

## **APPENDICES TO THE 2006-2008 STABILITY PROGRAMME**

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## **I - MACROECONOMIC SCENARIO**

### **I.1. Current situation and short-term outlook**

In France as in the rest of the euro area, the recovery that began in the summer of 2003 has continued, with a somewhat buoyant GDP growth rate, on an annualised basis, in the first half of the year (slightly more than 2.5% in France). The euro area benefited from growth in international trade and the stabilisation of the exchange rate. While the pick-up in growth in Germany stemmed almost entirely from foreign trade, a renewed increase in internal demand contributed to stronger than expected growth in France and a significantly higher growth rate than in the rest of the euro zone. Initial estimates point to a slowdown in growth in Europe in the third quarter due mainly to a less favourable international environment. In France, this slowdown was further influenced by exceptional factors, particularly in the automotive sector. Business surveys in the industrial, services and construction sectors, however, lead us to anticipate a business rebound in the fourth quarter. Such a rebound, combined with the higher number of days worked this year, should result in an average annual growth rate of 2.5% in 2004, which is in line with the estimates of the 2005 budget bill.

The GDP is expected to continue to grow at a rate of 2.5% in 2005. French exports should benefit both from the gradual upturn in demand in Europe and from a still strong – though slowing down – international environment, and then increase significantly based on the assumption of a stable euro exchange rate. Household consumption should remain relatively steady as the purchasing power of income increases thanks to the gradual improvement in the employment rate. Positive demand trends and the continued existence of favourable financing terms should also boost the pick-up in business investment.

### **I.2. Outlook up to 2008**

***The potential growth of the French economy in the period to 2008 is pegged at 2.25%***

The growth and inflation forecasts of the 2005 budget bill are based on the assumption of an average Brent oil price of US\$ 36.5 per barrel in 2005 and on the conventional assumption of a stabilisation of the dollar/euro exchange rate at its August level, i.e. 1 euro = US\$ 1.22. If these assumptions hold true, the recent hike in oil prices and weakening of the dollar would mean a downward revision of these short-term growth forecasts.

The potential growth of the French economy, which was roughly 2-2.25% per year in the early 1990s, increased slightly as the decade progressed – nearing 2.50% in 2003 – thanks to a reduction in structural unemployment and strong investment growth at the top of the cycle. Potential growth should, however, taper off on its own in coming years due to the ageing of the population. In fact, starting in 2005-2006, large numbers of baby

boomers will begin to reach retirement age, triggering slower growth in the labour force during this period. The structural reforms introduced by the government, particularly as regards the labour market and retirement pensions, are designed to increase the labour force participation rate to offset this slowdown.

In addition, a measure approved in 2003 that eliminated a public holiday should cause potential activity to eventually increase by approximately 0.3 GDP points. It could take several years for the effect of this change to be felt, starting in 2005. Potential growth is therefore estimated at 2.25% over the 2005-2008 period.

***A scenario of 2.25% actual growth per year has been adopted***

Following three years of slow growth, the French economy built up an estimated output gap at 2 GDP points in 2003. Two years of stronger-than-potential growth would reduce this gap to slightly more than 1.50 GDP points in 2005, with the prospect that activity would continue to catch up in the medium term. The programme also assumes that growth will continue at an annual rate of 2.50% over the 2006-2008 period. This growth would be mainly driven by domestic consumer demand. Inventories would have only a slightly positive impact on growth, at a time when growth would merely be returning to its average rate. Consumption would increase by approximately 2.50% per year, underpinned by a continuing gradual decline in the savings rate. Total investment is expected to increase by 3%, slightly more than business activity, mainly because of firms' need to bring their capital stock up to date. Foreign trade would no longer have an adverse effect on growth in 2005, and would affect it only minimally thereafter, given the fact that growth in France would be similar to that of the euro zone. Inflation would be held at 1.50% per year during the 2006-2008 period since the output gap would allow an improvement in activity without a rise in prices.

***Stronger growth remains likely***

The assumption of an average actual growth rate of 2.5% per year in 2006-2008 is conservative in light of the growth gap built up in recent years. According to previous estimates, this gap would only be partially reduced within the projected timeframe. Stronger actual growth without inflationary pressures is therefore conceivable so long as monetary and financial conditions remain favourable within the euro zone.

<i>2006-2008 average</i>	<b>Scenario</b>
GDP	2.5%
Domestic demand	2.4%
Household consumption spending	2.5%
General government expenditure	1.2%
Gross fixed capital formation	3.0%
Including companies <sup>1</sup>	4.5%

<sup>1</sup> Non-financial corporate companies and unincorporated companies.

Contribution from inventories	0.1%
Exports	6.1%
Imports	6.1%
GDP prices	1.5%
Consumer prices	1.5%
Private sector wage bill	4.0%
Average nominal per capita wage - private sector	2.9%
Dependent labour force - private sector	1.1%

### I.3. Sensitivity test regarding the macroeconomic scenarios

The macroeconomic scenario used in the stability programme is based on a set of assumptions regarding the French economy's international and financial environment, which, of course, is subject to a number of risk factors. International forecasts for 2005 are based on the following assumptions, which, for the most part, have been conventionally carried forward over the 2006-2008 period.

- A very gradual return of international trade to its long-term growth trajectory. The United States would see growth of 4.1% in 2004 and 2.9% in 2005, vs. 4.4% and 3.0% respectively for these two years according to the latest forecasts by the European Commission<sup>2</sup>. Growth in Japan would be at 4.2% in 2004 and 2.3% in 2005, compared with 4.2% and 2.1% respectively. The growth forecasts for the euro area are also very similar: 1.9% in 2004 and 2.2% in 2005, vs. 2.1% and 2.0% according to the European Commission. Overall, these differences are consistent with an assumption that international demand for French goods is slightly lower than that assumed by the European Commission for 2005 (7.0% vs. 7.4%).
- A crude oil price of US\$ 36.7 per barrel in 2004 followed by an average of US\$ 36.5 in 2005, compared with US\$ 39.3 in 2004 and US\$ 45.1 in 2005, according to the Commission.
- A conventional stabilisation of the dollar/euro exchange rate at US\$ 1.22, vs. US\$ 1.24 for the Commission in 2004.

Should these different assumptions become a reality, it is possible to assess the implications for the French economy by recalling the consequences of stronger growth in world demand for French goods, a rise in oil prices and an appreciation in the exchange rate, and by mentioning, for the record, the effect of a rise or fall in interest rates. According to the results shown above, we can see that, based on the Commission's assumptions, activity would be revised downward – though minimally (-0.2 points) – in 2005 and almost not at all in 2006 (- 0.1 point).

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<sup>2</sup> In its "Economic Forecast: Autumn 2004".

## A. Impact of higher world demand for French goods

An increase in world demand for French goods begins by having an impact on exports alone (almost), later spreading to the rest of the economy, in particular via an upward revision of corporate investment.

Assuming that nominal interest rates remain unchanged, a permanent increase of 1% in world demand would therefore result in an improvement in activity of roughly one-quarter GDP point and approximately 30,000 additional jobs after two or three years. The impact on inflation would be virtually nil if the exchange rate remained the same.

By way of illustration, an increase of 1% in world demand for French goods, for example, corresponds to a one-off increase in US growth of two-thirds of a point with a spillover effect on the entire world economy.

### Impact on the French economy of a 1% increase in world demand for French goods (1)

*(% deviation from the benchmark scenario)*

	2006	2007	2008
GDP	0.2/0.3	0.3	0.2/0.3
Total employment (thousands)	5/10	25	30
Household consumption prices	0.0	0.0	0.0
Government net lending (GDP points)	0.0	0.1	0.1

Source: MINEFI Forecasting Directorate calculations.

(1) Long-term increase of 1% in world demand occurring in early 2006.

## B. Impact of higher oil prices

A long-term increase in oil prices constitutes a negative supply shock for the French economy and its principal industrialised partners. A hike in the per-barrel price leads to an increase in imported inflation, which directly causes consumer prices to rise. In addition to this automatic effect, prices are pushed upward by the increase in companies' production costs and by the indexing of wages on prices. The rise in consumer prices and the weakening of corporate profits then converge to curb activity.

