

## STABILITY PROGRAMME 2007-2009

In the spring of 2005, the French economy experienced a significant upturn in activity, reflected in a growth rate of 0.7% in the third quarter. According to the economic information available, this improvement should continue in 2006. Ranging from 1.5% to 2% in 2005, growth can therefore be expected to be between 2% and 2.5% in 2006.

This recovery of growth and the accompanying drop in unemployment are not just the product of a stronger international environment. They are also a result of the economic policy conducted by the government, designed to:

- modernise the labour market as part of the *Plan d'urgence pour l'emploi* (Employment Emergency Plan), particularly the *Contrat Nouvelles Embauches* (New Recruitment Contract) for firms with less than 20 employees;
- boost the industrial and research-oriented policies in order to stimulate growth, primarily through regional competitiveness centers (the so-called "pôles de compétitivité") and the law on Research funding;
- support corporate growth, especially for SMEs, by facilitating firms' access to financial support, adopting measures in favour of business development and transfers, and reforming protection and bankruptcy procedures.

They are also driven by the public spending control policy implemented since 2002, which imposes compliance with stable State spending levels in real terms and introduced pension and health insurance reforms.

These first results are obviously not the end of the road. High unemployment and the negative impact of public debt on the government's investment capacity and initiative clearly show the need to continue and intensify the government's economic policy measures.

This is what the government has been doing since it came into office and what it intends to extend through the Budget bill for 2006, which projects a public deficit of 2.9% of GDP, a level which would lead to a stabilisation of public debt. Moreover, spending on the *Plan d'urgence pour l'emploi*, reforming income taxes and local business taxes (*taxe professionnelle*), consolidating the budget even further, and dedicating more spending to public investment should also sustainably boost the growth rate of the French economy. These objectives need to be guided by the permanent wish to offer every citizen the social protection they need as well as growing standard of living.

The rebound in economic growth underway since the middle of 2005, our European partners economic recovery, the recent drop in oil prices and the stabilisation of the euro at a level which more closely reflects fundamentals should all create the right environment for the implementation of these measures.

**After 2005, the Stability Programme presented by the Government for the 2007- 2009 period reflects a determined multiyear debt reduction strategy underpinned by three pillars:** increased efforts to rationalise public spending, efforts to boost potential growth, and divestment of non-strategic assets. The 2007-2009 programme's objective is to achieve a credible reduction of public debt, in line with the ambitious medium-term objectives set by the Government: the public accounts are expected to return to balance and public debt should once again fall below 60% of GDP by the end of the decade.

To reach these goals, the Government plans to adopt new spending rules. State spending should gradually move towards a stabilisation in nominal terms (known as the "zero nominal spending growth rule"). To get there, the Government intends to use the Constitutional Bylaw on Budget Acts (LOLF), designed to upgrade the efficiency of budgetary expenditure. Local government can be expected to

start stabilising real expenditure (the so-called "zero real spending growth rule"). The objective for social security funds is a 1% increase in real terms, which takes into account the natural dynamics of certain social benefits (such as pensions).

Thus the general government net lending should gradually move toward balance over the projection period, which would entail a significant drop in public debt.

### **1. Government policy will support the upswing in activity observed since the spring of 2005 and continue to reduce the public deficit.**

*Strict public spending control should enable a reduction in the public deficit from 3.6% to 3.0% in 2005 despite a weaker than expected economic environment*

Public finance results in 2005 will be affected by a less attractive than expected economic environment. Despite good consumption figures, French growth should be slightly down from 2004 - between 1.5% and 2% - mainly owing to the oil price hikes.

In this difficult environment, the Government has maintained a very strict spending discipline in order to **bring the deficit back to the 3% level in 2005**.

**As regards the State**, the most recent figures confirm that tax revenues should only be slightly lower than the amount forecasted in the initial Budget bill despite a weaker than expected economic environment. Moreover, the Government has adopted a budgetary regulation amounting to almost € billion, and has more recently cancelled a string of appropriations (€ billion) in order to stabilise real State spending in 2005 for the third year in a row.

The situation of the **social security accounts** is clearly improving. The deficit should amount to 0.2 percentage point of GDP in 2005, compared with 1 percentage point of GDP in 2004. This improvement primarily reflects the first impacts of the health insurance reform. Health spending has increased slowly since the beginning of the year. In June 2005, the "Comité d'Alerte" (Early Warning Committee) instituted as part of the health insurance reform did not report significant overspending compared with the nominal spending objective of about 4%. Furthermore, in 2005, the social security accounts benefited from the measures taken to allow the admission of electricity and gas industries pension scheme to the general scheme (lump sum transfer payment for electricity and gas industries)

In all, **the slight increase in public spending as a percentage of GDP - from 53.5% in 2004 to 53.8% in 2005 - was primarily due to local government expenditure's modest** slowdown (a growth rate of almost 3% in real terms after nearly 4% in 2004), which was not enough to keep the growth rate of local spending below that of the GDP.

*Public accounts will continue to improve in 2006; the objective is to lower the public deficit to 2.9% of GDP*

Tax and social security revenues are likely to increase significantly in 2006, due to the cyclical upturn observed in recent months. However, aggregate **tax burden ratio should stabilise at around 44%**.

The decrease in public spending will gather momentum in 2006: general government spending will rise by 1.6% in real terms, which means that **the proportion of public spending in national wealth will fall to 53.6%**.

This result will reflect efforts on behalf both of the State and of the social security funds:

- For the fourth consecutive year, the Budget Act provides for **stable State expenditure in real terms**: this objective reflects the government's unreserved commitment to quality management

and its wish to keep improving the productivity of the public services. A major redeployment effort will be required to achieve this objective given the increase in committed expenditure (mainly pensions) and the need to finance government priorities;

- The **growing impact of the health insurance reform** as well as the complementary measures adopted in order to help achieve the goals of the reform would slow down the increase in health spending (ONDAM) by about 1 percentage point compared with 2005. Moreover, the improvement of the labour market is likely to result in lower unemployment benefits. Lastly, the impact of a number of measures adopted in previous years should reach its full level (plan for dependent people, early retirement for long careers).

By contrast, **local government expenditure** should continue to rise rapidly at a rate of about 3% in real terms.

**The improvement of public accounts in 2006 should primarily reflect the improvement in the State accounts** (the corresponding deficit should be reduced by 0.5 percentage point in the national accounts) and, in view of the historically dynamic nature of health spending, tight control of the social security accounts, the deficit of which should stabilise in 2006 despite the impact of the payment of the electricity and gas industries lump sum transfer in 2005. However, **local government accounts should remain in deficit** in 2006 for the third consecutive year after 10 years of surplus.

**The cyclically-adjusted structural balance should improve by 0.5 percentage point of GDP**, in line with our commitments.

The decrease in the public deficit and the allocation of a significant portion of income from the divestment of public assets to the central and general government debt-reduction programme should reduce the speed of the increase in public debt. **Thus public debt should stabilise gradually, reaching first 65.8% of GDP in 2005 and subsequently 66.0% of GDP in 2006.**

## **2. The government will intensify the consolidation of public finances in 2007 as part of its debt-reduction strategy**

The Government has set two ambitious medium-term objectives for public finances:

- public accounts should return to balance by 2010;
- the public debt should fall below 60% of national wealth by the same deadline.

The Stability Programme for 2007-2009 plays an important part in this determination to reduce debt and consolidate public accounts.

***Structural reforms intended to make public spending more efficient and therefore less dynamic have been successfully implemented since 2002***

The 2003 pensions reform as well as the 2004 health insurance reform were both major steps in the debt-reduction strategy implemented since 2002:

- The effect of the 2003 pension reform is to reduce the tax gap for pensions by at least one-third for the 2040 horizon; for State employees alone, the reform will reduce the corresponding implicit pensions liabilities by 40%;
- The health insurance reform, implemented in 2004 and complemented by the measures taken as part of the Social Security Budget Bill ("PLFSS") for 2006, will make our health system

more efficient and reverse the downward trend of health insurance accounts. In addition to yielding higher revenues, controlling health insurance spending during the programme period should permit significant expenditure savings until 2009;

- In addition to these two reforms, adopting the Constitutional Bylaw on Budget Acts ("LOLF") and the Constitutional Bylaw on Social Security Budget Acts ("LOLFSS") will enable a rationalisation of public spending by introducing more transparency in the presentation of budget acts and by shifting to a public management system based on results and performance.

### *In 2007, the Government will increase efforts to reverse the debt dynamics*

Assuming the deficit remains under 3% in 2006, we will pursue efforts to begin reducing the debt as soon as possible. The independent committee appointed by the Government to analyse the public debt and to determine debt-reduction possibilities (Mission Pébereau) reported its findings in December 2005. The Government has included the committee's proposals in its intensified debt-reduction strategy, based upon three pillars:

- **tightening the control of public expenditure** : each entity concerned must contribute to this effort according to its capacity. The Government has already agreed, from 2007 onwards, to go beyond what is needed to stabilise State expenditure in real terms ("zero real spending growth rule") and to aim for the stabilisation of State expenditure **in nominal terms** ("zero nominal spending growth rule"). Budgets from 2007 onwards will benefit fully from the application of the LOLF, since the government has already identified sources of potential savings in 2006 and after. The organisation of a National Public Finances Conference (Conférence Nationale des Finances Publiques) in January 2006, in order to bring together all of the economic participants in charge of public spending, should help develop means to achieve the different spending growth control objectives: 1% p.a. in real terms for social security expenditure and "zero real spending growth" for local government expenditure;
- **raising potential growth**, first by raising employment rates : this is the purpose of the "Plan d'urgence pour l'emploi", of the income tax reform programmed for 2007 and of the adoption of a bigger "Prime pour l'emploi" (earned income tax credit), intended to make employment financially more attractive than unemployment. However, this goal will also be achieved by allocating more budgetary resources to public investment for the future; this was carried out in 2005 and 2006 by endowing the "Agence Nationale de la recherche" (ANR, the national research agency), the "Agence pour l'Innovation Industrielle" (AII, the industrial innovation agency) and the "Agence de Financement des Infrastructures de Transport en France" (AFITF, the agency for financing transport infrastructures in France) with exceptional funds in order to enhance R&D investment in firms. Last but not least, this is the objective of the local business tax reform (taxe professionnelle), which makes our country more attractive;
- **Sales of non-strategic assets** and allocating the corresponding revenues to the reduction of public debt: this is already illustrated by the privatisation, launched in the autumn of 2005, of toll motorway concessions. From 2007 to 2009, the government intends to continue selling non-strategic assets, which would help reduce the public debt by €5 to 10 billion p.a..

### **3. The return to balance of the public accounts by the end of the decade will reduce public debt to less than 60% of GDP**

#### *The Government presents two economic scenarios*

The Government has chosen to present two public finance scenarios for the 2007-2009 period. They **differ by the level of economic growth considered.**

**The first scenario (low-growth scenario) is cautious.** Indeed, it only marginally takes into account the positive response of the economy to the measures announced by the Government in order to supply a lasting stimulus for employment and productivity. Furthermore, it does not take into account the possible consequences of new measures taken in this direction until 2009. Concerning public finances, the State and the social security funds will continue to rigorously consolidate public accounts while the local authorities will tighten spending control in order to participate in the debt-reduction effort, while maintaining globally stable local tax rates.

**Growth should reach 2.25% p.a.,** i.e. roughly the same level as potential growth. This first scenario provides a robust - because cautious - base for multiyear budget estimates, and particularly for tax and social security revenue projections.

