COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

**COUNCIL RECOMMENDATION**

**with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit**

and

Proposal for a

**COUNCIL DECISON**

**on making public the recommendation with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit**

(presented by the Commission)

## EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], includes an early warning system under which the Council will alert a member State at an early stage to the need to take the necessary budgetary corrective action in order to prevent a government deficit becoming excessive. Article 6(2) of the regulation sets out for Member States participating in the single currency how the early warning system is applied. Regular monitoring of the implementation of stability programmes by the Council is carried out in particular with a view to identifying actual or expected significant divergence of the budgetary position from the medium term objective for the government balance, or the adjustment path towards it, as set in the programme. In the event that the Council identifies a significant divergence, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, it addresses a recommendation to the Member State concerned to take the necessary adjustment measures. This early warning is made in accordance with the procedure of Article 99(4) of the Treaty and is based on a recommendation from the Commission.

The Commission considers that there is a significant divergence when latest estimates and forecast for the government balance in the most recent and current or future years are appreciably worse than the targeted adjustment path set by a Member State in its preceding stability programme, in a situation in which a Member State budgetary position is not yet consistent with the medium term budgetary objective of close to balance or in surplus required by the Stability and Growth Pact. In these circumstances, a further deterioration in the general government deficit must be prevented in order to avoid the risk of an excessive deficit and there is a need to get back on track towards a sound medium-term budgetary position. The sources of deviation from plans must also be examined and will have relevance for assessing the appropriate policy response.

The 2001 update of the stability programme of France, submitted to the Commission on 11 December 2001, covered the period from 2002 to 2005. It projected a general government deficit at 1.4% and 1.3% of GDP in 2002 and 2003 respectively, under the assumption of an increase in real GDP by 2.5% in both years. In February, the French authorities revised downwards their real GDP growth forecast for 2002 to 1.5% and, consequently, adjusted their objective for the 2002 general government deficit upwards from 1.4% of GDP to 1.8% of GDP. This revision only reflected the impact of cyclical factors. In May 2002, after the presidential elections, the new government launched an audit on public finances, which estimated the general government deficit in 2002 within a range 2.3-2.6% of GDP. The audit was based on two main assumptions: (1) 1.3% real GDP growth in 2002 and (2) a no-policy-change assumption. Compared to the projections of the 2001 updated stability programme for 2002, the audit identified two main sources of slippage. First, a cyclical effect on tax revenues and unemployment expenditures, due to the deceleration in economic activity, estimated at 0.3-0.4% of GDP. Second, an overrun in expenditures, particularly in the State and the health sectors, evaluated by the auditors at 0.6-0.7% of GDP.

In July, the French authorities presented a corrective budget bill for 2002 aimed at adjusting the government budgetary forecasts in line with the results of the audit on

[1] OJ L 209, 2.8.1997

public finances and at implementing a cut in the income tax by 5%. In this corrective budget bill, the French authorities decided to target a general government deficit of 2.6% of GDP in 2002, which is the highest value of the range of the auditors projections, thus not correcting the observed slippage in the budgetary situation. In its Autumn 2002 forecasts, the Commission projects the 2002 general government deficit at 2.7% of GDP, i.e. 1.3 percentage point higher than the 1.4% of GDP planned in the budget bill for 2002 and in the 2001 update of the stability programme.

According to Commission services calculations, about one half of the total slippage can be attributed to cyclical factors. The remaining half represents a deterioration in the cyclically-adjusted balance. As also identified by the audit on public finances, this worsening is mainly due to an overrun in State expenditures and to a further slippage in health spending. According to Commission calculations, the cyclically-adjusted government deficit, roughly stable at around 2% of GDP between 1999 and 2001[2], has increased in 2002 by 0.7 percentage point of GDP to slightly above 2½%. This level is clearly too high to ensure that the general government deficit does not breach the 3% of GDP reference value under normal cyclical fluctuations. In light of the above, the public finance developments in 2002 constitute a significant divergence with respect to the plans of the 2001 update of the stability programme.

In September, the French authorities presented the draft budget for 2003, which projects a mere stabilisation in the general government deficit at 2.6% of GDP, despite an expected acceleration in real GDP growth to 2.5%. The absence of improvement in the general government deficit as against 2002 is due to the fact that the margins created by control in real expenditures growth are just sufficient to accommodate the implementation of tax cuts worth 0.2 percentage point of GDP and a reduction in non-fiscal revenues by 0.1 percentage point of GDP. It is recalled that the Broad Economic Policy Guidelines for 2002 recommended that France should "aim at a sufficient decline of the 2003 deficit to ensure that a close to balance position in 2004 can be achieved".

