeter of the Finance act adopted by the Parliament, under the framework of the Constitutional Bylaw on Finance Acts (Loi Organique Relative aux Lois de Finance or LOLF) adopted on 1 August 2001.

[18] "Cette nouvelle norme (…) apparaît prometteuse dans son principe mais doit être nuancée en ce qui concerne ses conséquences pour 2008. (…) Toutefois, l'examen attentif par votre commission des finances de son impact pour 2008 montre qu'elle se traduit par un relatif relâchement de la discipline applicable à l'État stricto sensu.", Rapport général sur le projet de loi de finances pour 2008, Philippe Marini (Sénat), 22 November 2007). See also Section 4.

The rule in its initial formulation ("0% volume increase expenditure rule") has proven rather successful, putting pressure on State expenditure; in the 2003-2006 period targets were always met (definitive figures on the implementation of the -1% volume rule for 2007 are at present not available[19]). However, it also produced some negative side effects or "*points de fuite*"[20]. First, it left scope for creative accounting. Indeed, a growing number of "fiscal expenditures" (or *dépenses fiscales*: mechanisms that derogate from standard fiscal rules for a given tax, broadly equivalent to cuts in revenues) was adopted in each budget act since the introduction of the rule (notably tax credits on income and corporate taxes), in an effort to circumvent the constraint on State expenditure in nominal terms and increasing the complexity of the fiscal system. Fiscal expenditures were estimated[21] at around €50bn in 2003 and €59.4bn in 2006 (around 20% of fiscal revenues). The mid-term review of the *Révision Générale des Politiques Publiques* (see Section 2.5) of 10 December 2007 highlighted growing concerns about the need to limit accounting practices aiming at circumventing the rule, and recommended measures to limit the adoption and assess the efficiency of new *dépenses fiscales,* or implement a global ceiling. Second, until 2008, the rule did not encompass all State expenditure and notably not the most dynamic spending such as transfers to local authorities. In this respect, progress has been made for 2008, as discussed above. As a final point, a short-term view of rule constraints may lead public authorities (in line with the findings of the public choice school) to cut less inflexible spending with no regard to their efficiency and favour day-to-day rather than long-term management. This side effect is often stressed by the French Court of Auditors, which regularly criticizes the abuse of budgetary regulation practices.

2.4.2.2. Social security

Soaring growth of healthcare expenditure in the early 1990s drove the French authorities to adopt an annual budget act for social security (*Loi de Financement de la Sécurité Sociale* or *LFSS*) in 1996. It covers expenditure and revenue for the four branches of the social security (see above – Section 2.3), and usually also contains additional measures to curb the deficit of social security, with a view to improving the control on social security expenditure. The LFSS includes a non-binding expenditure target: the objective for national health insurance spending objective or ONDAM (*Objectif National de Dépenses d'Assurance Maladie*).

The LFSS has led to a real debate in Parliament about social spending but it remains more an information tool for the Parliament rather than a binding limit for expenditure evolution such as the annual *Loi de Finance* for the State. Firstly, while room for manoeuvre (the so-called *regulation budgétaire*) on an infra-annual basis exists for the State (notably, the Ministry of Finance can freeze, postpone or cancel credits depending on the budgetary evolution), social expenditures are mostly inflexible, at least on a constant legislation basis and cannot easily be curbed during the year. Secondly, and contrary to the budget act which has a quasi monopoly for measures that concern State

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[19] According to the finance bill for 2008, the objective in value underlying a decrease in volume by 1% may be achieved, but the decrease in volume would be smaller than 1% due to lower inflation than expected.

[20] According to the expression used by the *Conseil d'Analyse Economique*: Economie politique de la LOLF, Arkwirght, Boissieu, Lorenzi and Samson, 2006.

[21] "La fiscalité dérogatoire – pour un réexamen des dépenses fiscales, XXIe rapport au Président de la République", Conseil des Impôts, September 2003; Notes bleues de Bercy, n°304, Ministère de l'Economie, des Finances et de l'Industrie, 10 March 2006.

finances, the main measures having an impact on social security finances are often not decided in a LFSS, but usually in specific laws (e.g. the "pension reform" of 2003 or the "healthcare reform" of 2004). Lastly, the perimeter of the law is limited: it puts a strong emphasis on healthcare spending (which represents approximately 40% of total social security expenditure) through the ONDAM (*Objectif National de Dépenses d'Assurance Maladie*) leaving out notably pension and family benefits. The ONDAM itself somewhat lacks credibility, since the objective has been reached only in one out of ten years since it was introduced (Table 2). On the positive side, the introduction with the 2004 healthcare reform of an alert committee has proven useful. The Committee identifies substantial deviations from the target (slippages larger than 0.75%) and recommends measures to be taken during the year to address the slippage. In 2007, the action of the Alert Committee led to the adoption of additional measures in July to curb the deficit (although insufficient to prevent a significant breach in the ONDAM objective – see table 3).

Table 3: Healthcare expenditure (ONDAM) evolution (in percent of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
ONDAM achieved	1.5%	4.1%	2.6%	5.5%	5.6%	7.3%	6.9%	5.1%	4.7%	3.4%	4.2%
ONDAM achieved on a constant perimeter basis	1.5%	4.0%	2.6%	5.6%	5.6%	7.1%	6.4%	4.9%	4.0%	3.1%	4.2%
ONDAM voted	1.7%	2.4%	1.0%	2.9%	2.6%	4.0%	5.3%	4.5%	3.5%	2.5%	2.6%
Difference between achieved and voted	-0.2%	1.6%	1.6%	2.7%	3.0%	3.1%	1.1%	0.4%	0.5%	0.6%	1.6%

Source : Commission des Comptes de la Sécurité Sociale, September 2007 (forecast for 2007)

2.4.2.3. Local authorities

Local authorities' expenditures are limited by two constraints, partially amended in 2008. Firstly, there is a kind of "golden rule" with a legal basis[22], which prevents authorities from raising debt to finance operational expenditure (this section of the local budgets is therefore necessarily balanced). It consequently restricts the use of debt to investment financing and forbids to pay back interests on debt with additional borrowing, thus limiting the risk of a "snowball effect".

Secondly, funds transferred by the State to local authorities (including tax allowances, direct transfers, compensation for tax breaks…) are limited by a rule set by the State. As mentioned above, in 2008, the new 0% volume growth rule for the State expenditure will apply also to *prélèvements sur recettes* which encompass a large part of these transfers (although not all of them). This objective will be backed by a sub-objective set for the "growth and solidarity contract" ("*contrat de croissance et de solidarité*"), opportunely renamed "stability contract" ("*contrat de stabilité*"), a pool of transfers which encompasses most *prélèvements sur recettes*[23]: the expenditure which falls under this

[22] Code Général des Collectivités Territoriales, article L1612-4: "Le budget de la collectivité territoriale est en équilibre réel (…) lorsque le prélèvement sur les recettes de la section de fonctionnement au profit de la section d'investissement, ajouté aux recettes propres de cette section, à l'exclusion du produit des emprunts, et éventuellement aux dotations des comptes d'amortissements et de provisions, fournit des ressources suffisantes pour couvrir le remboursement en capital des annuités d'emprunt à échoir au cours de l'exercice."

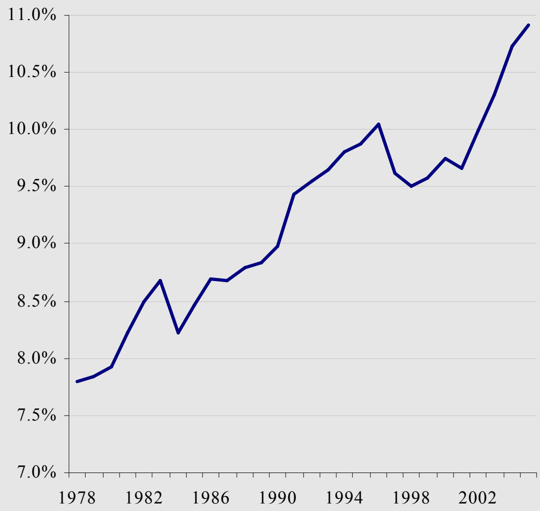
[23] Notably, the *dotation globale de fonctionnement* (or DGF) represents 86% of the "*contrat de stabilité"* perimeter, equivalent to EUR 40.1 billion in the finance bill for 2008, on a total of EUR 51.2 billion for the *prélèvements sur recettes*. The remaining part of the *contrat de stabilité* is only partially included in the *prélèvements sur recettes*.

contract between the State and local authorities will now grow in line with inflation rather than nominal GDP growth. It is too early to assess whether this constraint will entail a virtuous behaviour from local authorities through a cut in their overall expenditure, or if they will try to compensate the loss of revenue by increasing local taxes[24].

Box 1: Local Authorities' Expenditures

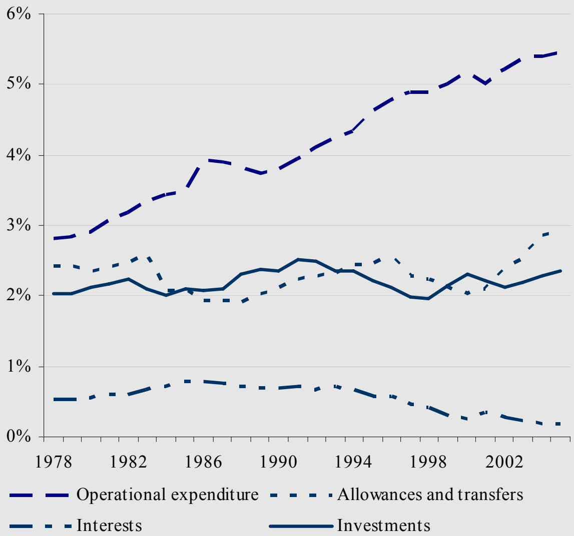
It appears useful to go back to 1982 when the region was created as an administrative unit (step 1 of the decentralization process) to study the evolution of local authorities' expenditure, because local administrations have faced deep changes since then, in terms of missions, financing, autonomy and relations with the central State. In particular, significant tasks have been transferred since then from the central State to local authorities (e.g. in education, social protection, economic development...).

Figure 8: Local authorities' expenditure 1978-2005 (in % of GDP)



Source: INSEE

Figure 9: Expenditure by category 1978-2005 (in % of GDP)



Source: INSEE

The process was strengthened in 2003 (step 2 of the decentralisation) with a revision of the Constitution leading to even more local autonomy. Since then, several laws were adopted in order to transfer new missions to the local level (e.g. economic development to regions, social tasks to departments). Between 1982 and 2005, local expenditure increased by an estimated 1.1 percentage point of GDP[25]. There is no evidence that such transfers reduced in parallel central State staff and expenditure: on the contrary, sometimes duplicated structures with similar tasks were created.

On a "constant missions" perimeter (i.e. not taking into account the impact of missions transferred), local expenditure increased by 1.8 percentage points of GDP between 1982 and 2005. This reflects the cost of numerous administrative levels with complex task sharing[26], in a

[24] Local authorities only have the possibility to decide the rate of a number of taxes (local taxes), although in a range defined by the law.

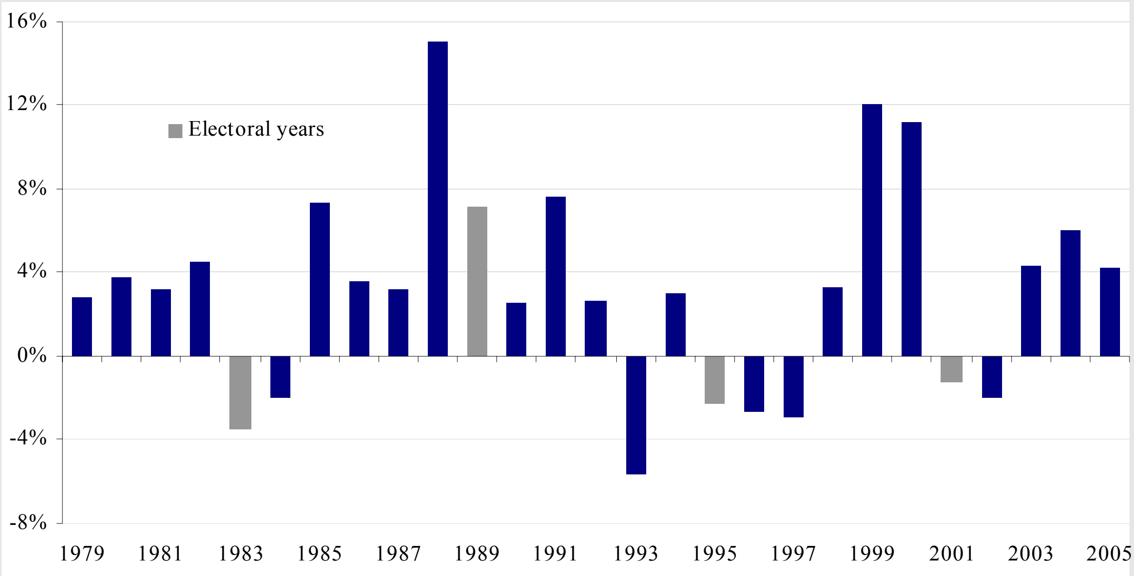
[25] DGTPE (2006), *Bilan des finances locales depuis 1980,*, DPAE n°97, January 2006.

[26] Three levels are mentioned in the Constitution: communes, départements and régions, but local authorities also have the possibility to merge some of their missions to create other intermediate units, in order to benefit from scale economies

context where local authorities benefit from growing fiscal autonomy (although it is controversial to which extent the "financial autonomy" mentioned in the French Constitution - *titre XII, Des collectivités territoriales* - also applies to local revenues). The cost of this process for local authorities was financed both by increasing transfers from the central State, and higher local taxes.

Finally, in addition to their increasing trend, local authorities' expenditures highly depend on the electoral cycle[27] (notably for municipalities). This has a significant influence on the evolution of investment (which is lower in electoral years, and higher in the final years of the mandates: figure 10).

