Stability programme: 2004-2006

Beginning in the early 1980s, average annual growth in both France and the European Union as a whole remained slightly above 2%. While intended to reverse trends of rising unemployment and public deficits, in the end the cumulative impact of successive regulations and levies actually impeded economic and employment growth. Despite significant progress in the last ten years, our human and technological resources remain insufficiently exploited and our economies are now coming up against the challenges posed by an ageing population.

In this context, the French government's top economic policy objective is to restore strong, durable economic and employment growth by actively pursuing reductions in tax and social security contributions, bringing down the public deficit, and implementing the necessary structural reforms to promote entrepreneurial initiatives and the long-term viability of public finances.

The stability programme presented in this document sets forth the budgetary framework of this strategy within the medium term. The measures implemented or currently planned by the government are in line with this programme's objectives. The 2003 Budget Bill represents the first step.

Beyond administrative, legal, and tax simplifications to introduce flexibility in labour regulations and give a boost to innovation and business creation, the government intends to actively reduce the level of taxes and social security contributions which weigh on entrepreneurial initiative and employment growth. Reductions in social security contributions will be pursued in order to promote the recruitment of young jobseekers and low-skilled labour. Tax burdens on businesses and households will in this way be reduced, increasing France's attractiveness in terms of investment and encouraging employment growth.

This strategy in favour of economic growth is accompanied by a return to rigorous control of public spending. In line with the 2003 Budget Bill, this stability programme provides for deep spending cuts while at the same time respecting new priorities fixed by the government in the areas of internal and external security, justice, and official development assistance. This rationalization of public spending will not be pursued at the expense of the quality of public services and social welfare programmes; however, it will call for rapid implementation of structural reforms, particularly in the area of public interventions and healthcare. The government has taken major steps in launching these reforms. In 2003, the retirement system reform it plans to present to Parliament in the first half of the year will represent one very significant example of such measures.

Public spending control will further contribute to tax and social security cuts and a progressive return to a close-to-balance situation. Through these consolidation measures, the French economy will recover the room for manoeuvre required in order to respond to challenges posed by an ageing population. As with the reform of the retirement system, reducing public debt in relation to GDP will also contribute to the well-being and prosperity of future generations.

I - A programme based on conservative, clearly defined assumptions

1. Realistic growth scenarios

The stability programme has adopted two actual growth scenarios: the first with growth at 2.5%, the second at 3%. These scenarios correspond to forecast potential growth of between 2¼% and 2¾%, accompanied by a progressive catch-up in demand.

Last year's stability programme was based on two potential growth scenarios of 2½% and 3%. These projections have been revised downwards to better reflect the impact of the first consequences of the ageing population. These revised projections are closer to those proposed by the Commission (2¼% to 2¾% for the 2004-2006 programme, and approximately 2½% according to the Commission).

The projection of 2.5% for actual growth is in line with the lower range for potential growth (2¼%). This scenario does not provide for either acceleration in total factor productivity (which could be driven by the development of new technologies) or reductions in structural unemployment, considered stable at approximately 8½%. In this more modest scenario for potential growth, actual growth of 2.5% would only partially absorb the initial output gap. For this reason, this scenario is intentionally on the conservative side.

The scenario for 3% in actual growth reflects the goals of the new Government. The attainment of this objective is based on measures in favour of achieving a better deployment of the labour force, under the combined impact of reduced structural unemployment and employment growth among less-active population segments (new jobseekers, older workers). The government's strategy in this area, launched in the first half of 2002 and in 2003, will be pursued in 2004 and the following years by reductions in tax and social security levies plus structural reforms of the labour market and the market for goods and services.

2. Conservative assumptions for tax and social security revenue

The elasticity retained in the 2004-2006 programme is less pronounced than that applied last year. Elasticity regarding tax and social security charges will be 0.9 in 2003, 1.05 in 2004 and 2005, and 1.0 in 2006[1], representing an average of 1.0 over 2003-2006. This assumption is consistent with actual long-term performance. Elasticity for tax receipts was close to 2.0 in 1999, 2000, and 2001, representing an exception related to the cyclical catch-up of a significant output gap. Surplus achieved in tax receipts during these years turned out to be temporary nature, unlike the new expenditures andtax cuts they were supposed to finance.