Traditional macroeconomic models suggest that a long-term increase of 20% in oil prices expressed in US dollars, for example from \$35 to \$42, could result – assuming unchanged European macroeconomic policies – in a loss of activity of approximately two-tenths of a point and a rise in consumer prices of slightly more than one-half point after two years.

If higher inflation also led monetary authorities to raise their interest rates, this would have a further negative impact on activity in the short term.

### **Impact on the French economy of a 20% increase in oil prices in dollar terms (1)**

*(% deviation from the benchmark scenario)*

	<b>2006</b>	<b>2007</b>	<b>2008</b>
GDP	-0.1	-0.2	-0.2
Household consumption prices	0.3/0.4	0.5/0.6	0.5/0.6
Government net lending	0.0	0.0	-0.1

(1) Increase in the price per barrel of Brent crude oil from \$35 to \$42 in early 2006.

### **C. Impact of a 10% appreciation in the euro exchange rate**

A 10% appreciation in the euro exchange rate against other currencies would trigger a slowdown in activity in France of the order of 0.7 points in the first year via a deterioration of external competitiveness and a decline in activity among our euro zone partners. The impact of the drop in exports would be aggravated by the usual multiplier and accelerator effects. Employment would also suffer from this slowdown.

As in the rest of the euro zone, inflation would, however, be mitigated by the appreciation in the effective exchange rate, thereby giving the monetary authorities greater leeway.

Through its effects on activity, the appreciation of the euro would have a significant impact on dependent employment and subsequently on VAT revenue. Revenue losses for the general government sector as a whole would be 0.1 GDP points in the first year.

### **Impact on the French economy of a 10% rise in the euro exchange rate<sup>(1)</sup>**

*(% deviation from the benchmark scenario)*

	<b>2006</b>	<b>2007</b>	<b>2008</b>
GDP	-0.7	-0.7	-0.7
Dependent employment (thousands)	-40	-100	-100
Household consumption prices	-0.6	-1.6	-2.4
Government net lending (in GDP points)	-0.1	-0.1/-0.2	-0.1/-0.2

<sup>(1)</sup> At unchanged nominal interest rates.

### **D. Impact of a 100-bp interest rate increase**

An overall increase in interest rates (including short- and long-term rates) caused by stronger-than-expected inflationary pressures would impair activity in three ways: via the cost of capital, a shift from consumption to savings and, potentially, the exchange rate.

- Investment would suffer most from a rise in interest rates: the increase in financial costs would impair companies' solvency and the return on capital would decrease.

Households' housing investment would also be limited by more expensive credit; at the same time, the increase in interest rates would tend to encourage saving over consumption (substitution effect).

- If the rise in interest rates were to trigger an appreciation in the exchange rate, it would also have an adverse effect on activity through the loss of competitiveness vis-à-vis countries outside the euro zone.

With a constant exchange rate, a one-point increase in short- and long-term interest rates in the euro zone would result in a reduction in activity of nearly .25 point in the first year and .75-1 GDP point in the second and third years. The resulting drop in inflation would be marginal since domestic prices would respond only slightly to this decline in activity.

These assessments factor in the effects of the macroeconomic dynamics within the euro zone, i.e. the negative impact on the French economy of lower demand among its euro zone partners.

**Impact on the French economy of a 100-bp increase in interest rates in the euro zone (1)**

*(% deviation from the benchmark scenario)*

	<b>2006</b>	<b>2007</b>	<b>2008</b>
GDP	-0.2	-0.7/-1.0	-0.7/-1.0
Total employment (thousands)	-7.5	-60/-75	-60/-75
Household consumption prices	0.0	-0.1	-0.2
Government net lending (in GDP points)	-0.1	-0.2	-0.3/-0.5

(1) Long-term increase of 100 basis points in short- and long-term interest rates occurring in early 2006 with the exchange rate remaining constant.

Public finances are affected by an increase in interest rates in two ways. First, general government debt service charges increase due to the increased cost of refinancing and of financing new deficits; second, the decline in activity leads to a deterioration in public accounts.

A 100-bp increase in interest rates would result in a rise in interest expense for the general government as a whole by 2008.

Both public revenue and expenditure would feel the impact of a drop in activity:

- Weaker growth automatically generates lower tax and social security revenue. Revenue received by social security organisations, which is mainly based on the wage bill, is not very sensitive to the composition of the demand. This is not the case, however, with State revenue: VAT revenue is severely affected by a slowdown in household demand but is virtually unaffected by a drop in exports.
- Nominal expenditure (excluding interest expense) would be increased by a weaker labour market and reduced by the fact that most expenses are pegged to inflation (wage bill, benefits etc.).

## II - GENERAL GOVERNMENT BALANCE

### *The public deficit is set to fall below the 3% threshold in 2005*

The 2005 budget bill is based on reducing the public deficit from 3.6 GDP points in 2004 to 2.9 GDP points in 2005. The stability programme calls for a continuation of this consolidation effort during the 2006-2008 period, which would reduce the public deficit to 0.9 GDP points in 2008. The approach described in the previous stability programme would therefore be maintained and the efforts would be carried over into 2008.

Controlling public spending is expected to be the cornerstone of this deficit reduction effort. Government expenditure (on a budget accounting basis) would remain at constant prices during the programme period. Growth in health insurance expenses would be limited to an annual average rate of 3.6% at current prices.

**Table 1: Key public finance indicators (GDP points)**

	2005	2006	2007	2008
<i>General government net lending*</i>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.6</b>	<b>-0.9</b>
Expenditure	53.6	53.0	52.4	51.7
Revenue* <sup>3</sup>	50.7	50.8	50.8	50.7
Compulsory levies (including EU)	43.7	43.7	43.7	43.7

\* Including a one-off payment made in 2005, estimated at € 6.9 billion at the time of the budget bill's presentation.

### *Changes by general government subsector*

The improvement in the general government's financial position would stem primarily from a reduction in the net borrowing of the State by 1.5 GDP points between 2005 and 2008. This reduction would result mainly from the contained increase in the State expenditures (0% per year, at constant prices).

The social security agencies, whose lending capacity remains deteriorated in 2004, are expected to balance their budget in 2007. Savings resulting from health insurance reform and lower unemployment rates should play a role in reducing expenditure. At the same time, the increases in social security taxes implemented under the retirement pension and health insurance reform should help boost revenues.

In the case of state government agencies, the surplus is expected to grow during the 2006-2008 period. Payments made by the CADES (social security debt repayment fund) to the State are scheduled to end in 2006 and the debt of the defeasance agencies (agencies in charge of public debt amortisation through sales) should decline during the period.

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<sup>3</sup> Revenue = compulsory levies + revenue excluding compulsory levies – European Union levy.

Lastly, the lending capacity of local governments is expected to improve after 2006, with local authorities curbing their investment spending during the early years of the new municipal term.

**Table 2. Net lending (+) / borrowing (-) by subsector**

GDP points	2003	2004	2005	2006	2007	2008
<b>General government</b>	<b>-4.1</b>	<b>-3.6</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.6</b>	<b>-0.9</b>
State	-4.0	-3.2	-3.0	-2.3	-2.0	-1.5
State government agencies(1)	0.4	0.4	0.7	0.3	0.3	0.3
Local government	0.1	0.0	0.0	0.1	0.1	0.2
Social security funds	-0.7	-0.8	-0.6	-0.2	0.0	0.1

(1) Including the one-off payment made in 2005 for the admission of EDF's pension scheme to the general scheme, estimated at €6.9 billion, i.e. 0.4 GDP points, at the time of the presentation of the budget bill.

*General government structural balance*

**The structural balance<sup>4</sup> is expected to improve by 0.5 GDP points per year during the 2006-2008 period**

Between 2006 and 2008, real public expenditure should grow much more slowly than potential growth (1.2% on average, versus 2.25%), which would provide some leeway in terms of expenditure, thereby improving the structural balance by 0.5 GDP points per year.