Figure 10: Local authorities' investment growth 1979-2005 (percentage growth in real terms)



Source: INSEE, Commission services

2.5. Conclusion

In conclusion, a number of important steps have been taken to strengthen the budgetary framework. This includes notably the adoption of the LOLF, which aims at moving towards a result-oriented framework thereby increasing the efficiency, which could ultimately lead to better expenditure control. Moreover, the forthcoming *Revue Générale des Politiques Publiques,* which will review in depth public expenditure, also appears to be an encouraging development since it will provide input for the announced rationalization in the administration. As far as the expenditure rules are concerned, the redefinition of the State rule to include most of the transfers to local authorities is a first step to curb the high increase in local government expenditure, which has been one source of slippages for the general government. However, its consequences on the general government expenditure level still have to be tested, also since the rule does not cover all local government expenditure. As far as the social security is concerned, which has also been an important source of slippages of general government expenditure, the current rule covers only the health sector and is non-binding.

Looking forward, the reduction in expenditure will need to be backed by an efficient medium-term budgetary framework. This will notably require better co-ordination

[27] e.g. Besson, D. (2002), L'investissement des administrations publiques locales: influence de la décentralisation et du cycle des élections municipales, Insee Premières n°867, October 2002.

between all levels of government and further strengthening the monitoring and enforcement of the multi-annual targets. In this context, there is a need to effectively enforce existing rules and to broaden their coverage.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes macroeconomic vulnerabilities and how they are expected to develop according to the programme.

For the period 2009-2012, the programme presents two different macro-economic scenarios; a "low growth scenario" in which real GDP growth averages 2½% per year (and potential growth increases gradually from 2.1% in 2007 to 2½% in 2012) and a "high growth scenario[28]" where real GDP increases by 3% per year (and potential growth reaches 3% in 2012). It is assumed that the impact of measures taken in 2007 and 2008 and of planned structural reforms on domestic demand (private consumption and investment) is stronger in the higher growth scenario than in the "low" growth scenario. The "low" growth scenario is alternatively mentioned as "central" scenario, suggesting the programme identifies it as the baseline. It is also the one closest to the Commission services' autumn forecasts. Against this background, and since the "low" growth scenario is the more plausible of the two, it is considered to be the reference scenario in this assessment.

3.1. Economic activity

After 2.0% in 2006, the programme envisages that real GDP growth will pick up from 2% in 2007 to 2-2.5% in 2008 and to 2.5% over the rest of the programme period, which is higher than the Commission services' estimate of potential growth of just above 2%.

The programme does not use common external assumptions on the main extra-EU variables provided by the Commission. Rather, it builds on those contained in the draft Budget Bill adopted by the government on 26 September 2007. The programme assumes a lower dollar/euro exchange rate and oil prices than the Commission services' autumn 2007 forecasts[29]. The assumptions on the global economic activity, world GDP and trade growth are also different from the autumn forecast external assumptions, and assume an accelerating growth of relevant foreign markets for France in 2008 and a still high external demand for French products from 2009 onwards.

From 2007 to 2012, real GDP growth would be fuelled by domestic demand like in the past decade, and especially by private consumption, while the contribution of net trade,

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[28] In the "high growth scenario", annual GDP growth is the same as in the "low" growth one in 2008; it reaches 3.0% in 2009 and thereafter continues at this pace, thanks to a stronger positive impact of structural reforms on economic activity. GDP growth would be largely driven by domestic demand, with a negligible contribution from the external sector (as in the "low" growth scenario). The employment rate would increase from 63.2% in 2006 to almost 70% in 2012, reaching the Lisbon reference objective (unlike the "low" scenario, where the Lisbon objective is not reached). External assumptions are the same as in the reference scenario, except for a higher external demand for French products from 2009 onwards. In this "high" growth scenario, a balanced budget would be achieved in 2010.

[29] The programme assumes a dollar/euro exchange rate of 1.37 vs. 1.42 in the Commission services' autumn forecasts and oil prices of $73 per barrel in 2008 and $74.1 in 2009 vs. $78.8 and $76 in the autumn forecasts, which now seems optimistic.

which in the past five years averaged -0.4%, would become negligible as from 2008. The contribution from domestic demand is similar to the historical average, but a further breakdown shows a higher contribution of private consumption and a lower contribution of government consumption than the average of the last decade.

Table 4: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010	2011	2012
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	1.9	2 - 2.5	2.0	2 - 2.5	1.8	2.5	2.5	2.5	2.5
Private consumption (% change)	1.9	2.0	2.3	2.5	2.1	2.8	2.8	2.8	2.8
Gross fixed capital formation (% change)	3.5	2.7	3.1	3.3	3.1	3.2	3.2	3.2	3.2
Exports of goods and services (% change)	3.2	3.6	3.5	5.7	3.4	6.6	6.6	6.6	6.6
Imports of goods and services (% change)	3.7	4.4	4.4	5.5	4.6	6.2	6.2	6.2	6.2
Contributions to real GDP growth:									
- Final domestic demand	2.2	2.2	2.4	2.3	2.3	2.4	2.4	2.4	2.4
- Change in inventories	-0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.1
- Net exports	-0.2	-0.3	-0.3	0.0	-0.4	0.0	0.0	0.0	0.0
Output gap[1]	-0.3	-0.8	-0.3	-0.8	-0.6	-0.6	-0.5	-0.3	0.0
Employment (% change)	1.0	1.1	0.9	1.1	0.7	0.8	0.8	0.8	0.8
Unemployment rate (%)	8.6	n.a.	8.2	n.a.	8.1	n.a.	n.a.	n.a.	n.a.
Labour productivity (% change)	0.9	1.0	1.1	1.3	1.1	1.7	1.7	1.7	1.7
HICP inflation (%)	1.5	1.4	1.7	1.7	1.6	1.6	1.6	1.6	1.6
GDP deflator (% change)	1.9	1.8	2.1	1.8	2.0	1.6	1.6	1.6	1.6
Comp. of employees (per head, % change)	3.0	3.0	3.0	3.0	3.0	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.3	-2.3	-2.2	-2.5	-2.2	-2.3	-2.2	-2.1	-2.0

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source:

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)

In 2008 and 2009, the difference in GDP growth compared to the Commission services' autumn forecasts is mainly due to the contribution from net exports, which in the programme is driven by optimistic external assumptions and by more favourable dynamics of labour productivity not explained by other factors than adopted and announced structural reforms.

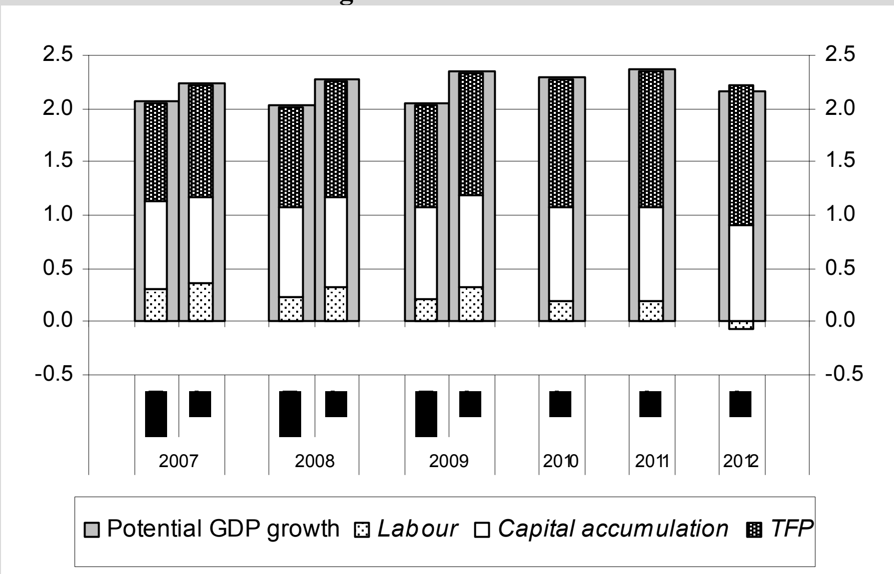
The composition of growth in the programme is broadly similar to the Commission services' autumn 2007 forecasts, with economic activity driven by domestic demand in both cases, but the programme is more favourable as far as private consumption developments are concerned. For 2008, the projection of private consumption appears somewhat optimistic also in view of the possible impact of the latest price developments on disposable income (see below and Section 3.2). For 2009, the high domestic demand involves a somewhat quick rebound of private consumption when the Commission services' forecast expects a slowdown, while underlying developments in wages are similar and the projection for employment is slightly higher. This evolution of private consumption apparently implies a decrease in the saving rate of households against a constant saving rate in the autumn forecasts. In the programme, the main reason for the better performance of private consumption is the expected positive impact on the purchasing power of (i) tax and social contribution cuts, not explicitly quantified in the programme, introduced with the TEPA package adopted in 2007 and in the Finance Act for 2008 and of (ii) the implementation of structural reforms in the labour and product markets. On the other hand, the programme foresees the dynamics of government consumption to be more subdued in 2008 and 2009.

Overall, the programme growth outlook is favourable throughout the period and markedly favourable in 2009. This assessment is even reinforced by the latest information on oil prices, inflation and the international environment, based on which the economic outlook in the programme's reference scenario should be considered even more optimistic for 2009 and beyond. This is also suggested by the programme's sensitivity analysis to changes in oil price assumptions (see Section 3.2).

Box 2: Potential growth and its determinants

Potential output growth consistent with the programme's macro-economic scenario[30] is between 2.2 and 2.4% per year over the whole programme period, which is higher than potential growth estimates in the Commission services' 2007 autumn forecast, especially for the years 2008 and 2009 (see graph).

Potential growth and its determinants



Average potential growth over the programme period is slightly above the 2.2% average annual growth of real GDP over the past ten years but markedly above the average of the recent past (1.6% see Annex 2). However, it should be recalled that the programme's macroeconomic projections include an assumed positive impact on labour and factor productivity of the envisaged labour and product markets structural reforms, which aim to boost potential growth. Using the scarce information provided in the programme, it is not possible to rigorously assess the impact of these reforms on potential output because few reforms have been implemented to date and the channels through which the reforms are projected to impact on growth are not sufficiently explicit or described.

According to the programme's own projections, potential GDP growth is expected to gradually increase from 2008 onwards to reach 2.5% in 2012. This seems rather optimistic because the improvement would essentially result from the enhanced contribution of labour (rising from 0.3 to 0.7 over the period 2007-2012), with the French economy achieving almost full employment in 2012[31], while the contributions of capital and total factor productivity would remain unchanged. The rising contribution of labour in potential GDP growth seems to depend on a very ambitious improvement of the employment rate, which remained almost constant since 2002. In the programme, employment would rise thanks to the already adopted elimination of taxation on overtime (in terms of hours worked - TEPA package), and thanks to still to be adopted measures to increase participation of older workers in the labour market (among them, the pension system reform). However, the positive effects of these measures remain uncertain. There could be also a positive impact on the labour input growth as a result of product market reforms. Finally, the programme seems to assume a positive effect of these reforms already in 2008, whereas many of them cannot be implemented before mid 2008, so their impact on growth may take longer.

30 According to the Commission services' recalculations using the commonly agreed methodology based on the information provided in the programme.

31 The reference scenario mentions that "les effets des réformes structurelles (…) devraient contribuer à (…) et à un repli sensible du taux de chômage, rapprochant ainsi l'économie française du plein emploi fin 2012".

The output gap implied by the programme update and recalculated by the Commission services on the basis of the commonly agreed methodology is assumed to gradually narrow and close in 2012 (from -0.8 in 2007), in line with the above-potential projected economic growth. In the years 2006 to 2008, the output gap implied by the programme is around ½% of GDP lower than the output gap in the Commission services' autumn forecast. However, in both forecasts, the negative output gaps have a virtually similar evolution over time for the period 2006 to 2008 (decreasing and then stabilizing). For 2009, the significant difference in the economic growth forecasts (of 0.7 percentage points) results in a divergent evolution of the output gap. In the programme, the output gap improves in 2009 by 0.2% of potential growth, whereas in the Commission services' autumn 2007 forecast it worsens by 0.3%.

3.2. Labour market and cost and price developments

Both the programme and the Commission services' projections assume employment growth to remain robust in 2008 (+1.1% and +0.9%, respectively after +1.1% and +1.1% respectively in 2007) and to gradually slow in 2009. However, the employment performance is slightly stronger in the programme than in the Commission services' autumn 2007 forecast for 2008 and 2009 and just above the average of the past five years.

The labour content of real GDP growth, calculated as the percentage increase in employment vis-à-vis the percentage increase in real GDP, averages 0.5 in 2007 and 2008 in the programme, which is somewhat higher than the average over the past ten years (0.4). For the years 2009 to 2012, the labour content of economic growth is assumed to fall to around 0.3. The programme does not provide a justification for this decline in the labour content of growth, but it may reflect difficulties for the French economy to create jobs and may also reflect wishes of the French authorities to cut the number of employees in the public sector, in line with the expenditure restraint mentioned in the programme. The stability programme apparently expects the unemployment rate to noticeably fall until the end of the programme period. This pattern is in line with the diminishing output gap and the rising employment growth over the period.

The wage dynamics in the programme are similar to the Commission services' autumn 2007 forecast, and they are expected to continue to be moderate in 2008 and 2009. The outlook for productivity growth is considered to be optimistic, in particular the increase foreseen in 2009 (from 1.3% in 2008 to 1.7% thereafter), which is substantially above the average of the past decade (+1.2%). The programme seems to attribute the increase in productivity growth to the positive impact of the reforms in labour and product markets. In light of the insufficient information on planned structural reforms and on the time needed for their positive impact to spread, the developments in labour productivity seems markedly favourable (see Box 2, Section 3.1).

Inflation is foreseen to rise at a moderate pace in 2008 (1.7%) and thereafter (1.6% per year), exactly as in the Commission services' autumn forecasts. The inflation projections in the programme are consistent with the assumed wage and productivity developments. However, in the light of the latest developments in oil and food prices, this inflation outlook now seems to be on the low side during the whole projection period (this applies to the Commission forecast for 2008 and 2009 as well). Indeed, the programme's sensitivity analysis mentions that the effect of a durable $10 increase in oil prices would determine at least a 0.4% hike in inflation from 2009 onwards[32].