3. Exceptional revenues will decline

Between 1999 and 2002, non-tax government revenue increased by 50%, while levies on public businesses and bodies doubled, increasing from € 9 billion to more than € 18 billion. This rise was in large part exceptional, since in the medium-term all non-tax revenue will keep pace with GDP.

For this reason, the 2004-2006 stability programme expects non-tax government revenue to remain stable in real terms in order to return to sustainable, acceptable levels in 2006.

[1] The tax burden would automatically decline by 0.1 GDP points in 2003 and increase by 0.2 points in 2004-2006 before the implementation of any new measure.

Current € (billion)	1999 (outturn)	2002 (Initial Budget Act)	2003	2006
Non-tax revenue	23.1	35.2	31.5	32.7

Total general government revenue excluding taxes and social security contributions will therefore decline by 0.3 GDP point between 2002 and 2006, after rising 0.2 point between 1999 and 2002.

II - Containment of public expenditure backed by real reforms

France's strategy is based on ensuring that growth in public spending does not exceed economic growth. This is the only durable means of financing the deficit and the tax and social security cuts planned by the new Parliament.

Multi-year spending targets favour the adoption of a transparent budgetary policy; however, they must be accompanied by structural reforms in order to be credible. The French government priorities in this area include reforming the State and the health insurance system, as well as decentralization. By seeking to contain public expenditure through the intelligent deployment of reforms rather than simply applying a one-size-fits-all approach, it will be possible, at the same time, to maintain and even improve the quality of public services, i.e. to do more and better with less. This new strategy aimed at containing public expenditure will be launched in 2003 and pursued in the years ahead.

Average annual growth of public expenditure (at constant prices)

	1998-2002	**2003**	**2004-2006**
Central government expenditure *(budget accounting)*	1.0%	0.2%*	0.3%
Health insurance benefits	3.8%	3.8%	2.5%
Public expenditure	**2.2%**	**1.2%**	**1.3%**

** Compared to the 2002 Initial Budget Act increased by recurring expenditure introduced in the Supplementary Budget Act.*

1. A sharp reversal in spending trends starting in 2003

Public expenditure increased at an average rate of 2.2% p.a. (at constant prices) over 1998-2002, whereas the first stability programme budgeted increases of 1.1% p.a. at constant prices[2]. The initial spending targets for central government and healthcare benefits were largely exceeded.

In relation to this previous trend, 2003 will mark a significant reversal, with public expenditure rising by 1.2% (at constant prices), including 0.2% for central government and 3.8% for social security funds (+5.3% at current prices). By redeploying resources, it will be possible in 2003 to finance governmental priorities (security, justice, defence, and official development assistance). The recent trend of growth in the number of public sector employees on the central government payroll has also been reversed. Objectives in 2003 for healthcare expenditure are based on reforms in various sectors to assure improved efficiency in delivery.

2. Reforms launched in 2003 pursued and intensified in 2004-2006

Real central government expenditure will rise on average by 0.3% p.a. over 2004-2006

This target is ambitious. As a result of rising debt service charges and retirement benefit costs, it means that primary expenditure excluding retirement pensions should increase at an average rate of only € 1.2 billion p.a.. Such an increase implies that growth in payroll expenses will keep pace with inflation and expenses for operating, intervention, and investment needs, including the government's priorities, will remain stable in nominal terms.

Under these conditions, purchasing power gains will be tied to productivity improvements in public administrations. Their reorganization will be supported by retirement-linked workforce reductions and more modern techniques in the management of public-sector jobs, career planning, and job skills, with performance incentive measures. The stabilization of other expenditures in nominal terms (for operating, intervention, and investment budgets) means that governmental priorities will be financed via a redeployment of resources. A major spending review of central government intervention and investment programmes will be launched in 2003 and should progressively produce increasingly significant results in 2004-2006.