Based on the conventional assumptions used to make this projection, the rate of compulsory levies should stabilise during this time. At the beginning of the period, the spontaneous growth in public revenue should be slightly higher than GDP growth in view of the delayed impact of the economic improvement on revenue. In addition, the programme takes into account changes in levies resulting from measures already approved or proposed (such as the phasing-in of exemptions from social contributions, business tax relief for new investments, and tax measures included in the 2005 budget bill).

**Table 3. Change in the general government balance (in GDP points)**

	2004	2005	2006	2007	2008
Public deficit	-3.6	-2.9	-2.2	-1.6	-0.9
Structural balance, absolute level	-2.6	-2.0	-1.5	-1.0	-0.5
Variation in the structural balance	0.5	0.6	0.5	0.5	0.5

<sup>4</sup> The structural balance is the general government balance adjusted for the effects of the cycle on the public accounts.

### **Box 1: Structural balance and discretionary variation (“structural effort”)**

The general government balance is affected by the position of the economy in the cycle. This means that there is a revenue shortfall and an expenditure surplus (particularly expenditure related to unemployment benefits) when GDP is below its potential level and, conversely, a revenue surplus and a decrease in expenditure when it is above this level.

The purpose of the usual structural balance indicator is to adjust the observed public balance for these cycle-related fluctuations. The method of evaluating the structural balance consists of first calculating the cyclical element of the public balance, i.e. the element related to the economic environment, using a methodology that is common to most international organisations. Practically speaking, this calculation is based in particular on the assumption that cyclical revenues evolve at the same rate as GDP, and that expenditure – with the notable exception of unemployment benefits – is not sensitive to the economic environment. The structural balance is then calculated as a “remainder”, i.e. the difference between the observed balance and the cyclical element.

This indicator provides an international benchmark for assessing the direction taken by fiscal policies. Once the effects of the cycle have been eliminated, we see that the changes in the structural balance include:

- The effort to control spending, measured by the difference between the growth in expenditure and potential growth. When public expenditure grows less quickly than potential growth, the result is a structural improvement in public finances.
- The new measures regarding compulsory levies.

However, aside from these factors, which are directly linked to the direction taken by fiscal policy, the structural balance is affected by other, less relevant factors:

- i) **The structural balance is affected by certain “elasticity effects” on the side of public revenue.** In practical terms, the assumption of unitary elasticity between revenue and GDP<sup>5</sup>, used to calculate the cyclical balance, is in fact valid only on average over an economic cycle. In the short term, however, there are significant fluctuations in this elasticity. In the case of the central government, for example, the range of the apparent elasticity of tax revenue is wide, due primarily to the variability of corporate income tax: the elasticity of net tax revenue can range from zero to two. To assume a unitary elasticity is therefore equivalent to attributing the fluctuations in revenue elasticity entirely to variations in the structural balance, whereas these fluctuations are largely due to the position in the economic cycle. The result is a great deal of confusion in the interpretation of variations in the structural balance.
- ii) Other factors can also come into play, such as variations **in revenue excluding compulsory levies** (non-tax State revenue, for example). Since these changes are not considered “cyclical”, they do affect the structural balance.

In order to focus on factors whose structural nature is the most firmly established, we can therefore remove elasticity effects and revenue (excluding compulsory levies) from the structural balance. The resulting indicator, which can be described as “structural effort” or “discretionary variation in the structural balance”, reflects only the impact of expenditure control and new

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<sup>5</sup> This means that a nominal increase of 1% in activity results in a 1% increase in public revenue.

measures regarding compulsory levies approved by the public authorities. The difference between the structural balance variation indicator and the “structural effort” indicator can be great.

- For example, in 2000 and 2001, we saw a discretionary easing of public finances in the amount of -2.1 points; however, because elasticity of revenue was temporarily well above 1 (approximately 2 for the central government’s net tax revenue), the deterioration in the structural balance was “only” 1 point.
- Conversely, when the apparent elasticity of revenue is less than one, as often happens during periods of sluggish economic activity, the structural balance worsens accordingly. This was the case in 2002-2003. In 2004, **the discretionary consolidation effort, which focused mainly on controlling spending, was expected to reach 0.6 GDP points**, which is not correctly reflected in the variation in the structural balance, because elasticity of revenue was again less than one. **In 2005, the structural effort (excluding the EDF one-off payment) is expected to reach 0.4 GDP points (+0.8 GDP points, including the one-off payment resulting from the EDF’s change in status), 0.3 points of which is the result of controls on spending. During the programme period, the structural balance is expected to improve by 0.5 points each year.**

**Table 4 - Breakdown of the structural balance**

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Real balance	-2.7	-1.8	-1.4	-1.5	-3.3	-4.1	-3.6	-2.9	-2.2	-1.6	-0.9
Structural balance: absolute level	-1.4	-0.9	-1.7	-2.0	-3.2	-3.1	-2.6	-2.0	-1.5	-1.0	-0.5
Structural balance: annual change	0.3	0.5	-0.8	-0.3	-1.2	0.1	0.5	0.6	0.5	0.5	0.5
<b>“Structural effort” 1/</b>	<b>0.7</b>	<b>-0.4</b>	<b>-1.4</b>	<b>-0.8</b>	<b>-0.8</b>	<b>0.1</b>	<b>0.6</b>	<b>0.4</b>	<b>0.4</b>	<b>0.5</b>	<b>0.6</b>
Gains due to difference between spending and GDP growth	0.5	-0.2	-0.4	0.1	-0.4	0.0	0.5	0.3	0.5	0.5	0.6
New measures concerning compulsory levies	0.2	-0.3	-1.0	-0.9	-0.4	0.2	0.1	0.1	-0.1	0.0	0.0
<b>Other</b>	<b>-0.5</b>	<b>0.9</b>	<b>0.7</b>	<b>0.5</b>	<b>-0.4</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.3</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.1</b>
Mechanical increase in compulsory levies (general government as a whole) above GDP growth	0.1	1.0	0.6	0.5	-0.4	-0.1	-0.1	0.0	0.1	0.0	0.0
Revenue excl. compulsory levies	-0.6	-0.1	0.1	0.0	0.0	0.0	0.1	0.2	0.0	0.0	-0.1

1/ Discretionary variation in structural balance, excluding the EDF/GDF one-off payment in 2005.

### **Box 2: One-off payment by EDF-GDF**

The reform – passed by Parliament this summer – of the status of the national power and gas company EDF-GDF entails a change in the nature of the pension system for its employees. The company's change of status from that of a public establishment to that of a limited liability company means that the retirement system for employees will be linked to the general pension systems for company employees, namely the national old-age insurance fund (CNAV – *Caisse Nationale d'Assurance Vieillesse*) and the supplementary retirement insurance systems for executives and non-managerial employees (AGIRC-ARRCO - *Association Générale des Institutions de Retraite des Cadres/Association des Régimes de Retraite Complémentaires*). As part of this reform, and given the characteristics of the pensions of EDF-GDF employees, the transfer of pension obligations entails a net increase in costs for these general systems that will be offset by the firms concerned through a procedure yet to be specified.

The treatment of this transaction in the national accounts must comply with the two principles adopted by Eurostat for equivalent issues. First, payments made to general pension systems that are part of the general government are recorded as public revenue and thus reduce the public deficit by an equal amount. Second, this transaction or "one-off payment" should be booked as a capital transfer received by the general government at the moment when the pension obligations are transferred, regardless of the moment when the funds are actually paid.

The Budget Bill provided for a one-off payment of €6.9 billion (0.4% of GDP). The figure represents only the one-off equalisation payment for the CNAV; no such payment was recorded in the budget for the AGIRC-ARRCO.

The amount of the CNAV one-off payment was recently revised to €7.7 billion. Since all the details of the transaction have yet to be finalised, however, this stability programme will stick to the evaluation adopted for the Budget Bill.

The programme does not take account of any other transactions from which the supplementary pension schemes might benefit. In particular, companies in the electrical and gas industries are supposed to pay €750 m into them in order to offset the cost of their changing over to the CNAV. This payment could be spread over two or three years. In addition to this fee for admission to the CNAV, the current accounting scheme does not take into account any transfers due for joining the supplementary pension systems (possible equalisation payment by electrical and gas industry companies to AGIRC-ARRCO).