3.3. Macroeconomic challenges

Between 2001 and 2005, annual real GDP grew by just above 1½ % on average. This was in line with average growth in the euro area, while inflation was marginally below the euro average. Since 2006, GDP growth in France has fallen below the euro area average, with increasing evidence of structural problems and a related deterioration competitiveness. Although the unemployment rate has improved since 2005, it remains well above the euro area average, and the employment rate and the hours worked are still low. In this context, the envisaged wide-ranging labour and product market reforms planned by the Government over the coming five years aim at increasing potential growth and competitiveness, and may, in the long term, improve the sustainability of public finances. Government deficits and debt, though decreasing, remain high. While positive steps have been taken recently to curb spending, notably in social security, France has the highest expenditure-to-GDP ratio in the euro area and its deficit is still fairly close to the 3% of GDP threshold. Thus, key challenges for the coming years will be to implement reforms to increase potential growth, improve the competitiveness of the French economy and help sustain the budgetary consolidation process, as well as to forcefully restrain expenditure at all levels of government and improve its efficiency.

The government which took office in May 2007 has stated its commitment to boost economic growth through structural reforms, to reduce unemployment and to increase employment, to consolidate public finances, and to strengthen the competitiveness of the business sector. So far, the government has notably adopted a university reform and additional incentives to corporate research and has agreed on reforming the special pension regimes. Moreover, reforms under discussion cover a wide range of areas such as further reforming the pension system and the labour market including through a review of the labour contracts, as well as the modernisation of the French economy taking into account the proposals of the "Attali Commission" (see Section 6, Box 7). However, the positive effects of these measures remain uncertain and quantitative impacts given in the programme are indicative and rather generic[33].

Less buoyant growth in the medium term than foreseen in the programme is a distinct possibility, not only because the programme builds on optimistic assumptions concerning the international environment, but also because the announced growth-enhancing labour and product market reforms still have to be specified and implemented and will only gradually increase growth potential.

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[32] In the programme's sensitivity analysis, a durable increase of $10 in the oil price (from $70 to $80 at the beginning of 2008) would have a negative impact of 0.25 pp on GDP growth in 2009 and 0.5 pp in 2010 and 2011. It would increase the deficit by 0.3 pp in 2010 and 0.2 pp in 2011 and would raise inflation by 0.4 pp, 0.8 pp and 1.0 pp in 2009, 2010 and 2011, respectively. In fact, the oil price reached $91.2 in December and $92.3 in January, that is almost $20 higher than the oil price assumed in the programme ($73 for 2008).

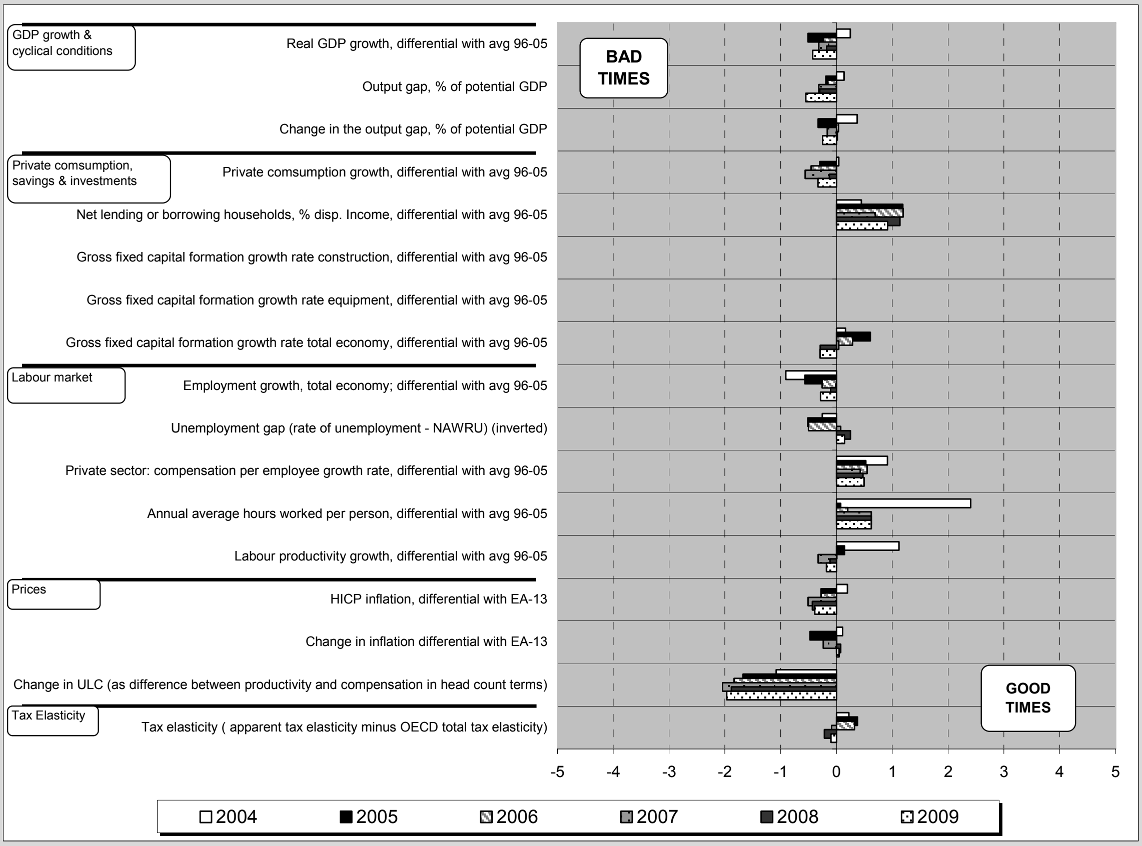
[33] The impact of structural reforms, still largely unspecified, on potential growth was also illustrated by the simulations performed by the Ministry for the Economy, Finance and Employment for the Eurogroup meeting in September 2007, which estimated the impact of the reforms to be around +1.0 pp on potential GDP growth in the long term (+0.5 from the labour market reform and +0.3 from the product market reform, at least).

Box 3: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in neither good nor bad ("neutral") economic times taking into account tax elasticities in the period 2007-2009.

The output gap estimated in the Commission services' autumn forecasts is increasingly negative but still very small at close to -0.5% of potential GDP in 2009. In spite of this, the economic situation in France cannot be assessed as bad times. The economic activity is largely driven by domestic demand suggesting tax-rich growth. It should also be noted that the unemployment rate has been on a downward trend since 2005, declining to 7.9% in November. Compared to the OECD total tax elasticity, the apparent tax elasticity is slightly higher until 2006 and slightly lower in 2007-2009 implying neutral times. From 2007 onwards, most indicators in the fields of savings and investment, the labour market and tax elasticities, confirm that the French economy is in neutral times.

Good versus bad times



4. General government balance

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme.

The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 5 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the stability programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[34]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of GDP revisions.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections turning out higher or lower than anticipated in the previous update of the programme.
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme.

[34] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

Table 5: Budgetary implementation in 2007

	2006		2007	
	Planned SP Dec 2006	Outcome COM	Planned SP Dec 2006	Outcome COM
Revenue (% of GDP)	50.6	50.8	50.4	50.6
Expenditure (% of GDP)	53.3	53.3	52.9	53.2
Government balance (% of GDP)	-2.7	-2.5	-2.5	-2.6
Nominal GDP growth (%)			4.2	3.8
Nominal revenue growth (%)			3.8	3.5
Nominal expenditure growth (%)			3.4	3.6
Revenue surprise compared to target (% of GDP)			**0.2**	
Of which [1] *:* 1. Base effect			0.2	
2. GDP growth effect on the denominator			0.2	
3. Revenue growth effect			-0.2	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than1 [2]			*0.0*	
Expenditure surprise compared to target (% of GDP)			**0.3**	
Of which [1] *:* 1. Base effect			0.0	
2. GDP growth effect on the denominator			0.2	
3. Expenditure growth effect			0.1	
Government balance surprise compared to target (% of GDP)			**-0.1**	
Of which: 1. Base effect			0.2	
2. GDP growth effect on the denominator			0.0	
3. Revenue / expenditure growth effect			-0.2	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2]Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source:
Commission services

Based on an expected decline in the general government deficit from 2.9% of GDP in 2005 to 2.7% of GDP in 2006, the previous update set a deficit target of 2.5% of GDP for 2007. This target was revised by the French authorities to 2.4% in Spring 2007 (when the outcome in 2006 turned out to be 2.5% of GDP) and is confirmed in the new update. It is based on the same growth assumption for 2007 as the previous update (between 2.0 and 2.5%), although the latest update considers that the lower bound of this range is more plausible.

The decomposition of the 0.1% of GDP worse outturn in 2007 (according to the Commission services' autumn 2007 forecast showing a deficit of 2.6% of GDP) compared to what had been planned in the December 2006 programme update (Table 5) shows that it took place against a background of (a) a positive base effect following higher-than expected revenue in 2006 and (b) a negative expenditure surprise. According to the Commission services' autumn forecast, revenues in 2007 are 0.2% of GDP higher than expected in the budget for 2007 due to the base effect. Revenues could have been even higher in 2007. However, they were partially offset by the implementation from October of the fiscal package adopted in summer (mainly tax cuts reducing revenue in 2007 by around 0.1% of GDP, see Box 4), which went counter the decision of the previous government to allocate such extra fiscal revenue to debt reduction as reaffirmed in the previous update and in the finance act for 2007[35]. Expenditure growth is 0.3% of GDP higher than anticipated. Two-thirds of this higher-than-planned increase is due to nominal GDP growth turning out lower than anticipated; the rest concerns notably social security, while State expenditure is expected to come close to the objective[36].

One-off revenues in 2007 would be around 0.1% of GDP, including the advance payment of a dividend from Electricité de France – EDF (0.05% of GDP), decided at end November[37]. Since the cut-off date of the Commission services' forecast was 24 October, no information available after that date was taken into account therein. The budgetary objective set in the previous update may thus have been achieved[38].

The policy invitation included in the Council opinion of 27 February 2007 on the previous update of the stability programme was to *"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 (...). In particular, the 2007 budget should be fully and effectively implemented and any opportunity should be seized to step up the structural adjustment."* In view of the budgetary implementation in 2007, and taking into account the fact that not all extra revenues have been used to step up the structural adjustment (limited to 0.3 percentage points – see Section 4.2) but some were also used to finance tax cuts and were offset by slippages on the expenditure side, it appears that this invitation was only partially followed in 2007.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

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[35] Loi n° 2006-1666 du 21 décembre 2006 de finances pour 2007, article 52: "Pour 2007, les éventuels surplus mentionnés au 10° du I de l'article 34 de la loi organique n° 2001-692 du 1er août 2001 relative aux lois de finances sont utilisés dans leur totalité pour réduire le déficit budgétaire". Article 34 of the Loi organique relative aux lois de finances: "La loi de finances de l'année comprend deux parties distinctes. I. - Dans la première partie, la loi de finances de l'année : (…) 10° Arrête les modalités selon lesquelles sont utilisés les éventuels surplus, par rapport aux évaluations de la loi de finances de l'année, du produit des impositions de toute nature établies au profit de l'Etat".

[36] The target set for State expenditure for 2007 was a decrease in volume by 1%, which corresponded to an 0.8% increase in value. The modest increase in value may indeed be achieved, but, due to lower inflation than anticipated, the objective in volume terms is however unlikely to be reached.

[37] The decision taken at end November on the schedule of dividend payments by EDF, which remains State-owned at 84.8% (as of 14 January 2008), seems to be of a permanent nature: from now on, EDF will pay a partial dividend based on the estimated profit of the year, rather than only on the profit of the previous year. The decision would however seem to have a transitory impact on the government accounts in 2007, since the State will exceptionally collect two dividends from EDF in 2007; the concentration of revenue in 2007 should thus be considered as one-off, when assessing the fiscal effort and estimating the structural deficit. All this assumes that this dividend is eligible to be recorded as deficit-reducing in 2007. At the time of writing, Eurostat is exchanging views with the French statistical institute (INSEE) discussing whether the "advance" nature of the dividend implied any specific recording in the ESA95 accounts.

[38] The revenue surprise in Table 3 would then amount to 0.3% of GDP and there would be no difference between outcome and plan.

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

The main goal announced by the French authorities in the most recent update of the stability programme is to curb public expenditure through a durable increase in growth, in order to achieve the medium-term objective of a balanced budget in 2012 at the latest.

According to the programme, the headline deficit would fall from 2.4% of GDP in 2007 to 2.3% of GDP in 2008 and then by 0.6 percentage points per year until 2012. The primary balance would follow a similar path since interest expenditure is expected to decrease only very marginally (from 2.6% of GDP in 2007 to 2.5% at the end of the programme period); it is expected to improve from a surplus of 0.2% of GDP in 2007 to a surplus of 2.5% of GDP in 2012, with the improvement accelerating from 0.3 percentage point of GDP in 2008 to 0.6 percentage point of GDP in 2011 with a slight slowdown at the end of the programme period. The structural balance (Commission services' calculations on the basis of the information in the programme according to the commonly agreed methodology[39]) is projected to decrease from a deficit of 2.0% of GDP in 2007 to 1.9% of GDP in 2008 and then decrease by around 0.5 percentage point of GDP per year until the end of the programme period. Against this background, the planned stance of budgetary policy is broadly neutral in 2008 and restrictive over the rest of the programme period.

The latest update significantly revises the adjustment planned in the previous programme, which had set 2010 as a target year to achieve the MTO, under a reference scenario of 2¼% GDP growth over the 2008-2010 period. The reference scenario of the latest update postpones the achievement of the MTO by two years to 2012, against the background of a more optimistic annual GDP growth of 2½% over the extended 2009-2012 period (2¼% in 2008).

The French authorities contend that the postponement of the achievement of the MTO in the reference scenario is to be seen against the background of (1) the Government's reform programme; (2) measures taken to stimulate potential growth (such as the TEPA package involving tax cuts) and hence to secure the path of public finances; and (3) assumptions strengthening the stability programme's credibility which include more prudent - i.e. higher - expenditure projections (especially for social security) than in the past.

Indeed, the TEPA package alone cannot entirely explain the marked slowdown in the adjustment in 2008 compared to plan. The previous update foresaw a reduction in both the nominal and the cyclically adjusted deficit of 0.7 percentage points of GDP in 2008. The new update only foresees an improvement in the nominal and cyclically-adjusted balance by 0.1 percentage points, while the impact of the TEPA package in 2008 is estimated at around 0.4 percentage points of GDP in the Finance Act. Hence, even setting aside the TEPA package, the adjustment is less than envisaged a year ago against the background of the same growth forecast.