**The second scenario (high-growth scenario) consists in a more proactive approach.** It takes into account the impact of the structural reforms implemented by the Government over the last three years (pension schemes reform, health insurance reform, initiatives to facilitate the creation of new firms, adjustment of the 35-hour working week, “Plan d'urgence pour l'emploi”, reform of the “Galland Act”, Law for Confidence and Modernisation of the Economy (Loi pour la confiance et la modernisation de l'économie), LOLF, etc.). In the same spirit, it builds upon a number of adjustments in the goods market (as described in the National Reform Programme as part of the Lisbon strategy) and in the labour market. The economy will also fully benefit from the leverage generated by the coordination and cofinancing of projects produced by the regional competitiveness centers (pôles de compétitivité), by the “Agence de l'Innovation Industrielle”, the “Agence Nationale de la Recherche” and the AFITF. As in the first scenario, the government will continue to consolidate public accounts.

**Our growth potential will be gradually strengthened (and should reach 3% p.a. at the end of the projection period)** thanks to the stronger dynamics of employment and investment.

**This second scenario illustrates the objectives of the incumbent Government in terms of economic policy.**

In both scenarios, the macroeconomic framework reflects the most recent demographic forecasts, which will have a negative impact on potential growth. When the generation of numerous baby-boomers reach the retirement age, this will automatically reduce the size of the labour force: over the projection period, the 20-59 year old population will even decrease every year.

By contrast, this scenario takes into account the impact in terms of lagging demand (“output gap”), that has accumulated since 2002 due to the cyclical slowdown experienced by France (about 1.5 percentage points of growth). This will have a positive impact on the effective annual growth rate since both scenarios assume that this cumulative output gap will gradually close.

### ***Pursuing efforts to control public spending***

*The LOLF will be fully applied to the State budget*

After four years of stabilised State spending in real terms, the implementation of the LOLF will introduce a new management approach to public expenditure driven by performance and results. Grouping the Budget and the State Reform under the same ministry will also contribute to this effort.

The gradual implementation of the LOLF from 2007 to 2009 foreshadows **far more effective public management.** In fact, the full impact of the LOLF will not be felt before 2007. This is due to two factors. Firstly, the performance indicators will have been measured for the first time in 2006 - and

will therefore be used as a benchmark. Secondly, the audits conducted as part of the State modernisation process will have unearthed sources of potential savings. A first wave of such audits was launched in September 2005 (see part 6).

These gains in efficiency should allow us to go beyond the stabilisation of spending in real terms. Now that the LOLF is fully applied, the prerequisites are in place to ensure a **nominal stabilisation of State spending in the medium term**. A first step towards this objective should be reached as early as 2007, with a slight decrease in State spending in real terms. For example, a 1-percentage-point decrease in State spending in real terms should provide additionally spending margin almost amounting to €3 billion, i.e. nearly the cost of the income tax reform programmed for 2007. After 2007, State spending should be contained even more effectively in order to reach the "zero real spending growth rule" objective: -1.25% in real terms in 2008 and -1.5% in real terms in 2009.

This should speed up the reduction in the State deficit, **down to -1.4% or -1.8% of GDP by 2009, depending upon the scenario**.

*Lower expenditure will make it possible to bring the social security funds back to balance over the projection period.*

For all of the social security funds, it should be possible to limit the average real increase in social security spending to about 1% p.a. during the period from 2007 to 2009.

The decrease in health insurance spending growth rate in 2004 (+5% in nominal terms after +7% in 2003), should continue in 2005 (estimate of around +4%). The recovery of the health insurance branch is therefore well underway and is likely to continue during the period from 2007 to 2009.

Unemployment benefits are expected to decrease, thanks to declining unemployment. The extent of this decrease naturally depends on the scenario considered.

Lastly, family benefits spending should begin to decrease with the gradual return to balance of the branch. On the other hand, spending on the old-age benefits should remain dynamic as the baby-boomer generation begins to reach the retirement age.

#### *Local governments are contributing to the debt-reduction effort*

**In both scenarios**, local governments are aware of the need to take part, like all other general government sector units, in the debt-reduction effort. They will curb their expenditure accordingly. Over the projection period, their expenditure will increase on average by 0.5% p.a. in real terms, reaching "zero real spending growth" in 2009.

## Increase in public spending during the 2007-2009 period

<i>(in real terms, average p.a.)</i>	Low-growth scenario	High-growth scenario
Public spending <i>o.w.:</i>	0.6%	0.5%
State (budget accounting)	-1.25%	-1.25%
State (national accounting)	0.0%	-0.1%
State government agencies	0.3%	-0.6%
Social security funds <i>of which.</i>	0.9%	1.0%
Health insurance spending (ONDAM)	2.2%	2.2%
(in nominal terms)	4.1%	4.1%
Pension spending (in nominal terms)	4.1%	4.1%
Local authorities	0.5%	0.5%

### *A steady reduction in the public deficit*

**Thus the public deficit should return to balance in the high-growth scenario, dropping from -2.9% of GDP in 2006 to a slight surplus of 0.1% of GDP in 2009.** The cyclically-adjusted balance should improve by 0.9% p.a., i.e. almost twice the 0.5% demanded by the Stability and Growth Pact. The deficit should mainly be reduced by efforts to lower public spending.

**The improvement should be slower in the low-growth scenario.** The public accounts should be affected by the additional public revenues not taken into account in the cautious macroeconomic scenario. Thus the deficit should improve from -2.9% in 2006 to -1.0% in 2009.

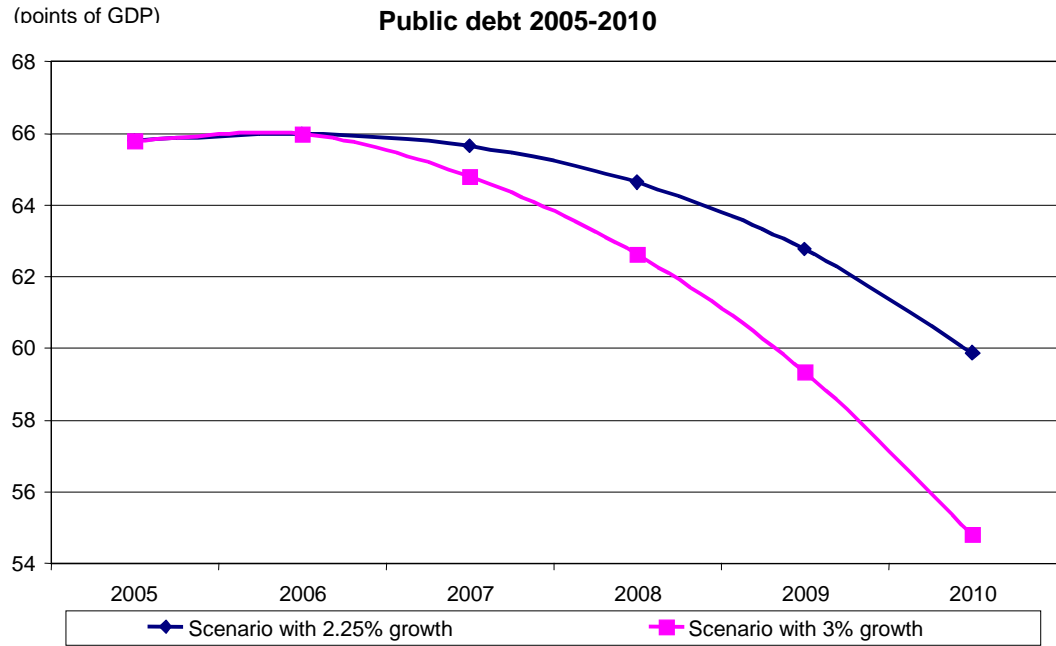
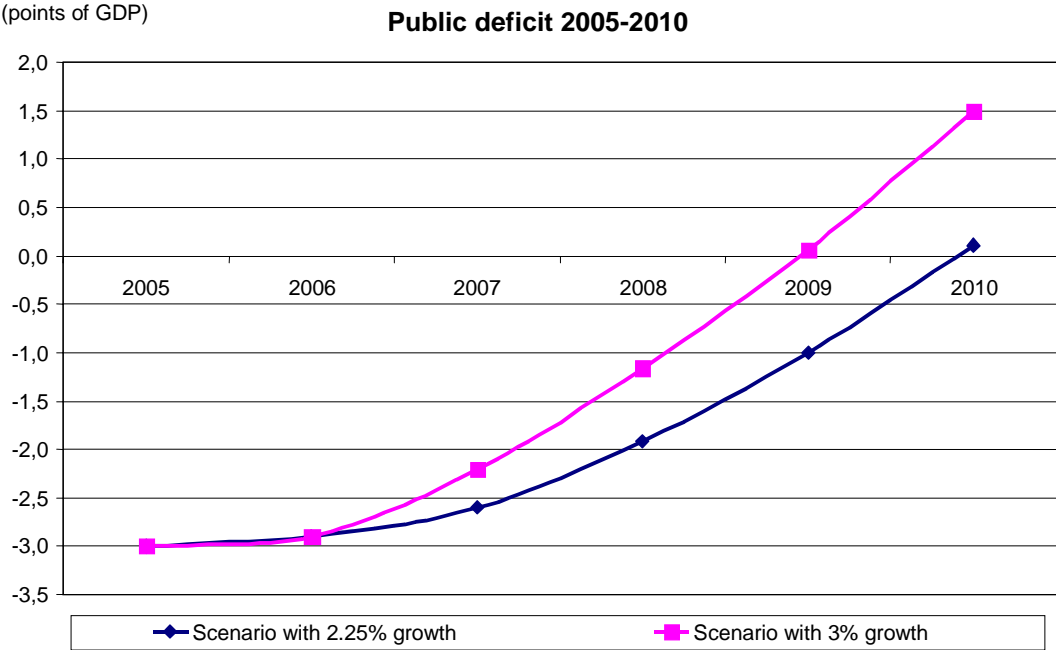
**In both scenarios, public accounts should return to balance before the end of the decade:** in 2009 for the high-growth scenario, in 2010 for the low-growth scenario.

### *The public debt should start to decrease in 2007 in the high-growth scenario*

The debt/GDP ratio is expected to reach 66.0% in 2006, i.e. almost the same as in 2005 (65.8%). In both scenarios, the implementation of the intensified debt-reduction strategy will begin to yield results during the 2007-2009 period :

- in the high-growth scenario, the debt/GDP ratio should fall below the Stability and Growth Pact reference value at the end of the period (59.3% of GDP);
- in the low-growth scenario, the debt/GDP ratio should start improving in 2007 and should return by 2009 to the level recorded in 2003 (62.8% of GDP).

Once the public accounts have returned to balance, **public debt will return to below 60% of GDP before the end of the decade, regardless of the scenario.** In the low-growth scenario, it will be slightly below 60% of GDP by 2010; in the high-growth scenario, it will fall below this threshold in 2009 and hover around 55% of GDP in 2010.







# 1. Economic outlook

## 1.1. Current situation and short-term outlook (2005-2006)

The French economy began to recover in 2004 with a growth rate of 2.3% in a relatively stimulating global environment. The economy slowed down in the beginning of 2005, when France - like all other members of the euro zone - was hurt by slowing growth of the world economy and soaring oil prices. French growth should therefore be slightly down in 2005, ranging between 1.5% and 2%.

Economic growth has nevertheless recovered since the end of the spring of 2005. Entrepreneurs in France, Europe and the rest of the world began to recover confidence at the same time. Thus 2006 offers the prospect of an upswing in international trade in a dynamic global environment. In the event of stable oil prices and a stable exchange rate for the euro, French exports can be expected to improve markedly thanks to this turnaround.

French domestic demand should continue to pick up. Household consumption should remain strong, in line with faster growth of purchasing power as the labour market continues to improve. Capital expenditure should increase in response to sustained demand.

The growth rate for France should range between 2% to 2.5% in 2006. This scenario is strengthened by the recovery of growth recorded in the third quarter of 2005. This central scenario is of course subject to international risks (oil prices, interest rates, foreign exchange rates).