### III - GENERAL GOVERNMENT EXPENDITURE

The strategy concerning public finances is based on strict control of public expenditure. It involves setting targets for the growth of public spending in real terms, to be met through State reform, the health insurance system and the pension systems.

#### *Public expenditure set to grow by an average of 1.2% per year in real terms*

Public expenditure is expected to grow at a rate of **1.2% per year, on average, in real terms** over the 2006-2008 period, which represents a substantial easing of the trend observed for the last 20 years. As a result, public spending as a share of GDP should fall by 1.9 percentage points between 2005 and 2008, from 53.6% in 2005 to 51.7% in 2008.

**Table 5 – Annual average growth of public expenditure (constant prices)**

	<b>2006-2008 programme</b>
<b>Public expenditure, of which:</b>	<b>1.2%</b>
State (budget accounting)	0%
State (national accounting system)	0.2%
Social security funds	1.7%
<i>Of which health insurance system (national target for health insurance spending - ONDAM)</i>	<i>2.1%</i>
Local government	1.8%

#### **State expenditure**

For the third consecutive year, the 2005 Budget Bill provides for stabilisation of State spending in real terms, and this is to continue over the 2006-2008 period, confirming the commitment made in the previous programme. Long-term control of general budget expenditures requires considerable redeployment of funds in order to free up resources to pursue the government's priorities.

The factors that contribute to making spending inflexible are indeed very strong. Owing to the steady accumulation of fiscal deficits for 23 years, the government today faces a debt service burden amounting to nearly 14% of the central government budget. In addition, it faces a steep rise in spending for civil service pensions in a demographic context where increasing numbers of government employees are reaching retirement age. Structural reforms will be carried on with, in particular through implementation of the Constitutional Bylaw on Budget Acts, in order to be able to contain the future trend in non-deferrable expenditures and continue to finance the major multi-year sectorial estimates acts of the current legislature.

### **Box 3: Budget reform**

The Constitutional Bylaw of 1 August 2001 introduced a comprehensive reform of the State budget. This new "financial constitution" will be fully implemented by year-end 2005 so that its benefits will be felt throughout the 2006-2008 programme period. **This constitutes an important instrument for State reform.**

In addition to adopting the new budget architecture, the public management system is obliged to make the transition from a resource-based culture to a performance-based culture: the management framework introduced by the Constitutional Bylaw will henceforth be focused on managerial accountability and performance monitoring.

In addition, the Constitutional Bylaw should give Parliament more power in budgetary matters and inform strategic choices concerning public finance: it increases the transparency of budget management and extends the scope of parliamentary authorisation.

In practice, the budget for 2006 and those of subsequent years will be adopted according to an architecture defined in terms of missions, programmes and actions. A *mission* is defined as "a set of programmes contributing to a given policy". Missions, whether ministerial or interministerial in scope, are the budget units on which the Parliament votes, and have been designed to stimulate democratic debate over government policies. *Programmes* cover "appropriations for implementation of an action or set of actions coming under a single ministry and for which specific objectives are assigned, defined in accordance with the public interest, as well as the expected results, and which are subject to evaluation." Programmes are thus the new specialised unit for appropriations, and as such constitute the framework within which public managers must work to meet their assigned objectives. *Actions* describe the content of the programme and consist of various appropriations made for the same purpose. Actions allow precise identification of the components of a public policy, as well as the modes of action and the duties and responsibilities of each body involved.

Moreover, the Constitutional Bylaw introduces a new form of management based on performance. Managers are given considerably more budgetary discretion: they can steer and guide public policy toward the achievement of objectives and thus make the most efficient use possible of budgetary resources. The Bylaw thus makes possible and encourages a new mode of public governance.

Its implementation is a considerable challenge for the government: new ministry budgets, a new accounting system, new management methods and new information systems. As of the end of 2004, significant steps have been taken regarding transparency, performance assessment and the application of experiments in managerial autonomy.

The Constitutional Bylaw on Budget Acts will come fully into effect on 1 January 2006, but many provisions have been implemented early or have been tried on an experimental basis.

**Transparency:** The 2005 budget is the first to be presented in terms of missions, programmes and actions. For the first time, the 2005 Budget Bill presents, for informational purposes only, the appropriations of the State budget according to this new classification scheme based on the end purpose of expenditures. The State is now in a position to indicate the amounts it allocates to each of the 34 missions in the general budget, including nine interministerial missions, and to each of their 132 constituent programmes. The programme coordinators that will be responsible for implementing public policies in our new budgetary framework as from 1 January 2006 were

appointed in June 2004. It is their task, over the coming months, to ensure that the principles of the budget reform are enforced.

In addition, the new government accounting standards, published in July, will allow government agencies to present clearer accounts modelled on the standards applicable to businesses.

**Performance:** This year, on the occasion of the submission of the 2005 Budget Bill, the government sent to Parliament an initial version of the strategies, targets and performance indicators associated with each public policy.

**Experience:** In 2004, all ministries conducted at least one experiment in anticipation of the implementation of the reform. The pace will be stepped up considerably in 2005: all ministries and regions will try out the new framework laid down by the budget reform. These experiments will affect two-thirds of the programmes for which appropriations can be aggregated, amounting to €28 billion in expenditure or 10% of the total amount of the budget. The experiments will give local and regional divisions with devolved powers a more comprehensive view of their spending, and particularly of personnel expenditures, which had previously been managed at the central level. They will thus be able to manage their resources more efficiently and generate considerable budgetary room to manoeuvre.

#### *Debt service and retirement pensions*

Debt service charges should increase much faster than aggregate central government expenditure over the 2006-2008 period: +5.7% per year on average at current prices, given certain assumptions concerning interest rate changes that are consistent with the macroeconomic scenario of economic recovery and catch-up in growth over the programme period. For comparative purposes, the annual increase in debt service charges over the 2001-2005 period should average out to 2.2% at current prices.

#### **Debt service charges over the 2001-2005 and 2006-2008 periods**

	<b>2001-2005</b>	<b>2006-2008</b>
Growth in debt service (annual average at current prices, in %)	+2.2%	+5.7%

The rate of growth in pension expenditure reflects the increased number of government employees reaching retirement age. It will be 4.8% on average at current prices over the 2006-2008 period, as compared to 4.0% over the five-year period of 2001-2005.

**Retirement pension payments by the central government  
over the 2001-2005 and 2006-2008 periods**

	<b>2001-2005</b>	<b>2006- 2008</b>
Growth in pension payments (annual average at current prices, in %)	+4.0%	+4.8%

*Civil service spending*

Expenditure on the civil service, including retirement pensions (43% of all general budget expenditures), should increase by 2.1% per year at current prices over the 2006-2008 period, a rate of growth identical to that used in the previous programme.

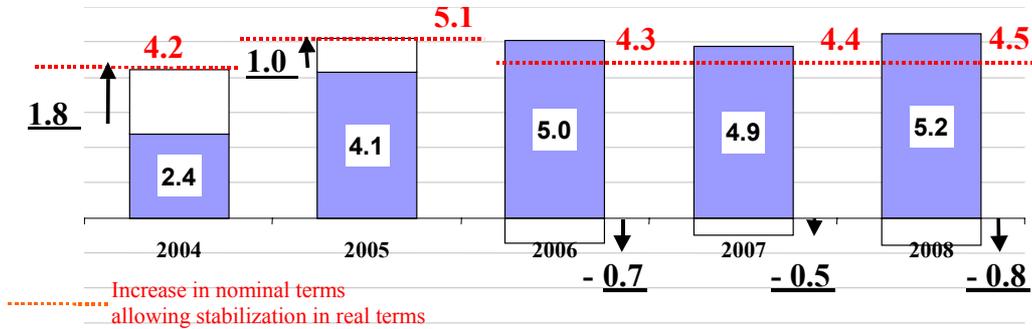
The number of State employees leaving the workforce will increase over the 2006-2008 period. This demographic effect will make it easier to adapt the staffing of various government agencies to their tasks.

