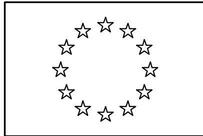

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 8.1.2003
SEC (2003) 15 final

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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, 2004-2006

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

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]. The first, second and third updates to the stability programme of France were assessed by the Council on 13 March 2000[3], on 12 February 2001[4], and on 12 February 2002[5] respectively. France submitted its fourth updated stability programme, covering the period 2004-2006, on 13 December 2002. The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council of 27 November on strengthening the co-ordination of budgetary policies[6]. This evaluation warrants the following assessment.

> The 2002 update of the stability programme of France, which covers the period from 2003 to 2006, is the first programme prepared by the new government which took office in June 2002. According to the French authorities, the programme provides a multi-annual budgetary strategy designed to support a strong and lasting improvement in economic and employment growth. This is to be achieved through alleviation in the tax burden, reduction in the general government deficit and the implementation of structural reforms. The budgetary strategy is based on norms for general government expenditure increases in real terms; the budgetary margins arising from lower-than-GDP growth in expenditures are split between deficit reduction and tax relief. The 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 if some aggregates, in particular employment figures, are provided in a definition not fully compatible with the code of conduct.

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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
5. OJ C 51, 26.2.2002
6. COM (2002) 668 final, 27.11.2002.

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On 19 November 2002, the Commission, considering that budgetary developments observed in 2002 and planned for 2003 constitute a significant divergence from the projections of the 2001 update, recommended to the Council to send an early warning to France in order to prevent the occurrence of an excessive deficit. In this recommendation, the Commission considered that France should ensure (1) that the 2002 general deficit will not exceed 2.6% of GDP[1] and (2) that the general government deficit does not breach the 3% of GDP threshold in 2003. To this end, the Commission considered that adopting measures in 2003 apt to improve the underlying 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. Finally, the Commission considered that (3) continuous adjustment in the underlying position by at least 0.5% of GDP per year should be pursued in subsequent years in order to reach a close to balance or in surplus position by 2006 at the latest.

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In 2002, the French public finances deteriorated markedly. The 2002 update of the stability programme estimates the 2002 general government deficit at 2.8% of GDP, a level higher than that estimated by the French authorities when the early warning was launched. It is recalled that the deficit projected in the 2001 update was 1.4% of GDP. Monthly budgetary indicators until November suggest that the 2002 general government deficit could even come out closer to the 3% of GDP Treaty reference value. According to Commission services calculations, the larger part of the total slippage in public finances in 2002 is due to a deterioration in the cyclically-adjusted balance, which mainly reflects an overrun in expenditures. The remaining part can be attributed to cyclical factors: economic activity decelerated in 2002, real GDP growth being estimated at 1.2% in the current updated stability programme, as against 2.5% in the 2002 Budget.

The budget for 2003 projects the general government deficit at 2.6% of GDP, after 2.8% in 2002. 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 figures of the programme are consistent with a decrease in the cyclically-adjusted deficit by 0.2 percentage point in 2003, to 2.6% of GDP[2]. In Commission's view, the risk for the government deficit to be worse than projected, and that the deficit becomes excessive in 2003, i.e. the starting year of the current update of the stability programme, is large if new measures are not implemented. Indeed, the macroeconomic assumption underlying the budget of an increase in real GDP by 2.5% is to be considered as optimistic; for that year, the Commission projects real GDP growth at 2.0%[3] and an increase in the general government deficit by 0.2 percentage point between 2002 and 2003. Moreover, a further deterioration in the 2002 position, which appears possible in view of recent budgetary indicators, or an eventual slippage in government expenditures could also contribute to an increase in the general government deficit above 3% of GDP in 2003.

[1] This value was that planned by the French authorities when the early warning was adopted by the Commission.

[2] These calculations are based on the production function method approved by the Council.

[3] Attaining in 2003 a rate of growth of 2.5% would imply a marked acceleration in real GDP growth as from the end of 2002 which is not heralded by monthly indicators. It is recalled that the November 2002 OECD forecast projected real GDP growth at 1.9% in 2003 in France.

The general government debt is projected to increase from 57.3% of GDP in 2001 to 59.1% of GDP in 2003. This forecast does not take into account the impact on general government accounts of recently decided financial operations[1]. These decisions could bring the debt ratio to level close to 60% of GDP in 2003, and, in the event of higher than projected deficit or lower nominal growth, this threshold may even be breached.

