COMMISSION OF THE EUROPEAN COMMUNITIES

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EU RESTRICTED

Recommendation for a

COUNCIL DECISION

giving notice to France, in accordance with Article 104(9) of the EC Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. THE EXCESSIVE DEFICIT PROCEDURE FOR FRANCE

The excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by Regulation (EC) N°1467/97 of 7 July 1997 on the speeding up and clarifying the implementation of the excessive deficit procedure, which is part of the Stability and Growth Pact. It is completed by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

According to data on government deficit and debt levels published by Eurostat on 17 March 2003, based on March 2003 reporting by the French authorities, the general government deficit in France amounted to 3.1 per cent of GDP in 2002. Based on this evidence, the Commission initiated the Excessive Deficit Procedure for France on 2 April 2003, with the adoption of the report foreseen in Article 104(3) of the Treaty. The Commission, taking into account the Opinion of the Economic and Financial Committee, adopted on 7 May 2003 an Opinion stating that an excessive deficit exists in France. The Council decided accordingly, in conformity with Article 104(6), on 3 June 2003.

Consequently, on 3 June 2003, the Council adopted a recommendation addressed to France with a view to bringing the situation of an excessive deficit to an end in 2004 at the latest, according to Article 104(7) of the Treaty. The Council established the deadline of 3 October 2003 for the French government to take appropriate measures to this end. On 8 October 2003, in accordance with the provisions of Article 104(8) of the Treaty and of Article 4(1) of Regulation (EC) No 1467/97, the Commission has recommended the Council to decide that no effective action has been taken in response to the recommendations addressed under Article 104(7) within the period laid down in this Recommendation.

According to Article 5 of Regulation (EC) No 1467/97, any Council decision to give notice to the participating Member State concerned to take measures for the deficit reduction in accordance with Article 104(9) shall be taken within one month of the Council decision establishing that no effective action has been taken in accordance with Article 104(8).

2. FISCAL POLICY REQUIREMENTS FOR 2004 AND 2005

When presenting the budgetary plans for 2004, the French authorities projected a decline in the general government deficit from 4.0% of GDP in 2003 to 3.6% of GDP in 2004, under the assumption of an increase in real GDP by 1.7% in 2004 after 0.5% in 2003. Most of the reduction in the deficit between 2003 and 2004 would be achieved through a planned increase in real general government expenditures slower than expected real GDP growth, while, on the other side, discretionary measures on the revenue side would have a net effect reducing the general government deficit by 0.1 percentage point of GDP.

The Commission, in its Autumn 2003 forecasts, projects the 2003 general government deficit slightly higher than the French authorities, at 4.2% of GDP. The difference stems from the fact that 2003 GDP growth is projected at 0.1% in real terms and 1.8% in nominal terms by the Commission, as against 0.5% and 2.5% for the French authorities. For 2004, the Commission projects real GDP growth at 1.7%, the same rate as the French authorities, and a decline in the general government deficit to 3.8% of GDP.

According to Commission calculations, the draft Finance Laws for 2004 will lead to an improvement in the cyclically-adjusted balance in the order of magnitude of 0.6 percentage point of GDP. Such an improvement, albeit consistent with the minimum reduction in the cyclically-adjusted balance of 0.5 percentage point of GDP recommended by the Council to France in June, is insufficient to ensure that the nominal deficit is brought below 3% of GDP in 2004.

While the recommendation of the Council under Article 104(7) set the deadline of 2004 for correcting the excessive deficit, the Council when issuing the "notice" under Article 104(9) can decide to confirm such a deadline or establish a new one. Several elements have to be considered when making this choice.

The reduction in the cyclically-adjusted deficit necessary to bring the general government deficit below the 3% of GDP Treaty reference value in 2004 is larger than it was expected in June when the Council adopted its recommendation according to Article 104(7). This is partly due to the fact that no visible improvement in the cyclically-adjusted balance was achieved in 2003, conversely to what was recommended by the Council in June. However, it is also the result of the marked and abrupt deterioration in the macroeconomic situation in 2003 and of prospects for 2004. According to the Commission Autumn forecasts, the cumulated loss of real GDP growth over the period 2003-2004 compared to what was expected in the Spring amounts to about 1.5 percentage point.