The 2003 draft budget does not provide a correction to the significant divergence occurring in 2002. Indeed, absence of improvement in the government deficit was projected initially in the 2001 update of the stability programme and this was noted by the Council in its Opinion on the 2001 update[3]. However, currently, the absence of budgetary adjustment in 2003 assumes a more worrying significance, as in 2002 the actual and cyclically-adjusted budgetary positions have clearly deteriorated to values dangerously close to 3% of GDP. Moreover, the real GDP growth assumption on which the 2003 draft budget was built appears on the very high side of possibilities, as it would imply an acceleration in activity as from the end of 2002 which so far is not heralded by available indicators. As a consequence, the risk for the actual general government deficit to breach the 3% of GDP threshold in 2003 is large. The Commission Autumn forecasts project an increase in the general government deficit from 2.7% in 2002 to 2.9% of GDP in 2003, in a context where

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2 Nevertheless, the deterioration of the cyclically-adjusted deficit between 1999 and 2000 reflects the effects of pro-cyclical fiscal measures.

3 OJ C 51, 26.2.2002, p.4.

real GDP growth accelerates from 1.0% in 2002 to 2.0% in 2003; the cyclically-adjusted deficit would remain roughly unchanged[4].

The Commission considers that (1) a significant divergence appeared in the estimated budgetary results in 2002 when compared to the plans included in the 2001 update of the stability programme; (2) that neither the corrective bill implemented in July 2002 nor the draft budget bill for 2003 do provide any correction to this divergence; (3) that the cyclically-adjusted budgetary position in 2003 will be at a level which could lead to the occurrence of an excessive deficit, should the expected rebound in the economy be insufficiently strong or should a further slippage in expenditures occur; and (4) that this divergence influences medium term commitments: the attainment of a close to balance position is postponed and now foreseen for 2006/2007, instead of 2004/2005 as in the 2001 update of the stability programme.

This calls for the activation of the early warning system in the case of France.

In view of the above, the French authorities should ensure that the general government deficit will not exceed 2.6% of GDP in 2002.

The French authorities should, in 2003, ensure that the general government deficit does not breach the 3% of GDP threshold. To this end, adopting measures apt to improve the cyclically-adjusted budgetary position by at least 0.5 percentage point of GDP would not only reduce the risk for the general government deficit to breach the 3% of GDP threshold in 2003, but also contribute to resuming a budgetary consolidation path towards a close to balance position as from 2003.

Continuous adjustment in the cyclically-adjusted budgetary position by at least 0.5% of GDP per year should be pursued in subsequent years, in order to achieve the medium-term budgetary position of close to balance or in surplus in 2006 at the latest. To this end, the French authorities should respect the currently foreseen expenditure limits. In this context, it will prove instrumental to further rein in expenditures in the health sector and to control the wage bill in the public sector, two areas in which expenditures were particularly dynamic in the last few years, as well as to compensate for the increase in expenditures stemming from the financing of the priorities of the new government by cuts in other sectors and for the planned tax cuts. Finally, additional budgetary revenues which might proceed from stronger than expected GDP growth should be allocated to government deficit reduction.

Based on this assessment, the Commission has adopted the attached recommendation for a Council recommendation giving an early warning to France, and is passing it to the Council for decision. The Commission considers that, in the interests of openness and transparency, the Council early warning should be made public and has also adopted a proposal for a Council decision to this effect, in accordance with the provision of Article 99(4) of the Treaty.

[4] Neither the IMF in its Staff Report on the 2002 article IV consultation on France nor the OECD in its forecasts of October 2002 (STEP) project an improvement in the structural deficit in 2003, despite using methods for calculating structural deficits different from that of the Commission.

Recommendation for a

## COUNCIL RECOMMENDATION

**with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit**



THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 99(4) thereof,

Having regard to the Council regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[5], and in particular Article 6(2) thereof,

Having regard to the recommendation of the Commission,

Whereas:

(1) Article 6(2) of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies as part of the Stability and Growth pact establishes an early warning system for alerting a Member State at an early stage to the need to make the necessary budgetary adjustment to prevent a government deficit becoming excessive. An early warning shall be given when the Council identifies actual or expected significant divergence of the budgetary position in a Member State from the medium-term budgetary objective, or the adjustment path towards it, set in the Member State's stability programme for the government balance.

(2) In the Resolution on the Stability and Growth Pact adopted in Amsterdam on 17 June 1997[6] the European Council invited all parties to implement the Treaty and the Stability and Growth Pact in a strict and timely manner.

(3) In the 2001 updated stability programme of France, on which the Council delivered an opinion on 12 February 2002[7], the French authorities aimed at a 1.4% of GDP general government deficit in 2002 and 1.3% of GDP in 2003. The projections for the 2002 general government deficit were rectified to 1.8% of GDP in February by the French authorities, when they revised the projections for the 2002 real GDP growth from 2.5% to 1.5%.