*Other expenditures*

Primary expenditures, apart from civil service expenditures, account for 43% of the general budget for 2005. These expenditures are to be cut by 0.5% per year on average at current prices over the 2006-2008 period (amounting to a reduction of 2% per year in real terms) owing to the savings generated by reform of the State and the redefinition of its intervention policies.

Overall, the growth in State spending is to be limited to the inflation rate while still funding the current legislature's priorities (defence, interior affairs, justice, official development assistance and social cohesion). This spending control will be made possible by continued structural reform and a renewed effort to reallocate resources.

**Stabilisation in real terms of State expenditure, 2006-2008**  
**Annual increases (in billions of €)**



- Change in other spending, current prices
- Debt service and civil service expenditure

- ↑ (+) Leeway for adjusting other expenditures
- ↓ (-) Savings to be made by cutting other expenditures

**Box 4: State budget expenditures: from budgetary accounting to national accounting**

The scope of State expenditures as defined in the national accounting system is somewhat different from that of central government budget expenditure in budget accounting terms. Expenditure is higher in the national accounts, mainly because of two items:

- **Some direct levies on revenue** are recorded as State expenditures. This is true in particular of the "GNP resource" that France contributes to the financing of the European Union.
- State expenditure also includes **imputed social contributions**, which represent the contributions that the State would have to pay to balance the civil and military pension system if it did not pay all these pensions itself. The increased numbers of people reaching retirement leads us to forecast rapid growth in pension expenditure over the programme period. This adjustment is neutral with respect to the State balance.

Other accounting restatements in the national accounts also change the spending growth norm of State budget (the shift to the accrual basis of accounting, debt remission for developing countries, spending by special Treasury accounts, and specific budgets).

**Table 6 – Budget accounting and national accounting of State expenditure**  
 (Items contributing to higher expenditure figures in the system of national accounts)  
 [Annual average, at constant prices, in %]

	<b>2006-2008</b>
<b>State expenditure on a like-for-like basis (budgetary accounting)</b>	<b>0</b>
<b>Direct levies on revenue in budget accounting</b>	<b>0.1</b>
<i>For the benefit of local government</i>	<i>0.0</i>
<i>For the benefit of the European Union (GNP resource)</i>	<i>0.1</i>
<b>Imputed social contributions</b>	<b>0.2</b>
<b>Other adjustments</b>	<b>-0.1</b>
<b>State expenditure (national accounting)</b>	<b>0.2</b>

### **Expenditure by social security administrations**

*The reform of the health insurance system should contain the rise in health spending*

On the basis of the analysis of the High Council for the Future of the Health Insurance System (*Haut Conseil pour l'Avenir de l'Assurance Maladie*), Parliament passed legislation in August to reform the health insurance system in order to make it more efficient and check the deterioration in the health-care benefits account. This reform will come into effect on 1 January 2005. The set of measures adopted (see box) aims at generating savings of €11 billion on health-care expenditure by 2007. The growth in the national target for health insurance spending (ONDAM) would thus be brought down to an average annual rate of 3.6% (at current prices) over the 2006-2008 programme period. At the same time, the health insurance system would take in additional revenue amounting to slightly over €4 billion<sup>6</sup>.

#### *Spending on other social benefits*

Over the 2006-2008 period, spending on pensions is expected to grow at a relatively brisk pace as the first of the baby boomers reach retirement age. In 2006, however, the rise in

<sup>6</sup> In all, then, an improvement of €15 billion is expected in the accounts of the health insurance system between now and 2007. For all general government agencies taken together, the improvement is somewhat smaller, about €13 billion, owing to the transfer of central government revenue to social security funds, the transfer of the debt to the Social Security Debt Amortisation Fund (CADES), which allows some savings to be realized on the interest payments of the National Health Insurance Fund for Salaried Employees (CNAMTS), and the impact of the rise in the social security levy on all taxable income (CSG) on the income tax take.

pension expenditures will slacken as the early retirement measure adopted as part of the pension system reform ceases to exert upward pressure. Old age insurance benefits should increase by 2.7% in real terms over the 2006-2008 period.

Family benefits are forecast to increase by 1.0% in real terms over the period. Expenditures for the child-rearing allowance (PAJE - *Prestation d'Accueil Jeune Enfant*) are expected to plateau in 2007.

Lastly, as unemployment drops and the reform of unemployment benefits (the December 2002 agreement) comes fully into play over the 2005-2008 period, unemployment benefits paid by the UNEDIC (National Union for Employment in Industry and Commerce) will stop rising and the UNEDIC will be back in surplus by 2008. Expenditure on unemployment insurance should drop by 4.4% per year, at constant prices.

**Average change in social welfare benefits over the 2006-2008 period (at constant prices)**

Health	1.7%
Old age insurance	2.7%
Family benefits	1.0%
Employment	-4.4%
Housing	1.5%
<b>Total</b>	<b>1.7%</b>

**Box 5: Reform of the health insurance system**

The reform of the health insurance system involves three main thrusts:

**1. Reorganisation of the management of the health insurance system**

The clarification of the division of responsibilities between the State and the health insurance funds, within the framework of a revised system of joint representation, gives the funds a stronger role and enhanced prerogatives with respect to financial management of the system: the funds become the guarantors of the financial balance of the health insurance system and the attainment of public health targets, and they also have the task of making proposals to Parliament; plus, their means of taking action have been broadened (real discretionary power over rates, repayment terms and medical fees) and their structure reformed (in particular, with enhanced managerial powers for the director of the national health insurance fund - CNAM). Another aim is to decompartmentalize the management of the system: decisions taken jointly by the various health insurance systems are encouraged both at the national level – with the establishment of the National Union of Health Insurance Funds (UNCAM) – and the regional level; the funds are invited to participate in formulating policy on hospitals and medication; and a procedure has been established to consult supplementary insurance providers, represented by the National Union of Supplementary Health Insurance agencies (*Union Nationale des Organismes d'Assurance-Maladie Complémentaire*).

The creation of the High Authority for Health will allow informed decision-making by all agencies concerned. Among other things, the authority will be involved in defining medical

criteria and standards regarding best practices and proper use of health-care services, as well as in developing tools to promote effective utilisation of such facilities, both in hospitals and elsewhere.

## **2. Measures aimed at changing the behaviour of both users and health-care professionals, and establishing instruments for medicalised control of health spending**

- Introduction of a personal medical record, mandatory designation of an attending physician, incentives to consult one's general practitioner before seeing a specialist, and an overhaul of the system for care of people with long-term illnesses are all aimed at improving coordination between care providers and management of patients.
- Creation of regional health task forces to handle issues involving both hospital and home care, and experimentation with regional health agencies.
- An obligation for physicians in private practice to undertake a process of evaluation of their practices, to be based on protocols laid down by the High Authority.
- Overhaul of the system of agreed-upon fees for care and an option for the Regional Unions of Health Insurance Funds to enter into contracts with health-care professionals.
- Firmer controls on prescribed exemptions from work and transport, as well as inclusion of a photograph on the next "Vitale" health insurance smart card in order to limit misuse and/or failure to comply with the laws and regulations in force.
- Measures concerning medication (including promotion of generics), modernisation of hospital management, and efforts to obtain productivity gains in health insurance, all of which are aimed at rationalisation of spending.

## **3. Increased revenue**

Revenue transfers from the central government, private-sector contributions via an increase in the corporate social solidarity contribution (known as the C3S, for *contribution sociale de solidarité des sociétés*), broadening of the base of the CSG (social security levy on all taxable income) on wages, increase in the CSG rate on pensions and income from capital and from gambling, and an increase in the tax on the output of the pharmaceutical industry.

## **Local government expenditure**

Expenditure by local government should increase at a rate of 1.8% per year in real terms over the 2006-2008 programme period. Investment should continue to grow at a relatively brisk pace in 2005-2006, in keeping with the local electoral cycle, and then slow down during the two following years. Rising charges under the disability plan and transfers of authority in connection with the decentralisation process should also fuel the increase in local spending. In contrast, interest payments should remain stable over the entire period.