According to Commission calculations, bringing the general government deficit below 3% of GDP next year would require a further effort by 0.8 percentage point of GDP compared to current budgetary plans, if actual growth in 2004 is in line with current Commission projections. *Ceteris paribus*, the total reduction in the cyclically-adjusted balance required to bring the deficit below 3% of GDP in 2004 would then amount to roughly 1.5 percentage point of GDP.

While budgetary consolidation may not be harmful for growth in the medium-term, especially if it is of the right composition, too large an effort may prove economically costly in a single year, in particular given the downward revision in growth prospects.

However, the increase in the general government deficit in France in the recent years is a matter of serious concern. If not corrected, it will lead to a continuous and large increase in the debt to GDP ratio, which may in turn weigh on economic agents expectations and be damaging for growth. Moreover, the impact of ageing population on public finances will start accelerating from 2005-2006, making it even more urgent to reduce rapidly the general government deficit and debt. Finally, the deterioration in the budgetary situation of France might have negative consequences for growth in the euro area, should this situation be the origin of a tightening of monetary conditions in the eurozone.

Consideration should also be taken of the fact that the French government is undertaking a substantial effort of structural reforms, started with the reform of the pension system in 2003. The government is committed to implement a structural reform of health insurance in the first half of 2004, with the aim of curbing the dynamic of health expenditures, which have constituted a major problem in controlling general government expenditures for several years. These reforms are welcome as they will improve the long term sustainability of government finances, but, given that their impact in the short term will remain relatively limited, they should not be considered as a substitute for the needed correction of the excessive deficit.

In view of these elements, the Commission considers that extending by one year to 2005 the deadline which the Council set in June for the elimination of the excessive deficit in France would provide the conditions for a balanced correction, provided that effective measures are taken by the French authorities in order to achieve in 2004 a larger reduction in the general government deficit than that currently planned by the French authorities. This would allow to catch up in 2004 for the lack of adjustment in 2003 and to set a credible basis for bringing the deficit below 3% of GDP in 2005.

In order to achieve a lower general government deficit in 2004, France should secure a larger reduction in the cyclically-adjusted balance in 2004 than that currently planned. The Commission is of the opinion that an overall budgetary adjustment amounting to one percentage point of GDP in 2004 should be implemented by France. Given its size, and provided that it is of the right composition, the additional adjustment compared to current plans needs not be harmful for growth in the short term and, by enhancing the sustainability of public finances, will have favourable effects in the longer run. Under current Commission projections, such an adjustment would bring the deficit to 3.4% of GDP in 2004; this would set a credible basis for bringing the deficit below 3% of GDP in 2005.

As part of the multi-annual projection for government finances for the period 2005-2007 presented by the French authorities on 25 September 2003, the general government deficit is projected to decline from 3.6% of GDP in 2004 to 2.9% of GDP in 2005, under the most plausible macroeconomic scenario of a real GDP growth of 2.5% over the period. According to the French authorities, the cyclically-adjusted deficit would be reduced by 0.6 percentage point of GDP in 2005.

According to the Commission, given the current growth prospects and provided that a reduction in the cyclically-adjusted deficit by about 1 percentage point of GDP is implemented in 2004, the budgetary effort currently envisaged by the French government for 2005 would be the minimum to secure that the general government deficit is credibly reduced below 3% of GDP in 2005. Given that the excessive deficit has to be corrected in 2005 at the latest, and that the notice under Article 104(9) is the last step of the excessive deficit procedure before an eventual decision on the sanctions foreseen by the Treaty and the Stability and Growth Pact is taken, the French authorities should be ready to achieve a larger adjustment than that currently planned should this be necessary to correct the excessive deficit.

In line with the provisions of Article 104(9) of the Treaty, the French authorities should be requested to submit a report to the Commission outlining the decisions to achieve the additional adjustment in the cyclically-adjusted balance required for 2004. France should also include in this report a description as precise as feasible of the measures to be implemented in 2005 to reduce the budget deficit. This report should be sent to the Commission before 15 December 2003, and will be examined by the Commission and the Council in view of assessing compliance with the notice given in accordance with Article 104(9).