## 1.2. Medium-term outlook (2007-2009)

Two macroeconomic scenarios have been taken for the 2007-2009 period.

**The first scenario (low-growth scenario) is cautious.** It assumes a growth rate of 2.25% p.a. and potential growth of about 2% during the 2007-2009 period. In this scenario, the output gap should be closed gradually, allowing growth to remain slightly above its potential during the projection period without inflationary pressure.

This scenario extends past trends while taking into accounts the consequences of an ageing population. The labour force should increase more slowly as the large group of baby boomers begins to reach the retirement age, lowering the potential growth from 2.25% (during the last two decades) to 2%.

This said, this scenario does not take into account the consequences of any new measures adopted until 2009 to improve the employment rate and productivity.

**The second scenario (high-growth scenario) consists in a more proactive approach.** It assumes a growth rate of 3% p.a. for the 2007-2009 period with a steady increase of the potential growth during the projection period, to reach 3% in 2009. In this scenario, the pace of reforms implemented by the government is maintained, which means that the impact of an ageing population will be offset by the development of other sources of growth, especially labour supply.

This scenario assumes an **increase in the employment rate** due to a lower structural unemployment rate and a higher participation rate of the labour force. These changes should be helped by the recently adopted measures, particularly the *Plan d'urgence pour l'emploi* and the *Contrat Nouvelles Embauches*, as well as the implementation of future recommendations of the Employment Policy Council (Conseil d'orientation pour l'emploi) with regard to improvements in the labour market.

Other factors should help reinforce potential growth, especially an increase in the number of hours worked per capita, faster accumulation of capital and **productivity gains** driven by further adjustment

of the goods markets, the dissemination of new technologies and the impact of renewed research initiatives (particularly the creation of the “Agence pour l’Innovation Industrielle”, the “Agence Nationale pour la Recherche”, and regional competitive centers).

Economic activity should also be driven by the tax measures introduced in the Budget Bill for 2006, which are intended to stimulate employment (the purpose of the earned income tax credit reform which consists in raising the tax credit by 50% over two years and providing for payment on a monthly basis) and to make employment financially more attractive (this is the purpose of the income tax reform, which simplifies the scale of tax brackets and caps taxation). Lastly, the reform of the local business tax (“taxe professionnelle”) is intended to stimulate firms’s investment and competitiveness.

On the demand side, the two scenarios are characterised by different relative adjustments of the components of growth. In a context of stable world growth and constant exchange rates, the contribution of foreign trade to growth should be roughly neutral while domestic demand should grow steadily. Domestic demand should nevertheless be stronger in the high-growth scenario, helped by a more dynamic improvement of employment and income.

Lastly, the two scenarios are characterised by a lack of inflationary pressure, due to the assumed stability of oil prices, as well as a negative output gap over the projection period.

**Table: macroeconomic scenario, 2007-2009**

<i>Average for 2007-2009</i>	<b>Low-growth scenario</b>	<b>High-growth scenario</b>
GDP	2¼ %	3.0%
Domestic demand	2¼ %	3.0%
Household spending	2.4%	3.1%
General government spending	0.9%	0.6%
Gross fixed capital formation	2.8%	4.8%
o.w. businesses <sup>1</sup>	3.8%	7.0%
Contribution from inventories	0.1%	0.1%
Contribution from foreign exchanges	0.0%	0.0%
Exports	5.9%	7.0%
Imports	5.6%	6.7%
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GDP deflator	1¾ %	1¾ %
Consumer price index	1¾ %	1¾ %
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Private-sector wage bill	4%	4¾ %
Average nominal private-sector wage per capita	3¼ %	3.5%
Dependent employment in the private sector	¾ %	1¼ %

## 2. General government balance and debt

<sup>1</sup> Non-financial corporations and unincorporated enterprises.

In 2006, the public deficit will return below the 3% of GDP reference value : the Budget Bill assumes a public deficit of 3.0 percentage points of GDP in 2005 and 2.9 percentage points of GDP in 2006.

The Prime Minister has set two objectives for the period after 2006:

- public accounts should return to balance by 2010;
- the public debt should fall below 60% of GDP by the same deadline.

These objectives are fully taken into account in the Government's objectives for this 2007-2009 Programme. In the low-growth scenario, the public deficit should return to 1.0 percentage point GDP by 2009 while the high-growth scenario provides for a surplus of 0.1 percentage point of GDP in 2009. Strict spending control is the guiding principle of the public finances strategy in both scenarios.

**Table: General government balance (points of GDP)**

	2006	2007	2008	2009
<b>Low-growth scenario</b>	-2.9	-2.6	-1.9	-1.0
<b>High-growth scenario</b>	-2.9	-2.2	-1.2	0.1

## 2.1. Changes by sub-sector of the general government

The financial situation of the general government should primarily be improved by lowering the net borrowing of the State by 1.0 percentage point of GDP between 2006 and 2009 in the low-growth scenario. This reduction should mostly be due to a contained increase in State expenditure (see part 4). In the high-growth scenario, more dynamic revenues should make it possible to reduce the State's net borrowing by 1.4 percentage points of GDP between 2006 and 2009.

The social security funds should gradually return to balance by the end of the programme period. The savings generated by control of health insurance expenditure and the decrease in unemployment should help reverse the spending curve (see part 4). The strong growth in the high-growth scenario should generate more revenue and lower unemployment benefits, which should improve the balance of the social security funds in 2009 by 0.3 percentage point of GDP more than in the low-growth scenario.

In the low-growth scenario, the balance of the central government agencies ("ODAC") should improve by 0.1 percentage point of GDP during the 2007-2009. The defeasance structures should continue to pay off their debts during this period, which should help reduce interest expenditure on public debt. Moreover, the asset allocation strategy of the FRR (the pension reserve fund) should boost its lending capacity. In the high growth scenario, the decrease in benefits paid, thanks to declining unemployment, additional revenues and the transfer of the CNAM's<sup>2</sup> surplus to CADES<sup>3</sup> in 2009 should improve the balance of the central government agencies by an additional 0.2 percentage point of GDP.

Lastly, local governments should recover their net-lending capacity, during the entire programme period in the high-growth scenario and from 2008 onwards in the low-growth scenario. Local governments should moderate their investment spending during the first years after the municipal elections and step up efforts to control operating costs. In the high-growth scenario, local governments should receive additional revenues.

<sup>2</sup> National Health Insurance Fund

<sup>3</sup> Social Security Debt Repayment Fund

**2.2. During the 2007-2009 period , the average improvement of the cyclically adjusted balance<sup>4</sup> should range from 0.5 to 0.9 percentage point of GDP, depending upon the scenario**

**Table: Change in general government balance (points of GDP)**

		2006	2007	2008	2009
<b>Low-growth scenario</b>	Public deficit	-2.9	-2.6	-1.9	-1.0
	Change in cyclically-adjusted balance (net of one-offs)	0.5	0.2	0.6	0.8
<b>High-growth scenario</b>	Public deficit	-2.9	-2.2	-1.2	0.1
	Change in cyclically-adjusted balance (net of one-offs)	0.5	0.6	0.9	1.2

In the low-growth scenario, public expenditure growth should average 0.6% p.a. in real terms between 2007 and 2009, with an average annual potential growth of 2.0%. A significant effort should therefore be made to control expenditure, which should help improve the cyclically-adjusted balance. In the high-growth scenario, efforts to control public spending should be even more sustained, with, on average, a real annual growth of public spending of 0.5% and average annual potential growth of 2.75%.

The elasticity of State taxes to GDP is 1.2 in the Budget Bill for 2006. The multiyear programme provides for a gradual return to a unit elasticity in 2009. From 2007 onwards, the income tax reform - including €3.6 billion from the tax bracket reform - will help limit State tax burden ratio. Taxes charged by local governments conventionally reacts to activity with a unit elasticity. For the social security funds, a part of revenues (particularly tobacco excise) is slightly under-indexed with respect to GDP. In all, the tax burden ratio will go down by 0.6 percentage point of GDP in both scenarios, to 43.4 percentage points of GDP in 2009.

**2.3. Consolidation of the public accounts and allocation of the proceeds from asset sales to the debt-reduction effort should allow us to start lowering the public debt**

**Table: General government deficit and debt (points of GDP)**

		2006	2007	2008	2009
<b>Low-growth scenario</b>	Public deficit	-2.9	-2.6	-1.9	-1.0
	Public debt	66.0	65.6	64.6	62.8
<b>High-growth scenario</b>	Public deficit	-2.9	-2.2	-1.2	0.1
	Public debt	66.0	64.8	62.6	59.3

The Stability Programme assumes that asset divestments will contribute €7.5 billion p.a. to the debt reduction strategy between 2007 and 2009. Together with the decrease in the public deficit during the

<sup>4</sup> The structural balance is the general government balance adjusted for the effects of the economic cycle on the public accounts and for one-off measures

programme period, this should lower the debt/GDP ratio in both scenarios starting 2007. In 2009, this debt ratio should therefore be 62.8 percentage points of GDP in the low-growth scenario and 59.3 percentage points of GDP in the high-growth scenario, both consistent with the objective to return to below 60% of GDP after the programme period.

### 3. Sensitivity analysis and comparison with previous updates

#### 3.1. Sensitivity to international assumptions

The macroeconomic scenarios of the Stability Programme are underpinned by a series of assumptions regarding the international financial environment of the French economy, which naturally remain subject to a number of risks. The underlying international scenario is as follows:

- the oil price remains stable at \$60 in late 2005 and through 2006 and thereafter at the same level in real terms;
- the exchange rate remains stable at a conventional €1=\$1.23;
- global activity and global trade continue to follow their long-term trend in the low-growth scenario and are slightly more dynamic in the high-growth scenario, mainly owing to the additional growth (0.4 percentage point p.a.) generated in the EU by the implementation of structural reforms designed to support growth (Lisbon strategy). World demand for France should thus increase with a growth rate of 6% in the low-growth scenario and 6.5% in the high-growth scenario.

These assumptions are slightly different from those of the Commission. Nevertheless, it is possible to determine the impact of these differences on the French economy and, more generally, the impact of unforeseen factors connected with these assumptions. To do so, we will look at the consequences of a stronger increase in world demand for French goods and services, lower oil prices, a rising exchange rate and lower interest rates.

#### *Impact of a stronger increase in world demand for French goods and services*

An increase in world demand for French goods and services is reflected almost entirely in exports, after which it spreads to the rest of the economy, primarily through increased corporate investment.

At constant nominal interest rates, a permanent increase of 1% in world demand would improve activity by about 0.25 percentage point of GDP and generate about 40,000 extra jobs after two to three years. The impact on inflation would be marginal at constant exchange rates.

A 1% increase in world demand for French goods and services could for example be due to an increase in US growth of 0.66 percentage point, taking into account its dissemination to the rest of the world economy.

**Table: Impact on the French economy of a 1% increase in world demand for goods and services from France<sup>1</sup>**

*(deviation from baseline scenario as a %)*

	<b>2007</b>	<b>2008</b>	<b>2009</b>
GDP	0.2	¼	¼
Total employment (thousands)	16	37	42
Consumer prices	0.0	0.0	0.1
Government net lending (GDP percentage points)	0.0	0.1	0.1

<sup>1</sup> Lasting 1% increase in world demand at the start of 2007

### ***Impact of lower oil prices***

A lasting decrease in oil prices would come as a positive supply shock for the French economy and its principal industrialised partners. Declining crude oil prices help lower imported inflation, directly slowing consumer prices. In addition to this mechanical effect, prices are pushed downwards by the slowdown in production costs and the indexation of wages to prices. Activity is stimulated by a combination of lower consumer prices and higher corporate profitability.