This effort will involve all members of the government and the participation of the Parliament. It is consistent with the terms of the Constitutional bylaw on budget acts of 1 August 2001. This process will provide the State with the opportunity to define objectives and implement organizational reforms at the ministerial level.

Reforming the State remains a key objective of the government. The Prime Minister sent a letter to all ministers on 2 December regarding this reform that announced a new budget procedure, to be launched in the first quarter of 2003. To this end, the ministers will conduct a mid-term review of measures launched in connection with the current Budget Act and propose further means of achieving greater efficiency in the deployment of financial and human resources over 2004-2006. The multi-year reform programme of the ministries will then be developed by each minister and presented to the Parliament before the end of 2003.

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[2] See the multi-year programme for France for 1999-2002.

Social security expenditure will increase by 1.6% p.a. over 2004-2006

This rate is marginally above the growth rate retained in the preceding programme. However, it represents a more credible projection and is based on the assumption that cost-containment efforts and efficiency improvements pursued in 2003 will continue over 2004-2006.

> *Forecast trends for health insurance expenditure will be accompanied by an in-depth reform of the healthcare system.*

The Social Security Financing Bill for 2003 provides for growth in health insurance spending of 3.8% next year in real terms. The government has targeted average growth of 2.5% p.a. in real terms over the 2004-2006 period. After particularly steep increases in 2001 and 2002 (+4% at constant prices), this return to a more reasonable rate will depend on general improvements in administration and management and will not be achieved at the expense of the excellent quality of the healthcare system.

The Social Security Financing Bill for 2003 constitutes a first step in this process. In particular, it implements structural reforms to achieve savings on prescription drugs, given the particularly high level of spending in this area in France combined with the low penetration of generics. To this purpose, fixed coverage amounts will be applied for the generic category while prescription drugs of limited or insufficient clinical utility will progressively cease to be reimbursed.

A Supplementary Social Security Financing Act is to be presented by mid-year to provide an opportunity to introduce necessary corrective measures. This initiative is aimed at strengthening the credibility of the government's objectives in healthcare spending.

In general, the government has laid the foundations for a new partnership with healthcare professionals, based on building a relationship of confidence and instituting greater direct responsibility for healthcare professionals. This new partnership will be accompanied by the abandonment of certain control mechanisms that have proven ineffective in favour of an approach based on dialogue and recommendations similar to examples found in other European countries and in some French regions. It will also involve negotiations on cost-containment measures, such as the reduction of the number of house calls and the development of generic drug prescriptions, moves which have already shown very positive results.

In conjunction with these reforms, the government also launched a major initiative to modernize hospital management and services (*Hôpital 2007*) accompanied by an investment programme involving innovative financing mechanisms and reforms inspired by international pathology pricing standards. Its ultimate goal is to develop a true public health strategy: key objectives include developing a better system of prevention and remedying existing weaknesses in this area.

In the future, the government intends to launch a major consultation process involving lawmakers, business and labour groups, health insurance administrations, and other key partners of the healthcare system, focusing on three areas: the clarification of the role and responsibilities of the various partners (particularly the central government and the social security administration), the sharing of coverage between basic insurance and complementary insurance, and the fixing of spending objectives based on medical criteria.

*For **old age insurance**, the government will launch a reform in 2003 of the pay-as-you-go retirement systems to ensure their long-term viability.*

As the baby boom generation reaches retirement age in large numbers and gains in life expectancy continue to be made, major financial imbalances can be expected in the years ahead if nothing is done now. For this reason, the government intends to launch a reform of the retirement system, after extensive consultations with business and labour groups between now and the end of the first half of 2003.

<u>Local government spending will remain at strong levels</u>

Local government spending would increase at a rate of 1.9% p.a. at constant prices over 2004-2006. The impact of the long-term care allowance for the elderly (*allocation personnalisée d'autonomie*) adds to local expenditure, requiring local government to raise taxes in 2002 and, undoubtedly, in 2003. For this reason, the government announced a reform designed to give local government greater leeway in determining the conditions of access to this benefit and to guarantee greater solidarity among the various *départements*. The contracts between the State and local government (*contrats de plan*) and expenses devoted to treatment facilities for water and household waste will continue to drive local government investments (approximately +3.3% p.a. at constant prices). Debt service charges will decrease as local government continues to reduce its debt.