## **Central government agencies expenditure**

Expenditure by miscellaneous central government agencies should increase at a sustained pace in 2006 owing to the interest charges connected with the assumption of the debt of the ACOSS (Central Agency of Social Security Organisations), which is one of the steps

called for in the reform of the health insurance system. In 2007 and 2008, however, they should grow only slightly owing to the gradual termination of defeasance bodies (e.g. for the national coal-mining company Charbonnages de France) and the scheduled termination of the youth employment scheme, the funding for which passes through a central government agency.

#### **IV - TAXES AND SOCIAL SECURITY CONTRIBUTIONS**

Substantial reductions in taxes and social security contributions have been introduced since 2002. In 2005, the overall impact of the measures taken in recent years by government, employers' organisations and labour organisations is expected to be neutral. The provisions of the Budget Bill and Social Security Budget Bill will bring a net reduction of €1.8 billion in 2005 and a further decline in social charges amounting to €1.6 billion. On the other hand, the reform of the health insurance system should lead to a revenue surplus (CSG, C3S) of approximately €3 billion and the funding of the disability plan in the amount of about €1 billion.

The programme takes into account the measure providing for exemptions from local business tax for new investment spending. It also factors in the decline in taxes and social security contributions over the 2005-2007 period, which should result from the measures that have already been adopted.

On the other hand, the programme takes account of the excess of social security contributions arising from the funding of the disability and dependence plans, and, as in the previous programme, provides for rises in compulsory levies that the government and other stakeholders (local authorities, employers' unions and labour unions) could decide to introduce in order to achieve specific objectives.

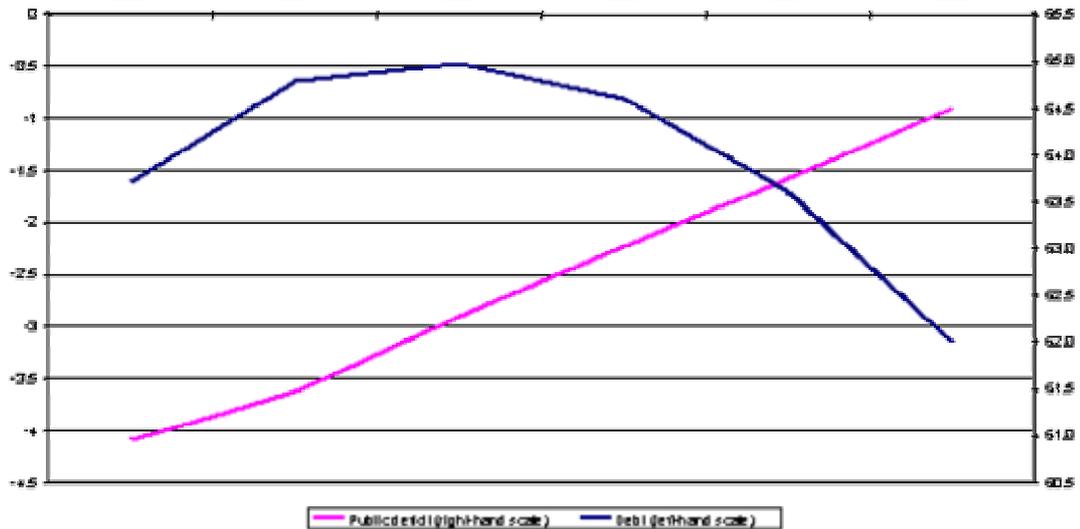
Taken together, the new measures should be neutral with respect to the rate of compulsory levies, which should hold steady at 43.7% of GDP over the 2006-2008 period.

#### **V - GENERAL GOVERNMENT DEBT**

***Consolidation of the public accounts should put a stop to the rise in public debt in 2005 and later cause it to roll back***

The recent increase in the debt/GDP ratio is the consequence of the economic slowdown and the ensuing surge in public deficits. It can also be attributed in part to non-recurring factors. In 2003, for example, the public debt ratio rose by 1.6 GDP points as a result of the increase in the equity capital of France Telecom (€9.6 billion) and of the increase in the central government's cash requirements when the deposits of the Pension Reserve

Fund (*Fonds de Réserve des Retraites*) were withdrawn from its Treasury account. Rapid deficit reduction beginning in 2004 and the return to a 2.5% growth trajectory should make it possible to start lowering the debt/GDP ratio from 2006 onward. This would mark the turning point, and public debt would drop back to 62.0% of GDP in 2008. Debt reduction via the sale of government assets, as happened with France Telecom in 2004, would speed this process along.



When the apparent cost of debt exceeds the economic growth rate, primary budget surpluses are necessary to reduce the debt ratio. Reduction of the public deficit would generate an effective primary surplus above the threshold required to stabilise the debt in 2005. This surplus will continue to improve over the forecasting period, accelerating the debt reduction process.

**Table 4: Change in the debt ratio**

<i>As a percentage of GDP</i>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Debt ratio</b>	64.8	65.0	64.6	63.6	62.0
Variation in the debt ratio	1.1	0.2	-0.4	-1.0	-1.6
Apparent cost of debt	4.6	4.6	4.7	4.9	5.1
Nominal GDP growth (%)	4.5	4.3	4.0	4.0	4.0
Effective primary balance	-0.7	0.1	0.8	1.5	2.2
Primary balance stabilising the debt ratio	0.0	0.2	0.4	0.6	0.6
Interest payment	3.0	3.0	3.0	3.1	3.1

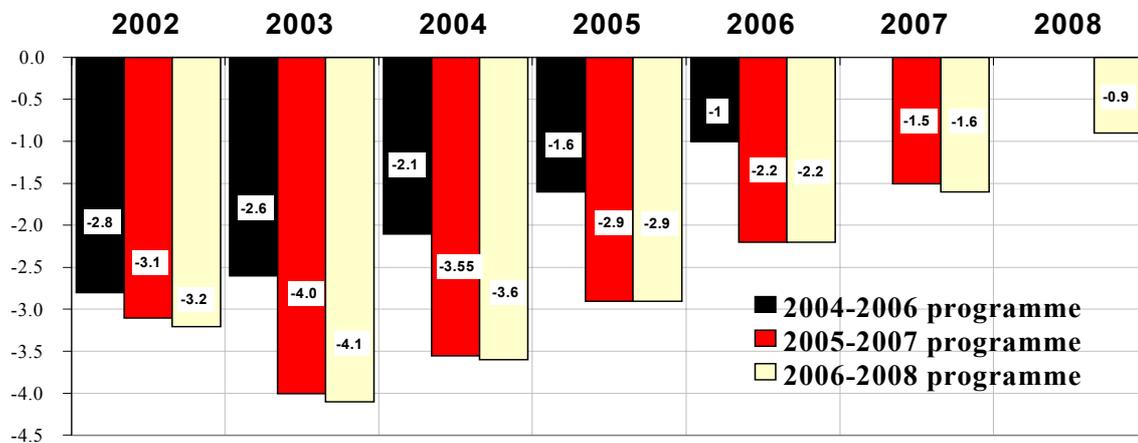
Looking at the State subsectors, the reduction in the central government debt ratio would be obtained mainly through deficit reduction. To a lesser extent, the accumulation of

some lending capacity by miscellaneous central government agencies (mainly the CADES and the Pension Reserve Fund) should reduce their financial liabilities.

## **VI - FROM ONE STABILITY PROGRAMME TO THE NEXT**

The updated stability programme for the 2006-2008 period confirms the pace of improvement in public finances called for in last year's programme, which covered the 2005-2007 period.

**Change in the public deficit from one programme to the next ( 2.5% growth scenarios)**



*The improvement in public finances will follow a path similar to that of last year*

**For 2004**, the target for the public deficit is unchanged, at -3.6% of GDP: the windfalls resulting from tax revenue which were higher than those forecast in the March 2004 notification to the Commission, were offset by a further decline in the accounts of social security organisations and local authorities.

Tax revenue windfalls are mainly due to a pickup in household consumption, reflected in increased VAT revenue and unexpectedly high corporate tax revenue.