For the period 2004-2006, the macroeconomic projections of the 2002 updated stability programme are based on the same two scenarios as in previous updates: a "cautious" scenario, real GDP growth averaging 2.5% a year over the period, and a "favourable" scenario where real GDP growth reaches 3% per year. The "cautious" scenario appears the more plausible one. Indeed, the favourable scenario makes the assumption of a strong increase in total investment and in the employment rate which, in the absence of bolder than already announced reforms, appears uncertain. In the cautious scenario, real GDP follows the same path as its potential level as calculated by Commission services on the basis of the national authorities figures or on the basis of the Autumn Commission forecast. This scenario, consistent with a potential output growth averaging 2.5%, the central value of the range provided by the French authorities, is then considered in this assessment as the reference scenario for assessing budgetary developments.

On the basis of the "cautious" macroeconomic scenario, the government deficit is projected to decline by 0.5 percentage point of GDP per year as from 2004 to reach 1.0% of GDP in 2006. The budgetary adjustment in actual terms would be faster should the "favourable" scenario materialise, the government deficit declining on average by 0.7 percentage point of GDP per year to reach 0.5% of GDP in 2006. To reach this outcome, real expenditures are planned to increase by a cumulated 3.9% in real terms over the period 2004-2006, a rate lower than real GDP growth. The margins thus created are partly allocated to tax relief: in the cautious scenario, the tax cuts average 0.2 percentage point of GDP per year; in the favourable scenario, they average 0.3 percentage point of GDP per year. The general government debt is projected to decline from 59.1% of GDP in 2003 to 57.0/55.4% of GDP in 2006, depending on the macroeconomic scenario.

The 2002 update lacks ambition concerning the time profile and the size of the budgetary consolidation. First, the budgetary adjustment is back-loaded, as the effort (measured as the change in the cyclically-adjusted balance) planned for 2003 reaches barely 0.2 percentage point of GDP. Second, between 2002 and 2006, the underlying budgetary position improves on average by hardly 0.5 percentage point a year. These plans are not in conformity with the understanding of the October Eurogroup that, as from 2003, countries "which have not yet reached a close to balance position need to pursue continuous adjustment of the underlying balance by at least 0.5 percentage point of GDP per year", neither with the subsequent Commission Communication[2], which stated that countries with high deficits should seek an improvement in the underlying budget position "higher than 0.5 percentage point of GDP each year".

Moreover, a close to balance underlying budgetary position is not reached in the end-year of the programme in the cautious scenario while in the favourable scenario

1 These financial operations include, in particular, the capital injection by the State in the company France Télécom and the sale of the state owned assets of the company Crédit Lyonnais.

2 COM (2002) 668 final of 27.11.2002

such a position is reached in 2006 only thanks to a projected sudden improvement in potential output as from 2004, which reflects optimistic projections for capital accumulation and labour market developments. The developments projected for the medium-term are therefore in contrast with the latest recommendation of the early warning stating that a close to balance underlying budgetary position should be reached in 2006 at the latest. A consequence of these projections is that, according to Commission calculations, a budgetary position providing a sufficient safety margin to avoid breaching the 3% of GDP Treaty reference value under normal cyclical conditions (i.e. the so-called minimal benchmark) would not be attained before 2005.

Finally, it is to be remarked, in particular, that the reduction in the actual deficit planned between 2002 and 2005 is lower than that planned in the 2001 update under similar macroeconomic assumptions. After the large slippage of 2002, and given that the budgetary position is currently at a level which could lead to the occurrence of an excessive deficit, a higher priority should have been attached to deficit reduction in the early years of the period covered by the programme.

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The slow budgetary adjustment path projected in the 2002 update is partly due to the implementation of tax cuts from 2003. The previous update conditioned the implementation of tax cuts after 2003 on the attainment of a close to balance budgetary position. Such a relevant condition was welcomed by the Council in its opinion on the 2001 update. Moreover, in the context of the favourable scenario, a part of the margins created by favourable growth conditions are used to implement larger tax cuts, and the budgetary effort is comparable to that of the cautious scenario. These plans are not considered sufficient by the Commission in view of its Communication of 27 November stating that countries should seek a more ambitious annual improvement in the underlying budgetary position if growth conditions are favourable.