Assuming constant European macroeconomic policies, traditional macroeconomic models suggest that a lasting decrease in crude oil prices by \$10 - e.g. from \$60 to \$50 - would lift activity by about 0.5 percentage point and lower consumer prices by about 1 percentage point after two to three years.

This disinflation would moreover make it possible to continue relaxing the monetary policy of the euro zone, which would further stimulate demand.

**Table: Impact of a \$10 decrease in oil prices on the French economy<sup>2</sup>**

*(deviation from baseline scenario as a %)*

	<b>2007</b>	<b>2008</b>	<b>2009</b>
GDP	0.2	0.5	0.5
Consumer prices	-0.4	-0.8	-1.0
Government net lending (in GDP percentage points)	0.0	0.3	0.2

<sup>2</sup> Lasting decrease of price of Brent from \$60 to \$50 per barrel at the start of 2007

### ***Impact of a 10% appreciation of the euro***

A 10% appreciation of the euro with respect to other currencies would reduce French activity by about 0.7 percentage point during the first year due to a weaker competitive position on the export market and to our euro area partners' declining activity. The effect of reduced exports would be amplified by the usual multiplying and accelerating effects. This slowdown would also affect employment.

As in other countries of the euro zone, inflation would be kept down by appreciation of the effective exchange rate, which would give the monetary authorities more room for manoeuvre.

Through its impact on activity, an appreciation of the euro would have major consequences for taxable jobs and therefore for revenues from VAT and other taxes. Moreover, a higher exchange rate would help reduce social security contributions (based on the wage bill). Thus, the loss of revenue for the general government as a whole would be 0.3 percentage point of GDP from the first year. This phenomenon would be partly offset by lower expenditure (0.1 percentage point of GDP during the first year) on the assumption that most expenses are indexed on inflation.

**Table: Impact of a 10% increase in the euro exchange rate on the French economy<sup>3</sup>**

*(deviation from baseline scenario as a %)*

	<b>2007</b>	<b>2008</b>	<b>2009</b>
GDP	-0.7	-0.8	-0.8
Dependent employment (thousands)	-40	-114	-131
Consumer prices	-0.6	-1.4	-2.4
Government net borrowing (in GDP percentage points)	-0.2	-0.3	-0.5

<sup>3</sup> At constant nominal interest rates.

***Impact of a 100 bp increase in interest rates***

A faster than expected recovery could entail a faster rise in euro-area interest rates. An increase in both short and long term interest rates would affect activity in three ways: cost of capital, consumption/savings trade-off and, potentially, exchange rates.

- capital expenditure would be hurt most by rate hikes: higher financial charges would weaken corporate solvency and capital returns would diminish.
- household investment in housing would also be limited by more expensive credit; rate hikes would moreover tend to favour savings over consumption (substitution effect).
- if the increase in interest rates triggered a higher exchange rate, it would also dent activity through loss of competitiveness vis-à-vis countries outside the euro zone.

Assuming a constant exchange rate, a one-point increase in short and long-term interest rates of the euro area would reduce activity by nearly 0.25 point during the first year and 0.75 to 1 percentage point of GDP after three years. The ensuing decrease in inflation would remain modest as domestic prices respond slowly to declining activity.

These evaluations take into account the macroeconomic balance within the euro area, i.e. the negative impact of weaker demand from France's euro-area partners on the French economy.

**Table: Impact on the French economy of a 100 bp increase in interest rates in the euro area<sup>4</sup>**

*(deviation from reference scenario as a %)*

	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>Without appreciation of the euro</b>			
GDP	-0.2	-0.5	-0.8
Total employment (thousands)	-9	-57	-105
Consumer prices	0.0	-0.1	-0.2
Government net lending +/-net borrowing (-) (in GDP percentage points)	0.0	-0.2	-0.4

<sup>4</sup> Lasting 100 bp increase in short and long term interest rates at the start of 2007 at constant exchange rates.



Public finances are affected in two ways by interest rate hikes. First, the general government debt burden increases due to a higher refinancing cost and the cost of financing new deficits. Secondly, public accounts deteriorate owing to weaker activity.

Slowing growth is mechanically reflected in lower tax and social security revenue. The revenue of social security funds is only marginally affected by the composition of demand because it is mainly based on the wage bill. By contrast, State revenue is much more sensitive to the following factor: slowing household demand cuts into VAT revenue, which is hardly affected by declining export sales. As a result, State tax revenue is reduced.

Nominal expenditure would be raised by a worsening labour market and rising interest charges (by about €1 billion in the first year and about €3 billion in the third). This is offset by the fact that almost all expenses are indexed on inflation (wage bill, benefits, etc.) and by the application of strict rules for State spending growth.

### **3.2. Comparison with previous programme**

The updated Stability Programme for the period from 2007 to 2009 confirms the fact that France's public deficit should return below the 3% of GDP reference value and shows that the public accounts trend is more ambitious than in last year's programme (similar in the low-growth scenario, significantly more ambitious in the high-growth scenario) but has been delayed due to the unfavourable economic environment in 2005.

Comparison between updated programme and previous programme

2005 2006 2007 2008 2009

Real GDP growth

Previous programme		2.5	2.5	2.5	2.5
Updated programme ( low-growth scenario)		1.5-2.0	2.0-2.5	2.25	2.25
	<i>Difference</i>	-1.0 / -0.5	-0.5/0.0	-0.25	-0.25
Updated programme ( high-growth scenario)		1.5-2.0	2.0-2.5	3.0	3.0
	<i>Difference</i>	-1.0 / -0.5	-0.5/0.0	0.5	0.5

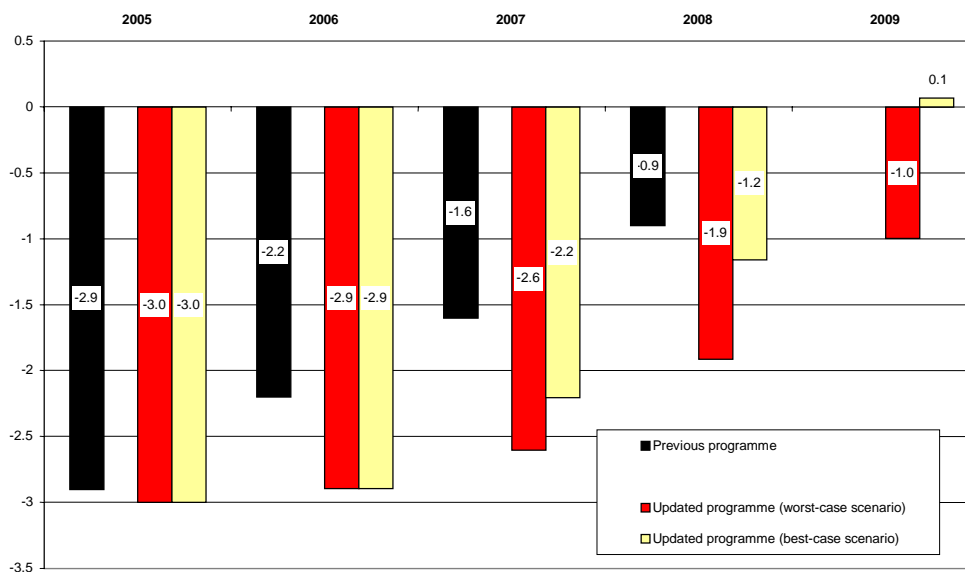
Government net lending (+) / net borrowing (-) (in percentage points of GDP)

Previous programme		-2.9	-2.2	-1.6	-0.9
Updated programme (low-growth scenario)		-3.0	-2.9	-2.6	-1.9
	<i>Difference</i>	-0.1	-0.7	-1.0	-1.0
Updated programme (high-growth scenario)		-3.0	-2.9	-2.2	-1.2
	<i>Difference</i>	-0.1	-0.7	-0.6	-0.3

Gross debt (consolidated general government debt in percentage points of GDP)

Previous programme		65.0	64.6	63.6	62.0
Updated programme (low-growth scenario)		65.8	66.0	65.6	64.6
	<i>Difference</i>	0.8	1.4	2.0	2.6
Updated programme (high-growth scenario)		65.8	66.0	64.8	59.3
	<i>Difference</i>	0.8	1.4	1.2	0.6

Government net lending(+)/ net borrowing (-) (in percentage points of GDP)



The public deficit projected for **2005** is 3.0%, versus 2.9% in the previous programme. This difference is mainly due to slower growth (1.5 to 2.0%, compared with a 2.5% forecast in the previous programme), mainly owing to declining exports in a lacklustre international environment and oil price hikes. Revenues nevertheless remain dynamic, partly due to sustained household consumption and especially to tax bases linked to stock market and property trends. As expenditure was contained, the revision of the deficit amounted to only 0.1 percentage point of GDP.

Thanks to the rebound in investments and exports in recent months, the forecasts for **2006** suggest stronger growth, between 2.0 to 2.5%, which is still below the previous programme's assumption (2.5%). The deficit will remain below the 3% reference value - at 2.9% of GDP - thanks to a significant improvement in the cyclically-adjusted balance net of one-offs (the lump-sum transfer payments for electricity and gas industries pension scheme, corresponding to 0.5 percentage point of GDP in 2005). This reflects the government's intention to consolidate public finances, particularly through strict spending control. The projection of a higher public deficit in 2006 than in the previous programme is mainly due to the delayed impact of a weaker-than-expected economic environment in 2005.

After 2006, the following table describes the consolidation curve of public finances during the period from 2007 to 2009.

#### Improvement in government net lending according to the previous and updated programmes

	Previous programme	Updated programme	
		Low-growth scenario	High-growth scenario
<b>2006</b>	0.7		
<b>2007</b>	0.6	0.3	0.7
<b>2008</b>	0.7	0.7	1.0
<b>2009</b>		0.9	1.2
<b>Annual average during the period from 2006 to 2008</b>	0.7	<b>Annual average during the period from 2007 to 2009</b>	0.6
			1.0

Consolidation of public finances will call for tighter spending control than last year. The Government is giving itself all the means needed to achieve the objectives set by the Prime Minister for the period out to 2010 (in particular the new public finance governance tools described in part 6). **Public expenditure should thus be less dynamic than in the previous programme** : 0.6% in real terms during the period from 2007 to 2009 in the low-growth scenario and 0.5% in the high-growth scenario, 1.2% in the previous programme.

#### Average expenditure growth p.a. in real terms over the projection period

<i>Change in real terms</i>	Programme from 2006-2008	Programme from 2007-2009	
		Low-growth scenario	High-growth scenario
<b>General government</b>	<b>1.2%</b>	<b>0.6%</b>	<b>0.5%</b>
<b>State (in the national accounting)</b>	0.2%	0.0%	-0.1%
<b>State (in the budget accounting)</b>	0.0%	-1.25%	-1.25%
<b>Social security funds</b>	1.7%	0.9%	1.0%
<b>Local government</b>	1.8%	0.5%	0.5%
<b>Central government agencies</b>	1.1%	0.3%	-0.6%

## 4. Public finance trend

### 4.1. Public spending

The Government's public finance strategy is underpinned by strict public spending control. *Average real public spending should increase by 0.6% p.a. over the period from 2007 to 2009 in the low-growth scenario and by 0.5% in the high-growth scenario.*

The spending control objective presented in this programme represents a major effort given the rising cost of debt and the weight of the ageing population and the need to restore the necessary room for manoeuvre to face it.

In the low-growth scenario, the share of public spending should go down by 2.5 percentage points of GDP from 53.6 percentage points in 2006 to 51.1 percentage points of GDP in 2009. In the high-growth scenario, it should decrease by 3.8 percentage points of GDP to 49.8 percentage points of GDP in 2009.