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[39] It should be noted that there are uncertainties linked to the calculations of cyclically-adjusted and structural balances, notably due to the difficulty of contemporaneous output gap estimates and budgetary elasticity volatility. Thus, any interpretation should be made with caution (see Box 2 for further details).

Box 4: The TEPA package

The TEPA law or "fiscal package" (*Loi en faveur du Travail, de l'Emploi et du Pouvoir d'Achat*) was adopted on 22 August 2007. It consists mostly of tax cuts: (i) elimination of taxation on overtime, (ii) deductibility from taxable income of interest payments on mortgage loans, (iii) suppression of the inheritance tax, and (iv) a reform of the tax shield which limits the total amount paid on account of different direct taxes by each taxpayer to a maximum of 50% (previously 60%) of his/her income, with an overall deficit increasing impact around 0.1 percentage point of GDP in 2007, an additional 0.4 percentage point in 2008 and 0.1 percentage point in 2009. Most of these measures entered into force on 1 January 2008 (except the elimination of taxation on overtime, which is effective since 1 October 2007).

The TEPA was challenged before the Constitutional Court on the grounds that a number of provisions (notably the deductibility of mortgage interest payments) did not ensure the equal treatment of taxpayers. The Constitutional Court validated the overall structure of the TEPA, but decided that only interest due on mortgages contracted after 6 May 2007 can be deducted. An additional deductibility from taxable income of interest payments on mortgage loans (doubled from 20% to 40% in the first year) was thus adopted in the Finance Act for 2008 (see Box 5).

	Cost on annual basis (in % of GDP)	**2007**	**2008**	**2009**
Elimination of taxation on overtime (TEPA 2007)	€6.6bn (0.34%)	0.06% of GDP	0.22% of GDP	0.05% of GDP
Deductibility from taxable income of interest payments on mortgage loans (TEPA 2007)	€3.7bn (0.18%)	none	0.01% of GDP	0.04% of GDP
Suppression of the inheritance tax (TEPA 2007)	€2.3 bn (0.12%)	0.02% of GDP	0.08% of GDP	0.02% of GDP
Tax shield and ISF (TEPA 2007)	€1.2bn (0.06%)	none	0.06% of GDP	No additonal
Elimination of income tax for students (TEPA 2007)	€40m (<0.01%)	none	<0.01% of GDP	No additonal

Sources: Commission services and French Ministry of Finance

Table 6: Evolution of budgetary targets in successive programmes

		2006 [2]	2007	2008	2009	2010	2011	2012
General government balance (% of GDP)	**SP Nov 2007**	**-2.5**	**-2.4**	**-2.3**	**-1.7**	**-1.2**	**-0.6**	**0.0**
	SP Dec 2006	*-2.7*	*-2.5*	*-1.8*	*-0.9*	*0.0*	*n.a.*	*n.a.*
	COM Nov 2007	-2.5	-2.6	-2.6	-2.7	n.a.	n.a.	n.a.
General government expenditure (% of GDP)	**SP Nov 2007**	**53.4**	**53.2**	**52.6**	**51.9**	**51.2**	**50.6**	**49.9**
	SP Dec 2006	*53.3*	*52.9*	*52.0*	*51.1*	*50.4*	*n.a.*	*n.a.*
	COM Nov 2007	53.3	53.2	52.8	52.7	n.a.	n.a.	n.a.
General government revenue (% of GDP)	**SP Nov 2007**	**50.8**	**50.7**	**50.4**	**50.1**	**50.0**	**50.0**	**50.0**
	SP Dec 2006	*50.6*	*50.4*	*50.2*	*50.3*	*50.3*	*n.a.*	*n.a.*
	COM Nov 2007	50.8	50.6	50.2	50.0	n.a.	n.a.	n.a.
Structural balance [1] (% of GDP)	**SP Nov 2007**	**-2.5**	**-2.0**	**-1.9**	**-1.4**	**-1.0**	**-0.4**	**0.0**
	SP Dec 2006	*-2.5*	*-2.2*	*-1.6*	*-0.7*	*0.2*	*n.a.*	*n.a.*
	COM Nov 2007	-2.8	-2.5	-2.6	-2.4	n.a.	n.a.	n.a.
Real GDP (% change)	**SP Nov 2007**	**2.0**	**2 - 2.5**	**2 - 2.5**	**2.5**	**2.5**	**2.5**	**2.5**
	SP Dec 2006	*2.0-2.5*	*2.0-2.5*	*2¼*	*2¼*	*2¼*	*n.a.*	*n.a.*
	COM Nov 2007	2.0	1.9	2.0	1.8	n.a.	n.a.	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.1% of GDP in 2006 and 0 for the rest of the period covered (2007-2012) according to the most recent programme. According to the Commission services' autumn forecast they are 0.3% of GDP in 2006, 0.05% of GDP in 2007 and 0.1% of GDP in 2008.

[2]As the most recent programme does not provide information for 2006 (except for cyclical developments), figures were taken from the Commission services' autumn 2007 forecast.

Source :
Stability programmes (SP); Commission services' autumn 2007 economic forecasts (COM).

As illustrated by Table 6, like in the previous programme the consolidation path is back loaded, but in the new update there is almost no adjustment in the first programme year, the adjustment is spread over a longer period although starting from a better position (structural balance of 2.5% in 2006 in the previous programme and of 2.0% of GDP in 2007 in this programme) against the background of an underlying reference growth scenario that is more favourable from 2009 onwards.

4.2.2. *The composition of the budgetary adjustment*

Table 7: Composition of the budgetary adjustment

(% of GDP)	2006 [3]	2007	2008	2009	2010	2011	2012	Change: 2012-2007
Revenue	**50.8**	**50.7**	**50.4**	**50.1**	**50.0**	**50.0**	**50.0**	**-0.7**
of which:								
- Taxes on production and imports	15.4	15.3	15.1	15.1	n.a.	n.a.	n.a.	**n.a.**
- Current taxes on income, wealth, etc.	11.8	11.7	11.7	11.6	n.a.	n.a.	n.a.	**n.a.**
- Social contributions	18.3	18.3	18.2	18.1	n.a.	n.a.	n.a.	**n.a.**
- Other (residual)	5.3	5.4	5.4	5.3	n.a.	n.a.	n.a.	**n.a.**
Expenditure	**53.4**	**53.2**	**52.6**	**51.9**	**51.2**	**50.6**	**49.9**	**-3.3**
of which:								
- Primary expenditure	50.8	50.6	49.9	49.3	48.6	48.0	47.4	**-3.2**
of which:								
Compensation of employees	13.1	12.9	12.6	12.3	12.1	11.8	11.6	**-1.3**
Intermediate consumption	5.2	5.2	5.2	5.2	5.1	5.1	5.0	**-0.2**
Social payments	23.4	23.6	23.3	23.2	23.0	22.9	22.7	**-0.9**
Subsidies	1.5	1.4	1.3	1.3	1.3	1.3	1.2	**-0.2**
Gross fixed capital formation	3.4	3.3	3.2	3.2	3.1	3.1	3.1	**-0.2**
Other (residual)	4.2	4.1	4.1	4.0	4.0	3.9	3.9	**-0.2**
- Interest expenditure	2.6	2.6	2.7	2.6	2.6	2.6	2.5	**-0.1**
General government balance (GGB)	**-2.5**	**-2.4**	**-2.3**	**-1.7**	**-1.2**	**-0.6**	**0.0**	**2.4**
Primary balance	**0.0**	**0.2**	**0.5**	**0.9**	**1.4**	**2.0**	**2.5**	**2.3**
One-off and other temporary measures	0.1	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**
GGB excl. one-offs	**-2.6**	**-2.4**	**-2.3**	**-1.7**	**-1.2**	**-0.6**	**0.0**	**2.4**
Output gap [1]	-0.2	-0.8	-0.8	-0.6	-0.5	-0.3	0.0	**0.8**
Cyclically-adjusted balance [1]	-2.3	-2.0	-1.9	-1.4	-1.0	-0.4	0.0	**2.0**
Structural balance [2]	**-2.5**	**-2.0**	**-1.9**	**-1.4**	**-1.0**	**-0.4**	**0.0**	**2.0**
Change in structural balance		*0.5*	*0.1*	*0.5*	*0.4*	*0.5*	*0.4*	
Structural primary balance [2]	0.1	0.6	0.8	1.2	1.6	2.2	2.5	**1.9**
Change in structural primary balance		*0.5*	*0.2*	*0.4*	*0.4*	*0.5*	*0.3*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2006 and 0 for the rest of the period covered (2007-2012) according to the most recent programme.

[3]As the most recent programme does not provide information for 2006 (except for cyclical developments), figures were taken from the Commission services' autumn 2007 forecast.

Source:

Stability programme; Commission services' calculations.

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 (1.4% annual growth in 2008 and 1.1% on average over the period 2009-2012)[40] that imply a reduction of the expenditure-to-GDP ratio. The planned consolidation would be totally expenditure-driven, with the expenditure-to-GDP ratio, which averaged 52.8% over the last decade, decreasing by more than 3 percentage points of GDP from 53.2% of GDP in 2007 to 49.9% of GDP in 2012. The revenue-to-GDP ratio would also decline from 50.7% of GDP in 2007 to 50.1% of GDP in 2009 and thereafter stabilise at 50.0% of GDP.

[40] Given the nominal GDP growth rate assumed (at 4.1% per year over the period), the envisaged reduction in the expenditure ratio is compatible with expenditure growth in nominal terms of about 1.1% per year.

This consolidation relies on measures adopted in the latest social security finance act (*Loi de Financement de la Sécurité Sociale* or *LFSS)* and on the implementation of the redefined rule on state expenditures so as to also cover part of transfers to local governments and on the national health insurance spending objective (*Objectif National des Dépenses d'Assurance Maladie* or *ONDAM*, see Section 2.4) backed by administrative reforms which are not specified in the programme. No major one-offs are mentioned in the programme, and according to the Commission services' autumn forecast, one-off measures should be marginal in 2008 (around 0.1% of GDP). Table 7 shows that over the programme period the decrease in the expenditure ratio would nearly entirely rely on a decrease in primary expenditure (by 3.2 percentage point of GDP over 2007-2012) as interest expenditure is expected to remain broadly stable at 2½% of GDP (decreasing marginally by 0.1 percentage point of GDP over the period). According to the programme, the decrease in primary expenditure would mainly stem from the compensation of employees and social transfers. This is likely to concern particularly healthcare expenditure and unemployment benefits, but a more detailed breakdown of expenditure is not available in the programme. Gross fixed capital formation would slightly decline from 3.3% to 3.1% of GDP.

In the current update, the planned reduction in the expenditure-to-GDP ratio would notably stem from the enhanced expenditure-growth rules at the *State* level. As discussed in Section 2.4, the "zero *nominal* spending growth rule" by 2010, to be implemented progressively starting in 2007 with a reduction by 1% in volume terms, has now been replaced by a new "zero *volume* rule" with a reference to a broader category of expenditure including the State and "*prélèvements sur recettes*" (most of the transfers to local authorities and the contributions to the EU)[41]. As mentioned in the programme, implementing this rule will require a substantial effort, notably because of increasing mandatory expenditure, especially debt service[42] and civil servant pensions (expected to increase by about 3.4% per year in volume between 2009 and 2012), which will substantially weigh on French public finances. Therefore, the rule actually implies a reduction in volume in other expenditure by 1.3% per year over the period, which would essentially be backed by unspecified measures following up on the RGPP (*Revue Genérale des Politiques Publiques,* see Section 2.4.1). The programme envisages that the new spending rule will help speed up the reduction of the State deficit from 2.0% of GDP in 2007 to 0.5% of GDP in 2012.

Concerning the *social security funds*, there is no new norm envisaged and the existing one on health-care expenditure remains non-binding. In 2007, the targeted increase of the ONDAM is estimated to have again been breached by around 1½ percentage point in spite of measures adopted in summer following advice from the "Alert committee"[43]. For

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[41] As mentioned in section 2.4.1, in 2008, this new rule could turn out to be less restrictive for the State according to the previous perimeter definition. Therefore the cost of the reduction would mostly be borne by transfers to local authorities.

[42] As mentioned in the programme, while interest payments decreased by 1.7% (in volume terms) on average per year over the period 2000-2007 thanks to the refinancing of the existing debt at lower interest rates, they are expected to annually increase by 2.4% (in volume terms) on average over the period 2009-2012 in the reference scenario due to tighter financing conditions.

[43] 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. The slippages envisaged by the Committee in June 2007 indeed led to corrective measures, yet unable to avoid a significant breach in the ONDAM.

the 2009-2012 period, social security expenditure is expected to rise at an average annual rate of 3.5% in value. While pension expenditure would still be rather dynamic (+4.7% on average per year over the 2009-2012 period), the expected improvement on the unemployment front, the recently adopted "*franchise de soins*" and a better coordination in the healthcare system would help curb social security expenditure growth (see Box 5). The programme expects the social security funds to reach a 0.5% of GDP surplus at the end of the forecast horizon from a deficit of 0.2% of GDP in 2006.

At the *local authorities'* level no rule in terms of expenditure-growth exists. However, the new expenditure rule for the State, which includes most of the transfers to the local authorities, is expected by the government to lead to savings in the general government expenditures, while the electoral cycle would also lead to a decrease in investments in 2008 (see Box 1, Section 2.4.2). Henceforth, the transfers which fall under the "*Contrat de croissance et de solidarité*" (with a partially different perimeter compared to the transfers included in the *prélèvements sur recettes*), will evolve in line with inflation rather than growth (the contract was logically renamed "*Contrat de stabilité*"). Therefore, the programme envisages that the local government budget will be balanced in 2012, from a 0.2% deficit in 2007.

On the revenue side, the 0.7 percentage point decline relative to GDP between 2007 and 2012 is notably explained by the reduction in the tax burden as a result of tax cuts adopted in summer 2007, in the finance act for 2008 (with an effect at around ½ percentage point of GDP in 2008), cuts in local *taxe professionelle* decided by the previous government, and by the reverse effect in 2009 of 2008 one-offs. Tax elasticities are expected to converge toward 1 from 2009 onwards, hence to stabilize the revenue-to-GDP ratio at 50.0% after 2010.