On the expenditure side, the target for the increase in real general government expenditures is the same as in the previous update. However, some concerns exist about the achievability of this objective if ambitious reforms are not rapidly implemented. First, recent budgetary developments have brought further evidence of the difficulties in meeting the multi-annual targets set for real expenditures in the previous updates; indeed, the expenditure increments targeted for the periods 2000-2002 and 2001-2003 in the 1998 initial stability programme and its first update will be missed by a large margin due to slippages in the health sector, and, more recently, in the State sector and in the unemployment insurance. Second, the constraints arising from the ageing of population and the debt burden will increase during the period covered by the current update, making the environment less favourable for expenditure restraint. Finally, while the ceiling remains the same as in the previous update, new priorities have emerged on the expenditure side since the general elections of 2002; financing these priorities will require tight expenditure restraint in other areas.

Beyond the direct consequences on deficit targets, the non respect of expenditure ceilings could, if repeated, damage the overall credibility of the budgetary strategy, given the relevance of these norms as an anchor. A positive first step towards improving expenditure control was made recently with the introduction of structural measures designed to curb ex ante expenditures, in particular in the health sector. In the same vein, the actions designed to improve the control of budgetary execution in the State sector are also welcome. A second positive step is the commitment to implement corrective infra-annual measures in the social security sector in the event

of an evidence of overspending. These measures constitute clear progresses. However, they should be complemented by the introduction of a mechanism ensuring automatic compensation across years of eventual overspending in the general government sector.

All in all, the current update of the stability programme does not comply with essential requirements of the stability and growth pact, in particular with that of reaching a close to balance budgetary position in the medium term. The budgetary adjustment planned in the programme lacks of ambition, in particular in the first years of the period covered by the programme. A larger improvement in the underlying budgetary position in 2003 and 2004 would contribute to reduce the risk for the general government deficit to breach the 3% of GDP threshold and allow the attainment of an underlying budgetary position close to balance by the end of the period covered by the programme.

The Commission considers that on the basis of current policies, the risk of persistent budget imbalances cannot be excluded. The planned move to a deficit of 1% by 2006 of GDP is inadequate in light of the projected budgetary impact of ageing populations. A greater degree of budgetary ambition is required, and France should complete the transition to a position of budget balance before 2006. Moreover, achieving sustainability will require maintaining a balanced budget position in underlying terms over the very long run: this implies running large primary surpluses for many years so that a large reduction in the debt ratio is recorded prior to the budgetary impact of ageing populations taking hold. The Commission welcomes the intentions of the French authorities to reform pension and health care systems in light of ageing populations. These reforms need to proceed according to the time frame indicated in the programme, as they have been subject to repeated delays 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.

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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, 2004-2006

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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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[1], 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 [21 January 2003] the Council examined the updated stability programme of France which covers the period 2003-2006. This update is the first programme prepared by the new government, which took office in June 2002; it provides a budgetary strategy designed to support a strong and lasting improvement in economic and employment growth. The programme complies partly with the recommendations of the 2002 Broad Economic Policy Guidelines.

The Council, having identified a significant divergence in 2002 budgetary developments from the projections of the 2001 update of the stability programme, and considering that this divergence is not corrected in the plans for 2003, adopted today a recommendation with a view to giving early warning to France in order to prevent the occurrence of an excessive deficit. According to this recommendation, France should in particular ensure that the general government deficit does not breach the 3% of GDP threshold in 2003. To this end, the Council considered that adopting measures apt to improve the underlying 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. Finally, the Council considered that continuous adjustment in the underlying position by at least 0.5% of GDP per year should be pursued in subsequent years in order to reach a close to

balance or in surplus position by 2006 at the latest.

General government finances deteriorated markedly in 2002. The updated stability programme estimates the 2002 general government deficit at 2.8% of GDP, a level higher than that recommended in the early warning and well above the 1.4% of GDP planned in the previous update. According to Commission calculations, the larger part of the slippage in 2002 is due to a deterioration in the underlying balance, which mainly reflects an overrun in expenditures. The budget for 2003 projects the general government deficit at 2.6% of GDP; this projection is consistent with a decrease in the cyclically-adjusted by 0.2% of GDP in 2003 to 2.6% of GDP[2].