To achieve this target, the State is setting an example by sticking to particularly strict objectives : since 2003, State expenditure (in budgetary accounting) has been increasing at the same pace as inflation ("zero real spending growth" standard). The State is now taking this process one step further and commits to stabilising expenditure in nominal terms : real budgetary expenditure will decrease by 1% in 2007, 1.25% in 2008 and 1.5% in 2009.

#### *State expenditure*

For the first time, the budget (for 2006) was entirely presented, discussed and implemented according to the terms of France's new financial constitution<sup>5</sup>, which imposes presentation of expenditure in missions and programmes and ties budgetary appropriations to objectives and performance indicators (see part 6).

The Budget Bill for 2006 provides, for the fourth consecutive year, for stabilisation of real State expenditure, in line with the commitment enacted in the previous programme. Thus far, the implementation has fully met this requirement since the beginning of the legislature. In cash accounting terms, the Government has not spent one euro more than the limit voted by Parliament. For the period from 2007 to 2009, the objective is more ambitious. The plan is to reduce real State expenditure by 1% in 2007, 1.25% in 2008 and 1.5% in 2009 in order to approach stabilisation of nominal State expenditure, which will require an unprecedented savings and redeployment effort.

There are strong expenditure rigidity factors. The steady accumulation of budgetary deficits over the last 24 years saddles the State with interest expenditures on public debt amounting to nearly 15% of the general budget. The State must now also deal with rising civil service pension spendings as the number of retirements continues to rise. Civilian and military pensions, pegged since 2003 to the price index, will increase by €2 billion in 2006. Large-scale structural reforms will be implemented to keep up with the dynamic trend of irreducible expenditure and to maintain control of State expenditure over the long term.

#### *Cost of debt and pensions*

The cost of debt can be expected to rise much faster than overall State expenditure during the period from 2007 to 2009. The average annual increase should be 4.5% in nominal terms, assuming the

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<sup>5</sup> Constitutional Bylaw on Budget Acts of 1 August 2001 ("LOLF").

interest rate trend is consistent with the macroeconomic scenario for recovery and closure of the output gap during the programme years. By comparison, the nominal increase in the cost of debt is expected to average 1.3% during the period from 2002 to 2006.

The stock of debt has increased rapidly in recent years, albeit almost without impact on the State budget owing to a very favourable rate trend as the high interest rate debt issued in the 90s was paid-off and replaced by debt at low rates. Interest rates can be expected to rise thanks to the economic recovery, gradually erasing this positive effect.

**Comparison of cost of debt trend during the periods from 2002 to 2006 and from 2007 to 2009**

	<b>2002-2006</b>	<b>2007-2009</b>
Change in cost of debt of the State <i>(as an annual average and in nominal terms, as a%)</i>	+1.3%	+4.5%

The pension growth rate reflects the acceleration of civil service retirements. The nominal increase will be of 5.8% p.a. on average during the 2007-2009 period, compared with 4.7% during the last five years:

## Comparison of pensions paid by the State during the 2002-2006 periods and from 2007 to 2009

	2002-2006	2007- 2009
Change in pensions (as an annual average and as a %)	+4.7%	+5.8%

### *Primary expenditure*

Among primary expenditure, civil service personnel spending, including pensions, accounts for 44% of general budget expenditure. Thus an average decrease of nominal State expenditure by 1.25% p.a. will require major efforts to contain the wage bill excluding pensions.

The growing number of retirements will be exploited to adjust recruitment to the changes in structures and missions needed to make the public service more efficient.

Four levers will be used to achieve this:

- the budgetary reform, which introduces new tools to manage the workforce and wage bill more effectively;
- greater possibilities to buy off days off resulting from the reduction in working hours (RTT);
- an incentive mechanism tied to productivity gains, which will consist either of promotion or performance bonuses;
- modernisation audits (see part 6).

Primary expenditure excluding the civil service will amount to 41% of the State general budget in 2006. In order to achieve the objective of reducing the average real State expenditure by 1.25% p.a. in real terms, spending will have to be slashed by making the most of the efficiency gains generated by the LOLF.

The introduction of performance objectives and indicators in the budgetary discussion will allow us to shift gradually from a resource-based approach to a performance-based approach. This strategy is expected to have a positive impact on public management, the social dialogue and service to end users. The asymmetric fungibility<sup>6</sup> of appropriations introduced by the LOLF will further enable us to make the most of the productivity gains and the State reform.

### *Expenditure of the social security funds*

#### Average trend of nominal social security benefits during the programme period (2007-2009)

	low-growth scenario	high-growth scenario
<b>ONDAM</b>	2.2%	2.2%
<b>Family</b>	3.5%	3.5%
<b>Old age</b>	4.1%	4.1%
<b>Unemployment</b>	-5.8%	-6.8%
<b>Housing</b>	3.8%	3.0%

<sup>6</sup> This concept covers the possibility to reallocate part of civil service personnel appropriations (title 2) approved by Parliament to other expenditures, while reallocation in the opposite direction is prohibited.

*The health insurance reform and the measures approved as part of the Social Security Budget Act (LFSS) for 2006 should limit the increase in health spending.*

The marked decrease in health insurance spending in 2004 (+4.9% in nominal terms after +6.4% in 2003) is expected to continue in 2005 (+3.8%). The clearly visible recovery of the health insurance should gather pace during the programme period as the health insurance reform approved in August 2004 continues to come on-stream and social security finances begin to be managed more efficiently under the new Constitutional Bylaw on Social security Budget Bills (LOLFSS) of 2 August 2005 (see part 6).

Moreover, new savings measures have been announced in the Social Security Budget Act for 2006:

- the “pharmaceuticals plan” (“plan médicament”) has been reinforced along three basic lines. The first is the principle of the right price (extension of the list of generic medicines, measures to help speed up the dissemination of generic medicines, price cuts, development of packaging for three-month treatment). The second objective is to adapt the financial coverage of pharmaceuticals, which the High Authority for Health considers insufficient. The third objective is to make the pharmaceuticals industry contribute more to containing the growth of pharmaceuticals expenses;

- efforts will be continued to control the cost of medical treatment;

- hospitals will be asked to contribute to the recovery effort by modernising their purchasing policy, ensuring the use of good practices - particularly in the area of prescription - by restructuring hospital units or by developing alternatives to hospitalisation;

- actions to fight fraud and abuse will be stepped up.

In all, the increase in national health insurance expenditure ("ONDAM") should thus be reduced to 2.5% in 2006 (2.7% on a constant perimeter basis) and subsequently to an annual average of 2.2% during the period from 2007 to 2009.

#### *Other social security benefits*

Unemployment benefits can be expected to decrease due to the reform of unemployment insurance (UNEDIC) and diminishing unemployment thanks to the economic recovery and the reforms launched by the Government.

In the family branch, day-care allowances for young children will continue to rise until 2007. From 2008 onwards, the growth of expenditure is expected to slow down.

By contrast, old-age expenditure should remain dynamic as the baby-boomers begin to reach the retirement age.

To sum up, it should be possible to reduce the average growth of real social security expenditure to about 1% during the programme period.

#### *Local government expenditure*

In both scenarios, investment spending should remain relatively dynamic until 2007 and start to slow down in 2008 and 2009. Special efforts should be made to contain operating charges. Intermediate consumption and the wage bill of local governments should become relatively stable with the curb in the increase in staff, especially the resort to subsidised employment. Their average real expenditure should rise by 0.5% p.a. in both scenarios: +1% in 2007, +0.5% in 2008 and +0.0% in 2009.

#### *Expenditure of central government agencies*

In the low-growth scenario, the average increase in the real expenditure of the central government bodies should be 0.3% p.a. The defeasance structures would continue to pay off debt over the period, which would lower their interest expense. In the high-growth scenario, the slowdown of benefits due to a recovering labour market would also help curb the dynamism of the expenditure of central government bodies.

## 4.2. Revenues

### *State revenues*

The spontaneous elasticity of State taxes to GDP is 1.2 in the Budget Bill for 2006 after 1.4 in 2005. The stability programme conventionally provides for a gradual return to unit elasticity in 2009.

At the same time, the tax cuts announced for 2006 and 2007 should help reduce the tax burden ratio by 0.6 percentage point of GDP between 2006 and 2009 in both scenarios.

The Budget Bill for 2006 provides for extensive tax reforms for private citizens (income tax and earned income tax credit) and businesses (local business tax) in 2007.

In 2007, the income tax reform will help limit the State tax burden ratio. This radical overhaul of tax brackets will make the real household tax rate more transparent and mean a move of the higher marginal rate back towards the European average, at an overall cost of €3.6 billion.

For businesses, the programme contains the local business tax reform ("taxe professionnelle"), which caps this tax at 3.5% of value added and maintains exemption for new investments in order to give businesses a stronger investment incentive.

### *Revenues of social security funds*

During the programme period, the revenues of the social security funds will benefit from the long-term measures decided since 2004. From 2005 onwards, the health insurance reform of 2004 will generate additional revenues of €4 billion for the social security funds, including €2 billion from the increase in revenues generated by the general social security contribution ("CSG"), €0.8 billion from additional revenues generated by the Specific Corporate Solidarity Contribution ("C3S") and €1 billion from the transfer of tobacco excise revenues from the State budget. The revenues of the social security funds should furthermore be increased by €3.2 billion in 2006 and in subsequent years thanks to the increase in the contribution rates for the supplementary retirement benefits agreed by the social partners (AGIRC) and to the measures approved as part of the Social Security Budget Bill for 2006.

### *Local government revenues*

Taxes and social security contributions collected by local governments are conventionally assumed to respond with unit elasticity to activity during the programme period. In practice, this means overall stability of local tax rates during the programme period.

## 5. Sustainability of public finances

Under the impact of an ageing population and the rise in the dependency ratio expected to follow, the weight of certain expenses in national income, particularly pensions and health care, can be expected to increase spontaneously in the years ahead. This trend will be strengthened by the fact that the adjustment of our social security systems was delayed far too long : before the 2003 reform, France's tax gap for pensions was estimated to be about 3 percentage points of GDP.



In addition to the "mechanical" impact of an ageing population, the health spending trend is moreover determined by demand factors, such as a rising standard of living, and by supply factors, particularly technical progress. Thus, during the last forty years, the weight of health expenditure in national wealth rose from 3.5% of GDP in 1960 to 7.8% of GDP in 2003.

In order to deal with the ageing process, the government has launched two comprehensive measures in recent years, i.e. the pensions reform, expected to be finalised during the programme period, and the health insurance reform (reinforced this year by new measures designed to generate high health insurance savings) with the adoption of a new Constitutional Bylaw on Social Security Budget Acts (LOLFSS). The government furthermore continues to build up assets in the Pension Reserve Fund (FRR).

#### *The 2003 pensions reform and its impact on the sustainability of public finances*

The previous programme showed that the retirement reform voted in 2003 would generate an extremely significant gain, equivalent to a lasting cut in the cyclically-adjusted balance of at least 1 percentage point of GDP<sup>7</sup>. This evaluation is confirmed by the most recent figures.

The 2003 pensions reform also scheduled a "meeting" in 2008 between the social partners. This meeting will be an opportunity to once again discuss the parameters of the system (particularly the number of years over which public and private sector employees should contribute) after 2012. The tax gap for pensions remains around 1.5 points of GDP.

#### *The impact of the health insurance reform on the sustainability of public finances*

In order to improve the effectiveness of France's health system and to turn around the deterioration of the health insurance accounts, a health insurance reform was launched in 2004.

Since 2005, the health insurance branch has received additional revenues of slightly over €4 billion (transfer of State revenues, increase in the social solidarity contribution paid by companies, extension of CSG base on wages, higher CSG rate on pensions, investment and gambling income, higher tax on pharmaceuticals advertising).