As far as the specification of the measures underpinning the budgetary strategy is concerned, those contained in the social security finance act (see Box 5), cuts in public employment and additional resources stemming from the advance collection on taxation on dividends in 2008 could indeed partially offset the cost of the TEPA package. Besides, the adopted university reform and the increase in corporate research incentives could also have a positive, although limited, effect on potential output. However, the envisaged consolidation is not sufficiently supported by the reforms specified in the programme, especially after 2008, and its achievement remains subject to the further specification and implementation of important structural reforms to curb expenditure and raise growth, which are only partially evoked in the update and should be discussed within the coming months (see Section 6).

Box 5: The budget for 2008

The draft Budget Bill for 2008 was presented to the Parliament on 26 September 2007 and adopted by it on 18 December 2007. Under the assumption of real GDP growth between 2.0% and 2.5%, the 2008 Budget Bill foresees a decline in the general government deficit from 2.4% of GDP in 2007 to 2.3% of GDP in 2008. The draft social security budget bill was presented to the Parliament on 24 September 2007 and adopted by it on 19 December 2007.

Expenditure restraint is planned to stem notably from (a) the new "0% volume increase expenditure rule" for the State, which will be applied to a broader category of expenditures including the State and also "*prélèvements sur recettes*". The rule is backed by cuts in public employment scrapping 22 791 jobs, based on replacing two thirds of retirees in 2008; it is expected to have a positive impact of 0.02% of GDP in 2008; (b) a limited evolution of healthcare expenditure with a targeted increase of *ONDAM* set at 2.8% thanks to a reform in the healthcare system organisation (notably consisting in (i) making the financing of hospitals dependent on the number of patients and operations, (ii) experimenting new payments packages for doctors, such as all inclusive prices for a patient rather than payment for every single act, and (iii) a 6 month-delay before the implementation of any increase in consultation fees), as well as (c) the introduction of a "*franchise de soins*" (minimum payment charged to patients for certain expenditures: transport, pharmaceuticals) and the package of measures adopted in July following the advice from the Alert committee (see Section 4.2.2).

The decrease in the revenue-to-GDP ratio reflects the impact of discretionary measures on the fiscal side and especially the impact of the TEPA package adopted this summer (see Box 4), with an overall deficit-increasing impact of around 0.4 percentage point of GDP in 2008. Main measures included in the finance act for 2008 are (a) an advance collection of dividend taxation (qualifying as a one-off measure), with an impact on both State and social security revenues, (b) an increase in employment incentives (*Prime Pour l'Emploi*) with an almost negligible budgetary impact in 2008, and (c) an increase in corporate research incentives through a reform of the *Crédit Impôt Recherche* (no budgetary impact in 2008). Discussions at the Parliament only marginally impacted the deficit outcome.

Main measures in the budget for 2008

Revenue measures*	**Expenditure measures****
o Tax reform on dividends taxation (+0.1% of GDP) o Elimination of taxation on overtime (-0.2% of GDP) o Suppression of the inheritance tax (-0.1% of GDP) o Tax shield and ISF (-0.1% of GDP)	o Cuts in public employment (-0.02% of GDP) o Social security: July 2007 correction and LFSS measures (-0.1% of GDP) o Reform in healthcare system organisation (-0.1% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.

Sources: Commission services and French Ministry of Finance

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 8 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010	2011	2012
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP	SP
Revenue	**50.8**	**50.6**	**50.7**	**50.2**	**50.4**	**50.0**	**50.1**	**50.0**	**50.0**	**50.0**
of which:										
- Taxes on production and imports	15.4	15.3	15.3	15.2	15.1	15.1	15.1	n.a.	n.a.	n.a.
- Current taxes on income, wealth, etc.	11.8	11.7	11.7	11.5	11.7	11.4	11.6	n.a.	n.a.	n.a.
- Social contributions	18.3	18.3	18.3	18.2	18.2	18.2	18.1	n.a.	n.a.	n.a.
- Other (residual)	5.3	5.3	5.4	5.3	5.4	5.2	5.3	n.a.	n.a.	n.a.
Expenditure	**53.4**	**53.3**	**53.2**	**52.8**	**52.6**	**52.6**	**51.9**	**51.2**	**50.6**	**49.9**
of which:										
- Primary expenditure	50.8	50.7	50.6	50.2	49.9	50.0	49.3	48.6	48.0	47.4
of which:										
Compensation of employees	13.1	12.9	12.9	12.7	12.6	12.5	12.3	12.1	11.8	11.6
Intermediate consumption	5.2	5.3	5.2	5.3	5.2	5.3	5.2	5.1	5.1	5.0
Social payments	23.4	23.5	23.6	23.4	23.3	23.4	23.2	23.0	22.9	22.7
Subsidies	1.5	1.5	1.4	1.4	1.3	1.4	1.3	1.3	1.3	1.2
Gross fixed capital formation	3.4	3.4	3.3	3.4	3.2	3.4	3.2	3.1	3.1	3.1
Other (residual)	4.2	4.1	4.1	4.0	4.1	4.0	4.0	4.0	3.9	3.9
- Interest expenditure	2.6	2.6	2.6	2.6	2.7	2.6	2.6	2.6	2.6	2.5
General government balance (GGB)	**-2.5**	**-2.6**	**-2.4**	**-2.6**	**-2.3**	**-2.7**	**-1.7**	**-1.2**	**-0.6**	**0.0**
Primary balance	**0.0**	**0.0**	**0.2**	**0.0**	**0.5**	**-0.1**	**0.9**	**1.4**	**2.0**	**2.5**
One-off and other temporary measures	0.3	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.8**	**-2.6**	**-2.4**	**-2.7**	**-2.3**	**-2.7**	**-1.7**	**-1.2**	**-0.6**	**0.0**
Output gap[2]	-0.2	-0.3	-0.8	-0.3	-0.8	-0.6	-0.6	-0.5	-0.3	0.0
Cyclically-adjusted balance[2]	-2.5	-2.4	-2.0	-2.5	-1.9	-2.4	-1.4	-1.0	-0.4	0.0
Structural balance[3]	**-2.8**	**-2.5**	**-2.0**	**-2.6**	**-1.9**	**-2.4**	**-1.4**	**-1.0**	**-0.4**	**0.0**
Change in structural balance		*0.3*	*0.5*	*-0.1*	*0.1*	*0.1*	*0.5*	*0.4*	*0.5*	
Structural primary balance[3]	-0.2	0.1	0.6	0.0	0.8	0.2	1.2	1.6	2.2	2.5
Change in structural primary balance		*0.3*	*0.5*	*0.0*	*0.2*	*0.1*	*0.4*	*0.4*	*0.5*	

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2006 and 0 for the rest of the period covered (2007-2012) according to the most recent programme. According to the Commission services' autumn forecast they are 0.3% of GDP in 2006, 0.05% of GDP in 2007 and 0.1% of GDP in 2008.

Source:
Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations.

The budgetary outcome could be worse than targeted, taking into account macroeconomic risks as well as uncertainties on budget implementation. As concluded in Section 3.3 above, the macroeconomic scenario appears favourable over the entire programme period, implying a downward risk to the general government budget. The reference scenario relies upon a significant improvement in the international environment and on a major increase in potential growth from 2009 onwards (around ½ percentage points). Potential growth could indeed be boosted by the announced structural reforms (notably labour market, competition in goods markets, competitive framework for companies). However, even if the programme provides some estimates of their possible impact on potential growth, their budgetary impact is not spelled out and, also since these reforms are not yet decided and implemented, any impact assessment is very tentative. Moreover, such measures could entail significant implementation risks (e.g. in the case of the labour market reform or administrative reform), which could call into question their near-term adoption in the context of an unfavourable macroeconomic environment. In any case, the possible impact on growth may take longer than assumed (see Section

3.2, Box 2). Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point downward deviation from the real GDP growth projections in the programme over the 2007-2012 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2012, the cyclically-adjusted balance would be 0.9 percentage point of GDP below the central scenario.

The evolution of the deficit could also be negatively affected by a number of other factors. The reduction in the expenditure ratio is uncertain not only because of past experience but also because of the strongly back-loaded adjustment (with almost no adjustment in 2008, reflecting the cost of the TEPA package) and the fact that the underlying measures are not sufficiently specified. Indeed, as outlined in Section 4.2, expenditure restraint is expected to stem from further cuts in public employment after 2008, and also from a better organisation in the healthcare system as well as from the in-depth administrative reorganisation which is announced to follow the *Revue Générale des Politiques Publiques*. Given the lack of information concerning these measures and their implementation schedule, their impact on budgetary consolidation cannot be assessed at this stage.

The programme states that there are no one-offs or temporary measures for 2007-2012, after the occurrence of 0.1% of GDP in one-off revenues in 2006 (0.3% according to the Commission services' assessment[44]). However, the change in the corporate tax code (extension of the measure first proposed in 2006 to a wider range of companies, amounting to around 0.02% of GDP) and the advanced collection of social contributions on saving plans (around 0.02% of GDP) in 2007, as well as the anticipated collection of taxation on dividends in 2008 (around 0.1% of GDP according to the draft Budget Bill for 2008) undoubtedly qualify as such. Moreover, the advance dividend from EDF (around 0.05% of GDP in November 2007) could qualify as such as discussed in Section 4.1, but the recording of the dividend is still subject to discussion between Eurostat and INSEE. These one-off measures provide (limited) support to the achievement of deficit target in 2007 and 2008.

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 in line with those in the Commission services' autumn 2007 forecasts for the years 2008 and 2009. The difference with the OECD ex-ante elasticity is mainly related to the impact of the tax cuts implemented in the summer of 2007, 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 the discretionary measures are excluded, the tax-to-GDP elasticity is higher than the ex-ante elasticity due to a favourable composition component. All in all, the tax elasticities assumed in the update for the period 2008-2009 do not constitute a major risk for the budgetary projections (bearing in mind that the GDP growth projections are on the optimistic side).

Table 9: Assessment of tax projections

[44] In the Commission services assessment, the reduction in the deficit in 2006 relied on 0.3% of GDP 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 stag, as well as on a change in the corporate tax code (*aménagement de l'acompte d'impôts sur les sociétés)*. The authorities only consider the *soulte "la poste"* as one-off revenues and thus in 2006 the latter are limited to 0.1 percentage point of GDP according to the stability programme figures.

	2008			2009			2010	2011	2012
	SP	**COM**	**OECD**[3]	**SP**	**COM**[1]	**OECD**[3]	**SP**	**SP**	**SP**
Change in tax-to-GDP ratio (total taxes)	-0.3	-0.4	0.0	-0.2	-0.2	0.0	n.a.	n.a.	n.a.
Difference (SP – COM)	0.1		/	0.0		/	/	/	/
of which [2] *:*									
- discretionary and elasticity component	*0.1*		/	*-0.1*		/	/	/	/
- composition component	*0.1*		/	*0.1*		/	/	/	/
Difference (COM - OECD)	/	-0.4		/	-0.2		/	/	/
of which [2] *:*									
- discretionary and elasticity component	/	*-0.6*		/	*-0.4*		/	/	/
- composition component	/	*0.3*		/	*0.3*		/	/	/
p.m.: Elasticity to GDP	0.8	0.8	1.0	0.9	0.9	1.0	n.a.	n.a.	n.a.

Notes:

[1]On a no-policy change basis.

[2]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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

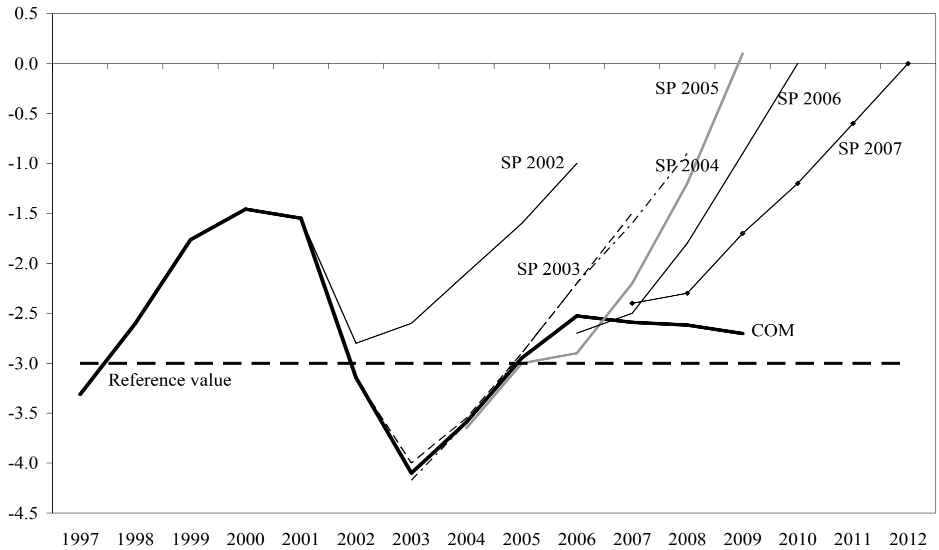
Source:

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

France's overall track record when it comes to respecting its budgetary targets is rather poor as illustrated by Figure 11. Long-term (more than two-year) projections have always been missed since 2000. Near-term objectives have been more often reached, although frequently thanks to significant one-offs, while the customary back-loaded consolidation path makes it easier to achieve a better track record in that field.

Overall, the assessment suggests that there are significant risks that deficit outcomes may be worse than targeted in the programme.

Figure 11: Government balance projections in successive programmes (% of GDP)



Note: Commission services' figures were revised backward in line with the INSEE decision of 19 September 2007 (see section 5.1.1). This revision is not reflected in the different updates of up to 2006.
Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

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 and, second, the final assessment also taking into account risks.

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

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	From 2009 onwards	Possibly towards the end of the (extended) programme period
b. Achievement of the MTO	In 2012	Probably not within the (extended) programme period
c. Adjustment towards MTO in line with the Pact[2]?	Inadequate especially in 2008 (0.1 pp of structural improvement)	Insufficient and should be strengthened significantly particularly in 2008 and backed up with measures thereafter

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 cyclically adjusted terms (for line b) and in structural terms (for line c) as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

In view of the risk assessment above, and the fact that the structural balance would hardly improve in 2008 and thereafter improve by around 0.5 percentage points of GDP per year over the remainder of the extended programme horizon, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2010, as targeted in the December 2006 stability programme update and indicated by the April 2007 Eurogroup, or even by 2012, as envisaged in the reference scenario of the programme.

According to the programme, the minimum benchmark needed to ensure a safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations, estimated for France as a deficit around 1½% of GDP, would only be reached in 2009. In view of the risks to the programme, the minimum benchmark is more likely to be reached only toward the end of the extended programme period.