If measures coherent with the recommendations of the early warning are not implemented, the risk for the government deficit to become excessive in 2003 is therefore large. Indeed, the macroeconomic assumption underlying the budget of an increase in real GDP by 2.5% is to be considered as rather optimistic. A further deterioration in the 2002 position, which seems today likely, or an eventual slippage in government expenditures could also bring the general government deficit above 3% of GDP in 2003. In its Autumn forecast, the Commission projected an increase in the government deficit by 0.2 percentage point between 2002 and 2003 under the assumption of real GDP growth at 2.0%. Finally, a risk exists that the government debt breaches the 60% of GDP reference value in 2003.

For the period 2004-2006, the macroeconomic projections of the 2002 update are based on two scenarios: a "cautious" scenario, with real GDP growth at 2.5% a year over the period, and a "favourable" scenario where real GDP growth reaches 3% per year. The Council considers that the projections of the "favourable" scenario encompass downside risks, and that the "cautious" scenario is the reference scenario for assessing budgetary developments. In the "cautious" scenario, the government deficit is projected to decline by 0.5 percentage point of GDP per year as from 2004 to reach 1.0% of GDP in 2006. This implies that the medium-term objective of close to balance or in surplus would only be reached in a year not covered by the programme. The medium-term budgetary adjustment would be faster in the "favourable" scenario, the government deficit reaching 0.5% of GDP in 2006.

The Council considers that the budgetary consolidation planned in the programme lacks ambition. The budgetary adjustment is back-loaded, as the effort planned for 2003 reaches barely 0.2 percentage point of GDP. Moreover, between 2002 and 2006, the underlying budgetary position improves by hardly 0.5 percentage point a year on average according to Commission calculations. The Council urges the French authorities to seek a larger

[1] OJ L 209, 2.8.1997
[2] These calculations are based on the production function method approved by the Council.

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improvement in the underlying budgetary position in 2003 and 2004, in order to reduce the risk for the general government deficit to breach the 3% of GDP threshold. This would also allow to attain a close to balance budgetary position by 2006, as recommended in the early warning. Finally, should the required budgetary adjustment in 2003 be not fully implemented, the Council considers that the French authorities should be ready to implement compensating measures as from 2004 to recover an adjustment path leading to a close to balance position in 2006.

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The slow budgetary adjustment is partly due to the implementation of tax cuts from 2003 worth 0.2/0.3 percentage point of GDP per year, in a context where expenditures are projected to increase at the same rate as in the 2001 update. Although considering that a reduction in the tax burden is to be welcomed in so far that it contributes to strengthen potential output growth, the Council regrets that the current update does not confirm that any reduction in the tax burden after 2003 is conditional on the attainment of a close to balance budgetary position. The Council welcomed the introduction of such a condition in its opinion on the 2001 update of the stability programme[1].

The budgetary strategy of the 2002 updated stability programme remains based on defining norms for general government expenditure increases in real terms. This strategy has already been commended by the Council in its opinions on the previous updated programmes. Over the period 2004-2006, real expenditures are planned to increase by 3.9% in real terms. The Council considers, in particular in view of recent economic and budgetary developments, that ambitious reforms should be rapidly implemented in order to ensure that this objective is achieved. The Council welcomes the structural measures designed to curb expenditures in the health sector taken recently and the actions aiming at improving the control of budgetary execution in the State sector. It also welcomes the commitment to implement corrective infra-annual measures in the social security sector in the event of an evidence of overspending. The Council considers, however, that these reforms should be complemented by a mechanism ensuring automatic compensation across years of eventual overspending in the general government sector.

The Council considers that on the basis of current policies, the risk of persistent budget imbalances cannot be excluded. The planned move to a deficit of 1% by 2006 of GDP is inadequate in light of the projected budgetary impact of ageing populations. A greater degree of budgetary ambition is therefore required, and France should complete the transition to a position of budget close to balance or in surplus by 2006. Moreover, achieving sustainability will require maintaining a balanced budget position in underlying terms over the very long

run: this implies running large primary surpluses for many years so that a large reduction in the debt ratio is recorded prior to the budgetary impact of ageing populations taking hold. The Council notes the intentions of the French authorities to reform pension and health care systems in light of ageing populations and urges them to implement comprehensive reforms according to the time frame indicated in the programme, as they have been subject to repeated delays in recent years.

[1] OJ C 51, 26.2.2002