3. BUDGETARY TARGETS BEYOND 2005

As far as the years after 2005 are concerned, the French multi-annual projection for government finances projects a reduction in the general government deficit from 2.9% of GDP in 2005 to 2.2% in 2006 and 1.5% in 2007[1], under the most plausible macroeconomic scenario of real GDP growth at 2.5% in 2006 and 2007[2]. Were this to be confirmed in France's stability programme, a close to

[1] Should real GDP growth reach 3.0% between 2005 and 2007, the general government deficit would be reduced to 0.7% of GDP in 2007.

[2] According to the French authorities, the cyclically-adjusted deficit would be reduced by 0.5 percentage point in 2006 and 0.6 percentage point of GDP in 2007.

balance or in surplus budgetary position would not be reached in the time span of the programme (2004-2007) in nominal terms, nor, according to Commission calculations, in structural terms. In order to prevent such an outcome, a larger budgetary consolidation than currently planned should be undertaken as from 2005.

Achieving an underlying budgetary position of close to balance or in surplus is important to ensure a rapid reduction in the debt to GDP ratio which is a necessary complement of the recent pension reform to tackle the public finances implications of the ageing of populations. This will also allow to let automatic stabilisers play fully without breaching the 3% of GDP deficit threshold in the event of an economic slowdown.

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In view of the findings mentioned above, the Commission recommends the Council to give notice to France under art. 104(9) to take measures for the deficit reduction the Council judges necessary in order to remedy the situation of excessive government deficit. The Commission also recommends, as foreseen by the Treaty, a regime of enhanced surveillance, where reports are to be submitted on a regular basis by the French authorities. The Commission and the Council will examine the reports in view of assessing compliance with the notice.

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THE COUNCIL OF THE EUROPEAN UNION

Having regard to the Treaty establishing the European Community, and in particular Article 104(9) thereof,

Having regard to the recommendation from the Commission under Article 104(9),

Whereas:

(1) According to Article 104(1) of the Treaty, Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[3].

(3) The Amsterdam Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact[4] solemnly invites all parties, namely the Member States, the Council and the Commission to implement the Treaty and the Stability and Growth pact in a strict and timely manner.

(4) By Council Decision 2003/487/EC[5], it was decided, in accordance with Article 104(6) of the Treaty, that an excessive deficit existed in France.

(5) In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council sent a Recommendation to France on 3 June 2003 establishing the deadline of 3 October 2003 for France to take measures to bring the existence of an excessive deficit to an end in 2004 at the latest.

(6) By Council Decision 2003/…/EC, it was established, in accordance with Article 104(8) of the Treaty, that no effective action had been taken in response to that Recommendation.

(7) According to Article 5 of Regulation (EC) No 1467/97, any Council decision to give notice to the participating Member State concerned to take measures for the deficit reduction in

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3 OJ L 209, 2.8.1997, p. 6.
4 OJ C 236, 2.8.1997, p. 1.
5 OJ L 165, 3.7.2003, p. 29.

accordance with Article 104(9) shall be taken within one month of the Council decision establishing that no effective action has been taken in accordance with Article 104(8).

(8) When defining the recommendations to be included in the notice, the following factors should be taken into account: (i) the worsening in cyclical developments which contributed to the deterioration of the budgetary situation in 2003 was abrupt and unexpected and it made the effort to bring the deficit below 3% of GDP in 2004 much larger than expected in June 2003; the Commission, in its Autumn 2003 forecasts, projects that the general government deficit will be 4.2% of GDP in 2003 and 3.8% of GDP in 2004, assuming there to be an increase in real GDP of 0.1% in 2003 and 1.7% in 2004; (ii) according to the Commission, the cumulated loss of real GDP growth over the period 2003-2004 compared to what was expected in the Spring now amounts to about 1.5 percentage point; (iii) the budgetary plans for 2004 submitted to Parliament in September are targeted at a reduction in the cyclically-adjusted deficit slightly larger than the minimum amount of 0.5 percentage point of GDP recommended by the Council in June. Consideration was also given to the fact that the French government committed to implement in the first half of 2004 a structural reform of the health insurance, with the aim of curbing the dynamic of health expenditures, which constituted a major problem in controlling general government expenditures over the latest years.

