COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997 on the updated Stability programme of France, 2003-2005

(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], stipulated that countries participating in the single currency were to submit stability programmes to this Council and the Commission by 1 March 1999. In accordance with Article 5 of the Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

France's first stability programme covering the period 1999-2002 was submitted on 18 January 1999 and assessed by the Council on 15 March 1999[2].

According to the Regulation, the updated stability programmes, to be presented annually, may be examined by the Council in accordance with these same procedures.

The first and second updates to the stability programme of France were assessed by the Council on 13 March 2000[3] and on 12 February 2001[4]respectively.

France submitted its third updated stability programme, covering the period 2003-2005, on 11 December 2001. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment.

> The 2001 update of the stability programme of France was submitted to the Commission on 11 December 2001. The programme covers the period from 2002 to 2005. The 2001 updated stability programme defines full employment and a 70% employment rate as the main long term objectives for economic policy. To this aim, the French authorities intend to maintain the stability stance of the budgetary policy and to increase the potential growth of the economy. The French stability programme is rich in information and broadly complies with the requirements of the Code of conduct on the content and format of the programmes. Even though not compulsory in the Code of conduct, it would have been useful to provide explicit projections for revenues and spending categories in national accounting. This would have allowed a more detailed analysis of revenues and expenditures.
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> Economic activity decelerated in France in 2001, though remaining sustained by rather buoyant domestic demand: after 3.1% in 2000, real GDP growth is estimated at 2.3% in 2001 in the updated stability programme, while it was projected at above 3% in the Finance Law for 2001. According to the 2001 updated stability programme, the government deficit for 2001 should remain unchanged at 1.4% of GDP, while a decline to 1% was expected in the budget. For 2002, the 2001 update projects real GDP growth at 2.5%. Then, for the years from 2003 to 2005, the projections included in the update are based on the same macroeconomic scenarios

1 OJ L 209, 2.8.1997
2 OJ C 124, 5.5.1999
3 OJ C 111, 18.4.2000
4 OJ C 77, 9.3.2001

adopted in the previous updates: a "cautious" scenario, potential growth remaining at 2.5% a year, the current level according to the French authorities, and a "favourable" scenario where potential growth increases to 3%.

On the basis of these assumptions, the general government deficit is projected to remain unchanged at 1.4% of GDP in 2002. For the remaining years of the programme, according to the cautious scenario, the government deficit would decline to 1.3% of GDP in 2003, then more sharply to 0.5% of GDP in 2004; balance should be attained in 2005, one year later than was recommended by the Council opinion of 12 February 2001[5]. The medium-term budgetary adjustment would be faster should the favourable scenario materialise, the government deficit declining to 1% of GDP in 2003, turning into balance already in 2004 and into a surplus of 0.3% of GDP in 2005. The government debt ratio, estimated at 57.1% in 2001, is expected to be progressively lowered to 52.9% in the cautious scenario and to 51.8% in the favourable scenario.

The macroeconomic assumptions underlying the 2001 update are to be considered as rather optimistic, particularly concerning 2002. The Commission Autumn forecasts project real GDP growth at 1.5%, as against 2.5% according to the French authorities. The two scenarios identified for the medium-term also appear to be in the high range of possibilities. The historical average of real GDP growth since 1978 does not exceed 2.2% per year: consequently, expecting potential growth to attain 3% over the years 2003-2005 in the favourable scenario, seems optimistic. Recently, after only three years of growth reaching 3%, some tensions emerged in the economy, which while not creating significant inflationary pressures suggest, nonetheless, that potential growth is below 3%. The cautious scenario, assuming potential growth at 2.5%, appears the most plausible.

On 22 January 2002, the French authorities sent a letter to the Commission stressing that, should GDP growth in 2002 be lower than expected and assumed it will average its potential rate between 2002 and 2005, the path of the cyclically-adjusted deficit projected in the 2001 updated stability programme should be maintained and the objective of a balanced government account by 2004/2005 achieved. Thus, there is a risk that the general government deficit in 2002 might approach 2% of GDP. In this case, the general government deficit would reach a close-to-balance position by 2004/2005, as stated in the 2001 updated stability programme, only if real GDP growth rebounds strongly in 2003 and 2004 and if the budgetary policy secures the projected structural adjustment.