Transfers of authority between central government and local government will occur as decentralization measures are implemented. Authorities that can be more effectively managed at the local level – and for which more direct proximity to beneficiaries and taxpayers is desirable – will be transferred. The sharing of authority between central government and local administrations will be clarified and areas of administrative overlap will be eliminated. This decentralization is meant to provide greater management efficiencies in favour of taxpayers. The transfer of resources accompanying this decentralization will allow local governments increased financial autonomy. The first phase of this process will involve granting greater freedom to local governments in setting local tax rates in 2003, and, in subsequent years, the transfer of central government taxes is foreseen. Because no decision has yet been made, the stability programme is based on current allocation amongst the various administrations.

The total share of public expenditure should decline by 0.6 % of GDP in 2003, after remaining relatively stable between 1998 and 2002. This downward trend will continue over 2004-2006, on the basis of 1.9 % of GDP in the 2.5% growth scenario and 2.6 % of GDP in the 3% scenario These structural improvements will enable the government to fully finance its tax and social contribution cuts while meeting its deficit reduction targets.

III - Structural tax reforms in favour of employment and entrepreneurial initiative

The situation in France is currently well documented. The level of taxes and social security contributions in France is 8 % of GDP higher than the average for the OCDE. This situation reflects past choices made in the area of welfare programmes and public services. In addition, over the last two decades the labour market has borne the burden of increases in tax and social charges, aggravating structural unemployment and undermining the competitiveness of the French economy. Finally, taxes and social security contributions are excessively complicated and heterogeneous: for example, 95% of taxes and duties account for only 20% of total receipts.

The government's strategy with respect to tax and social security levies has two objectives: on the one hand, to stimulate employment and entrepreneurial initiative, and on the other, to increase the attractiveness of the French economy. Reforms examined in the new parliament will focus on tax and social security cuts and the simplification of the tax system.

The second half of 2002 and the year 2003 will in this respect be a transitional period meant to encourage a better deployment of the workforce: a loosening of regulations concerning the 35-hour working week and the elimination of coexisting minimum wage systems in favour of the higher-paying scheme. This rationalization will be offset by tapered reductions in social charges on low salaries, incentives in favour of the recruitment of young jobseekers based on social security contribution exemptions for unqualified workers under 22 years of age, and incentives in support of a return to employment for part-time workers (extension and revaluation of the earned income tax credit, or *prime pour l'emploi*). The measures pursued to reduce the level of tax and social security are principally aimed at promoting employment.

This targeted strategy will be pursued in 2004-2006, with further reductions in social security charges and measures in favour of employment and entrepreneurial initiative meant to enhance France's growth potential. The stability programme accordingly provides for reductions of € 9 billion over three years in the 2.5% growth scenario and € 13 billion in the 3% scenario. These reductions will be added to cuts of € 6 billion achieved in 2002-2003.

The simplification of the tax and social security contributions system will increase the attractiveness of France, by eliminating small obsolete taxes and simplifying regulations, resulting in a tax law which will be easier to understand and less subject to change.

IV - The deficit will decline by at least one-half GDP point p.a. over 2004-2006

2003 will mark an end to a period of sustained growth in the public deficit

The structural public deficit, calculated according to the European Commission and other international organizations (IMF, OECD), increased approximately by ¾ to 1¼ GDP point between 1999 and 2002. This trend reflects a pro-cyclical budgetary policy in the up-cycle that contributed to a serious deterioration in France's public finances. This deterioration is highlighted by the fact that discretionary reductions of taxes and social security contributions exceeded, by 2.5 GDP points, the decline in public expenditure in GDP (which corresponds to structural room for manoeuvre) between 1999 and 2002. The effects of this structural slippage were temporarily concealed by tax windfalls[3] generated in 1999, 2000, and 2001 thanks to favourable economic trends, as well as the significant level of non-tax revenue raised (levies on companies and public bodies).