The pace of the adjustment towards the MTO implied by the programme is inadequate, especially in 2008, when the adjustment of 0.1 percentage point of GDP is neither in line with the 0.5% of GDP benchmark in the Stability and Growth pact nor in line with the orientations of the April 2007 Eurogroup.

Against this background and also recalling that the lengthy excessive deficit procedure for France was only terminated in January 2007[45], the pace of budgetary consolidation should be considerably strengthened and backed up with measures so as to ensure that a safety margin against breaching the 3% of GDP deficit threshold is attained, preferably already in 2008, and that the MTO is reached by 2010.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes 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

Compared to estimates in the previous update, the debt (and the deficit) ratios for the period 1993-2006 were revised upwards (by about ½ percentage point), as a result of the decision taken on 19 September 2007 by INSEE, in agreement with Eurostat, to include into the public perimeter the debt previously managed by a fund under responsibility of the French railways SNCF (*Service annexe d'amortissement de la dette de la SNCF - SAAD*). This decision increased general government debt in 2006 by an amount of € 8.2 billion (0.5% of GDP) to 64.2% of GDP.

After breaching the 60%-of-GDP Treaty reference value in 2003 and rising by about 2 percentage points of GDP per year until 2005 (when it reached 67% of GDP, 10 percentage points above its 2000 level), the debt-to-GDP ratio decreased significantly in 2006, from 66.7% to 64.2%. This turnaround was due to a full allocation of the privatisation receipts to debt reduction and a better overall management of the debt of the different general government entities.

As for 2007, the previous update had targeted a further decrease in the debt ratio by 1 percentage point to reach 63.6% (before data revision), backed notably by privatisation proceeds. However, in the latest update, the debt ratio is expected to stabilise (at 64.2%), with the effect of the small primary surplus (0.2 percentage points of GDP) being totally offset by interest payments (see Table 11). Indeed, contrary to the range of privatisation proceeds which was mentioned in the previous update (between 0.3 and 0.6% of GDP every year), the stock flow adjustment in the programme is zero in 2007 – and is estimated to be negligible throughout the programme period. According to the Government programme, uncertainties linked to presidential and Parliamentary elections and unfavourable financial market conditions in the second half of 2007 following the financial turmoil in summer curtailed privatisation plans, with the exception of the sale of a 5% stake in France Telecom in June[46] and a 2.5% stake in EDF in December[47]

[45] The Excessive Deficit Procedure for France was launched in June 2003; for an overview of this procedure see the Commission Services' Working Document (Economic Assessment) on the previous Stability Programme.

[46] The French State sold a 5% stake in France Telecom end of June 2007, for a total consideration of EUR 2.65 billion, or 0.1% of GDP. Following the transaction, the French government still holds 27.4% of the share capital of France Telecom.

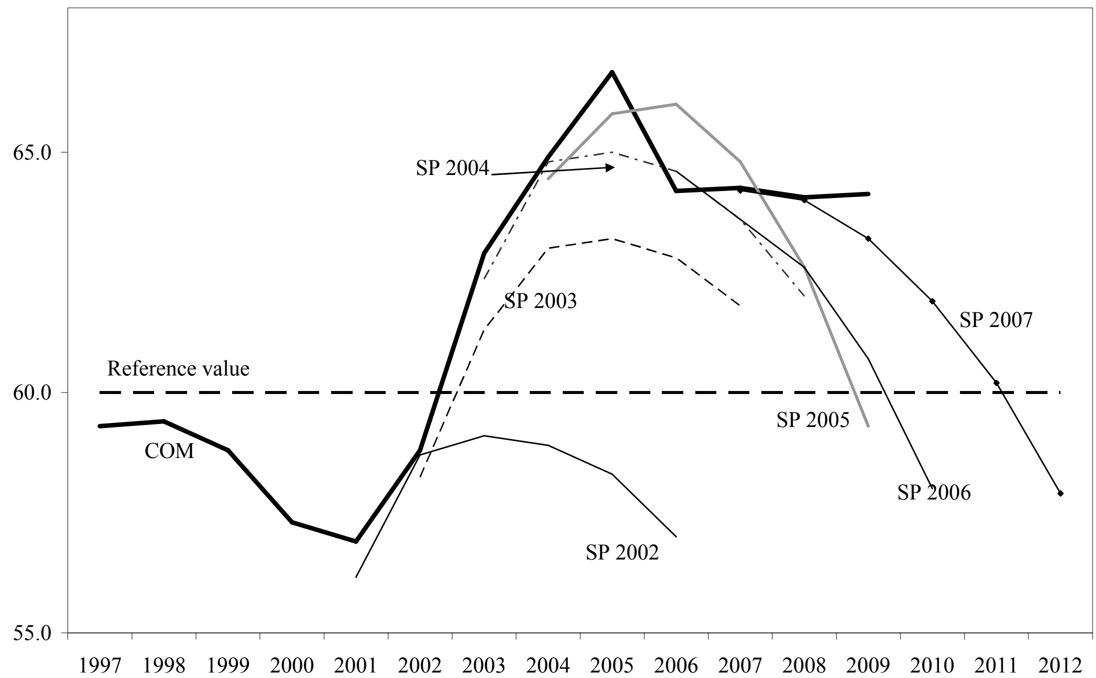
[47] Regarding the EDF partial privatisation, the future use of proceeds is not yet clear. Firstly, it has been announced by the President end November that it would be used to finance investments in universities,

(equivalent to around 0.1% of GDP in both cases). A similar debt evolution is assumed in the Commission services' autumn forecast (64.3%, the slight difference reflecting a higher deficit in the Commission forecast).

In 2008, the programme anticipates a slight reduction in the debt ratio by 0.2 percentage point, from 64.2% to 64.0%, broadly in line with the Commission services' autumn 2007 forecast of 64.1%. In 2009, the programme anticipates a further reduction to 63.2%, and diverges from the path foreseen by the Commission services (64.1%). In the reference scenario, the update's debt reduction path would bring the debt ratio very close to the Treaty reference value in 2011 (at 60.2%) and below it in 2012 (at 57.9%).

Over the last five years, the debt targets of the successive stability programme updates have constantly been revised upwards and often missed, even if the recent revision (around ½ percentage point) mentioned in the first paragraph of this section is not taken into account (see Figure 12). For example, the 2006 target was initially set at 57.0% in the 2002 update and was repeatedly revised upwards up to 64.6% in the January 2007 update, while the outcome was 64.2%. Similarly, the 2007 target was initially set at 61.8% in 2003 and revised upwards to 64.2% in the November 2007 update.

Figure 12: Debt projections in successive programmes (% of GDP)[48]



Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

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which would actually be a breach in the rule mentioned in the December 2006 update to allocate privatisation proceeds to debt reduction and would increase the deficit in the absence of offsetting measures. Second, the LOLF (article 21) obliges privatisations proceeds to be managed by a dedicated fund (*Participations financières de l'Etat*). They can only be allocated to debt reduction or public companies recapitalization, unless a finance act specifies a transfer to the general budget. No such act has been adopted for the moment.

[48] Commission services' figures were revised backward in line with the INSEE decision of 19 September 2007 (approximately ½ higher from 1993). This revision is not reflected in the different updates of up to 2006.

Table 11: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010	2011	2012
			COM	SP	COM	SP	COM	SP	SP	SP	SP
Gross debt ratio[1]	**63.2**	**64.2**	**64.3**	**64.2**	**64.1**	**64.0**	**64.1**	**63.2**	**61.9**	**60.2**	**57.9**
Change in the ratio	2.6	-2.5	0.1	0.0	-0.2	-0.2	0.1	-0.8	-1.3	-1.7	-2.3
Contributions[2] *:*											
Primary balance	**0.7**	**0.0**	**0.0**	**-0.2**	**0.0**	**-0.5**	**0.1**	**-0.9**	**-1.4**	**-2.0**	**-2.5**
"Snow-ball" effect	**0.7**	**-0.2**	**0.2**	**0.3**	**0.1**	**0.3**	**0.2**	**0.1**	**0.1**	**0.2**	**0.2**
Of which:											
Interest expenditure	2.8	2.5	2.6	2.6	2.6	2.8	2.6	2.6	2.6	2.6	2.5
Growth effect	-0.9	-1.3	-1.2	-1.2	-1.3	-1.4	-1.1	-1.5	-1.5	-1.5	-1.4
Inflation effect	-1.1	-1.5	-1.1	-1.1	-1.3	-1.1	-1.3	-1.0	-0.9	-0.9	-0.9
Stock-flow adjustment	**1.2**	**-2.2**	**-0.2**	**0.0**	**-0.2**	**0.0**	**-0.2**	**0.0**	**0.0**	**0.1**	**0.1**
Of which:											
Cash/accruals diff.	0.1	-0.2		n.a.		n.a.		n.a.	n.a.	n.a.	n.a.
Acc. financial assets	1.0	-2.1		n.a.		n.a.		n.a.	n.a.	n.a.	n.a.
Privatisation	*-0.3*	*-0.9*	*-0.2*	*n.a.*	*-0.2*	*n.a.*	*-0.2*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Val. effect & residual	0.0	0.0		n.a.		n.a.		n.a.	n.a.	n.a.	n.a.

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 (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations.

5.1.2. Assessment

The previous update of the stability programme strongly emphasised the role of the multi-annual programme for debt reduction targeting a debt level below 60% of GDP by 2010, in line with the "national commitment for debt reduction" adopted after the publication of the Pébereau report in 2005. In the latest update, the emphasis on debt reduction is reduced. The objective of bringing the debt-to-GDP ratio below 60% is postponed to 2012 and no longer depends on sizeable stock-flow adjustments. No information is provided on the sale of non-strategic assets, while a range for privatisation receipts envisaged throughout the period was mentioned in the previous update.

As a consequence, taking the programme targets at face value and in view of the rolling debt benchmark (see Box 6), the debt-to-GDP ratio is sufficiently diminishing to ensure that the 60% threshold would be reached at the end of the programme period. However, when taking into account the significant risks to the budgetary consolidation path, as well as the possibility that GDP may come out lower than assumed in the programme (which would mechanically increase the debt ratio), the debt ratio may not be sufficiently diminishing to reach 60% at the end of the extended period.

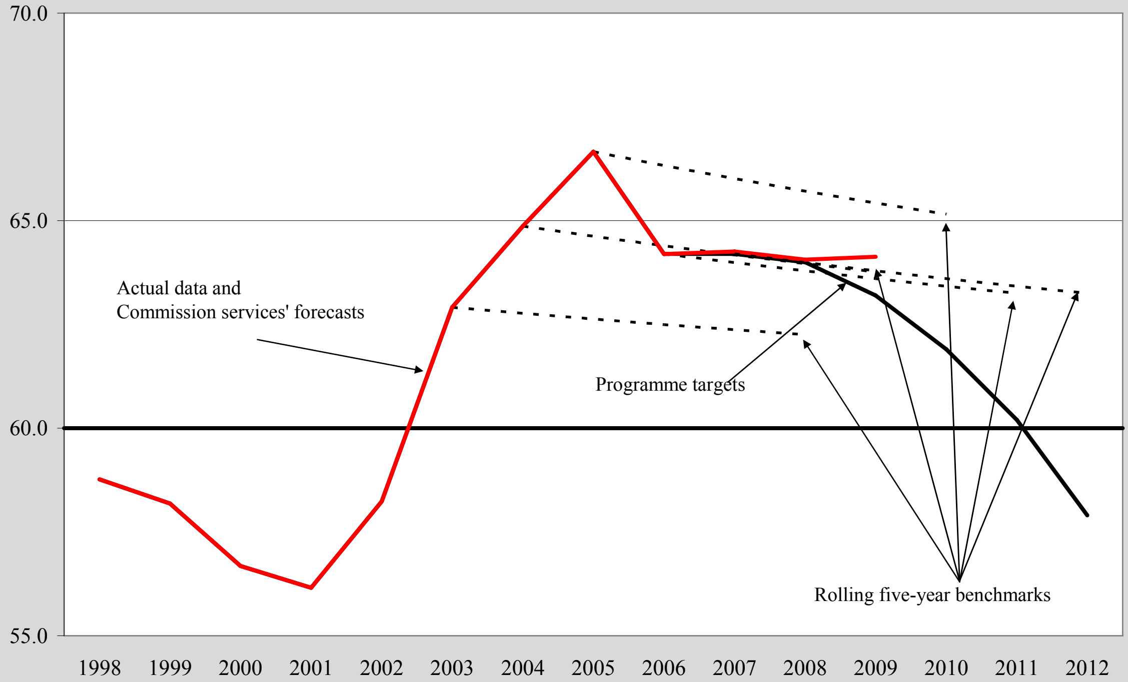
Box 6: The rolling debt reduction benchmark

The debt ratio has exceeded the 60% of GDP reference value since 2002 .

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 2007 forecasts until 2009 (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 2008 is compared with the value obtained for the same year by applying the formula starting in 2003. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

The graph clearly shows that the planned reduction of the debt ratio in the update is more than fulfilled by the five-year rolling debt reduction benchmark.

France: rolling five-year debt benchmark



<u>Source</u> : Stability programme and Commission services

(*) 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:

$\left(\frac{D_{t+1}}{Y_{t+1}}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$, 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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

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 and property income received by general government according to an agreed methodology.[49] Non age-related primary expenditure and primary revenue are 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	Change up to 50
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
Property income received	0.6	0.6	0.6	0.6	0.5	0.5	-0.1

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

Table 13: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	2.2	3.0	3.4	0.1	1.1	3.3
of which:						
Initial budgetary position (IBP)	0.3	0.4	-	-1.7	-1.6	-
Debt requirement in 2050 (DR)	0.0	-	-	-0.1	-	-
Long-term change in the primary balance (LTC)	1.9	2.6	-	1.9	2.6	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 13 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

[49] See the accompanying "methodological paper" for a description of the property income projections.

In the “2007 scenario”, the sustainability gap (S2), which satisfies the inter-temporal budget constraint, would be 3.0% of GDP.[50] Compared to the assessment of last year update of the stability programme, the sustainability indicator is smaller by around ¼ percentage point of GDP, reflecting the improvement in the structural primary balance in 2007 (by around ½ of GDP), which is partly offset by the inclusion of property income in the calculations of the sustainability indicator (-0.2 percentage point of GDP) and to a smaller extent the higher initial level of debt.