The budgetary strategy of the 2001 updated stability programme remains based on defining norms for general government expenditure increases in real terms. The budgetary margins arising from lower-than-real-GDP growth in real expenditures are split between deficit reduction and tax relief. Such a strategy was praised by the Council in previous opinions, considering that a clear binding norm for expenditure supports a transparent budgetary adjustment. It should be noted however that, according to the 2001 stability programme, the government deficit reductions for the period 2000-2002 targeted in the 1998 initial stability programme will not be achieved. At present, the decline in the government deficit is expected to be 0.2 percentage point of GDP over the period 2000-2002, while real GDP growth is

[5] OJ 2001/C77/05, 9-3-2001

projected by the French authorities to average 2.6%. This value coincides with the cautious scenario of the stability programme and its updates. On the basis of this macroeconomic scenario, the initial stability programme projected a reduction in the deficit by around 1 percentage point of GDP over the period 2000-2002.

Two main factors have contributed to limiting the budgetary adjustment: (i) tax reductions and (ii) deviation from the real expenditure multi-annual target set for 2000-2002 in the 1998 stability programme. In view of reducing the tax burden, the government decided to attach a higher priority to tax cuts in the course of 2000, at a moment when robust nominal GDP growth engendered large fiscal revenues. The tax alleviation strategy is a comprehensive set of measures which reduce both households income tax rates and corporate tax rates and introduce a tax credit for low paid earners. A significant reduction in the tax pressure will result from these measures, which is to be considered positively. Despite the implementation of this tax reform, the objectives in terms of deficit reduction set in the original stability programme for the period 2000-2002, that is a decline in the general government deficit by 1 percentage point of GDP, could have broadly been ensured if the spending norm set in 1998 for the period had been respected.

Part of the revision to initial expenditures plans is contained in the Finance Law for 2002, which projects an increase in real expenditures by more than 2%. This is a higher rate than projected in the previous updates of the stability programme and than recommended in the 2001 Broad Economic Policy Guidelines according to which the French authorities should "contain government expenditures in real terms within the 1.6% limit ... set by the government in the 2000 updated stability programme". As a consequence, and also due to lower-than-expected tax revenues, the deficit should remain unchanged in 2002 at 1.4% of GDP for the third consecutive year. In addition, the optimism of underlying macroeconomic assumptions creates a risk for the achievement of this target. As a comparison, in Autumn, the Commission projected the general government deficit in 2002 at 2% of GDP.

According to the cautious scenario, the government deficit will remain roughly stable in 2003, before declining abruptly to 0.5% of GDP in 2004, and reaching balance in 2005. However, achieving balance in 2005 is one year later than recommended by the Council last year; as a consequence, the budgetary adjustment should be speeded up. This is also justified because the largest part of the fiscal effort envisaged in the programme falls on the year 2004. The budgetary objectives included in the 2001 update of the stability programme comply with the requirement of close to balance and in surplus of the Stability and Growth Pact in 2004 and 2005. In cyclically-adjusted terms, balance will be reached only in 2005; however, the budgetary projections of the programme provide a sufficient safety margin to avoid breaching the 3% of GDP limit as from 2001 and reach close to balance position from 2004.

According to the 2001 update, the budgetary adjustment from 2003 to 2005 will be attained through two adjustments to the overall budgetary strategy. The norm for the cumulated increase in real expenditures from 2003 to 2005 is fixed at 4% in real terms, 0.5 percentage point lower than the same norm included in the 2000 update. This first reduction in the expenditure norm since the adoption by the French authorities of this budgetary strategy, although mainly due to accounting reasons, is to be considered as a positive development. The 2001 update also states that, should the cautious scenario materialise, all budgetary margins arising from lower than

GDP growth in expenditures will be allocated to deficit reduction from 2004, while in the previous update these margins were expected to be equally allocated to deficit reduction and tax relief.

Should the favourable scenario materialise, further tax cuts will be implemented. However, in order not to compromise the deficit reduction, expenditure growth in real term will have, at the same time, to remain in line with plans. To this respect, the main sources of concern are, at present, the developments in health expenditures, the dynamism of the wage bill in the public sector, and the asymmetric behaviour of planned real expenditures with respect to inflation surprises (when actual inflation turns out to be lower than expected, norms are overshot; yet the reverse happens only very partially).