In 2002, the public deficit associated with the year-end Supplementary Budget Bill was estimated at 2.8%, compared with 1.4% announced in the last stability programme.

2003 will mark an end to the sustained deterioration in the public deficit. Forecasts for the 2003 public deficit are 2.6%[4]. The weight of public expenditure will decline by 0.6 GDP

[3] Elasticity for tax revenue was near 2.0 in 1999, 2000, and 2001, whereas this elasticity is near 1.0 over the longer term. The exceptional and non-structural nature of this tax performance is highlighted by the low level of fiscal elasticity in 2002 (0.1) and 2003 (0.8 in the Budget Bill).

[4] Tax and non-tax measures representing € 0.7 billion, introduced by the amended Budget Bill for 2003, are meant to correct the revenue losses recorded in the 2002 Supplementary Budget Bill. The deficit of the central government for 2003 is consequently maintained at the level foreseen in September. In addition, business and labour partners will together consider the measures that may be deployed to achieve a durable balance for the unemployment insurance system, on the basis of an "escape clause" provided for in the current agreement on France's unemployment insurance organization, UNEDIC.

point, which, accompanied by net tax and social security contribution reductions of 0.2 point (€ 3.15 billion), will contribute to a reduction in the underlying public deficit by 0.4 GDP point. The automatic decline in the rate of tax and social security contributions (0.1 point) and reduced non-tax revenue (0.1 point) will result in a reduction in the real public deficit of 0.2 GDP point. In contrast, the preceding stability programme forecast virtual stability for the deficit between 2002 and 2003.

<u>Increased deficit reduction measures **over 2004-2006** in relation to the preceding programme</u>

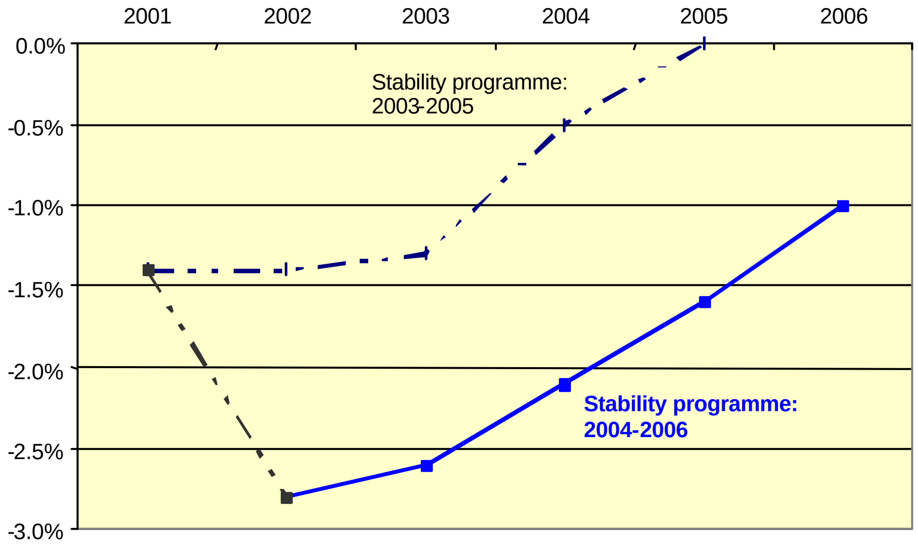
The public deficit will decline by 1.6 GDP point in three years in the 2.5% scenario (vs. 1.4 point in the previous programme), and 2.1 points in the 3% scenario (compared with 1.7 point in the previous programme). Measures to reduce the public deficit have been intensified in relation to the previous programme while maintaining realistic spending targets based upon conservative revenue forecasts.

The public deficit will be reduced to 1% of GDP in 2006 in the 2.5% scenario and 0.5% of GDP in the 3% scenario. The previous programme forecast a return to a balanced situation in 2005, though based on a public deficit in 2002 of 1.4% of GDP, compared with 2.8% today. This delay in balancing public finances reflects the increase in the public deficit registered at the outset and not reduced efforts in the budget consolidation process during the course of the programme.