Moreover, the measures adopted in the Social Security Budget Bill for 2006 and the control of health insurance spending (ONDAM) during the programme period should permit significant savings until 2009. The weight of health expenditure should drop from 7.9 percentage points of GDP in 2005 to 7.5 percentage points in 2009 in the low-growth scenario and from 7.9 to 7.3 percentage points of GDP in the high-growth scenario.

For the period after 2009, we have conventionally used two benchmark assumptions. The first assumes that expenditure will once again increase faster than GDP (1 point of growth more p.a.), the other that expenditure will follow activity. According to the macroeconomic scenario, the tax gap for health expenditure should range between -0.1 and 0.0 percentage point of GDP if expenditure tracks GDP and between 1.6 and 1.8 percentage points of GDP if health expenditure increases faster than GDP after 2010.

The Economic Policy Committee and the Ageing Working Group are currently working on common expenditure projections. The methodology used for health spending differs from the method presented here. It combines age-based expenditure profiles with demographic projections. The preliminary estimates lie in the range of the two conventional scenarios.

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<sup>7</sup> The additional gain would be 0.5 percentage point of GDP if the reform affects the labour supply and potential GDP.

## 6. Governance of public finances

Budgetary governance has recently been upgraded significantly in order to consolidate public finances. These improvements support and complement the European rules. This governance effort focuses particularly on the State and the social security funds. The government is furthermore trying to improve the oversight of public finances in general, including local finances, by organising an innovative public finance conference (Conférence des Finances Publiques) intended to raise the accountability of all public stakeholders for spending control.

### *Organisation of a National Public Finance Conference*

The efforts needed to control public expenditure and maximise efficiency call for a better dialogue between the parties involved in the trend of public expenditure: the State, the social security funds and the local authorities. This was the objective of the National Public Finance Conference held in January 2006. In addition to the State, this conference was attended by associations of elected officials, representatives of the social security funds and the social partners. Its purpose was to give the entire general government sector a clear and shared multiyear public finance strategy which was consistent with the debt reduction objective set by the Prime Minister and the objectives set out in this programme.

This forum was organised to provide all parties with the same amount of information about the trend of public expenditure, the balance of public finances and the trend of debt, to clarify the role of each participant in public expenditure decisions and to develop a general "governance agreement" between all public expenditure managers.

### *Governance of State finances*

Governance of State finances will be entirely modernised during the programme period: the budget for 2006 was the first to be presented in the "LOLF format". When France adopted a new Constitutional Bylaw on Budget Bills (LOLF) in 2001, it introduced more transparency and efficiency in the State budget and made the concept of performance the cornerstone of budgetary discussions (see the boxes on "The Budgetary Reform" and "State Modernisation Audits").

The LOLF moreover contains two specific articles intended to improve the oversight of public finances:

- in order to ensure compliance of the budget outturn with the overall cap on general budget expenditure approved by Parliament, article 51 (4bis) of the LOLF stipulates that the government must present the rates taken to reserves in an annex to the Budget Bill (a predetermined fraction of Budget Bill appropriations is frozen as soon as the Budget Bill is approved);
- in order to make sure windfalls are used properly, the Government must henceforth submit a rule for the allocation of any surplus revenues received during execution (article 34 of the LOLF) to Parliament. This rule must be presented each year in an article of the initial Budget Bill. For example, the Budget Bill for 2006 stipulates that any surplus must be used to reduce the budgetary deficit<sup>8</sup>. The State has agreed to use any windfalls during the 2007-2009 programme period to reduce the deficit.

### **The budgetary reform**

<sup>8</sup> Except any surplus tax revenues from oil products, which may be used to finance expenses connected directly with the impact of rising oil prices.

### *A more transparent presentation of public expenditure aimed at performance*

The new French budgetary architecture consists of three levels. Missions are the first. These constitute the voting unit and identify the State's main public policies (34 missions in the 2006 budget including 8 interministerial missions). Each mission consists of a set of programmes (133 programmes in the general budget for 2006), whose appropriations are divided into actions (620 actions in 2006). For example, the "Security" mission is interministerial (Interior and Defence). It consists of two programmes: the "National Police" programme, which comprises six actions (e.g. "Traffic Security" and "Criminal Police and Justice"), and the "Defence" programme, which includes five actions (e.g. "Public Order and Security" and "Execution of Defence Missions").

The budgetary documents attached to the Budget Bill (one document for each mission) have been adapted to this new architecture. They give a detailed outline of the mission programmes and actions (aims, coordinators, management methods, etc.) and a breakdown of appropriations by purpose (programmes and actions) and by type (personnel, operations, investment, interventions, etc.). These appropriations are moreover justified from the first euro. The allocation of all appropriations is shown, including a brief outline of their physical and financial content and an explanation of expenditure determinants (number of users, building surface, unit cost of intervention mechanisms, etc.). The new budgetary documents furthermore comprise a list of the tax expenses connected with each programme. In other words, the resources earmarked for each public function are grouped precisely in a single document, making the budget easier to read and more transparent. This gives members of Parliament a more accurate understanding of the use of public funds when examining the Budget Bill, which is a significant step forward. Before the implementation of the LOLF, pre-existing measures were automatically renewed and only new measures were discussed in Parliament, which meant that pre-existing expenses were never called into question.

Lastly, each programme is accompanied by performance objectives and indicators based on three criteria: socioeconomic effectiveness, service quality and management efficiency. These indicators and their target values can be found in the budgetary documents. Pooling financial information (appropriations and tax expenditure) and performance measurements a single document makes it easier to assess the long-term efficiency and effectiveness of public policies.

### *A more flexible management focused on performance and accountability*

The LOLF makes appropriations possible within the framework of the programmes and their breakdown into actions and types of expenditure is indicative at the moment of authorisation. However, due to their very long term consequences for public finances, personnel expenses - capped in terms of wage bills and numbers employed - may not be supplemented by funds taken from other types of expenditure.

This method of aggregating appropriations improves management flexibility. Each programme is run by a programme manager with agreed performance objectives and indicators. Managers will have to answer to the Parliament on their management choices, their actual expenses and their performance in the annual performance reports which will accompany the Budget Review Act in the spring of 2007. At a local level, each programme is moreover divided into programmes operating budgets designed to pursue national objectives according to local constraints. Performance has become the backbone of budgetary management, which should gradually allow us to optimise public expenditure.

### *A more pronounced top-down procedure*

The 2006 budget was the first to be presented according to the new framework of the LOLF, which required the implementation of a modernised budgetary procedure conceived with two key objectives in mind: adapting the system to the new budgetary framework and stimulating the consolidation of public finances.

The budgetary dialogue involved in preparing the budget for 2006 focused primarily on structural reforms and adopted a more pronounced top-down approach, in contrast with the old procedure, which tended to be more bottom up. A first government seminar on the overall public finance strategy laid down public finance objectives and control standards. This was followed by meetings on structural savings between the Ministry of Finance and the other ministries. Next came finalisation meetings between the Prime Minister and the ministers concerned, which culminated in choices and capping agreements, followed by a detailed itemisation of appropriations and staff. This approach has radically changed the budgetary procedure, since the budgetary negotiations - resulting in detailed allocation of appropriations within each mission - remained subject to overall constraints.

### **State modernisation audits**

As part of the new State reform policy, the Government has ordered a series of modernisation audits. The first 17 audits were launched simultaneously, with at least one audit at every ministry. No audit will take longer than two to three months. Every two months, a new wave will be launched. This high pace will trigger a continuous transformation process at State level.

Carried out at the request of the ministers themselves, audits must result in operational proposals, a concrete action plan which can be implemented rapidly, and a timetable. They must also present alternative scenarios designed to raise performance and tighten spending control.

These audits form the foundation of the new State reform policy. They are inspired by foreign and corporate practices. Implemented at the same time as the LOLF, they support the creation of a reform and management control culture at all government levels.

The audit reports will be submitted to Parliament and be available to the public for consultation on the internet.

The purpose of this first series of audits is to examine:

- procedures, such as the online income tax return;
- functions, such as the organisation of examinations at the Ministry of National Education and "airbase" activity at the Ministry of Infrastructures;
- services, such as the Air and Boarder Police Service at Roissy.

Thus it focuses on important subjects with significant budgetary aggregates. For example:

- €200 million to collect the apprenticeship tax;
- €130 m to organise the examinations and competitions of the Ministry of National Education.

This approach, which is new for France, will allow determining and correcting any deficiencies and breakdowns. Its objective is to improve user services and productivity gains.

### ***Governance of social security finances***

The governance of social security finances has been upgraded considerably in the last two years.

The health insurance reform of 2004 inter alia involved the creation of an Early Warning Committee ("Comité d'Alerte"), which is independent from the Government and responsible for warning Parliament of health insurance expenditure overruns. When the alarm is sounded, the health insurance organisations and the State, each insofar as it is concerned, develop adjustment measures the impact of which is evaluated by the Committee.

This year, the governance of social security finances was once again raised to a new level. In July 2005, the Parliament adopted a new Constitutional Bylaw on Social Security Budget Bills ("LOLFSS"). The LOLFSS introduces a radically new format for Social Security Budget Bills ("LFSS"). Its purpose is to improve the transparency and credibility of LFSSs and to align social security finance decisions more closely with overall public finance choices. Thus it continues to build on the health insurance reform of 2004 and on the Constitutional Bylaw on Budget Bills (LOLF) for the State. Like the State budget, social security finances will be presented to Parliament with the same concern for transparency and accuracy.

#### *More transparency and legibility*

The presentation of LFSSs will be more transparent. Under the new system, expenses and balances are shown by branch and the national health insurance objective for spending ("ONDAM") is divided into five sub-objectives. The new LFSSs are furthermore accompanied by a budget charter showing changes of responsibility between general government units in connection with social security regimes and health spending sub-objectives to ensure better spending control.

The financial structure of the new Budget Bills is moreover easier to decipher. The financial analysis stages are presented logically and clearly, including certification of the accounts, approval of the previous year's equilibrium tables, how deficits will be covered and surpluses will be used, and the debt repayment target for the current and following year.

#### *More consistency and credibility*

The LFSS has been given a broader scope to permit a better grasp of social security finances. The new LFSS may include any provision with an impact on the revenue or expenditure of the current or future years, risk management, the cash position, rules on contributions, debt repayment provisions and rules on appropriation of revenue to reserves. To avoid burdening future generations with the weight of today's social security finances, the LOLFSS stipulates that any debt transfer to the "*Caisse d'Amortissement de la Dette Sociale*" (CADES) must be offset by an increase in CADES revenues in order to avoid lengthening the social security debt repayment schedule.

To make it easier to see the trend of social security finance, LFSSs will henceforth be accompanied by a four-year projection - subject to vote - whose objectives are consistent with the multiyear budget estimates for public finances attached to the Budget Bill.

#### *Implementation of an "objectives-results" approach*

The "quality and efficiency programmes" introduced by the LOLFSS add a performance ingredient to social security finance management. Inspired by the LOLF, this approach allows us to equip social security finances with evaluation tools which are just as effective as those now available for the State budget.

#### ***Statistical governance of public finances***

INSEE is responsible for methodological matters involving the compliance of French national accounting statistics practices with the European System of Accounts (ESA95). The Institute maintains regular contact with Eurostat about these matters. Within the framework of the Treaty and specific regulations, the sources and methods used to evaluate national general government accounting data have been inventoried.

The **semi-final and final accounts** are prepared in the light of detailed information, particularly for the State and the central government bodies. For the State, the main accounting reference is the general account of the finance administration ("CGAF") published by the Public Accounting General Directorate. Restatement of the final outturn of the budget act as government net lending requires a series of corrections (timing differences, different treatments of certain transactions in the budgetary accounting and in the national accounting, etc.). The method used to evaluate the central government bodies' accounts is to restate the accounts of all central government bodies. The consolidated account produced for the national accounts is prepared after transcription of the accounts of the individual central government bodies in the national accounting. Production of the local government accounts (S13131) is based upon the individual cash-based accounts kept by the public accounting officers. The documents used to prepare the accounts of local government bodies (S13132) are not homogeneous due to the number of different legal statuses. The accounts of the social security funds (ASSO) are based upon different accounting plans (social security funds, funds of the general social security regime, hospitals).