The initial budgetary position is not sufficiently high to stabilize the debt ratio over the long term and entails a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. According to both sustainability gaps, the long-term budgetary impact of ageing is limited. This is in particular thanks to the pension reforms adopted in the past.

The programme plans a structural primary budgetary consolidation of around 1.9% of GDP between 2007 and 2012. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by lowering the S2 sustainability gap to 1.1% of GDP (“programme scenario”).

The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the stability programme targets would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is almost 3.4 percentage points of GDP, higher than the structural primary balance of about 2½% of GDP in the last year of the programme’s period.

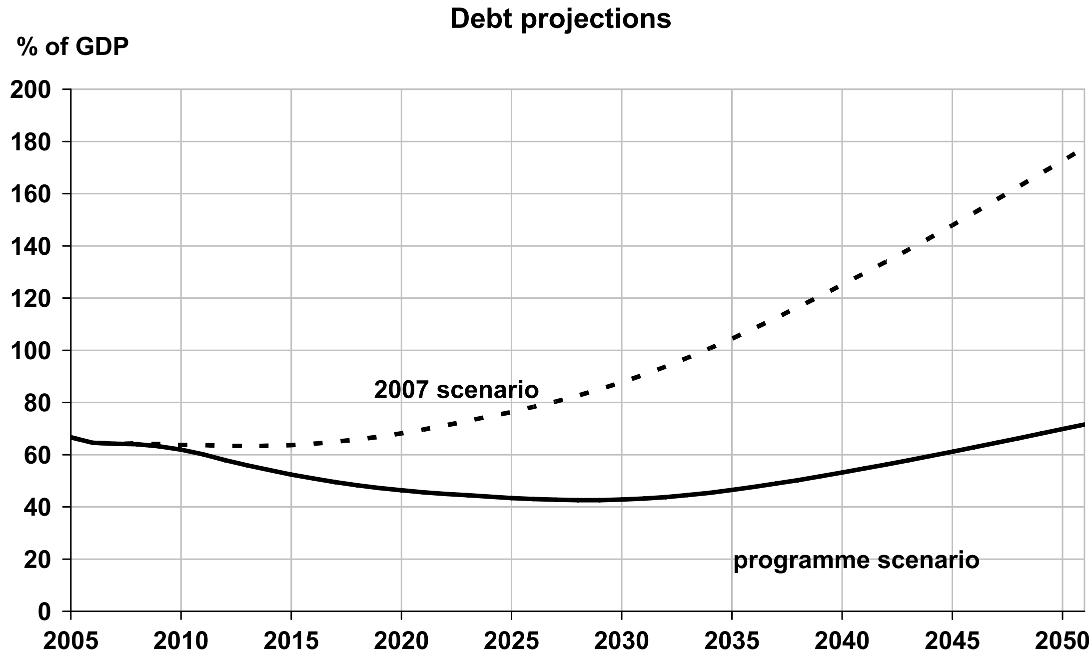
The sustainability gap indicators would increase by up to 0.4 percentage points of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

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 the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 4. The gross debt ratio is currently above the 60% of GDP reference value, estimated in the programme at close to 64.2% in 2007. According to the “2007 scenario”, the debt ratio is projected to remain above the reference value and increase substantially throughout the projection period to reach almost 180% in 2050. In the “programme scenario”, thanks to the stronger budgetary position in 2010, the debt ratio would fall below 60% in the mid-2010s and remain so over most of the projection period.[51]

[50] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be around 2.2% of GDP.

[51] 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.

Figure 13: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, France's current level of debt is higher than 60% of GDP. A reduction in the debt ratio to below the 60% of GDP reference value 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. According to the update of the stability programme, the 2008 pension conference[52] should be primarily devoted to increasing employment rates of older workers.

Finally, a reform of the so-called 'special' pension schemes (e.g. railway, underground operators) is currently under negotiation, in view of aligning those schemes with

[52] The 2003 pension reform envisages that a conference should take place every four years to examine the implementation of the reform and, if needed, to propose the necessary adjustments.

standard civil servants pension schemes. No estimate of the impact of this pension reform on public finances is available in the programme.[53]

5.2.3. Assessment

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

The long-term budgetary impact of ageing 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 adopted.

The budgetary position in 2007, as estimated in the programme, 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 reducing risks 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 the reforms being pursued to improve fiscal governance and support expenditure restraint (see also Section 2.

In terms of measures adopted in 2007, the latest update notably stresses the reforms adopted following the first Public Finance Conference in December 2006 and the report of the COFIPU (the "*Conseil d'Orientation des Finances Publiques*"[54]). In particular, this consists in a change of the budgetary process at the government level (the former *lettres de plafond*, which used to mention expenditure ceilings and were addressed by the Prime Minister to each Minister, have been abandoned and replaced by a governmental meeting) and the creation since the latest presidential election of a ministry that merges responsibility for budgetary issues, public accounts and public employment (*Ministère du budget, des comptes publics et de la fonction publique*) next to the Ministry of Finance, Economy and Employment.

However, the update underlines that these measures are only a prelude to key reforms, which would result from the global review of public policies (*Revue Générale des Politiques Publiques*) that is currently under way (see Section 2.4.1). It is indeed expected to back the consolidation of public finances, notably in providing room for manoeuvre to cut public employment, and improve the quality and efficiency of public finance. On the revenue side, the programme mentions the general taxes review (*Revue Générale des Prélèvements Obligatoires*), which is expected to take place in mid 2008 and could back the objective of a sharp decrease in the tax burden (over two mandates) announced during the presidential programme.

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[53] The 'special' pension schemes, which were non reformed in 2003, amount to 6.4% of pension expenditure in 2003 (source: *Conseil d'orientation des retraites*, fourth report, 2007)

[54] Which was established with a role 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.

As already presented in the previous update and discussed in the corresponding Commission services' assessment, for 2008 the programme makes a pledge to use windfall revenues for the reduction of the budgetary deficit. In fact, in order to make sure that windfall revenues are used properly, the LOLF requires the adoption in the Finance Act of a rule for the allocation of such revenues during the execution of the budget (see Section 4.1). The will to develop good practices to enable further debt reduction has also led to a rationalization of the management of real estate assets, and the disposal of some of them, under the supervision of a dedicated agency (*France Domaines*). Nevertheless, it cannot be assessed for the moment whether such practice will provide long-term benefits or lead to heavy leasing costs to accommodate public administrations.

These measures are expected to back the achievement of the expenditure ceilings set at different administrative levels (see respectively Section 2.4.2). However, the statement made in the assessment on the previous stability programme update that strengthening the monitoring and enforcement mechanisms for expenditure rules would be required to make the budgetary rules enforceable remains relevant. 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 the automatic compensation across years of possible slippages in a given year. Enforceability could be improved by establishing a national independent authority in charge of monitoring compliance with the expenditure targets and, if necessary, of ensuring enforcement of the rule, as was done for health-care expenditure.

In addition to measures adopted to improve the governance of public finance and reduce public expenditures, the new French government has stated its commitment to boost economic growth and job creation through structural reforms, which are also expected to have a positive impact on public finances (which is not assessed in the programme). Some measures have already been adopted, but more important ones are expected to be adopted in 2008 (see Box 7).

Box 7: Measures adopted and envisaged

The following measures were adopted in the previous months:

- The minimum service bill was adopted in summer 2007, but the implementation process is still ongoing. It is expected to regulate the right to undertake industrial action in the public services, in particular transport. Therefore, it is likely to reduce major disruptions of growth resulting from strikes.

- The reform of the university system was also adopted in summer 2007. It will allow greater independence of universities in the selection of professors, increase financial links with private companies or foundations and could somewhat improve the efficiency of French higher education system.

- The reform of the *Crédit Impôt Recherche,* adopted in the context of the Finance Act (see Box 5), implies additional incentives to corporate R&D spending, notably through a higher percentage of spending that can be deducted from the corporate tax. This appears in line with the objective of the Lisbon strategy to reach a R&D expenditure-to-GDP ratio of 3%.

- Higher social contributions tax rates on early retirement schemes included in the social security finance act for 2008 (see Box 5) could have a positive effect on senior employment rate, which is notably low in France (37.3% compared to 41.7% in Euro area).

- Among other measures (detailed in Box 4), the TEPA package, adopted in summer, includes an elimination of taxation on overtime. The impact of this measure on potential output is highly arguable, but it could somewhat lead to an increase in labour supply.

Reforms under discussion, also mentioned in the programme, cover a wide range of areas including:

- Pension system: negotiation launched in autumn 2007, with a view to increasing the convergence from the "special regimes" (railway workers, marines, miners…) towards the general regime (notably through an increase from 37.5 to 40 in the number of contribution years needed to be entitled to full pension) are still under way. In addition to the further implementation of the 2003 reform (which, as confirmed in the programme, will lead to an increase in the number of contribution years from 40 in 2008 to 41 in 2012, and in proportion of life expectancy evolution thereafter, which is already included in the update projections), a review is planned in 2008 with a view to improve the long-term sustainability of the pension system and therefore adapt its parameters.

- Labour market: the reform is expected to be achieved on the basis of negotiations between social partners. A first agreement among the social partners was adopted on 11 January. It notably includes a review of the labour contracts, which is currently being considered by the Government with a view to making a legislative proposal. Other elements of the envisaged reform would include the activation of people on benefits and the revision of the unemployment security system with the aim of making work pay. These measures would also imply the merger of the ANPE (the unemployment agency) and Unedic (the unemployment benefit fund).

- A law on the modernisation of the French economy (*Loi de Modernisation de l'Economie*) with a focus on competition in goods and services should be adopted after the conclusions of the Attali Commission ("*Commission pour la libération de la croissance française*"). The latter has been handed to the President and the Government on 23 January. The report contains more than 300 proposals to liberalise the French economy and it assumes that their implementation would raise France's growth to 3% within five years. The report stresses in particular the need to liberalise sheltered sectors of the economy, cut the cost and improve the flexibility of the labour market, streamline public administration, reform the regulatory framework in the retail sector with a view to lowering consumer prices (a field in which the law to develop competition in favour of consumers - "*Loi pour le développement de la concurrence au service des consommateurs*" - adopted on 3 January 2008 already achieved some progress), strengthen competition authorities, and promote competition in secondary schools and universities. The Attali Commission argues that its recommendations are broadly costs neutral. The President has supported the main conclusions of the Commission and a ministerial committee, convened early February, assigned a "*plan d'action*" to each Ministry, in order to decide which of the measures would be put in place and at which pace. Some of the proposed measures are controversial (like the recommendation for France to open its doors to 250 000 immigrants each year as a way of improving the growth rate).

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The measures in the programme update described in the preceding sections are broadly in line with the 2005 National Reform Programme (NRP) and its October 2007 implementation report. The key challenge in both programmes is to implement structural reforms in order to improve potential growth and enhance budgetary consolidation. Among the wide range of structural reforms covered in the NRP, the programme notably stresses the labour market reform, the reorganisation of the public administration, and the improvement of the competitive framework of companies.

The stability programme does not contain a qualitative assessment of the overall impact of the National Reform Programme within the medium term fiscal strategy, but it contains information on the impact of some of these reforms on potential growth and on employment. The main reforms which are in line with the NRP are expected to increase potential growth by 0.4 percentage points at the end of 2012[55]. Full employment would also be reached by the end of the programme period, by which date the balanced budget would be achieved.

The stability programme update does not provide systematic information on the direct budgetary costs (or savings) associated with the main reforms envisaged in the National Reform Programme; however the public finance consolidation relies on the implementation of the envisaged reforms, both directly, through the tightening of expenditure rules, and indirectly, through higher potential output.

The two programmes consequently seem to be consistent to some extent.

Box 8: The Commission assessment of the October 2007 national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of France's National Reform Programme and is summarised as follows:

France's National Reform Programme identified as key challenges: creating the conditions for strong economic growth, reducing unemployment and raising employment levels, and building a knowledge-based economy.

The Commission's assessment was that France has made steady progress in implementing its national reform programme over the 2005-2007 period.

Against the background of strengths and weaknesses identified, the Commission recommended that France is recommended to take action in the areas of: sustainability of public finances, increased competition in the gas, electricity and rail freight sectors, lifelong learning and labour market reforms.

Against the background of progress made, the Commission recommended that France should be encouraged to focus on the following challenges: further strengthening competition in regulated trades and professions, further enhancing better regulation policies by including impact assessments; and continuing to increase labour supply and making work pay.

The tables below provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations / points to watch and the recommendations for the euro area, adopted by the Council in March 2007. The budgetary strategy in the stability programme is only partly consistent with the country-specific recommendations / points to watch and the recommendations for the euro area.

[55] According to the programme, available studies show that the reforms launched by the French government and their scope of application match the objective to raise potential growth by 1% in the long term.

Table 14: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated 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 of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		

Notes:
[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

Table 15: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendations				
– Ensure the sustainability of its public finances taking into account the ageing of the population through continued budgetary consolidation and debt reduction. The meeting on pension systems scheduled for 2008 will have to hang on to the gains made following the introduction of the 2003 reform.		X		
2. Points to watch				
– *None*				X
3. Recommendations for euro area Member States				
– Make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark			X	
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability		X		
Source: Commission services				

* * *

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The programme broadly follows to the code of conduct as far as its table of contents is concerned.

(ii) Data requirements

The update broadly adheres to the code of conduct as far as data requirements are concerned. The missing data did not impede the assessment. Not all the compulsory data specified in the standard tables in Annex 2 of the code of conduct, **as amended by the September 2007 EFC**, have been supplied. Most compulsory data have been given except State government balance (table 2. General government budgetary prospects but it does not apply to France as it is not a federal state) and assumptions on short- and long-term interest rates are missing. Part of optional data are missing. Tables on general government expenditure by function and on long-term sustainability are empty (tables 3 and 7). Employment-hours worked, labour productivity-hours worked and compensation per employee (for 2009-2012) are missing (table 1.c labour market development); net lending/borrowing of the private sector and of general government, statistical discrepancy (table 1.d sectoral balances); government consumption (nominal) (table 2 general government budgetary prospects); stock-flow adjustment composition, liquid financial assets and net financial debt (table 4 general government debt developments); general government gross debt difference (table 6, the programme says "it is not relevant as the previous update did not incorporate the requalification of the debt of the SAAD as public debt"). In addition, figures for the year 2006, although available on INSEE website, are not provided (except in table 5 on cyclical developments) because year X has been considered wrongly as 2008 and year X-1 as 2007, instead of 2007 and 2006 respectively.