(4) The general government deficit in France in 2002 is now projected at 2.6% of GDP by the French authorities and at 2.7% of GDP by the Commission, thus 1.3 percentage point above the initial target set in the 2001 updated stability programme. According to Commission services calculations, about one half, i.e. 0.6 percentage point of GDP, of the total slippage in the general government deficit in 2002 can be attributed to

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[5] OJ L 209, 2.8.1997, p.1.
[6] OJ C 236, 2.8.1997, p.1.
[7] OJ C 51, 26.2.2002, p.4.

cyclical factors. The remaining half represents a deterioration in the cyclically-adjusted balance.

(5) As a consequence of this slippage, the French budgetary position in 2002 is far from close to balance, in actual and cyclically-adjusted terms. Indeed, the cyclically-adjusted deficit is estimated by the Commission services to have increased from about 2% of GDP in 2001 to slightly above 2½% of GDP in 2002. This level is clearly too high to ensure that the general government deficit does not breach the 3% of GDP reference value under normal cyclical fluctuations.

(6) In light of the above, the public finance developments in 2002 constitute a significant divergence with respect to the plans of the 2001 update of the stability programme.

(7) The draft budget for 2003 presented in September projects a mere stabilisation in the general government deficit at 2.6% of GDP, despite an expected acceleration in real GDP growth to 2.5%. The Broad Economic Policy Guidelines for 2002 recommended that France should "aim at a sufficient decline of the 2003 deficit to ensure that a close to balance position in 2004 can be achieved". According to Commission calculations, the cyclically-adjusted budgetary deficit will remain in 2003 at the same level as in 2002, slightly above 2½% of GDP.

(8) Taking also into account significant downward risks surrounding the macroeconomic perspectives, the budgetary position foreseen in the 2003 draft budget is at a level which could lead to the occurrence of an excessive deficit, should the recovery be less pronounced than assumed in the budget or in case further slippage in government expenditures would occur. The Commission Autumn forecasts project an increase in the general government deficit from 2.7% in 2002 to 2.9% of GDP in 2003, in a context where real GDP growth accelerates from 1.0% in 2002 to 2.0% in 2003.

(9) In view of these elements, the Commission is of the opinion that the significant divergence occurring in 2002 is not being addressed by the budgetary plans for 2003, so that the risk for the general government deficit to breach the 3% of GDP threshold is not removed. Moreover, this divergence influences medium term commitments, as the attainment of a close to balance position is now postponed to 2006/07, instead of 2004/05 as projected in the 2001 updated stability programme. In the view of the Commission, the close to balance budgetary position should be reached by 2006 at the latest as a result of continuous adjustment of the underlying budgetary position by at least 0.5% of GDP per year.

(10) On the basis of information provided by the French authorities and of the assessments made by the Commission, the Council identifies a significant divergence in terms of Article 6(2) of Council Regulation (EC) No 1466/97.

(11) There is a need for an early warning to be given alerting France in order to prevent the occurrence of an excessive deficit.

HEREBY RECOMMENDS:

1. The French authorities should, in 2002, ensure that the general government deficit will not exceed the currently planned value of 2.6% of GDP

2. The French authorities should, in 2003, ensure that the general government deficit does not breach the 3% of GDP threshold. To this end, adopting measures apt to improve the cyclically-adjusted budgetary position by at last 0.5 percentage point of GDP would not only reduce the risk for the general government deficit to breach the 3% of GDP threshold in 2003, but also contribute to resuming a budgetary consolidation path towards a close to balance position as from 2003.

3. Continuous adjustment in the cyclically-adjusted budgetary position by at least 0.5% of GDP per year should be pursued in subsequent years in order to achieve the medium-term budgetary position of close to balance or in surplus in 2006 at the latest. To this end, the French authorities should respect the currently foreseen expenditure limits. Additional budgetary revenues which might proceed from stronger than expected GDP growth should be allocated to government deficit reduction.



This recommendation is addressed to the Republic of France.

Done at Brussels, […]

*For the Council*
*The President*

Proposal for a

## COUNCIL DECISION

**on making public the recommendation with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit**



THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 99(4) thereof,

Having regard to the proposal from the Commission,

Whereas:

(1) On [….], the Council adopted its recommendation with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit, addressed to the French government.

(2) The Council considers that making public the recommendation will facilitate the surveillance an co-ordination of economic policies of Member States and the Community and will contribute to a better understanding among economic agents, facilitating the implementation of the recommended measures,

HAS ADOPTED THIS DECISION:

*Sole Article*

The Council recommendation of […] with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit shall be published in the *Official Journal of the European Communities*.

Done at Brussels, […]

*For the Council*
*The President*
*[…]*