The information used to prepare the **figures of the current year (n-1) for the first notification in year (n)** is less homogeneous. For the State, the accounting year ends at the end of January in year n. The "public" accounts of the central government are finalised towards the middle of March in year n, which means that the information used for notification purposes is likely to be reviewed, particularly the corrections needed to switch to accrual basis accounting. The central government bodies' accounts are partly based on projections. The accounting sources cover about 70% of revenue and expenditure. For the local governments, the accountants use information recorded in the accounting documents of the State and, since 2003, "direct" figures, which are exhaustive and centralised for the regions and "*departments*" (administrative districts) and based upon a sample for the communes. This is complemented by a number of estimates and forecasts. Lastly, for the first notification, the accounts of the social security funds are mainly based on estimates. The accounting documents of the regimes are not yet known at the moment of notification. Nevertheless, the availability of many - still provisional - accounting figures (benefits for the UNEDIC and the general regime, sample of hospitals, etc.) makes it possible to prepare the accounts of the main organisations with a certain reliability.

## ANNEX 1: Statistics tables (Code of Conduct)

**Table 1a. Macroeconomic prospects (low growth scenario)**

	ESA Code	Year	Year	Year	Year	Year	Year
		X-1	X-1	X	X+1	X+2	X+3
		level (*)	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	1 698 200	1,5 - 2,0	2,0 - 2,5	2 1/4	2 1/4	2 1/4
<b>2. Nominal GDP</b>	B1*g	1 698 200	3,0	3,7	4,1	4,1	4,1
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	P.3	957 310	2,0	2,3	2,3	2,4	2,4
<b>4. Government consumption expenditure</b>	P.3	405 263	1,4	1,9	1,2	0,8	0,6
<b>5. Gross fixed capital formation</b>	P.51	332 363	3,0	3,3	2,9	2,7	2,7
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53		1,1	1,2	1,3	1,2	1,4
<b>7. Exports of goods and services</b>	P.6	444 259	2,5	5,0	5,9	5,9	5,9
<b>8. Imports of goods and services</b>	P.7	461 191	5,6	5,6	5,6	5,6	5,6
<b>Contributions to real GDP growth</b>							
<b>9. Final domestic demand</b>			2,0	2,4	2,2	2,1	2,1
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53		0,5	0,1	0,1	0,1	0,1
<b>11. External balance of goods and services</b>	B.11		-0,8	-0,2	0,0	0,0	0,0

(\*) at current prices

**Table 1a. Macroeconomic prospects (high-growth scenario)**

	ESA Code	Year	Year	Year	Year	Year	Year
		X-1	X-1	X	X+1	X+2	X+3
		level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	1 698 200	1,5 - 2,0	2,0 - 2,5	3,0	3,0	3,0
<b>2. Nominal GDP</b>	B1*g	1 698 200	3,0	3,7	4,8	4,8	4,8
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	P.3	957 310	2,0	2,3	3,0	3,1	3,1
<b>4. Government consumption expenditure</b>	P.3	405 263	1,4	1,9	1,0	0,6	0,3
<b>5. Gross fixed capital formation</b>	P.51	332 363	3,0	3,3	4,8	4,8	4,8
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53		1,1	1,2	1,2	1,2	1,3
<b>7. Exports of goods and services</b>	P.6	444 259	2,5	5,0	7,0	7,0	7,0
<b>8. Imports of goods and services</b>	P.7	461 191	5,6	5,6	6,7	6,7	6,7
<b>Contributions to real GDP growth</b>							
<b>9. Final domestic demand</b>			2,0	2,4	2,9	2,8	2,8
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53		0,5	0,1	0,1	0,1	0,1
<b>11. External balance of goods and services</b>	B.11		-0,8	-0,2	0,0	0,0	0,0

**Table 1b. Price developments (low growth scenario)**

	ESA Code	Year	Year	Year	Year	Year	Year
		X-1	X-1	X	X+1	X+2	X+3
		level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>			1,3	1,4	1 3/4	1 3/4	1 3/4
2. Private consumption deflator			1,5	1,5	1 3/4	1 3/4	1 3/4
<b>3. HICP</b>			1,9	1,8	1 3/4	1 3/4	1 3/4
4. Public consumption deflator			1,3	1,7	1 3/4	1 3/4	1 3/4
5. Investment deflator			2,2	1,8	1 3/4	1 3/4	1 3/4
<b>6. Export price deflator (goods and services)</b>			1,3	1,4	1,2	1,2	1,2
<b>7. Import price deflator (goods and services)</b>			3,0	1,9	1,0	1,0	1,0

**Table 1b. Price developments (high-growth scenario)**

	ESA Code	Year	Year	Year	Year	Year	Year
		X-1	X-1	X	X+1	X+2	X+3
		level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>			1,3	1,4	1 3/4	1 3/4	1 3/4
2. Private consumption deflator			1,5	1,5	1 3/4	1 3/4	1 3/4
<b>3. HICP</b>			1,9	1,8	1 3/4	1 3/4	1 3/4
4. Public consumption deflator			1,3	1,7	1 3/4	1 3/4	1 3/4
5. Investment deflator			2,2	1,8	1 3/4	1 3/4	1 3/4
<b>6. Export price deflator (goods and services)</b>			1,3	1,4	1,2	1,2	1,2
<b>7. Import price deflator (goods and services)</b>			3,0	1,9	1,0	1,0	1,0

**Table 1c. Labour market developments (low growth scenario)**

	ESA Code	Year	Year	Year	Year	Year	Year
		X-1	X-1	X	X+1	X+2	X+3
		level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons</b>			0,3	0,9	0,6	0,6	0,6
2. Employment, hours worked							
<b>3. Unemployment rate (%)</b>							
<b>4. Labour productivity, persons</b>			1,5	1,4	1,7	1,7	1,7
5. Labour productivity, hours worked							
<b>6. Compensation of employees</b>	D1	884237	2,9	3,3	3,5	3,5	3,5

**Table 1c. Labour market developments (high-growth scenario)**

	ESA Code	Year	Year	Year	Year	Year	Year
		X-1	X-1	X	X+1	X+2	X+3
		level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons</b>			0,3	0,9	0,9	1,0	1,0
2. Employment, hours worked							
<b>3. Unemployment rate (%)</b>							
<b>4. Labour productivity, persons</b>			1,5	1,4	2,1	2,0	2,0
5. Labour productivity, hours worked							
<b>6. Compensation of employees</b>	D1		2,9	3,3	4,0	4,0	4,0



**Table 1d. Sectoral balances(low growth scenario)**

% of GDP	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>			-1,9	-2,2	-2,2	-2,1	-1,9
of which:			-1,0	-1,3	-1,2	-1,1	-1,0
- Balance on goods and services							
- Balance of primary incomes and transfers			-0,9	-0,9	-1,0	-1,0	-0,9
- Capital account			0,0	0,0	0,0	0,0	0,0
<b>2. Net lending/borrowing of the private sector</b>							
of which:							
- corporate sector							
- households and NPISHs							
<b>3. Net lending/borrowing of general government</b>							
<b>4. Statistical discrepancy</b>			optional	optional	optional	optional	optional

**Table 1d. Sectoral balances (high-growth scenario)**

% of GDP	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>			-1,9	-2,2	-2,2	-2,1	-1,8
of which:			-1,0	-1,3	-1,2	-1,2	-1,0
- Balance on goods and services							
- Balance of primary incomes and transfers			-0,9	-0,9	-1,0	-0,9	-0,8
- Capital account			0,0	0,0	0,0	0,0	0,0
<b>2. Net lending/borrowing of the private sector</b>							
of which:							
- corporate sector							
- households and NPISHs							
<b>3. Net lending/borrowing of general government</b>							
<b>4. Statistical discrepancy</b>			optional	optional	optional	optional	optional

Table 2 - General government budgetary prospects (low-growth scenario)

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>							
1. General government	S.13	-50,9	-3,0	-2,9	-2,6	-1,9	-1,0
2. Central government	S.1311	-46,2	-2,7	-2,6	-2,5	-2,1	-1,5
3. State government	S.1312						
4. Local government	S.1313	-1,1	-0,1	-0,1	0,0	0,2	0,4
5. Social security funds	S.1314	-3,6	-0,2	-0,2	-0,2	0,0	0,1
<b>General government (S13)</b>							
6. Total revenue	TR	862,1	50,8	50,7	50,3	50,2	50,1
7. Total expenditure	TE	913,0	53,8	53,6	53,0	52,1	51,1
8. Net lending/borrowing	EDP B.9	-50,9	-3,0	-2,9	-2,6	-1,9	-1,0
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	45,6	2,7	2,6	2,6	2,5	2,6
pm: 9a. FISIM							
10. Primary balance		-5,3	-0,3	-0,3	0,0	0,6	1,6
<b>Selected components of revenue</b>							
11. Total taxes (11=11a+11b+11c)		461,4	27,2	27,4	27,1		
11a. Taxes on production and imports	D.2	264,3	15,6	15,7	15,7	optional	optional
11b. Current taxes on income, wealth, etc	D5	188,7	11,1	11,2	10,9	optional	optional
11c. Capital taxes	D91	8,3	0,5	0,5	0,5	optional	optional
12. Social contributions	D61	309,9	18,2	18,3	18,2	optional	optional
13. Property income	D4	10,5	0,6	0,8	0,8	optional	optional
14. Other (14=15-(11+12+13))		80,4	4,7	4,2	4,2	optional	optional
15=6. Total revenue	TR	862,1	50,8	50,7	50,3	50,2	50,1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)		739,1	43,5	43,7	43,4	43,2	43,1
<b>Selected components of expenditure</b>							
16. Collective consumption	P32						
17. Total social transfers	D.62 + D.63	402,4	23,7	23,6	23,2	22,9	22,7
17a. Social transfers in kind	P.31 =D.63						
17b. Social transfers other than in kind	D.62						
18.=9. Interest expenditure (incl.FISIM)	EDP D.41 incl. FISIM	45,6	2,7	2,6	2,6	2,5	2,6
19. Subsidies	D.3	24,7	1,5	1,5	1,4	1,4	1,4
20. Gross fixed capital formation	P51	54,1	3,2	3,2	3,2	3,1	3,0
21. Other (21=22-(16+17+18+19+20))		386,2	22,7	22,7	22,6	22,2	21,4
22=7. Total expenditure	TE	913,0	53,8	53,6	53,0	52,1	51,1

Table 2 - General government budgetary prospects (high-growth scenario)