The target of moving towards a budgetary balanced position is a necessary step to placing public finances on a more sustainable footing. The strategy outlined in the 2001 updated programme to prepare for the budgetary costs of ageing in the programme lacks ambition. Unlike the programmes of other Member States, the stability programme of France makes very little reference to any reform of the pension system, reform which has been delayed several times in recent years.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the updated stability programme of France and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n° 1466/97 of 7 July 1997 on the updated Stability Programme of France, 2003-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[6], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [12 February 2002] the Council examined the updated Stability Programme of France which covers the period 2002-2005.

The 2001 update of the stability programme projects real GDP growth at 2.3% in 2001 and 2.5% in 2002. From 2003 to 2005, the projections are based on two macroeconomic scenarios: a "cautious" scenario in which GDP growth averages 2.5%, considered to be the current level of potential growth, and a "favourable" scenario where real GDP growth accelerates to 3%. The general government deficit is estimated to remain unchanged in 2001 and in 2002 at 1.4% of GDP, the level reached in 2000. From 2003 to 2005, according to the cautious scenario, the government deficit should decline to 1.3% of GDP in 2003 and 0.5% of GDP in 2004; the government balance is expected to be attained in 2005. The budgetary adjustment would be faster should the favourable scenario materialise, a government balance being expected in 2004, turning into a 0.3% of GDP surplus in 2005. The general government debt estimated at 57.1% of GDP in 2001 is projected to be lowered in 2005 to 52.9% of GDP in the cautious scenario and to 51.8% of GDP in the favourable scenario.

The Council considers that the macroeconomic projections encompass downside risks in the short term: in more recent forecasts, real GDP growth is expected not to exceed 2% in 2001 and 1.5% in 2002; consequently, the Council notes that the government deficit in 2002, the starting year of the projections, might be less favourable than expected. Moreover, in the two medium-term macroeconomic scenarios real GDP growth remains above its average of the last twenty years; thus, the Council considers the "cautious" scenario, in which real GDP growth averages 2.5% between 2003 and 2005, as the most plausible one.

The Council notes that, in the cautious scenario, the general government deficit is projected to be reduced significantly only from 2004; the reduction projected for 2003 is marginal and the deficit for that year will stay rather at the same level as in 2000. The deficit remains roughly

6 *OJ L 209, 2.8.1997*

unchanged in 2000-2003 also in cyclically adjusted terms. A balanced position is reached only in 2005, one year later than recommended in the opinion of last year. The Council therefore urges the French authorities to speed-up budgetary consolidation with a view to ensure that a balanced position is reached in 2004, at the latest.

The budgetary objectives included in the 2001 update of the stability programme respect the requirement of close to balance or in surplus of the Stability and Growth Pact in 2004 and 2005, although only in the latter year a balance in cyclically adjusted terms is expected. However, the underlying budgetary position provides a sufficient safety margin to avoid breaching the 3% of GDP threshold as from 2001.

The French budgetary strategy is based on predetermined multi-annual spending norms, in real terms; the Council commends such a strategy, considering that a clear binding norm for expenditure secures a transparent budgetary adjustment. However, the Council notes that, with macroeconomic developments in line with official expectations, respect of the spending norm as it was set in the 1998 stability programme for the period 2000-2002 would have broadly ensured the projected reduction in the general government deficit for the same period, despite the implementation of the tax reform. In particular, the Council notes that, in 2002, expenditures are planned to increase faster than recommended in the 2001 Broad Economic Policy Guidelines. The Council welcomes, however, that the multi-annual spending norm for the period 2003-2005 has now been reduced to 4%.

The Council welcomes the decision of making any reduction in the tax burden after 2003 conditional on real GDP growth; however, it considers that it might be more appropriate to link tax cuts after 2003 to the respect of the multi-annual norms for expenditure increase in real terms and to the attainment of the deficit objectives at least until a close to balance or in surplus budgetary position is reached.

The target of moving towards a budgetary balanced position is a necessary step to placing public finances on a more sustainable footing in view of the budgetary burden arising from ageing population in France. The Council notes that the strategy outlined in the 2001 updated programme to prepare for this challenge lacks ambition. The Council considers it necessary that France undertakes the reform of the pension system, which has been delayed several times in recent years, and to which the 2001 update of the stability programme makes very little reference.