The deterioration in the social security accounts can be attributed to several factors: the economic recovery was still too recent in 2004 to exert its full impact on the wage bill and hence on social security contributions; unemployment insurance expenditures were *temporarily* higher than forecast (owing in particular to a court decision against the immediate application of the new UNEDIC agreement); the national target for health insurance spending was exceeded once again (an increase of 5.2% as against the forecast 4.0%); and excessive spending on the part of local authorities led to a slight deterioration in local accounts as well.

**For 2005**, the budget bill maintains the target for the public deficit at 2.9% of GDP. Next year, France will thus have left this situation of excessive deficits behind.

**Subsequently, over the 2006-2008 period** the improvement in the general government balance should reach 1.9 GDP points, as in last year's programme.

**Public expenditure is expected to be slightly higher** than in the previous programme: an annual average growth of 1.2% in real terms over the 2006-2008 period, as against

1.1% in the 2005-2007 programme. Outlays on retirement benefits will increase over the programme period as the baby boom generation reaches retirement age.

### Average growth in real expenditure over the programme period

<i>In real terms</i>	2006-2008 programme	2005-2007 programme
<b>General government<sup>2</sup></b>	<b>1.2%</b>	<b>1.1%</b>
<b>State (budget accounting)</b>	<b>0%</b>	<b>0%</b>
<b>State (national accounting)</b>	<b>0.2%</b>	<b>0.3%</b>
Social security organisations <sup>1</sup>	1.7%	1.7%
- <i>Of which health insurance</i>	2.1%	2.2%
- <i>Of which retirement benefits</i>	2.8%	2.8%
Local government	1.8%	1.9%
Central government agencies	1.1%	0%

<sup>1</sup> Unchanged scope.

<sup>2</sup> The sum of the expenditure figures for the subsectors is not equal to total general government expenditure, because of transfers between subsectors.

On the revenue side, the two successive stability programmes are quite similar, with hardly any change in the rate of compulsory levies over the programme period: budget consolidation is to be achieved through better control of public spending rather than through higher taxes and social contributions.

## VII - THE LONG-TERM CONTEXT OF PUBLIC FINANCE

This section extends the time horizon over which public finances are assessed and places the multi-year programme in a long-term context, making it possible to grasp the negative impact of the ageing of the population on the sustainability of public finances and to gauge the scale of the structural reforms implemented to address this issue.

***The ageing of the population and the mechanical increase in health spending (before the reform) raise serious questions about the long-term sustainability of public finances.***

As an automatic consequence of the ageing of the population and the resulting rise in the dependency ratio, certain spending categories, particularly retirement benefits and health spending, can be expected to absorb a larger share of national wealth in the coming years. This trend will be particularly marked because the needed adjustments to our social security systems have been deferred for far too long: before the 2003 reform, it was estimated that outlays on retirement benefits in France would increase by 4 GDP points by the year 2040.

In addition to the "mechanical" impact of an ageing population, changes in health spending are determined by demand-side factors, such as the increase in the standard of living<sup>7</sup>, or by supply-side factors, in particular related to technological progress. Thus, over the past 40 years, spending on health care has grown two percentage points faster than our national wealth annually, rising from 3.5% of GDP in 1960 to 8.9% of GDP in 2002.

Forecasting the trend in public debt to assess the financial implications of the expected rise in social spending is a difficult matter. For this reason, international organisations use other indicators, such as the "present discounted value of the financing gap". This indicator corresponds to the immediate boost in revenue (obtained through an increase in contributions, for example), which – carried forward on an identical basis as a share of GDP in coming years – would set the social security accounts on a sustainable path<sup>8</sup>. This instrument summarises the various projections of future increases in social spending, transforming a long-term, year-to-year projection into a single indicator.

For the pension system, for example, the present discounted value of the financing gap ("h" in Box 6) was 3% of GDP in 2003 before the reform. The advantage of this indicator is that it provides a figure that is directly comparable to the usual public finance indicators: the deficit and spending as a percentage of GDP.

Under the conventional assumption used by the *Haut Conseil pour l'Avenir de l'Assurance-Maladie* (High Council for the Future of the Health Insurance System), which postulates that health spending will increase until 2040 at a rate 1.5 percentage points above the GDP growth rate<sup>9</sup>, the present discounted value of the financing gap associated with health expenditure would amount, before the reform, to 3.1% of GDP. This estimated figure is used as a reference, but it remains somewhat conventional owing to the assumptions made.

#### **Box 6: Implicit debt and present discounted value of the financing gap**

In the coming years, the ageing of the population will have major financial implications. This box presents two instruments (implicit debt and the present discounted value of the financing gap) that can be used to measure the consequences of the demographic shock for public finances.

Here,  $A_t$  designates the financial imbalance of the social security systems in year  $t$ . The equation traditionally used for debt accumulation enables us to define the "implicit debt" of unfunded social security systems. If  $D_t$  represents the stock of debt at the end of year  $t$ ,  $Y_t$  the GDP,  $i$  the nominal interest rate and  $g$  the nominal GDP growth rate, we have:

$$D_{t+1} = (1 + i)D_t - A_{t+1}$$

Or, expressed in GDP points and in first order:

<sup>7</sup> Apart from the impact of an aging population, if health is a "superior good", demand for which increases with income, then health spending will tend to increase as a percentage of GDP

<sup>8</sup> That is, a path that would make it possible to balance discounted flows of revenue and spending over a long-term horizon

<sup>9</sup> After 2040, it is assumed to increase at the same rate as GDP, a purely conventional assumption used to ensure that, over the very long term, health spending does not approach 100% of GDP.

$$d_{t+1} = d_t(1+i-g) - \alpha_{t+1} \text{ where } \alpha_{t+1} = \frac{A_{t+1}}{Y_{t+1}} \quad (1)$$

- The implicit debt  $\delta$  – which serves as an indicator of future imbalances – can thus be written (in contemporary GDP points):

$$\delta = -\sum_{t=0}^{\infty} \frac{\alpha_t}{(1+i-g)^t} \quad (<0) \text{ where } i > g$$

As a percentage of GDP, this quantity is homogeneous with a debt and represents the sum of the discounted value of future deficits, that is, the debt as seen from the standpoint of today and combined with projections of future deficits  $\alpha$ . This represents the amount that the general government would have to borrow today if it wished to cover all future increases in expenditure. Implicit debt is not a "real" debt unless the spending increase is inevitable.

- Another approach is to measure the immediate increase  $h$  in compulsory levies – held constant as a percentage of GDP and maintained over the entire projection period – that would make it possible to finance the additional expenditure. This indicator, which is homogeneous with a public deficit, is the present discounted value of the financing gap:

$$h \approx (g-i)\delta \quad (>0)$$

This indicator is a useful and informative tool, but has nothing to do with recommendations about economic policy. It is used for purely descriptive purposes: it measures only the immediate adjustment that would make it possible to restore the financial equilibrium of the social security systems.

### ***The ageing of the population makes structural reform essential to ensure the sustainability of public finances***

Short-term budget adjustments will not suffice. Structural reforms help to make public finances more sustainable because they bring lasting savings in public expenditure, thus enhancing the growth potential of the economy (pension reform has the further effect of limiting the shrinking of the labour force), and can induce lasting changes in behaviour (in the case of health insurance reform, this means changes in the supply of and demand for care). In order not to place the entire burden on future generations, these measures should be implemented as soon as possible.

#### ***Pension reform and its impact on the viability of public finances***

The pension reform passed in 2003 is considered to be a gain worth as much as a lasting reduction of the structural deficit by 1 GDP point in the same year. In addition to its direct impact on the financial equilibrium of our retirement system, by extending the contribution period needed to obtain full benefits the reform will lead to a prolongation of people's working lives and hence to an increase in the working population (about 400,000 more people by 2040), and, consequently, a boost in the economy's potential level of activity. This additional activity will bring in added revenue for all aspects of public finances. The gain, for the general government as a whole, would be equivalent to a

lasting reduction of 0.5% of GDP in the deficit. In short, the pension reform should bring a reduction of 1.5 GDP points in the financing gap associated with the pension system.