The tables on the following pages show the data presented in the November 2007 update of stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of Parliament			
… mentions status vis-à-vis national Parliament.		X	
… indicates whether Council opinion on previous programme has been presented to national Parliament.			
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.		X	
… explains significant divergences with Commission services' forecasts[1].		X	
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.			Not applicable since external deficit remains limited at 2% of GDP.
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable

The SCP…	Yes	No	Comments
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.		X	Significant revision of the consolidation path set at the April 2007 council
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.		X	
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.		X	
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.		X	
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.		X	
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.		X	
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).			
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme

[1]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 1

Table 1a. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	Bl*g	*n.a.*	n.a.	2 -2.5	2 - 2.5	2.5	2.5	2.5	2.5
2. Nominal GDP	Bl*g	*n.a.*	n.a.	3.8	4.1	4.1	4.1	4.1	4.1
Components of real GDP									
3. Private consumption expenditure	P.3	*n.a.*	n.a.	2.0	2.5	2.8	2.8	2.8	2.8
4. Government consumption expenditure	P.3	*n.a.*	n.a.	1.6	0.7	0.5	0.5	0.5	0.5
5. Gross fixed capital formation	P.51	*n.a.*	n.a.	2.7	3.3	3.2	3.2	3.2	3.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*n.a.*	n.a.	0.8	0.7	0.8	0.8	0.9	0.9
7. Exports of goods and services	P.6	*n.a.*	n.a.	3.6	5.7	6.6	6.6	6.6	6.6
8. Imports of goods and services	P.7	*n.a.*	n.a.	4.4	5.5	6.2	6.2	6.2	6.2
Contributions to real GDP growth									
9. Final domestic demand		-	n.a.	2.2	2.3	2.4	2.4	2.4	2.4
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	n.a.	0.1	0.0	0.1	0.1	0.1	0.1
11. External balance of goods and services	B.11	-	n.a.	-0.3	0.0	0.0	0.0	0.0	0.0

Table 1b. Price developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*n.a.*	n.a.	1.8	1.8	1.6	1.6	1.6	1.6
2. Private consumption deflator		*n.a.*	n.a.	1.7	1.7	1.6	1.6	1.6	1.6
3. HICP[1]		*n.a.*	n.a.	1.4	1.7	1.6	1.6	1.6	1.6
4. Public consumption deflator		*n.a.*	n.a.	1.7	1.5	1.6	1.6	1.6	1.6
5. Investment deflator		*n.a.*	n.a.	2.5	2.2	1.6	1.6	1.6	1.6
6. Export price deflator (goods and services)		*n.a.*	n.a.	0.0	0.7	1.1	1.1	1.1	1.1
7. Import price deflator (goods and services)		*n.a.*	n.a.	-0.1	0.7	1.1	1.1	1.1	1.1

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*n.a.*	n.a.	1.1	1.1	0.8	0.8	0.8	0.8
2. Employment, hours worked[2]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)[3]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Labour productivity, persons[4]		*n.a.*	n.a.	1.0	1.3	1.7	1.7	1.7	1.7
5. Labour productivity, hours worked[5]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees	D.1	*n.a.*	n.a.	4.1	4.1	4.1	4.1	4.1	4.1
7. Compensation per employee		*n.a.*	n.a.	3.0	3.0	optional	optional	optional	optional

[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	2006	2007	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	n.a.	-2.3	-2.5	-2.3	-2.2	-2.1	-2.0
of which :								
- Balance on goods and services		n.a.	-1.6	-1.6	-1.5	-1.4	-1.4	-1.3
- Balance of primary incomes and transfers		n.a.	-0.6	-0.9	-0.8	-0.8	-0.7	-0.7
- Capital account		n.a.	0.0	0.0	0.0	0.0	0.0	0.0
2. Net lending/borrowing of the private sector	B.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Net lending/borrowing of general government	EDP B.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Statistical discrepancy		n.a.	optional	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	2011 % of GDP	2012 % of GDP
Net lending (EDP B.9) by sub-sector									
1. General government	S.13	*n.a.*	n.a.	-2.4	-2.3	-1.7	-1.2	-0.6	0.0
2. Central government	S.1311	*n.a.*	n.a.	-2.0	-2.0	-1.7	-1.4	-0.9	-0.5
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*n.a.*	n.a.	-0.2	-0.2	-0.2	-0.1	-0.1	0.0
5. Social security funds	S.1314	*n.a.*	n.a.	-0.2	0.0	0.1	0.3	0.4	0.5
General government (S13)									
6. Total revenue	TR	*n.a.*	n.a.	50.7	50.4	50.1	50.0	50.0	50.0
7. Total expenditure	TE[1]	*n.a.*	n.a.	53.2	52.6	51.9	51.2	50.6	49.9
8. Net lending/borrowing	EDP B.9	*n.a.*	n.a.	-2.4	-2.3	-1.7	-1.2	-0.6	0.0
9. Interest expenditure	EDP D.41	*n.a.*	n.a.	2.6	2.7	2.6	2.6	2.6	2.5
10. Primary balance[2]		*n.a.*	n.a.	0.2	0.5	0.9	1.4	2.0	2.5
11. One-off and other temporary measures[3]		*n.a.*	n.a.	0.0	0.0	0.0	0.0	0.0	0.0
Selected components of revenue									
12. Total taxes (12=12a+12b+12c)		*n.a.*	n.a.	27.4	27.3	27.1	27.0	27.0	27.0
12a. Taxes on production and imports	D.2	*n.a.*	n.a.	15.3	15.1	15.1	optional	optional	optional
12b. Current taxes on income, wealth, etc	D.5	*n.a.*	n.a.	11.7	11.7	11.6	optional	optional	optional
12c. Capital taxes	D.91	*n.a.*	n.a.	0.5	0.4	0.4	optional	optional	optional
13. Social contributions	D.61	*n.a.*	n.a.	18.3	18.2	18.1	optional	optional	optional
14. Property income	D.4	*n.a.*	n.a.	0.8	0.8	0.8	optional	optional	optional
15. Other[4]		*n.a.*	n.a.	4.2	4.0	4.1	optional	optional	optional
16=6. Total revenue	TR	*n.a.*	n.a.	50.7	50.4	50.1	50.0	50.0	50.0
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			n.a.	44.0	43.7	43.5	43.4	43.4	43.4
Selected components of expenditure									
17. Compensation of employees + intermediate consumption	D.1+P.2	*n.a.*	**n.a.**	**18.2**	**17.8**	**17.5**	**17.2**	**16.9**	**16.6**
17a. Compensation of employees	D.1	*n.a.*	n.a.	12.9	12.6	12.3	12.1	11.8	11.6
17b. Intermediate consumption	P.2	*n.a.*	n.a.	5.2	5.2	5.2	5.1	5.1	5.0
18. Social payments (18=18a+18b)		*n.a.*	n.a.	23.6	23.3	23.2	23.0	22.9	22.7
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*n.a.*	n.a.	5.8	5.7	5.7	5.6	5.6	5.5
18b. Social transfers other than in kind	D.62	*n.a.*	n.a.	17.8	17.6	17.5	17.4	17.3	17.2
19=9. Interest expenditure	EDP D.41	*n.a.*	n.a.	2.6	2.7	2.6	2.6	2.6	2.5
20. Subsidies	D.3	*n.a.*	n.a.	1.4	1.3	1.3	1.3	1.3	1.2
21. Gross fixed capital formation	P.51	*n.a.*	n.a.	3.3	3.2	3.2	3.1	3.1	3.1
22. Other[6]		*n.a.*	n.a.	4.1	4.1	4.0	4.0	3.9	3.9
23=7. Total expenditure	TE[1]	*n.a.*	n.a.	53.2	52.6	51.9	51.2	50.6	49.9
p.m.: Government consumption (nominal)	P.3	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[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, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

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

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	n.a.	n.a.

[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	ESA Code	2006	2007	2008	2009	2010	2011	2012
1. Gross debt[1]		n.a.	64.2	64.0	63.2	61.9	60.2	57.9
2. Change in gross debt ratio		n.a.	0.0	-0.2	-0.8	-1.3	-1.7	-2.3
Contributions to changes in gross debt								
3. Primary balance[2]		n.a.	0.2	0.5	0.9	1.4	2.0	2.5
4. Interest expenditure[3]	EDP D.41	n.a.	2.6	2.7	2.6	2.6	2.6	2.5
5. Stock-flow adjustment		n.a.	-0.2	0.0	0.0	0.0	0.2	0.1
of which:								
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
of which:		-	-	-	-	-	-	-
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other[6]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		n.a.	4.1	4.3	4.1	4.1	4.1	4.1
Other relevant variables								
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[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 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	2011	2012
1. Real GDP growth (%)		n.a.	2 - 2.5	2 - 2.5	2.5	2.5	2.5	2.5
2. Net lending of general government	EDP B.9	n.a.	-2.4	-2.3	-1.7	-1.2	-0.6	0.0
3. Interest expenditure	EDP D.41	n.a.	2.6	2.7	2.6	2.6	2.6	2.5
4. One-off and other temporary measures[1]		n.a.	0.0	0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		n.a.	2.1	2.2	2.2	2.3	2.4	2.5
contributions:								
- labour		n.a.	0.3	0.3	0.4	0.5	0.6	0.7
- capital		n.a.	0.8	0.9	0.8	0.8	0.8	0.8
- total factor productivity		n.a.	1.0	1.0	1.0	1.0	1.0	1.0
6. Output gap		n.a.	-0.6	-0.5	-0.2	-0.1	0.0	0.0
7. Cyclical budgetary component		n.a.	-0.3	-0.2	-0.1	-0.1	0.0	0.0
8. Cyclically-adjusted balance (2 - 7)		n.a.	-2.2	-2.1	-1.6	-1.1	-0.6	0.0
9. Cyclically-adjusted primary balance (8 + 3)		n.a.	0.4	0.7	1.0	1.5	2.0	2.5
10. Structural balance (8 - 4)		n.a.	-2.2	-2.1	-1.6	-1.1	-0.6	0.0

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010	2011	2012
Real GDP growth (%)								
Previous update		n.a.	2 - 2.5	2.25	2.25	2.3	n.a.	n.a.
Current update		n.a.	2 - 2.5	2 - 2.5	2.5	2.5	2.5	2.5
Difference		n.a.	n.a.	n.a.	0.25	0.3	n.a.	n.a.
General government net lending (% of GDP)	EDP B.9							
Previous update		n.a.	-2.5	-1.8	-0.9	0.0	n.a.	n.a.
Current update		n.a.	-2.4	-2.3	-1.7	-1.2	-0.6	0.0
Difference		n.a.	0.1	-0.5	-0.8	-1.2	n.a.	n.a.
General government gross debt (% of GDP)								
Previous update		n.a.	63.6	62.6	60.7	58.0	n.a.	n.a.
Current update		n.a.	64.2	64.0	63.2	61.9	60.2	57.9
Difference*		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

*Non relevant: the previous update did not incorporate the requalification of the debt of the SAAD as public debt.

Table 7. Long-term sustainability of public finances

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

Table 8. Basic assumptions

	2006	2007	2008	2009	2010	2011	2012
Short-term interest rate[1] (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€ exchange rate (annual average) (euro area and ERM II countries)	n.a.	1.35	1.37	1.37	1.37	1.37	1.37
Nominal effective exchange rate	n.a.	110.4	110.7	110.7	110.7	110.7	110.7
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	n.a.	5.3	5	4.2	4.2	4.2	4.2
EU GDP growth	n.a.	2.6	2.3	2.1	2.1	2.1	2.1
Growth of relevant foreign markets	n.a.	4.7	6.4	6.3	6.3	6.3	6.3
World import volumes, excluding EU	n.a.	5.6	7.9	7.1	7.1	7.1	7.1
Oil prices (Brent, USD/barrel)	n.a.	68	73	74.1	75.3	76.5	77.7

[1]If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of France. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area..

Table: Key economic indicators

	France						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.2	2.8	1.6	1.7	2.0	1.9	2.1	2.7	1.4	1.5	2.8	2.6
Contributions to real GDP growth:												
Domestic demand	*2.4*	*2.7*	*2.0*	*2.3*	*2.4*	*2.1*	*2.0*	*2.7*	*1.3*	*1.7*	*2.6*	*2.4*
Net exports	*-0.1*	*0.1*	*-0.4*	*-0.6*	*-0.4*	*-0.2*	*0.1*	*0.0*	*0.1*	*-0.1*	*0.2*	*0.2*
Real GDP per capita (PPS; EU27 = 100)	118	119	116	115	114	112	113	114	112	110	110	109
Real GDP per capita (% change)	1.7	2.4	1.0	1.1	1.4	1.3	1.6	2.5	0.8	0.9	2.3	2.2
Prices, costs and labour market												
HICP inflation (%)	1.7	1.3	2.0	1.9	1.9	1.5	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	1.2	1.5	0.9	1.4	1.2	0.9	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	-0.1	-0.3	0.0	0.0	-0.4	0.2	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	1.0	1.4	0.6	0.4	0.8	1.0	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	10.0	10.8	9.2	9.7	9.5	8.6	9.1	9.8	8.5	8.9	8.3	7.3
Competitiveness and external position												
Real effective exchange rate (% change)	-0.5	-2.8	1.8	-0.1	1.0	1.7	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change)[1]	-1.0	-0.1	-1.9	-2.8	-2.2	-2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.9	2.0	-0.1	-1.7	-2.1	-2.3	0.8	0.9	0.7	0.3	0.0	0.1
Public finances												
General government balance (% of GDP)	-2.8	-2.6	-3.1	-2.9	-2.5	-2.6	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	59.9	58.0	61.8	66.7	64.2	64.3	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP)[2]	n.a.	n.a.	-3.7	-3.5	-2.8	-2.5	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
Financial indicators												
Short-term real interest rate (%)[3]	1.8	2.6	0.9	0.4	0.8	2.3	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%)[3]	3.3	4.3	2.3	1.6	1.5	2.4	n.a.	n.a.	1.9	1.5	1.9	2.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source :
Commission services