The structural balance should improve by 1¼ GDP point (2.5% scenario) to 1¾ GDP point (3% scenario) over 2004-2006. On the basis of a consensual evaluation for potential growth in line with Commission projections (approximately 2½%), the structural balance should improve by one-half GDP point p.a. over 2004-2006.

Comparison of public deficit trends in the previous stability programme and in the new version

(GDP points, 2.5% growth scenario)



V - Assuring the long-term sustainability of public finances

To improve public finances, two strategies must be pursued simultaneously in order to prevent the eventual impact of a demographic crisis, which would precipitate a sudden, sharp rise in the tax burden: reform of the pay-as-you-go retirement system, which, on the basis of its existing organization, will no longer be able to guarantee benefits by 2040-2050; and rapid debt reduction, to bring down debt service charges (currently 3 GDP points p.a.).

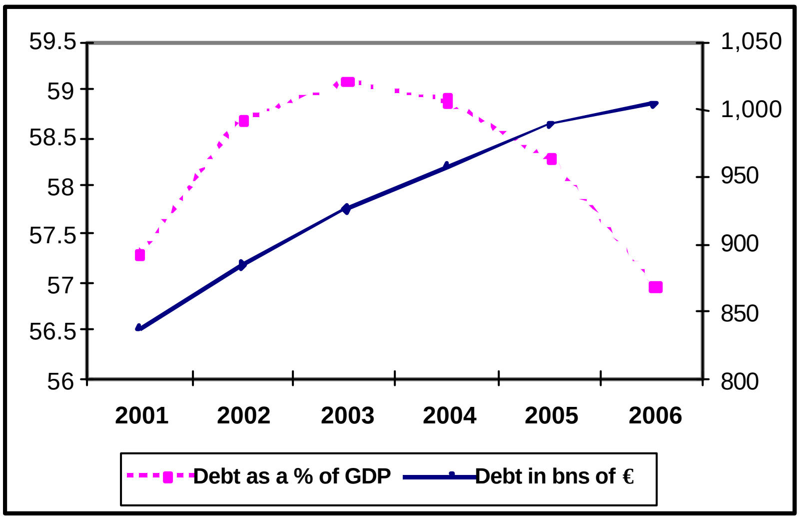
Reducing public debt by following a path already defined for 2006

Reducing the debt-to-GDP ratio is an issue of paramount importance:

- for current generations, because the debt service charge absorbs an increasing share of government resources, today representing an annual expense of € 38 billion, which could be used for other purposes;

- for future generations, which will be required to bear the burden of this charge. The reduction of the debt will contribute, along with the reform of the retirement systems, to guaranteeing benefits and coverage for future generations.

The stability programme provides for reducing the weight of public debt from 2 to 4 GDP points from 2003 to 2006, depending on the growth scenario retained. These debt reduction measures must be pursued beyond 2006 to bring down debt service charges.



Preparing for the consequences of the demographic shock

The work of the *Conseil d'Orientation des Retraites* (COR, advisory council on retirement pensions) and the EPC's Working Group on Ageing Population (AWG) has demonstrated that ageing population trends will have a severe impact on the situation of public finances, which will cease to be viable in the long term if corrective measures are not taken. In effect, durable increases in pension and healthcare costs will require permanent sources of financing to stabilize the weight of public debt in GDP over the years 2040-2050. The financing gap forecast for this prospect is estimated at between 4 and 6 GDP points p.a..

The government announced its plans to launch a reform of retirement systems within the first half of 2003. This reform will be based on several principles: it must assure a more equitable allocation of benefits among all beneficiaries, while taking into account the diversity in the situation and status of various categories of workers; it must also guarantee solidarity between the generations. The modification of the system's organization will be undertaken after consultation with business and labour groups. Finally, individual choice will be assured by creating incentives for continuing to work consistent with actuarial neutrality and opening the possibility of complementary pension benefits through specific savings schemes. In conjunction with this reform, early retirement mechanisms will be phased out in order to increase the activity rate of older workers.