*Impact of the health insurance reform on the sustainability of public finances*

To make our health system more efficient and check the slippage in the health sector accounts, a reform of the health insurance system has been initiated (see Box 5). Its effects will start to be felt as from 1 January 2005.

The set of measures adopted aims to generate savings of €11 billion on health-care expenditure by 2007. At the same time, the health insurance system will enjoy additional revenue amounting to slightly over €4 billion via revenue transfers from the central government, private-sector contributions through an increase in corporate social solidarity contributions (by means of the C3S – *contribution sociale de solidarité des sociétés*), a broadening of the base regarding the CSG (the social security levy on all taxable income) on wages, an increase in the CSG rate on pensions and income from capital and gambling, and an increase in the tax on the output of the pharmaceuticals industry.

Apart from the achievement of short-term objectives over the 2005-2007 period, the impact of the health insurance reform on the sustainability of public finances will depend on its long-term effects on individual behaviour. By way of example, two scenarios have been considered. In the first, after obtaining the expected savings from the reform of the health insurance system by 2007, it is assumed that beginning in 2008, expenditures will once again begin to grow faster than GDP (1.5 percentage points more per year). Under this hypothesis, the actuarial calculation shows that the reform would bring a structural adjustment of approximately .75 of a GDP point (of which 0.2 GDP point would be due to increased revenue). In the second scenario, which is much more optimistic, it is assumed that the increase in health insurance costs will slow down and stay slower: after 2008, these costs would rise at the same rate as GDP. Under this "high" scenario, the financing gap would be virtually eliminated.

**Figure 2**

**Health insurance spending (in billions of current €)**

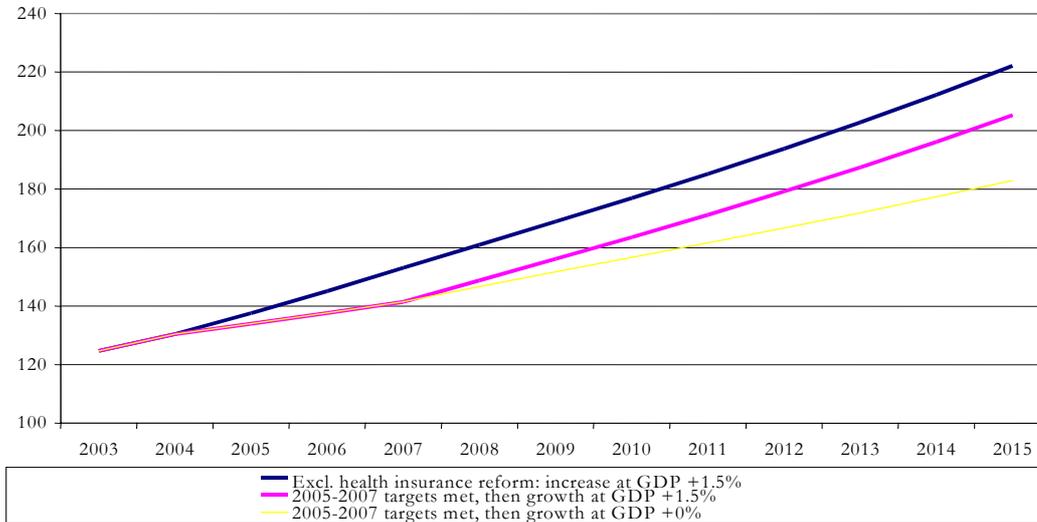


Table 8 below sums up these estimates of the long-term financial impact of reform of the pension and health insurance systems.

**Table 8 - Long-term financial impact of reform of pension & health insurance systems<sup>10</sup>**

<i>Present discounted value of the financing gap of the social systems (as a percentage of GDP)*</i>		Before reform	After reform	Structural gain from reforms
Pensions		3.0	2.0 or 1.5 <sup>11</sup>	1 or 1.5 <sup>12</sup>
Health insurance	Scenario 1: spending increases at GDP + 1.5% after 2007	3.1	2.4	0.7
	Scenario 2: spending increases at same rate as GDP after 2007	3.1	0.4	2.7

\* These estimates are based on discounting as from 2004 and a discount rate of 2% (nominal interest rates are assumed to be higher than the nominal GDP growth rate of 2%).

<sup>10</sup> Pension expenditure trends have their particular dynamics as a result of the inertia of large-scale demographic changes: estimates of the financial return on pension reform can thus be made with more certainty than those for the health insurance system, whose performance is highly sensitive to short-term shifts in individual behaviour.

<sup>11</sup> Once the increase in growth potential due to the reform is taken into account.

<sup>12</sup> Once the increase in growth potential due to the reform is taken into account

## VIII - KEY FIGURES AND MACROECONOMIC ASSUMPTIONS

### General government balance (as a percentage of GDP)

	2004	2005	2006	2007	2008
<b>Net lending (+) / Net borrowing (-) (B9)</b>					
General government	<b>-3.6</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.6</b>	<b>-0.9</b>
Central government	-3.2	-3.0	-2.3	-2.0	-1.5
Central government agencies	0.4	0.7	0.3	0.3	0.3
Local government	0.0	0.0	0.1	0.1	0.2
Social security funds	-0.8	-0.6	-0.2	0.0	0.1
<b>General government (S13)</b>					
Revenue	50.4	50.7	50.8	50.8	50.7
Expenditure	54.0	53.6	53.0	52.4	51.7
Budget balance	-3.6	-2.9	-2.2	-1.6	-0.9
Debt service	3.0	3.0	3.0	3.1	3.1
Primary balance	-0.7	0.1	0.8	1.5	2.2

### General government gross debt

	2004	2005	2006	2007	2008
Gross debt	64.8	65.0	64.6	63.6	62.0
<i>Annual change in gross debt</i>	1.1	0.2	-0.4	-1.0	-1.6

### Comparison between current programme and 2004-2006 programme

	2004	2005	2006	2007	2008
<b>GDP growth</b>					
Previous programme	1.7	2.5	2.5	2.5	-
Current programme	2.5	2.5	2.5	2.5	2.5
Difference	0.8	0.0	0.0	0.0	-
<b>Budget balance</b>					
Previous programme	-3.55	-2.9	-2.2	-1.5	-
Current programme	<b>-3.6</b>	<b>-2.9</b>	<b>-2.2</b>	<b>-1.6</b>	<b>-0.9</b>
Difference	0.0	0.0	0.0	-0.1	-
<b>Gross debt (consolidated general government)</b>					
Previous programme	62.8	63.2	62.8	61.8	-
Current programme	64.8	65.0	64.6	63.6	62.0
Difference	2.0	1.8	1.8	1.8	-

### Macroeconomic assumptions

<i>2006-2008 average</i>	<b>2004*</b>	<b>2005*</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Real GDP growth	2.5%	2.5%	2.5%	2.5%	2.5%
Nominal GDP growth	4.5%	4.3%	4.0%	4.0%	4.0%
GDP (in billions of current €)	1,627	1,698	1,766	1,837	1,910
GDP deflator	1.9%	1.7%	1.5%	1.5%	1.5%
CPI	2.2%	1.8%	1.5%	1.5%	1.5%
Domestic demand	3.1%	2.6%	2.4%	2.4%	2.4%
Dependent employment growth in market sector	0.1%	1.2%	1.1%	1.1%	1.1%
<i>Sources of growth</i>					
Household consumption expenditure	2.4%	2.4%	2.5%	2.5%	2.5%
General government consumption expenditure	2.4%	2.0%	1.2%	1.2%	1.2%
Gross fixed capital formation	3.6%	3.2%	3.1%	3.0%	3.0%
Contribution of inventories	0.5%	0.1%	0.1%	0.1%	0.1%
Exports	4.5%	6.3%	6.1%	6.1%	6.1%
Imports	7.1%	6.7%	6.1%	6.1%	6.1%
<i>Contributions to GDP growth</i>					
Domestic demand	3.1%	2.6%	2.4%	2.4%	2.4%
Contribution of inventories	0.5%	0.1%	0.1%	0.1%	0.1%
Net exports	-0.6%	0%	0.1%	0.1%	0.1%