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>							
<b>1. General government</b>	S.13	-50,9	-3,0	-2,9	-2,2	-1,2	0,1
<b>2. Central government</b>	S.1311	-46,2	-2,7	-2,6	-2,3	-1,7	-0,8
<b>3. State government</b>	S.1312						
<b>4. Local government</b>	S.1313	-1,1	-0,1	-0,1	0,1	0,3	0,5
<b>5. Social security funds</b>	S.1314	-3,6	-0,2	-0,2	0,0	0,3	0,4
<b>General government (S13)</b>							
<b>6. Total revenue</b>	TR	862,1	50,8	50,7	50,3	50,1	49,9
<b>7. Total expenditure</b>	TE	913,0	53,8	53,6	52,5	51,3	49,8
<b>8. Net lending/borrowing</b>	EDP B.9	-50,9	-3,0	-2,9	-2,2	-1,2	0,1
<b>9. Interest expenditure</b>	EDP D.41	45,6	2,7	2,6	2,5	2,5	2,5
<b>pm: 9a. FISIM</b>							
<b>10. Primary balance</b>		-5,3	-0,3	-0,3	0,3	1,3	2,6
<b>Selected components of revenue</b>							
<b>11. Total taxes (11=11a+11b+11c)</b>		461,4	27,2	27,4	27,2		
<b>11a. Taxes on production and imports</b>	D.2	264,3	15,6	15,7	15,8	optional	optional
<b>11b. Current taxes on income, wealth, etc</b>	D5	188,7	11,1	11,2	10,9	optional	optional
<b>11c. Capital taxes</b>	D91	8,3	0,5	0,5	0,5	optional	optional
<b>12. Social contributions</b>	D61	309,9	18,2	18,3	18,2	optional	optional
<b>13. Property income</b>	D4	10,5	0,6	0,8	0,8	optional	optional
<b>14. Other (14=15-(11+12+13))</b>		80,4	4,7	4,2	4,1	optional	optional
<b>15=6. Total revenue</b>	TR	862,1	50,8	50,7	50,3	50,1	49,9
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)</b>		739,1	43,5	43,7	43,4	43,2	43,1
<b>Selected components of expenditure</b>							
<b>16. Collective consumption</b>	P32						
<b>17. Total social transfers</b>	D.62 + D.63	402,4	23,7	23,6	23,0	22,5	22,2
<b>17a. Social transfers in kind</b>	P.31 =D.63						
<b>17b. Social transfers other than in kind</b>	D.62						
<b>18.=9. Interest expenditure (incl.FISIM)</b>	EDP D.41 incl. FISIM	45,6	2,7	2,6	2,5	2,5	2,5
<b>19. Subsidies</b>	D.3	24,7	1,5	1,5	1,4	1,4	1,3
<b>20. Gross fixed capital formation</b>	P51	54,1	3,2	3,2	3,1	3,0	2,9
<b>21. Other (21=22-(16+17+18+19+20))</b>		386,2	22,7	22,7	22,4	21,8	20,9
<b>22=7. Total expenditure</b>	TE	913,0	53,8	53,6	52,5	51,3	49,8

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	Year X-2	Year X+3
1. General Public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social Protection	10		
11. Total Expenditure (=item 7=26 in Table 2)	TE		

**Table 4 General government debt developments (low growth scenario)**

% of GDP	2005	2006	2007	2008	2009
<b>1. Gross debt</b>	65,8	66,0	65,6	64,6	62,8
<b>2. Change in gross debt ratio</b>	1,1	0,2	-0,3	-1,0	-1,9
<b>Contributions to changes in gross debt</b>					
<b>3. Primary balance</b>	-0,3	-0,3	0,0	0,6	1,6
<b>4. Interest expenditure (incl. FISIM)</b>	2,7	2,6	2,6	2,5	2,6
<b>5. Stock-flow adjustment</b>	0,0	-0,4	-0,4	-0,4	-0,4
of which: - Differences between cash and accruals					
- Net accumulation of financial assets of which : - privatisation proceeds					
- Valuation effects and other					
<b>p.m. implicit interest rate on debt</b>	4,3	4,1	4,0	4,0	4,1
<b>Other relevant variables</b>					
6. Liquid financial assets					
7. Net financial debt (7=1-6)					

**Table 4 General government debt developments (high-growth scenario)**

% of GDP	2005	2006	2007	2008	2009
<b>1. Gross debt</b>	65,8	66,0	64,8	62,6	59,3
<b>2. Change in gross debt ratio</b>	1,1	0,2	-1,2	-2,2	-3,3
<b>Contributions to changes in gross debt</b>					
<b>3. Primary balance</b>	-0,3	-0,3	0,3	1,3	2,6
<b>4. Interest expenditure</b>	2,7	2,6	2,5	2,5	2,5
<b>5. Stock-flow adjustment</b>	0,0	-0,4	-0,4	-0,4	-0,4
of which: - Differences between cash and accruals					
- Net accumulation of financial assets of which : - privatisation proceeds					
- Valuation effects and other					
<b>p.m. implicit interest rate on debt</b>	4,3	4,1	4,0	4,0	4,2
<b>Other relevant variables</b>					
6. Liquid financial assets					
7. Net financial debt (7=1-6)					

**Table 5. Cyclical developments (low growth scenario)**

% of GDP	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>1. Real GDP growth (%)</b>		1,5 - 2,0	2,0 - 2,5	2 1/4	2 1/4	2 1/4
<b>2. Net lending of general government</b>	EDP B.9	-3,0	-2,9	-2,6	-1,9	-1,0
<b>3. Interest expenditure (incl. FISIM recorded as consumption)</b>	EDPD.41+FISIM	2,7	2,6	2,6	2,5	2,6
4. Potential GDP growth (%) (1)		2,1	2,25	2,0	2,0	2,0
contributions:						
- labour		-0,1	0,0	-0,3	-0,4	-0,4
- capital		0,6	0,7	0,7	0,7	0,8
- total factor productivity		1,6	1,6	1,6	1,6	1,6
5. Output gap		-1,0	-1,0	-0,8	-0,5	-0,3
6. Cyclical budgetary component		-0,6	-0,6	-0,5	-0,4	-0,3
7. Cyclically-adjusted balance (2-6)		-2,4	-2,3	-2,1	-1,5	-0,7
8. Cyclically-adjusted primary balance (7-3)		0,3	0,4	0,5	1,0	1,9

**Table 5. Cyclical developments (high-growth scenario)**

% of GDP	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>1. Real GDP growth (%)</b>		1,5 - 2,0	2,0 - 2,5	3,0	3,0	3,0
<b>2. Net lending of general government</b>	EDP B.9	-3,0	-2,9	-2,2	-1,2	0,1
<b>3. Interest expenditure (incl. FISIM recorded as consumption)</b>	EDPD.41	2,7	2,6	2,5	2,5	2,5
4. Potential GDP growth (%) (1)		2,2	2,4	2,6	2,8	3,0
contributions:						
- labour		-0,1	0,0	0,1	0,2	0,4
- capital		0,6	0,7	0,7	0,8	0,9
- total factor productivity		1,7	1,7	1,7	1,7	1,7
5. Output gap		-1,2	-1,3	-0,9	-0,7	-0,6
6. Cyclical budgetary component		-0,7	-0,7	-0,5	-0,4	-0,4
7. Cyclically-adjusted balance (2-6)		-2,4	-2,3	-1,7	-0,8	0,4
8. Cyclically-adjusted primary balance (7-3)		0,3	0,4	0,8	1,7	2,9

**Table 6. Divergence from previous update (low growth scenario)**

	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>Real GDP growth (%)</b>						
Previous update		2,4	2 1/2	2 1/2	2 1/2	
Current update		1,5 - 2,0	2,0 - 2,5	2 1/4	2 1/4	2 1/4
Difference						
<b>General government net lending (% of GDP)</b>						
Previous update	EDP B.9	-2,9	-2,2	-1,6	-0,9	
Current update		-3,0	-2,9	-2,6	-1,9	-1,0
Difference		-0,1	-0,7	-1,0	-1,0	
<b>General government gross debt (% of GDP)</b>						
Previous update		65,0	64,6	63,6	62,0	
Current update		65,8	66,0	65,6	64,6	62,8
Difference		0,8	1,4	2,0	2,6	

**Table 6. Divergence from previous update (high growth scenario)**

	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>Real GDP growth (%)</b>						
Previous update		2,4	2,5	2,5	2,5	
Current update		1,5 - 2,0	2,0 - 2,5	3,0	3,0	3,0
Difference						
<b>General government net lending (% of GDP)</b>						
Previous update	EDP B.9	-2,9	-2,2	-1,6	-0,9	
Current update		-3,0	-2,9	-2,2	-1,2	0,1
Difference		-0,1	-0,7	-0,6	-0,3	
<b>General government gross debt (% of GDP)</b>						
Previous update		65,0	64,6	63,6	62,0	
Current update		65,8	66,0	64,8	62,6	59,3
Difference		0,8	1,4	1,2	0,6	

**Table 7. Long-term sustainability of public finances (low-growth scenario)**

% of GDP	2000	2005	2010	2020	2030	2050
<b>Total expenditure</b>						
Of which: age-related expenditures						
Pension expenditure		12,9	13,0	13,8	14,4	14,9
Social security pension						
Old-age and early pensions						
Other pensions (disability, survivors)						
Occupational pensions (if in general government)						
Health care		7,9	7,4 / 7,5	7,4 / 8,2	7,4 / 9,1	7,4 / 10,0
Long-term care (this was earlier included in the health care)						
Education expenditure						
Other age-related expenditures						
Interest expenditure						
<b>Total revenue</b>						
Of which: property income						
of which: from pensions contributions (or social contributions if appropriate)						
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
<b>Assumptions</b>						
Labour productivity growth						
Real GDP growth						
Participation rate males (aged 20-64)						
Participation rates females (aged 20-64)						
Total participation rates (aged 20-64)						
Unemployment rate						
Population aged 65+ over total population						

**Table 7. Long-term sustainability of public finances (high-growth scenario)**

% of GDP	2000	2005	2010	2020	2030	2050
<b>Total expenditure</b>						
Of which: age-related expenditures						
Pension expenditure		12,9	13,0	13,8	14,4	14,9
Social security pension						
Old-age and early pensions						
Other pensions (disability, survivors)						
Occupational pensions (if in general government)						
Health care		7,9	7,3	7,3 / 8,1	7,3 / 8,9	7,3 / 9,8
Long-term care (this was earlier included in the health care)						
Education expenditure						
Other age-related expenditures						
Interest expenditure						
<b>Total revenue</b>						
Of which: property income						
of which: from pensions contributions (or social contributions if appropriate)						
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
<b>Assumptions</b>						
Labour productivity growth						
Real GDP growth						
Participation rate males (aged 20-64)						
Participation rates females (aged 20-64)						
Total participation rates (aged 20-64)						
Unemployment rate						
Population aged 65+ over total population						

**Table 8. Basic assumptions (low growth scenario)**

	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>Short-term interest rate (annual average)</b>	2,1	2,1			
<b>Long-term interest rate (annual average)</b>	3,5	3,9			
<b>USD/€exchange rate (annual average) (euro area and ERM II countries)</b>	1,25	1,23	1,23	1,23	1,23
<b>Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)</b>	108,4	107,7	107,7	107,7	107,7
<b>World excluding EU, GDP growth</b>	4,8	4,6	4,2	4,2	4,2
<b>EU-25 GDP growth</b>	1,4	1,7	2,0	2,0	2,0
<b>Growth of relevant foreign markets</b>	4,2	6,0	6,0	6,0	6,0
<b>World import volumes, excluding EU</b>	7,3	7,7	7,1	7,1	7,1
<b>Oil prices, (Brent, USD/barrel)</b>	55,2	60,0	61,1	62,1	63,2

**Table 8. Basic assumptions (high-growth scenario)**

	Year X-1	Year X	Year X+1	Year X+2	Year X+3
<b>Short-term interest rate (annual average)</b>					
<b>Long-term interest rate (annual average)</b>					
<b>USD/€exchange rate (annual average) (euro area and ERM II countries)</b>	1,25	1,23	1,23	1,23	1,23
<b>Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-à- vis the €(annual average)</b>	108,4	107,7	107,7	107,7	107,7
<b>World excluding EU, GDP growth</b>	4,8	4,6	4,2	4,2	4,2
<b>EU-25 GDP growth</b>	1,4	1,7	2,4	2,4	2,4
<b>Growth of relevant foreign markets</b>	4,2	6,0	6,6	6,5	6,6
<b>World import volumes, excluding EU</b>	7,3	7,7	7,1	7,1	7,1
<b>Oil prices, (Brent, USD/barrel)</b>	55,2	60,0	61,1	62,1	63,2