(9) Taking into account these factors, it appears that the deadline which was set in June for the elimination of the excessive deficit in France should be extended by one year, provided that effective measures are taken by the French authorities as from 2004.

(10) Consequently France should achieve a larger reduction in the cyclically-adjusted balance in 2004 than currently planned, by strictly respecting budgetary plans and by implementing additional measures. An annual improvement in the cyclically-adjusted balance of 1 percentage point of GDP is appropriate. Based on Commission Autumn forecasts, this implies additional measures reducing the general government deficit by some EUR 6 billion or 0.4 percentage point of GDP as against the Finance Law for 2004. This would set a credible basis for bringing the deficit below 3% of GDP in 2005. Budgetary plans for 2005 must secure a sizeable adjustment in the cyclically-adjusted deficit in order to ensure the correction of the excessive deficit position in 2005 at the latest. Based on Commission Autumn forecasts, this implies a further improvement in the cyclically-adjusted balance of at least 0.6 percentage point of GDP relative to the outcome required for 2004.

(11) It is paramount that France moves rapidly towards a situation in which government finances are close to balance or in surplus. Such an underlying budgetary position must be achieved to ensure a rapid reduction in the debt to GDP ratio below the 60% of GDP reference value of the Treaty. The reduction in the debt ratio is a necessary complement of the recent pension reform in view of the implications for public finances of the ageing of populations. It will also enable automatic stabilisers to play fully without breaching the 3% of GDP reference value for the deficit in the event of an economic slowdown.

(12) When drawing up the measures to be taken in order to comply with the recommendations included in this Decision, France should take into account the recommendations issued by the Council in the framework of the Broad Economic Policy Guidelines. Budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancement of the quality of public finances and reinforcement of the growth potential of the economy. In particular, as prescribed by the Broad Economic Policy Guidelines, France needs in particular to curb the dynamics of spending in the health sector.

(13) France should submit a report to the Commission outlining the measures to be taken to respect the recommendations of this Decision in time for the Council and the Commission to analyse it within the time limit set out in Article 6 of Regulation (EC) No 1467/97.

(14) A strategy consistent with this recommendation and based on prudent macroeconomic assumptions should be presented in the Stability Programme to be updated by December 2003.

(15) According to the second subparagraph of Article 104(9) of the Treaty, the Council may request France to submit reports in accordance with a specific timetable in order to examine the adjustment efforts made by France. It is appropriate for the reports to be submitted just after the EDP reporting dates.

HAS ADOPTED THIS DECISION:

Article 1

France shall:

a) put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2005;

b) achieve in 2004 an annual reduction in the cyclically-adjusted deficit of 1 percentage point of GDP;

c) achieve in 2005 a reduction in the cyclically-adjusted deficit of at least 0.5 percentage point of GDP or by a larger amount so as to ensure that the general government deficit is brought below 3% of GDP;

d) allocate any higher-than-expected revenue to deficit reduction and, should the recovery in economic activity be stronger than currently expected, accelerate the reduction in the cyclically-adjusted deficit.

Article 2

France shall:

(1) submit by 15 December 2003 at the latest a report to the Commission outlining the announced decisions to respect the recommendations of this Decision. As regards 2004, the report shall announce the measures or reforms to be implemented, the time-horizon for their application. It shall contain estimates of the impact of such measures on the general government deficit,

including all the relevant assumptions made for the quantification. As regards 2005, the report shall indicate as clearly as possible the measures or reforms envisaged by the government. This report will be examined by the Council and the Commission in view to assessing compliance by France with this Decision;

(2) submit four implementation reports by the end of April 2004, October 2004, April 2005 and October 2005, examining progress made in complying with the recommendations of this Decision. Each of these reports will be examined by the Council and the Commission in view to assessing compliance by France with this Decision.

Article 3

In addition, France shall ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0.5 percentage point of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path.

This Decision is addressed to the French Republic.

Done at Brussels, … 2003.

For the Council